SNC-Lavalin

Third Quarter 2022 Results

Conference Call Transcript

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Speakers:

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Vice-President, Investor Relations

Ian Edwards
President and Chief Executive Officer

Jeff Bell
Executive Vice-President and Chief Financial Officer

Operator:
Good morning, and welcome to SNC-Lavalin's Third Quarter 2022 Results Conference Call.

As a reminder, all participants are in listen-only mode and the conference is being recorded. After the presentation, there will be an opportunity to ask questions.

I would now like to turn the conference over to Denis Jasmin, Vice-President, Investor Relations. Please go ahead.

Denis Jasmin:
Good morning, everyone, and thank you for joining the call.

Our Q3 earnings announcement was released this morning, and we have posted a corresponding slide presentation on the Investor section of our website. The recording of today's call, and its transcript, will also be available on our website within 24 hours.

With me today are Ian Edwards, President and Chief Executive Officer, and Jeff Bell, Executive Vice-President and Chief Financial Officer.

Before we begin, I would like to ask everyone to limit themselves to one or two questions to ensure that all analysts have an opportunity to participate. You are welcome to return to the queue for any follow-up questions.

I would like to draw your attention to Slide 2. Comments made on today's call may contain forward-looking information. This information, by its nature, is subject to risks and uncertainties and, as such, actual results may differ materially from the views expressed today. For further information on these risks and uncertainties, please consult the Company's relevant filings on SEDAR. These documents are also available on our website.

Also, during the call, we may refer to certain non-IFRS measures and ratios. These measures and ratios are defined, calculated and reconciled with comparable IFRS measures in our MD&A, which can be found on SEDAR and our website. Management believes that these non-IFRS measures provide additional insight into the Company's financial results, and certain investors may use this information to evaluate the Company's performance from period to period.

Now, I'll pass the call over to Ian Edwards. Ian?

Ian Edwards:
Thank you, Denis. Good morning, everyone, and thank you for joining us today.

I want to start, as I do every quarter, by taking a minute to recognize the tireless efforts of our 33,000 employees worldwide. I also want to officially welcome the new employees that joined in the quarter. We are excited to have you in the SNC-Lavalin family. Our core purpose is engineering a better future for our planet and its people, and we're only able to do this through the hard work and dedication of our employees, whose contributions help us achieve our long-term growth aspirations. I appreciate everything that they do.

With that, let's start on Slide 4.

During the third quarter, we saw a continued uptick in top line performance, as total revenues increased 4.5% year-over-year to $1.9 billion, driven by the continued acceleration of our Engineering Services business. During the third quarter, our LSTK Projects backlog declined further by $164 million from the second quarter to $664 million. As we approach completion of these projects, with the two Ontario projects on track to be largely physically complete by the end of the year, we remain confident in our financial risk estimates that we outlined earlier this year.

SNCL Services revenues were up 8.2% over Q3 of last year to $1.6 billion. Excluding the impacts of foreign currency, we achieved a robust organic growth of 12.6%. Segment Adjusted EBIT was $153 million and represented a 9.3% margin.

We're especially pleased by the continued execution in our Engineering Services business, which achieved a record-high backlog for the second consecutive quarter. The results these past two quarters further highlight our ability to execute our Pivoting to Growth Strategy and expand into our core geographies, which continue to demonstrate resilient growth. Total backlog for Engineering Services rose to $4.6 billion, which represented a 20% increase year-over-year, with further strong growth in the U.S.

We have been intentional in our pivot into specific core geographies and our chosen markets. Success this quarter further emphasised the strengths of our Pivoting to Growth approach, and our growth opportunities are unfolding as we planned. We continue to believe the strategy put in place represents the best opportunity for SNC-Lavalin, and we expect to continue to deliver on our stated goals.

While the macroeconomic environment is challenging and is projected to be so for the foreseeable future, our business model remains resilient. This is driven by public sector focus on sustainable infrastructure and long-term energy solutions.

Turning to Slide 5, our Engineering Services business continued its momentum from the last few quarters, delivering strong results during the third quarter. Business remains robust in our core geographies, as evidenced by our 18.3% year-over-year organic revenue growth to approximately $1.2 billion. Our sustained improvement quarter-over-quarter highlights our ability to capture market share and provides a clear roadmap for the growth prospects for sustainable infrastructure demand. Segment Adjusted EBIT margin and segment Adjusted EBITDA over net revenue margin were 8.3% and 14.5%, respectively, in our target ranges. On an absolute basis, segment Adjusted EBIT grew $5 million year-over-year.

Before discussing key wins, I want to highlight how proud I am of our teams for the quick response to assist the U.S. Emergency Relief Fund Program set up by FEMA to help those Floridians in need following Hurricane Ian. We send best wishes to all of those continuing to be affected by this disaster.

During the third quarter, we continued to realize significant wins across our core geographies, the U.S., the U.K. and Canada, but we also saw increase in demand in the Middle East, where we continue to secure project wins in sustainable building development to support increased population growth in the region.

The strong backlog increased in the U.S. was achieved through several government contract wins; notably, with the Department of Transport for infrastructure development in Florida, Georgia, Colorado and Texas. These wins, in addition to others, elevated our backlog to $4.6 billion, another record level, and 20% higher than where we stood as of September 30, 2021.

Looking forward, we remain optimistic at the long-term potential for our Engineering Services business, our pipeline remains robust, and we're well positioned to continue growing, capturing market share from increased governmental focus on sustainable infrastructure and renewable power alternatives. We also believe that the global energy transition that we're currently witnessing is positive for SNC-Lavalin, not only for our Nuclear and Infrastructure sectors, but also for our Mining and our Industrial sectors, which have seen a significant increase in demand for our services, such as studies for new minerals extraction processes, as well as engineering for new electrical vehicle battery plants.

I'd like to now move on to Slide 6 and the results for our Nuclear business. During the third quarter, Nuclear revenues and Segment Adjusted EBIT was similar to prior year, with slightly lower revenue being offset by a slightly higher Segment Adjusted EBIT margin. We continue to make progress across our Canadian refurbishment projects at Darlington and Bruce Power, and we're also seeing growing demand for life extension work for the CANDU reactor fleet around the world.

As countries continue to make commitments to net-zero, we're seeing this as a positive catalyst for nuclear as a low-carbon way to produce electricity and marking an increased focus on new-build opportunities to deliver baseload power into an evolving and greener power grid. We are also well positioned to capitalize on major upcoming new-build projects and small modular reactors, where we are dedicating a greater number of our highly skilled engineers to billable projects as we position our new-build business for growth. We are offering large reactor technology support and continue to partner with Rolls-Royce for small modular reactor work. The opportunity to participate in nuclear projects is robust, including Sizewell C in the U.K. and the potential for Cernavoda Units 3 and 4 in Romania.

Looking out, the pipeline for potential growth in this arena is very strong. Over the past three months, we've added a significant amount of new opportunities to the pipeline across all nuclear subsectors, life extensions and refurbishment, decommissioning and waste management, and new-builds. These high-quality prospects show the potential growth opportunity in front of us. Our technology and scale positions us to be market leaders in nuclear support and boosts the long-term growth potential of SNC-Lavalin.

Moving to Slide 7, and our O&M segment, which generated $124 million in revenue during the third quarter and a 12.2% organic increase year-over-year, this sector continued to deliver strong segment Adjusted EBIT with $16 million, representing a 12.7% EBIT margin, well above our long-term target of 5% to 7%.

Looking out, we have highlighted several opportunities across the U.K., the U.S. and Canada, through building and road infrastructure improvements. With the progress we're making on our final LSTK projects, we're also mobilizing for the O&M start-up at the REM, Eglinton and Trillium. We continue to see opportunities for growth in our strategic partnerships with key industry players and by leveraging our Capital Group to maximize bidding opportunities for future growth in core markets.

On Slide 8, our Linxon business was impacted by supply chain and manufacturing delays during the third quarter. Revenues declined to $123 million, representing an organic revenue decrease of 11.1%, compared to the third quarter of 2021. Segment Adjusted EBIT totaled $2 million in the quarter. Q3 and year-to-date margin is lower than our long-term target of 4% to 6%; therefore, our main focus will be winning more profitable work and will be in performance improvements to ensure we meet our targets in 2023. The pipeline of opportunities remains robust, driven by significant investments across the globe towards grid infrastructure and renewable energy power.

Our backlog ended the second quarter at $764 million. However, new orders of $217 million have been added to the backlog year to date, and we are anticipating further addition to the backlog in the fourth quarter, as we've secured a number of project wins subsequent to the quarter close.

Turning to Slide 9, and Capital, third quarter revenues increased $29 million and Segment Adjusted EBIT rose to $25 million, mainly due to the dividend received from Highway 407 ETR. This was partially offset by the previous disposal of our investment in InPower BC, which occurred in the first quarter of 2022. As COVID-19 restrictions in the Province of Ontario continue to ease, traffic pattern trends have been stronger on Highway 407, with traffic now reaching 88% of pre-pandemic levels. We received a $14 million dividend during the third quarter, and subsequent to quarter close, we received a $24 million dividend in October.

Moving to Slide 10, and the update on our LSTK projects. Our backlog continues to decrease at a robust pace, with the year-over-year decline from $1.2 billion to $664 million representing a 43% reduction. Sequentially, the backlog saw a 20% reduction from Q2.

Segment Adjusted EBIT continues to be impacted by the macro factors that we've been managing over several quarters as we work to complete these projects, including supply chain disruptions, elevated inflation, labour shortages, and the impact early in the quarter from an Ontario Safety Inspector strike. As we've previously explained, these post-pandemic macro economic factors, in our opinion, are largely recoverable under the contracts we have with our customers, and ongoing negotiations are in progress to recover the losses. We continue to progress the majority of these projects to completion at our cost, despite the lack of payment from our customers for contractual issues, for which we have a legal entitlement to compensation. Our shortfall in cash flow this year has been significantly impacted by the failure to receive these compensation payments, and we will continue to actively pursue claims for a timely recovery as we move into 2023.

As you can see on Slide 11, we have provided, as in Q2, a more detailed update of the wind-down of the LSTK projects. Two of the three Canadian projects, Eglinton and Trillium, remain on track to be largely physically complete by the end of the year, while REM continues to progress really well and is over 70% complete as at September 30, 2022.

We have recognized $111 million of EBIT losses year to date, with $77 million of those losses related to the $300 million of total financial risk to complete the LSTK projects, represented on the chart on the right-hand side of the slide. The remaining $34 million in losses is mainly related to the overhead costs in managing these projects. With each passing quarter, we gain increased visibility into the completion cost of these projects and we remain confident that any further additional financial risk should be contained within the $300 million envelope originally projected earlier this year.

Before turning it over to Jeff, I just wanted to highlight our 2021 Sustainability Report that we published on the 26th of September.

Helping customers reach their net-zero carbon targets is a fundamental part of our work and we want to be recognized as a global pioneer in sustainable infrastructure. We have proven our capabilities through a diverse track record that ranges from electrified light rail transportation, nuclear energy, to designing, building, financing and maintaining projects focused on transforming the build environment for a greener future. We are investing in data-driven digital innovation that we believe can unlock significant value for our customers by providing greater certainty over project timing and costs, increased operational efficiencies and a reduced carbon footprint. We're helping to engineer a better future by meeting the global demand for clean energy, decarbonizing the build environment, minimizing the impacts of new infrastructure, and building resiliency to climate change impacts. Helping our customers adopt clean power and renewable energy is a global effort which is expected to require significant investment over the next 30 years.

All of this is only achieved through the hard work and dedication of our employees, and we have successfully welcomed a net increase of 2,400 employees across the Company year to date, and we are further investing in their career to grow through our Global Talent Development Program. This is an exciting time to be at SNC-Lavalin.

With that, I'll now turn it over to Jeff to discuss the financial highlights.

Jeff Bell:
Thank you, Ian, and good morning, everyone.

Turning to Slide 14, total revenues for the quarter increased to $1.9 billion, driven by SNCL Services, which produced its sixth consecutive quarter of positive year-over-year revenue growth, while LSTK project revenues continued to decrease, as expected.

Total Segment Adjusted EBIT for the quarter was $134 million, which was comprised of $153 million for SNCL Services, a 3% increase year-over-year, $25 million for Capital, and negative $44 million for LSTK Projects. SNCL Services Adjusted EBIT margin was 9.3%, in line with our target range of 8% to 10%. The negative EBIT for LSTK Projects resulted from recognizing $31 million in the quarter of the $300 million potential financial risk disclosed in our Q4 2021 results, and $13 million, primarily from the segment overhead costs needed to support these projects.

Corporate SG&A expenses from PS&PM for the quarter was $25 million, in line with our expectations, and 43% lower than last year, as Q3 2021 included certain unfavourable estimate revisions. We continue to expect that corporate SG&A expenses for PS&PM should be about $100 million for full year 2022. Capital had $7 million of corporate SG&A, in line with last year and in line with our expectations.

IFRS net income from continuing operations this quarter was $45 million, compared to $19 million in Q3 2021, and was composed of a net income from PS&PM of $30 million and a net income from capital of $15 million. The adjusted net income from PS&PM was up 29% to $52 million, or $0.30 per diluted share, due to the lower corporate SG&A and higher segment Adjusted EBIT from SNCL Services, partly offset by higher losses in LSTK projects.

Backlog ended the quarter at $12.4 billion, compared to $12.8 billion at the end of Q3 2021, primarily due to a decrease in LSTK projects as we continue to execute our strategy to exit the LSTK construction contracts, partially offset by an increase SNCL Services. The SNCL Services backlog increased to $11.7 billion at the end of the quarter, which included a 20% increase in the Engineering Services segment backlog, despite a weaker British pound, compared to Q3 2021. This segment was awarded $1.6 billion of work in the quarter, representing a very strong 1.4 book-to-bill ratio. The Nuclear segment also had a good quarter, with a book-to-bill ratio of 1.2, ending Q3 at $859 million of backlog.

If we now turn to Slide 15, at the end of September 2022, the Company's net limited recourse and recourse debt was $1.5 billion and the net limited recourse and recourse debt to Adjusted EBITDA ratio was 3.3 times. While this ratio is above our target range of 1.5 to 2 times at the end of 2024, balance sheet strength and financial resilience are a core financial priority, and we remain confident of meeting the target as the LSTK projects complete and we continue to execute on our growth strategy.

Our day sales outstanding for Engineering Services continues to be lower than the pre-pandemic level, due to our continuing efforts on cash collections, and stood at 65 days at the end of the quarter. However, this is higher than what we've seen throughout the last four quarters as client payment terms are returning to more normalized levels.

If we now move on to Slide 16, and free cash flow, net cash used for operating activities was $159 million in the third quarter. SNCL Services continued to generate positive cash flow from operations, with $60 million for the quarter, while Capital generated $19 million. After cash taxes, interest in corporate items, which includes the payments for government fines, restructuring and transformation costs, amongst others, you can see that the Company used $60 million of operating cash flows, excluding LSTK, while LSTK Projects used $143 million. On a year-to-date basis, SNCL Services generated $213 million, and Capital $46 million of cash flow from operations, while LSTK Projects had a usage of $369 million. After cash taxes, interest and corporate items, total net cash usage for the first nine months of the year was $421 million.

As Ian has said, despite the lack of financial payment from our clients, we continue to progress well on the remaining LSTK projects. These continue to be affected by several external challenges, obliging us to fund the increased costs resulting from these events. We continue to believe that the clients are responsible for much of these additional costs and we are actively pursuing claims associated with the increased costs we've experienced. Discussions with our LSTK Projects clients remain constructive and ongoing. However, it may take some time to come to final resolution. At which point, the related cash received will be incrementally positive to the Company's net cash from operating activities.

For the last quarter of this year, we expect operating cash inflows from SNCL Services to improve, compared to Q3, and operating cash outflows related to LSTK Projects to reduce. As we are moving closer to the physical completion of two of these large infrastructure projects, we clearly expect that the cash outflows required to complete them will significantly reduce throughout 2023, and, therefore, year-on-year cash flow to improve, and our longer term targets haven't changed. We continue to expect that by the end of 2024, our free cash flow conversion rate to adjusted net income should be between 80% and 90%, as we've previously disclosed.

Turning to my last slide, Slide 17, for our 2022 outlook, as we are moving closer to our year end, we are making three adjustments to our 2022 outlook.

First, in line with what I just said on cash flow, we are now expecting full year 2022 net cash usage from operating activities to be approximately $300 million, with positive net cash from operating activities in the fourth quarter.

Second, given our robust backlog and strong performance year to date in Engineering Services, we are raising the SNCL Services organic revenue growth outlook for full year 2022, versus 2021, to be between 5% and 7%. Note that Engineering Services revenues in Q4 last year included a one-time $93 million favourable outcome from an arbitration decision, which is not expected to repeat this year, without which our 2022 revenue growth outlook would be even higher.

Thirdly, we are tightening the SNCL Services Segment Adjusted EBIT to segment revenue ratio outlook for full year 2022 to between 8.5% and 9%, in line with our year-to-date margin.

All other Company financial outlook metrics for full year 2022 remain unchanged.

Now, I'll hand it back to Ian.

Ian Edwards:
Thanks, Jeff.

Turning to Slide 19, I'd like to conclude my remarks with a few key takeaways.

Our core business is executing well, and we continue to do what we said we would do. We are delivering strong financial performance, with notable backlog expansion in Engineering Services in high-growth potential markets, and strengthening our pipeline of new business opportunities in nuclear positions us well in our core markets. We are continuing our plan to exit our LSTK business and are having close conversations with our customers to recoup the total cash owed for the work that we have already completed.

Recent results further demonstrate the resiliency of our business and our ability to grow in the current macro environment. We remain laser-focused on executing our Pivoting to Growth Strategy, while delivering sustained revenue and earnings to fuel the long-term health of SNC-Lavalin. We are strongly positioned with a leading presence across our core markets of Canada, the U.S. and the U.K., and we are deploying global capabilities locally to our clients and delivering unique end-to-end services across the whole lifecycle of an asset, positioning us as a partner of choice. We create value through the breadth and depth of our capabilities by consistently delivering high-quality services and solutions to our customers.

We have significant opportunities in front of us, leveraging our Engineering Services capability to support the development of new infrastructure projects and our global nuclear expertise as public entities seek alternatives to support their energy security and net-zero goals. We look forward to providing further updates on our progress of creating long-term value creation for all our stakeholders through our core growth drivers.

Thank you. We'll now open the call for questions.

Operator:

Thank you. We will now begin the question-and-answer session. We will pause for a moment as callers join the queue.

Our first question comes from Yuri Lynk of Canaccord Genuity. Please go ahead.

Yuri Lynk:
Good morning, everyone.

Jeff Bell:
Good morning.

Ian Edwards:
Good morning, Yuri.

Yuri Lynk:
Ian, I wanted to dig in a little bit on your comments on Eglinton and Trillium. You continue to guide to physical completion by year end, but they remain at 95% and 85% complete, which is the same numbers as the end of June, so what gives—it doesn't look like they're moving on the percent of completion numbers, at least, so maybe a bit more colour on when these things can wrap up.

Ian Edwards:
Sure, yes. Actually, we've executed $165 million of revenue in the quarter, so Q3 is a good quarter for executing physical work. Obviously, it's the back end of summer, weather's good. There's always some additional work that flows through, as well. That's why you see, probably, not the net coming down. But, the important thing about these two projects is getting the physical work complete, and as we've said before, the risk assessments that we've made and the risks that we've been incurring through this year, and clearly previous periods, is all about finishing the physical work. So, they're actually going well. I mean, these projects, both have progressed well. We will be where we said we would be at the end of the year, and next year is all about getting them into operation, testing, commissioning, obviously finishing landscaping, and things like that, when the winter's over, but, in the main, these jobs are where we expected them to be and we're feeling good about where they are, and for sure, the $300 million overall risk envelope that we put out there is definitely—we're confident that we're within that.

You may have seen—and I'll add to it—some media about the opening date. Now, obviously, the opening date very much depends on our customers and our clients and when they want certainty that they're ready for the operation of these assets, and we work closely with them to make sure that's a smooth transitioning into operation.

Yuri Lynk:
Okay, and you keep referencing physical completion.

Ian Edwards:
Yes.

Yuri Lynk:
I'm assuming, but correct me if I'm wrong, once physical completion is reached, the odds of material negative costs reforecasts from that point forward are minimal, zero? Like, how do we think about the tail risks on these things?

Ian Edwards:
Let's say reduced. I would say substantially reduced. Because, the cost to complete these projects is really in the civil and building work associated with completing the jobs. Once we get the physical work, in the main, complete, the risk is not zero, but it drops off, and then it's really about professional staff testing and commissioning the systems, getting the systems up and running, running the trains, vetting them in, so the risk envelope is quite a lot different as we move into next year. So, that's why we keep stressing this physical work complete on those two jobs.

Yuri Lynk:
Okay.

Ian Edwards:
Obviously, as we've reported in previous quarters, it's this hyper-inflation, it's this labour shortage, it's the supply chain, it's all those risks that have led to these cost overruns which are associated with actually executing physical work, not actually testing, commissioning and vetting the rail systems.

Yuri Lynk:

Got it. Second, and last, question, real quick, for Jeff. Debt EBITDA increased half-a-turn sequentially. I think another quarter like that and you're going to be close to your covenant, so just certainty around the cash that you expect to come in the door in the fourth quarter, particularly in light of your comments on your clients not paying you on these larger contracts. Thank you.

Jeff Bell:

Yes, no problem. From our perspective, we're well below our covenant ratios on our credit facilities and have a high degree of confidence in terms of where we're headed in the fourth quarter, both in terms of the cash generation from the Services business, but also, as Ian has said, as we come into winter and we approach the physical completion, particularly on the two Ontario projects, we start to get into a glidepath with lower cash usage on those LSTK projects. So, I'm not concerned at all about where our balance sheet is and our projection of cash flows from here.

Operator:

Our next question comes from Jacob Bout of CIBC. Please go ahead.

Jacob Bout:

Good morning.

Ian Edwards:

Good morning.

Jeff Bell:

Good morning.

Jacob Bout:

I wanted to go back to the LSTK project discussion and just how long do you think it's going to take to work out these claim recoveries at Eglinton and Trillium? I know you said that discussions are ongoing, but how long do you think it's going to take to work out, and, really, what's the bottleneck there?

Ian Edwards:

Clearly, we're disappointed that we've not recovered some of this loss in 2022, and that's the main driver of the revised operating cash outlook that we've put out. I mean, clearly, the best way to resolve these compensation payments is through negotiation. It's not the only way. There are other routes through dispute resolution and arbitration, or even litigation, which ultimately would take longer, so we're putting our efforts into working with our customers to negotiate. It is obviously complex, and our customers are, in the main, representing government, so they've got to be confident that any compensation that is paid is justified and correct. Whilst we're disappointed that we've not resolved that in '22, and obviously with two months to go we've had to reassess what our ability is to recover it, we are really focused on trying to get this done in '23.

Now, there's always two people and two parties in a negotiation, so I can't give a guaranteed outcome and I can't give you a guaranteed timeline, but we're working really hard to get this cash back, because, obviously, every claim that is settled is a cash upside, and we want to get and return to a normalized cash position in this Company as soon as we can, and putting LSTK behind us is clearly part of that.

Jacob Bout:

What's the main bottleneck here?

Ian Edwards:

Well, it's the magnitude of the issue, these are not small numbers. It's the complexity of the information, and it's the requirement from government entities to be able to understand and justify to themselves that the decisions that they're making in settling these claims are the right judgments and the right settlement judgements. Whilst I understand our customers' point of view, this is highly frustrating for us, because all the time that it takes to settle these claims is at our expense. We are completing these jobs at our expense. We're not just talking about the losses incurred in 2022, we're talking about losses incurred in prior periods, as well. It is a frustrating process, but we've just got to keep at it, and hopefully we'll get to an amicable resolution with our Ontario customers.

Jacob Bout:

Okay, and my second question is just on the Engineering Services subsegment of SNCL Services. The book-to-bill there 1.4 times in Q3, so it looks like you're gaining a lot of traction in the U.S. Just talk about what's driving this growth and are you seeing expansion into new areas within the U.S.?

Ian Edwards:

Yes. I mean, obviously, we're really pleased with the go-forward part of this Company. We have protected it over the last years, while we've been going through this transformation, and we went into the Pivoting to Growth Strategy a year ago, when we presented that through our Investor Day, and we're really pleased that we're delivering against it. Sixth quarter of year-over-year growth. Q3 growth in Engineering Services of 18%, I mean, that's really pleasing. The three core geographies where we're positioned, in Company, are giving us a very sustainable pipeline of opportunities that apply to our specific capabilities, and we are able to win work, because we're applying those capabilities to our customers in a strong demand market.

As you say, the U.S. is particularly pleasing, because we have this very defined land-and-expand strategy to not only continue to be successful in specific states, but also to take that success to new states, and that strategy is working. A good portion of the growth that you've seen in the backlog in Engineering Services, with a record backlog of $4.6 billion, has actually come out of the U.S. and that strategy.

Jacob Bout:

Great, thank you.

Ian Edwards:

Thank you.

Operator:

Our next question comes from Chris Murray of ATB Capital Markets. Please go ahead.

Chris Murray:

Yes, thanks, folks. Good morning.

Ian Edwards:

Good morning.

Chris Murray:

Maybe thinking about going back to your Investor Day and you talked a little bit about growth in the future, and I appreciate you talked a little bit in your script about the Pivoting to Growth Strategy around organic, but part of this was also around M&A, and, obviously, maybe some balance sheet caution is maybe the way I'll frame it, about maybe becoming hesitant with M&A, but is there a point where you probably can get more active in M&A, and is it still, as you laid out at the Investor Day, still looking to do either the land-and-expand type strategy in the U.S. or tuck-in in the U.S., or is there something changing in the way you're looking at M&A growth?

Ian Edwards:
No. No, I don't think anything's fundamentally changed in our capital allocation strategy, and, particularly to your point, about the land-and-expand in the U.S. I mean, clearly, until we're producing free cash flow, we're only in the preparation phase, which we're actually putting quite a lot of effort into the preparation phase. These things take a lot of pre-work and pre-kind of analysis to understand what targets are available and what's going to be the most accretive for us and that we can use as a base to build upon, but, obviously, right now, we haven't got the free cash flow to deploy.

Maybe, Jeff, you could maybe just reiterate our capital allocation kind of priorities.

Jeff Bell:
Yes, I mean, I think, as you heard us say, the balance sheet is the first priority as we return to free cash flow positivity down the road here, and at the same time we'd be looking for opportunities to deploy capital to further accelerate the strategy and growth, but at the same time we'll be looking at what it means in terms of returns to shareholders, both in terms of whether we actually have acquisitions that are compelling enough, but I think also includes depending on where the share price is at and whether we see a significant discount to the intrinsic value of the Company. So, we'll clearly be looking at both of those when we get to the point of deploying capital beyond the balance sheet.

Chris Murray:
Okay, and is it fair to think that you're waiting to get past the LSTK, or at least maybe the Ontario projects, and get some resolution before that becomes fair to think about, or will it be just purely numbers driven off the cash flow statement?

Ian Edwards:
In terms of M&A, Chris?

Chris Murray:

Yes, basically, yes.

Ian Edwards:

No, I think there's some overlap here. I mean, obviously, there's a pretty significant group of people in the Company that are focused on LSTK execution and LSTK costs recovery through the claims, and that group is highly focused on that, but there's another group of people that are focused on growing the Company forward and taking the Company forward. An M&A group, and a group particularly in the U.S., are looking what that looks like in the future and preparing for it. So, a little bit of overlap there, but, for sure, we're taking everything in a kind of step-by-step approach.

Chris Murray:

Fair enough. The other question I had is just maybe if you don't mind elaborating a little bit on Linxon. Certainly, when I think about some of the areas that they work, and I'm thinking about Europe, for the most part, but if you want to think about a part of the world that probably needs energy infrastructure help in a hurry, it certainly comes up there. Can you just maybe walk through what you're going to be able to do in the near term about improving those margins, and, then, any longer term thoughts around some of the—maybe it's the war in Ukraine and some of the other issues there, and Europe and its energy challenges, how that plays into all of this?

Ian Edwards:

I think the way I would phrase this is the market is far larger than our capability. I mean, the market is very strong, and globally strong. North America, Europe, Middle East, and even Asia, the market is strong, because almost everybody's trying to upgrade the transmission and distribution, and obviously Linxon sells the substation kind of service into that upgrade. We don't believe that we have an issue in winning work and growing the business, but, as you rightly say, we're disappointed in the margin profile. We've set an EBIT range here which we think is an achievable EBIT range, of 4% to 6%, which actually is a good EBIT range because of the amount of flowthrough work that goes through this business, but we need to get in that range. So, our focus will be on winning profitable work, primarily in Europe and North America, so it aligns with the overall strategy of SNC-Lavalin, and bringing those margins up and improving the performance in the business. In actual fact, we've got a real drive on that right now with the team.

Jeff Bell:
And maybe, Ian, the add to that, which I think was around the second part of your question, Chris, is that as we think of Europe more broadly and energy security, I mean, I think that pretty much plays into the Nuclear business and the Nuclear capabilities that we have there, both from a potential new-build perspective, and whether that's helping EDF with the next—or being a key part of the EDF Team, as part of the next new-build in the U.K., or, indeed, our CANDU reactor technology, which currently has two stations in Romania, and the potential for two more, for which we've seen a lot of good progress on. So, we think clearly there's, as Ian says, a lot of great market opportunity there.

Chris Murray:
All right, that's helpful. Thank you.

Jeff Bell:
Thank you.

Operator:
Our next question comes from Devin Dodge of BMO Capital Markets. Please go ahead.

Devin Dodge:
Thanks. Good morning. Can you help us to better understand the sequential decline in operating cash flow guidance from the updated figure you provided back in August? I'm just having a bit of trouble reconciling the $200 million additional cash flow usage this year with the, I would say, small increase in that $300 million max downside bucket.

Jeff Bell:
It's Jeff, Devin, why don't I do that? There's really a couple of components.

You could think about it as part of that is related to claims that we've been unable to negotiate with our customers. As Ian has said, we saw success in that in previous years, and we have been on good constructive discussions with clients, but we just haven't been able to reach resolution in the year, as we had expected earlier in the year, back in August.

The second is that we are seeing increased costs. In addition to what we see in terms of the absolute losses in the projects themselves, costs have run slightly higher than that, and we believe some of that we can get back, and so we book that as revenue, but the costs are running higher, as well.

So, you know, kind of part of one and part of the other is what has really driven into that $200 million.

Devin Dodge:
Okay, thanks for that. Then, maybe just sticking with the cash flow, if I look at Slide 16 of the deck, it shows SNCL Services having a pretty meaningful working capital usage. I mean, it's almost on par with the drag that we're seeing from LSTK, just both in Q3 and year to date. Can you talk about the drivers behind that and do you expect some of that to unwind in the coming quarters?

Jeff Bell:
Yes, that's been a trend that we've seen over the last few quarters. The primary driver of that, Devin, is the fact that we are seeing a rising DSO off what we would consider to be an abnormally low level in COVID, so that is coming back towards a more normalized level, which will be closer to 70 days outstanding, rather than the sort of the high 50s, 60s that we had been experiencing over the previous quarters.

The other thing that's driving into that is, frankly, the really significant growth rate that we're seeing in the Services business, and particularly in Engineering Services, and when revenue accelerates that way, you do end up with a drag in working capital as that builds up in width and receivables before it actually gets billed and turned into cash. It is why we've guided to the point that we do expect to see stronger cash flow in Q4, including in Services, as we start to see some of that normalizing out and the cash coming in.

Devin Dodge:
Thanks for that. I'll turn it over.

Ian Edwards:
Thank you.

Operator:
Our next question comes from Michael Kypreos of Desjardins Capital Markets. Please go ahead.

Michael Kypreos:

Good morning.

Ian Edwards:

Good morning.

Michael Kypreos:

Looking at what happened in Florida with Hurricane Ian, and given you have a couple of joint ventures and the FEMA work appraisal exposure, can we expect some sort of positive contribution in the upcoming quarter?

Ian Edwards:

Yes, I mean, I think some of the Q3 uptick in the U.S., or in part, was the FEMA work that we win. I mean, obviously, this disaster relief work, we have to deploy people quickly, and we have to find people across the business to support FEMA, and we did that. Obviously, that work is ongoing. It'll probably be ongoing through Q4, and maybe even into next year. So, yes, I think that's a fair assessment.

Michael Kypreos:

Perfect, thank you for the colour, and maybe just on free cash flow, looking at next year, 2023, do you believe it could be a total reversal, or is do you expect more of a gradual improvement, given you don't know the timeline of when the government could come to the negotiating table?

Jeff Bell:

Yes, I think, as you heard Ian—it's Jeff—as you heard Ian say, I think it is hard for us to predict exactly when we'll be able to resolve with the government, or the client, these different claims. We would remain hopeful that we can do that in a negotiated way and do that in 2023, but we'll have to see. I think, regardless of that, as we move into 2023, as you heard me say in the presentation, the two Ontario projects, being largely physically complete this year and moving into mostly testing and commissioning next year, that, by definition, will reduce the costs and the quarter-over-quarter cash flow usage that they require. Therefore, we do expect to see a clear improvement in cash flow over the course of 2023, just for that fact alone, as the projects complete and ultimately go into service.

Michael Kypreos:

Perfect, thank you. I appreciate the time.

Ian Edwards:

Thank you.

Jeff Bell:

Thank you.

Operator:

Our next question comes from Frederic Bastien of Raymond James. Please go ahead.

Frederic Bastien:

Hi, good morning. We've all seen central banks raise rates pretty aggressively in the recent past, and that's led to a step-change in the interest you paid during the quarter. Can you please remind us how much of your debt is fixed versus floating, and sort of what the terms are around that? Thank you.

Jeff Bell:

Yes, it's Jeff. We have taken some action over the course of this year to convert what was largely floating rate debt, some of it into fixed rate debt. I'd say, roughly, currently, it's two-thirds floating and one-third fixed, 75/25, kind of in that neighbourhood.

In terms of every kind of 1% increase in interest rates—and we give some disclosure, as we did at the end of the year, in our financial statement—call it $1 billion of floating rate debt. Economically, 1% would be about $10 million pre-tax.

Frederic Bastien:

Okay, that's helpful, Jeff. That's all I have. Thank you.

Jeff Bell:

Thank you.

Operator:

Our next question comes from Maxim Sytchev of National Bank of Financial. Please go ahead.

Maxim Sytchev:

Hi, good morning, everyone.

Ian Edwards:

Good morning.

Maxim Sytchev:

I just had a quick question in terms of Engineering Services, because I think there was a compression in EBIT margins year-on-year, and wondering, in terms of sort of the moving parts there, maybe any comment around wage inflation, and so forth. Thank you.

Jeff Bell:

Yes, Max, I think it was primarily around Engineering Services you were asking, so there's a couple elements in there, and then maybe I'll turn it over to Ian to talk a bit about wage inflation. One was we did have an arbitration settlement last year, which helped the margins last year, so I think about 8.9% last year versus 8.3% this year, so some of that was in there. The second is, is that the decrease in the pound has largely been offset by the strength of the U.S. dollar year-over-year, but not entirely, and so there's a small amount in there where we're seeing a bit of drag from FX. So, between those two, that makes up most of that difference in kind of year-over-year, but Ian will talk about wage inflation.

Ian Edwards:

Wage inflation, per se, particularly in the Engineering Services business, doesn't have an impact on profitability and margin levels, and the reason for that is, in the main, the Engineering Services business is on a short cycle, so, typically, the backlog is burned off in nine months, on average, therefore, you're constantly rebidding work and constantly winning work, and then there's also a fairly high proportion of that work which is reimbursable, which, obviously the inflation around wages is flowed through. Even previously, in other cycles of high inflation that we've seen, we've generally not seen a deterioration of margin, so I think it's really the other aspects that Jeff's spoken to.

Maxim Sytchev:

Right, and how should we think sort of directionally—obviously, you've compressed the guide versus some previous expectations for 2022, but in terms of 2023, and kind of beyond, some cost initiatives, optimizations, yes, how should we think about that on a go-forward basis?

Jeff Bell:

Yes, I think, Max, as we normally do, we'll come back at Q4 to set out our guidance for 2023, similar, I expect, to what we've done here in 2022, so we'll provide probably better perspective then, but I would say is that we do have cost transformation programs ongoing and we are driving those. Particularly in this environment, with the amount of inflation we're seeing, a lot of focus on how do we manage the cost base, obviously, particularly from an overhead perspective, and we'll continue to aspire to drive margins higher up in our range, but we'll come back and provide better perspective on that in 2023.

Ian Edwards:

Yes, and another key element, as I think we've said a couple of times, is consistency. We want to keep consist, obviously. We always aspire to the higher end of our ranges, but growth is key, and our focus is around growing these businesses.

Maxim Sytchev:

Right, and then just one last question to squeeze in, in terms of operating cash flow and how that sort of ebbs and flows, especially next year. Do you think by pushing out sort of free cash flow generation to 2024 then, and there's kind of no chance of that happening next year, because, again, of the uncertainty of when you're going to get paid from the government, or how are you guys thinking at this point of the year? Thanks.

Jeff Bell:

Yes, Max, I think, kind of as I said earlier, with largely physically complete in the interior projects the end of this year, early next year, we do expect that cash flow usage to start to clearly improve as the projects complete through—certainly, through the first half, or so, of next year. If you just look at Slide 16 in the presentation, as we reach quarters where, particularly later next year, there's little or no drag from the LSTK projects, the rest of the business is a consistent operating cash flow generating business. So, I think it really is tied to—ignoring when we get amounts back from the government, it's really about as we complete those projects, we would start to believe we're entering a period of seeing free cash flow generation. I don't think we necessarily see that as being in 2024, or having to wait that long, but we'll continue on this path in 2023.

Maxim Sytchev:
Right, and no concern kind of on REM and the payment terms there?

Jeff Bell:
No, that contract is set up in a way that we haven't seen the same issues that way.

Ian Edwards:
And projects are progressing well.

Jeff Bell:
Indeed.

Maxim Sytchev:
Okay, that's great. Thanks a lot. That's it for me.

Ian Edwards:
Thank you.

Operator:
Our next question comes from Michael Tupholme of TD Securities. Please go ahead.

Michael Tupholme:
Thank you. Good morning.

Ian Edwards:
Good morning.

Jeff Bell:
Good morning.

Michael Tupholme:
Jeff, can you talk about expectations for changes in non-cash working capital in the fourth quarter? Often, there's a seasonal reversal, but I'm not sure if everything you've been describing there with respect to the LSTK Projects and timing affects that this year and somehow alters that, but just your thoughts on that would be helpful.

Jeff Bell:
Yes, I'm not sure we'll see a big change in non-cash working capital, or that trend, from an LSTK perspective. As you heard Ian say, we continue to kind of fund the cost of these projects and we would expect to continue to see that trend without reimbursement or further reimbursement from the clients, so I don't think we'll see that trend.

But, to your point on the Services side, we do typically and historically see a reduction in non-cash working capital as we come into the end part of the year, and to my sort of previous answer, I can't remember who asked the question, with the rapid increase in our revenue, particularly in Engineering Services, it does create kind of a quarter delay in terms of converting that additional width in revenue into actual cash, so we would expect to see that starting to normalize out in Q4 and into the beginning part of next year. So, I would expect to see improvement in non-cash working capital for that reason, all else being equal.

Michael Tupholme:
Okay. So, when you put all that together for the fourth quarter, do you have a view as to whether or not, on an overall net basis, you would be positive, or is that not …

Jeff Bell:
As I said in the presentation, based on where we are at nine months, we are expecting to be operating cash flow positive in the fourth quarter, even with LSTK, when you look at our guidance of having a usage of $300 million, overall.

Michael Tupholme:

Okay, and then can you talk about how you see leverage and leverage ratio evolving as you move forward, I guess, into the end of the year, but also, more specifically, into next year, and any targets you have and if the timing on those is intact or if there's been any shifting?

Jeff Bell:
Yes, I don't think we see any material shift in that. As I said, we continue to see a very clear path to being in our target range of 1.5 to 2 times in 2024. It does shift around a bit quarter-by-quarter and period-to-period, and you see that when you go back to the end of last year, for instance. So, I would expect, clearly, over time for the ratio to improve. We'll see where we are at the end of the year, but, as I said, continue to have a high degree of confidence in our balance sheet and our ratio at this point. It's just the impact, really, that the LSTK losses are, that we're seeing, as we look to finish out those projects, particularly from a physical completion perspective.

Michael Tupholme:
Okay, that's great. Thank you.

Operator:
Our next question comes from Sabahat Khan of RBC Capital. Please go ahead.

Sabahat Khan:
Hi. This is more of a question on the operating backdrop. Can you comment, maybe, a little bit on the U.K.? I think the government is undertaking a capital review there, too. Just some thoughts.

Ian Edwards:
Yes, for sure, and, obviously, we're watching the U.K. closely. We understand and we're trying to follow how this will play out. However, I think that our specific business is resilient to—our specific business is actually quite resilient, we think, to any kind of austerity measures that we might see, and the reason for that is it's a very, very diverse business we've got across the U.K. We have a lot of services, different services that we sell to different end markets. I mean, the markets are in the—the two biggest areas is nuclear and transportation, we're also in water defense buildings and places, a lot of it leaning towards government, but it's not all in Capital projects. We think it's probably the larger Capital projects which may get delayed, probably not cancelled, but may get delayed, and as we sell a lot of services into consultancy or we sell a lot

of services into the operation of assets, such as water, rail and road, obviously, operation and maintenance of those assets have to continue and the funding has to continue for that.

I think the other positive is the commitment for energy transition, particularly energy transition into nuclear. We have a significant number of people on the Hinkley Point nuclear power station, and then we're still very optimistic that Sizewell is going to be announced soon, and then we already have pre-negotiated a large position on Sizewell, and that's going to fuel our business very, very significantly.

So, all in all, I think we need to keep a really close eye on that. You will have seen earlier this year that we onboarded Baroness Ruby McGregor-Smith as a Board member, it gives us really good insight into the market, and we think we can have a resilient kind of approach to any headwinds that we're going to see in the U.K.

Sabahat Khan:
Okay, great, thanks very much for that.

Ian Edwards:
Thank you.

Operator:
This concludes the question-and-answer session. I would like to turn the conference back over to Denis Jasmin for any closing remarks.

Denis Jasmin:
Thank you very much, everybody, for joining us today. If you have any further questions, please don't hesitate to contact me. Have a great day and good weekend. Thank you very much.

Ian Edwards:
Thank you.

Jeff Bell:
Thank you.

Operator:

This concludes today's conference call, you may disconnect your lines. Thank you for participating and have a pleasant day.