AAR CORP
Form 10-Q
December 22, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended November 30, 2017

or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File No. 1-6263

AAR CORP.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**36-2334820** (I.R.S. Employer Identification No.)
One AAR Place, 1100 N. Wood Dale Road **Wood Dale, Illinois** (Address of principal executive offices)	**60191** (Zip Code)

(630) 227-2000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, smaller reporting company, and emerging growth company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer o Non-accelerated filer o Smaller reporting company o Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

As of November 30, 2017, there were 34,729,373 shares of the registrant s Common Stock, $1.00 par value per share, outstanding.

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AAR CORP. and Subsidiaries

Quarterly Report on Form 10-Q

For the Quarter Ended November 30, 2017

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PART I FINANCIAL INFORMATION

Item 1 Financial Statements

AAR CORP. and Subsidiaries

Condensed Consolidated Balance Sheets

As of November 30, 2017 and May 31, 2017

(In millions, except share data)

ASSETS

	November 30, 2017 (Unaudited)	May 31, 2017
Current assets:		
Cash and cash equivalents	$ 27.1	$ 10.3
Accounts receivable, less allowances of $8.5 and $5.8, respectively	258.4	251.4
Inventories	479.4	483.1
Rotable spares and equipment on or available for short-term lease	99.6	118.0
Deposits, prepaids and other	27.7	25.7
Total current assets	892.2	888.5
Property, plant and equipment, net of accumulated depreciation of $422.4 and $413.9, respectively	195.3	201.9
Other assets:		
Goodwill	128.9	115.4
Intangible assets, net of accumulated amortization of $31.3 and $29.8, respectively	30.2	32.8
Rotable assets supporting long-term programs	180.4	159.6
Other	117.3	105.9
	456.8	413.7
	$ 1,544.3	$ 1,504.1

The accompanying Notes to Condensed Consolidated Financial

Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries

Condensed November 30, 2017 and May 31, 2017

(In millions, except share data)

LIABILITIES AND EQUITY

	November 30, 2017 (Unaudited)	May 31, 2017
Current liabilities:		
Current maturities of long-term debt	$ 1.7	$ 2.0
Accounts and trade notes payable	195.9	177.4
Accrued liabilities	138.9	155.7
Total current liabilities	336.5	335.1
Long-term debt, less current maturities	215.8	155.3
Deferred tax liabilities	15.6	37.2
Other liabilities and deferred income	69.9	62.3
	301.3	254.8
Equity:		
Preferred stock, $1.00 par value, authorized 250,000 shares; none issued		
Common stock, $1.00 par value, authorized 100,000,000 shares; issued 45,300,786 and 45,175,302 shares at cost, respectively	45.3	45.2
Capital surplus	462.3	460.8
Retained earnings	710.7	727.9
Treasury stock, 10,571,413 and 10,820,844 shares at cost, respectively	(275.0)	(279.8)
Accumulated other comprehensive loss	(36.8)	(39.9)
Total equity	906.5	914.2
	$ 1,544.3	$ 1,504.1

The accompanying Notes to Condensed Consolidated Financial

Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries

Condensed Consolidated Statements of Operations

For the Three and Six Months Ended November 30, 2017 and 2016

(Unaudited)

(In millions, except share data)

	Three Months Ended November 30, 2017	Three Months Ended November 30, 2016	Six Months Ended November 30, 2017	Six Months Ended November 30, 2016
Sales:				
Sales from products	$ 253.9	$ 231.3	$ 498.6	$ 445.2
Sales from services	195.8	192.5	390.3	383.4
	449.7	423.8	888.9	828.6
Cost and operating expenses:				
Cost of products	203.2	197.3	402.8	376.8
Cost of services	174.0	160.3	349.1	324.1
Cost of services impairments and other charges	51.6		51.6	
Selling, general and administrative	52.2	46.3	100.2	91.1
Selling, general and administrative impairments	2.6		2.6	
	483.6	403.9	906.3	792.0
Operating income (loss)	(33.9)	19.9	(17.4)	36.6
Interest expense	(2.0)	(1.2)	(3.7)	(2.5)
Interest income	0.1	0.1	0.1	0.1
Income (Loss) from continuing operations before provision for income taxes (benefit)	(35.8)	18.8	(21.0)	34.2
Provision for income taxes (benefit)	(13.3)	6.7	(9.1)	12.2
Income (Loss) from continuing operations	(22.5)	12.1	(11.9)	22.0
Loss from discontinued operations	(0.1)		(0.1)	(0.4)
Net income (loss)	$ (22.6)	$ 12.1	$ (12.0)	$ 21.6
Earnings (Loss) per share basic:				
Earnings (Loss) from continuing operations	$ (0.66)	$ 0.35	$ (0.35)	$ 0.64
Earnings (Loss) from discontinued operations				(0.01)
Earnings (Loss) per share basic	$ (0.66)	$ 0.35	$ (0.35)	$ 0.63
Earnings (Loss) per share diluted:				
Earnings (Loss) from continuing operations	$ (0.66)	$ 0.35	$ (0.35)	$ 0.64
Earnings (Loss) from discontinued operations				(0.01)
Earnings (Loss) per share diluted	$ (0.66)	$ 0.35	$ (0.35)	$ 0.63

The accompanying Notes to Condensed Consolidated Financial

Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries

Condensed Consolidated Statements of Comprehensive Income (Loss)

For the Three and Six Months Ended November 30, 2017 and 2016

(Unaudited)

(In millions)

	Three Months Ended November 30, 2017		Three Months Ended November 30, 2016		Six Months Ended November 30, 2017		Six Months Ended November 30, 2016
Net income (loss)	$	(22.6)	$	12.1	$	(12.0)	$ 21.6
Other comprehensive income (loss), net of tax expense (benefit):							
Currency translation adjustments		1.9		(1.1)		2.5	(2.6)
Pension and other post-retirement plans:							
Amortization of actuarial loss and prior service cost included in net income, net of tax of $0.2 and $0.2 for the three months ended November 30, 2017 and 2016, respectively, and $0.3 and $0.3 for the six months ended November 30, 2017 and 2016, respectively		0.3		0.2		0.6	0.5
Other comprehensive income (loss), net of tax		2.2		(0.9)		3.1	(2.1)
Comprehensive income (loss)	$	(20.4)	$	11.2	$	(8.9)	$ 19.5

The accompanying Notes to Condensed Consolidated Financial

Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

For the Six Months Ended November 30, 2017 and 2016

(Unaudited)

(In millions)

	Six Months Ended November 30, 2017	Six Months Ended November 30, 2016
Cash flows used in operating activities:		
Net income (loss)	$ (12.0)	$ 21.6
Loss from discontinued operations	0.1	0.4
Income (Loss) from continuing operations	(11.9)	22.0
Adjustments to reconcile net income to net cash used in operating activities:		
Asset impairments and other charges	54.2	
Depreciation and intangible amortization	28.5	24.3
Stock-based compensation	5.4	4.9
Amortization of overhaul costs	4.7	10.6
Deferred tax provision (benefit)	(22.1)	(1.7)
Gain on asset disposal		(2.6)
Changes in certain assets and liabilities:		
Accounts receivable	(3.3)	(29.7)
Inventories	(15.7)	(6.0)
Rotable spares and equipment on or available for short-term lease	2.5	5.1
Equipment supporting long-term programs	(28.4)	(47.9)
Accounts and trade notes payable	14.7	16.7
Accrued and other liabilities	(29.1)	7.3
Other, primarily program and overhaul costs	(8.2)	(3.3)
Net cash used in operating activities continuing operations	(8.7)	(0.3)
Net cash used in operating activities discontinued operations	(1.2)	(0.9)
Net cash used in operating activities	(9.9)	(1.2)
Cash flows used in investing activities:		
Property, plant and equipment expenditures	(17.9)	(18.9)
Payments for acquisitions	(22.9)	
Proceeds from aircraft joint ventures	7.3	
Proceeds from asset disposals	1.3	18.0
Other	(0.6)	(2.8)
Net cash used in investing activities	(32.8)	(3.7)
Cash flows provided from (used in) financing activities:		
Short-term borrowings, net	37.0	19.0
Reduction in long-term borrowings		(5.0)
Proceeds from long-term borrowings	24.8	
Cash dividends	(5.2)	(5.2)
Purchase of treasury stock	(5.2)	(14.8)
Stock option exercises	9.2	3.9
Other	(1.1)	(0.7)
Net cash provided from (used in) financing activities	59.5	(2.8)
Effect of exchange rate changes on cash		(0.5)
Increase (Decrease) in cash and cash equivalents	16.8	(8.2)

Cash and cash equivalents, beginning of period		10.3		31.2
Cash and cash equivalents, end of period	$	27.1	$	23.0

The accompanying Notes to Condensed Consolidated Financial

Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries

Condensed Consolidated Statements of Changes in Equity

For the Six Months Ended November 30, 2017

(Unaudited)

(In millions)

	Common Stock	Capital Surplus	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Equity
Balance, May 31, 2017	$ 45.2	$ 460.8	$ 727.9	$ (279.8)	$ (39.9)	$ 914.2
Net loss			(12.0)			(12.0)
Cash dividends			(5.2)			(5.2)
Stock option activity		0.1		9.2		9.3
Restricted stock activity	0.1	1.4		0.8		2.3
Repurchase of shares				(5.2)		(5.2)
Other comprehensive income (loss), net of tax					3.1	3.1
Balance, November 30, 2017	$ 45.3	$ 462.3	$ 710.7	$ (275.0)	$ (36.8)	$ 906.5

The accompanying Notes to Condensed Consolidated Financial

Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

November 30, 2017

(Unaudited)

(Dollars in millions, except per share amounts)

Note 1 Basis of Presentation

AAR CORP. and its subsidiaries are referred to herein collectively as AAR, Company, we, us, and our, unless the context indicates otherwis The accompanying Condensed Consolidated Financial Statements include the accounts of AAR and its subsidiaries after elimination of intercompany accounts and transactions.

We have prepared these statements without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission (SEC). The Condensed Consolidated Balance Sheet as of May 31, 2017 has been derived from audited financial statements. To prepare the financial statements in conformity with U.S. generally accepted accounting principles (GAAP), management has made a number of estimates and assumptions relating to the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities. Actual results could differ from those estimates. Certain information and note disclosures, normally included in comprehensive financial statements prepared in accordance with GAAP, have been condensed or omitted pursuant to such rules and regulations of the SEC. These Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and notes thereto included in our latest annual report on Form 10-K.

In the opinion of management, the condensed consolidated financial statements reflect all adjustments (which consist only of normal recurring adjustments) necessary to present fairly the condensed consolidated financial position of AAR CORP. and its subsidiaries as of November 30, 2017, the Condensed Consolidated Statements of Operations and the Condensed Consolidated Statements of Comprehensive Income (Loss) for the three- and six-month periods ended November 30, 2017 and 2016, the Condensed Consolidated Statements of Cash Flows for the six-month periods ended November 30, 2017 and 2016, and the Condensed Consolidated Statement of Changes in Equity for the six-month period ended November 30, 2017. The results of operations for such interim periods are not necessarily indicative of the results for the full year.

New Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers, which provides guidance for revenue recognition. This ASU affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of non-financial assets. This ASU will supersede the revenue recognition requirements in Accounting Standards Codification (ASC) 605, Revenue Recognition, and most industry-specific guidance. This ASU will also supersede certain cost guidance included in Subtopic 605-35, Revenue Recognition-Construction-Type and Production-Type Contracts. In August 2015, the FASB issued ASU No. 2015-14 which deferred the effective date of the new standard by one year which will make the new standard effective for us beginning June 1, 2018.

We will adopt this ASU as of June 1, 2018, using the modified retrospective transition method and are currently continuing our evaluation of the expected impact of the adoption on our consolidated financial statements and related disclosures. Under the modified retrospective transition method, we will be required to recognize the cumulative effect of adopting this ASU as of June 1, 2018 in our first quarter ending August 31, 2018. We expect to estimate the cumulative effect upon adoption of the new ASU in the fourth quarter of fiscal 2018 based on expected contracts in process at May 31, 2018.

The accompanying Notes to Condensed Consolidated Financial

Statements are an integral part of these statements.

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Notes to Condensed Consolidated Financial Statements

November 30, 2017

(Unaudited)

(Dollars in millions, except per share amounts)

In February 2016, the FASB issued ASU 2016-02, Leases. This ASU amends the existing accounting standards for lease accounting, including requiring lessees to recognize most leases on their balance sheets, including those classified as operating leases under the current accounting guidance. In addition, this ASU will require new qualitative and quantitative disclosures about the Company s leasing activities. This new standard will be effective for us beginning June 1, 2019 with early adoption permitted. This ASU requires a modified retrospective transition approach for all leases existing at, or entered into after, the date of initial application, with an option to use certain transition relief. We are in the preliminary phases of assessing the effect of this ASU on our portfolio of leases. While this assessment continues, we have not yet selected a transition date nor have we determined the effect of this ASU on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, which amends ASC Topic 718, Compensation Stock Compensation. This ASU requires excess tax benefits or deficiencies for share-based payments be recorded in the period shares vest as income tax expense or benefit, rather than within equity. Cash flows related to excess tax benefits are now included in operating activities and are no longer classified as a financing activity. We adopted this ASU on June 1, 2017 and recognized excess tax benefits of $0.4 and $1.6 million as a reduction to income tax expense during the three- and six-months ended November 30, 2017, respectively. We have also presented the excess tax benefits within operating activities in the condensed consolidated statement of cash flows for the six-months ended November 30, 2017. As permitted, we adopted the statement of cash flow presentation guidance on a prospective basis with no adjustments to the previously reported amounts.

Note 2 Discontinued Operations

During the first quarter of fiscal 2017, we completed the shut down of the metal machining operation of our Precision Systems Manufacturing business. This business is reported as discontinued operations for all periods presented. Liabilities of discontinued operations of $5.9 million and $6.9 million at November 30, 2017 and May 31, 2017, respectively, were classified as *Accrued Liabilities* on the Condensed Consolidated Balance Sheet.

Unless otherwise noted, amounts and disclosures throughout these Notes to Condensed Consolidated Financial Statements relate to our continuing operations.

Note 3 Revenue Recognition

Sales and related cost of sales for product sales are recognized upon shipment of the product to the customer. Our standard terms and conditions provide that title passes to the customer when the product is shipped to the customer. Sales of certain defense products are recognized upon customer acceptance, which includes transfer of title. Under the majority of our expeditionary airlift services contracts, we are paid and record as revenue a fixed daily amount per aircraft for each day an aircraft is available to perform airlift services. In addition, we are paid and record as revenue an amount which is based on number of hours flown. Sales from services and the related cost of services are generally recognized when customer-owned material is shipped back to the customer. We have adopted this accounting policy because at the time the customer-owned material is shipped back to the customer, all services related to that material are complete as our service agreements generally do not require us to provide services at customer sites. Furthermore, serviced units are typically shipped to the customer immediately upon completion of the related services. Sales and related cost of sales for certain large airframe maintenance contracts and performance-based logistics programs are recognized by the percentage of completion method, based on the relationship of costs incurred to date to the estimated total costs. We recognized favorable cumulative catch-up adjustments of $0.4 million and $0.8 million during the three month periods ended November 30, 2017 and 2016, respectively, and $0.4 million and $4.6 million during the six month periods ended November 30, 2017 and 2016, respectively, resulting from changes to the estimated profitability of these contracts.

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AAR CORP. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

November 30, 2017

(Unaudited)

(Dollars in millions, except per share amounts)

Lease revenues are recognized as earned. Income from monthly or quarterly rental payments is recorded in the pertinent period according to the lease agreement. However, for leases that provide variable rents, we recognize lease income on a straight-line basis. In addition to a monthly lease rate, some engine leases require an additional rental amount based on the number of hours the engine is used in a particular month. Lease income associated with these contingent rentals is recorded in the period in which actual usage is reported to us by the lessee, which is normally the month following the actual usage.

Certain supply chain management programs we provide to our customers contain multiple elements or deliverables, such as program and warehouse management, parts distribution, and maintenance and repair services. We recognize revenue for each element or deliverable that can be identified as a separate unit of accounting at the time of delivery based upon the relative fair value of the products and services.

In June 2016, the U.S. Air Force awarded the new contract for the KC-10 Extender Contractor Logistics Support Program (KC-10 Program) to a competitor. Our principal services under the prior contract for the KC-10 Program were completed in January 2017; however, we have provided limited services since that date and will continue to do so for an unspecified period of time. Sales for the KC-10 Program during the three-month periods ended November 30, 2017 and 2016 were $9.3 million and $29.4 million, respectively, and sales during the six-month periods ended November 30, 2017 and 2016 were $21.0 million and $68.0 million, respectively. Gross profit for the KC-10 Program during the three-month periods ended November 30, 2017 and 2016 were $1.1 million and $1.7 million, respectively, and gross profit during the six-month periods ended November 30, 2017 and 2016 were $2.2 million and $4.5 million, respectively.

Included in accounts receivable as of November 30, 2017 and May 31, 2017, were $7.6 million and $14.5 million, respectively, of unbilled accounts receivable related to the KC-10 Program. These unbilled accounts receivable related to costs we have incurred on parts that were requested and accepted by our customer to support the KC-10 Program. These costs have not been billed by us because the customer has not yet issued the final paperwork necessary to allow for billing.

Note 4 Asset Impairments

Our Contractor-Owned, Contractor-Operated (COCO) business included in our Expeditionary Services segment completed certain contracts in the second quarter of fiscal 2018. As the aircraft supporting these contracts have not been placed onto new contracts and coupled with the continued decline in operational tempo within the U.S. Department of Defense (DoD) and an excess supply of aircraft assets in the market, we determined there was an impairment triggering event in the period and tested the recoverability of our COCO aircraft, rotable assets, support parts, and related assets. In the three-month period ended November 30, 2017, we recognized impairment and other charges of $54.2 million including aircraft impairment of $14.5 million, inventory reserves of $21.2 million, rotable asset impairment of $15.9 million, and other impairment charges of $2.6 million. The fair value of the aircraft and related assets was based on available market data for similar assets and is classified as Level 3 in the fair value hierarchy..

As a result of the triggering events discussed above, we also performed an interim goodwill impairment test of our Airlift reporting unit in the second quarter of fiscal 2018. The fair value of the Airlift reporting unit exceeded its carrying value, and as a result, no goodwill impairment charges were recognized.

The accompanying Notes to Condensed Consolidated Financial

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AAR CORP. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

November 30, 2017

(Unaudited)

(Dollars in millions, except per share amounts)

Note 5 Accounting for Stock-Based Compensation

Restricted Stock

In the three-month period ended August 31, 2017, as part of our annual long-term stock incentive compensation, we granted 98,750 shares of performance-based restricted stock and 24,425 shares of time-based restricted stock to eligible employees. The grant date fair value per share for these shares was $35.26 (the closing price on the grant date). In June 2017, we also granted 55,000 shares of time-based restricted stock to members of the Board of Directors with a grant date fair value per share of $34.95.

Expense charged to operations for restricted stock during the three-month periods ended November 30, 2017 and 2016 was $1.5 million and $1.3 million, respectively, and $2.9 million and $2.6 million during the six-month periods ended November 30, 2017 and 2016, respectively.

Stock Options

In the three-month period ended August 31, 2017, as part of our annual long-term stock incentive compensation, we granted 453,450 stock options to eligible employees at an exercise price per share of $35.26 and weighted average fair value of $9.27.

The total intrinsic value of stock options exercised during the six-month periods ended November 30, 2017 and 2016 was $6.5 million and $2.6 million, respectively. Expense charged to operations for stock options during the three-month periods ended November 30, 2017 and 2016 was $1.3 million and $1.1 million, respectively, and $2.4 and $2.3 million during the six-month periods ended November 30, 2017 and 2016, respectively.

Note 6 Inventory

The summary of inventories is as follows:

	November 30, 2017	May 31, 2017
Raw materials and parts	$ 47.7	$ 45.0
Work-in-process	31.3	25.8
Aircraft and engine parts, components and finished goods	400.4	412.3
	$ 479.4	$ 483.1

Note 7 Supplemental Cash Flow Information

	Six Months Ended November 30, 2017	2016
Interest paid	$ 3.0	$ 2.0
Income taxes paid	14.8	2.2
Income tax refunds received	0.1	1.0