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QUESTION AND ANSWER SESSION

Marc Parent, President and Chief Executive Officer

Operator, we'll now open the line to members of the investment community.

Operator
Thank you. Ladies and gentlemen, if you would like to register a question, please press the 1 4 on your telephone. You will hear a three-tone prompt to acknowledge your request. If your question has been answered and you would like to withdraw your registration, please press the 1, followed by the three. One moment, please, for the first question.

Our first question comes from Fadi Chamoun with BMO. Please proceed.

Faci Chamoun

Thank you, operator. Thanks, guys. So I'm trying to kind of see how to best think about the trajectory of defense margins. Marc, you mentioned the focus on accelerating the retirement of risk associated with these legacy contracts, which I understand that this quarter, the impact was 200 basis point. And there's also the idea that the backlog growth and top line growth and kind of implementing higher margin contracts should be margin accretive, as we go forward. Does the margin start to improve from the current level that we're at right now or are we stuck at these kind of lower level for some time?

The other thing, what exactly you mean by accelerating the retirement? Are you able to exit these contracts earlier, or is it a cost action that you're taking to improve the performance of these specific contracts?

Marc Parent

Lots there, Fadi, but fair questions for sure. Look, yes, I'm going to go right to the end of your last question, because I remember it, right off the bat. When we talk about the accelerating retirement, what we're really talking about here is that, we're likely going to incur potential costs on a faster -- put it this way, a faster timeline as we work through the execution on these contracts or even take actions like, for example, close out some of these contracts ahead of time.

And I'll give examples of that, but let me just end it right now. Because whatever we do, we're going to offset it by mitigating efforts that we try to limit the cost growth. But let me just basically, tell you some of the things that we might do.

Look, we might decide to de-scope a contract. And I'm talk about these eight, legacy contracts that we're talking about. We might decide to de scope a contract. So what does that mean? That means we close out, and we're looking at this, in at least one specific contract, potentially incur liquidated damage, if that makes sense for us to cut off a future tail of programmatic risk on that program.

So better to take that pain now, than take a lot more later, if you know what I mean. But of course, that depends on the negotiation, specifically, that we have on the -- underway, under -- with that specific customer. Other things we might do, is we might agree to alternative terms or schedule. And then we're looking at that on some of these programs, as well.

Or we might incur a follow-on contract, say, an addendum and an engineering change proposal on any one of these contracts. And we're looking at that, and that's a potential of some of these contracts, that what we'll do is give us more work, in which case, we can spread the cost around, over a bigger quantum, lessening the impact of any individual product (ph). So we're doing all of that.

So if I look back to your, maybe the margin question, and I'll quickly go to Sonya on this one. Look, we saw that -- we talked about 200 basis points this quarter and I'm going to go straight to Sonya on that one, not going too deep on that on. But what we’re -- there's going to be variability from quarter-to-quarter, for the reasons I talked about. This is not going to be linear, because we are taking active steps to try to retire these contracts as soon as we can, especially retire the risk -- take the right actions.

Now mind you, we're never going to give up on our customers. That's not what we do at CAE. We will deliver the products and services that we committed to our customers. That's culture. And don't forget that's the mission that we have in defense. So we're not going to do that. But I mean, that's the way I look -- I would look at this. And finally, before I give it to Sonya, the one thing I would tell you, is there's nothing new here, relative to disclosure, that we gave you last quarter, in terms of a quantum.

What we're trying to do here, is to give you a little bit more precision on the number of contracts that are dragging our performance, these legacy contracts, the duration, how long they last, and the steps that we're taking to actively mitigate them. Now maybe -- I'll stop there to -- I'll turn it over to you, Sonya, just to expand on the 200 basis, at least for this quarter, anyhow.

Sonya Branco

Absolutely. Thanks, Marc. Hi, Fadi. So what we've done this quarter is endeavored to bring sense (ph) to the few contracts that have a disproportionate, negative impact on the business. In doing so, it -- as you can appreciate, this is a process. There's a strict definition, and we're committing to continuing disclosure to report back on these legacy contracts and our progress on them.

So you can see that, in this quarter, there was an impact of 2%, 200 basis points this quarter. But by the way, there's also an impact of an under-absorption of cost needed to achieve scale and support of all of the business, like R&D and SG&A, that can be up to another 100 basis points. So -- which makes the impact slightly higher, at around 300 basis points. Now that's a snapshot for Q3.

Now, I can't say that the next six to eight quarters will look exactly like it, as we're constantly working to -- all the different levers to mitigate these risks and work with our customers, as Marc has highlighted. So while there will be some variability, quarter-to-quarter, this quarter's impact is a rough baseline of the headwind that we face, on average.

Fadi Chamoun

Okay. That’s great. So, basically, you're talking about a scenario where you can take these losses upfront ,and ultimately kind of exit out of that contract risk earlier, so that's -- so it’s going to be lumpy. The comment about the 100 basis point absorption -- is this tied to backlog deployment and how quickly you deploy the backlog to get improvement in that cost absorption? Is that what you mean by that?

Sonya Branco

Absolutely. Yes. As you drive volume and profitability, you have a better volume to support all of these costs that are needed to scale and support a business of this size and growing. So now, at this level, there's an under-absorption that you can assume has about 100 basis points added to the other 200 basis points.

Fadi Chamoun

Okay. So the timeline of six to eight quarters, that's kind of the most, I want to say, the pessimistic kind of timeline. Hopefully, you can deal with some of these contracts earlier, take some of these losses, maybe earlier, and then move on from that?

Marc Parent

Yes. That's definitely what we're going to be seeking to do.

Fadi Chamoun

Okay. Thank you. I appreciate it.

Operator

Our next question comes from Cameron Doerksen with National Bank Financial. Please proceed.

Cameron Doerksen

Good afternoon. Maybe I'll ask a question on the civil business. The utilization rate in the quarter was really strong, 76%, which I don't have it going all the way back, but it seems like, maybe, that's one of the best Q3s you've had. I'm just wondering if you can maybe discuss what you're seeing, as far as demand across the various training components. Are you seeing any changes there, or is it continuing to be strong in the fourth quarter, like we saw in Q3?

Marc Parent

Well, Cameron, what we're seeing is very strong demand. I can tell you, I've look out my window here at the parking lot in Montreal, I can tell you it's full. I keep saying that, but perversely, that's a pretty good indicator of what we see as utilization of training centers, and that's across all the training centers. I see no softening of demand.

And as we said before, as you can do the math, we fully expect a pretty darn good Q4. And we have very good visibility on that, because, obviously, we're pretty close to the end, and we know what scenarios (ph) we have to deliver. And again, we have some very strong bookings in our train center. And these days, I can tell you, nobody is looking to cancel bookings.

Cameron Doerksen

Okay. That’s good to hear. And maybe just a very brief, just follow-up to Fadi’s questions, just on the defense -- you mentioned you may be seeking some, I guess, equitable adjustments. I know that's something you've discussed in the past. Have you had any success there? I mean, are you optimistic at all that you'll some relief from your customers, with some -- maybe some pricing adjustments within these legacy contracts?

Marc Parent

I'm optimistic, but I'm not optimistic on the timing, meaning -- because I can't -- I've been wrong every time. So I could tell you that that bulk of it -- we've gotten a bit. I would tell you about, give or take, about 10% of what we believe that we have very, very strong cases and documented, evidentiary reports -- claims into customers.

But again, there’s -- just depends on so many things that I don't control that -- I would tell you we have made some assumptions, I would say conservative assumptions, with regard to -- we looked at mitigations on some of these legacy contracts, that -

- some of that is included, but certainly not the full quantum.

Cameron Doerksen

Okay. That’s helpful. Thanks very much.

Operator

Our next question comes from Kevin Chiang with CIBC.

Kevin Chiang

Thanks for taking my question. I know you don't have multiyear guidance for -- or targets for defense. But, if I just kind of -- if I rewind, let's say, back to fiscal Q2, and you provided an update on defense at that point in time, I think the market read it as -- you have around mid-single-digit EBIT margin for the remainder of this year, maybe get up to higher single-digits in fiscal 2025, and then you can normalize to a run rate closer to your target of low-double-digits sometime in fiscal 2026 -- the fact that you haven't changed your three year EPS target, I'm just trying to level set.

Is that still the trajectory you think you can do as you roll off some of these contracts? Or was it like the double-digit EBIT margin maybe cloudier here today given the new disclosure you provided?

Marc Parent

Sonya?

Sonya Branco

Yes. So clearly, there's some dependency on the timing of the risk retirement on those legacy contracts and the pace of the new programs ramping up, and we're working this as indicated. At the same time, our outlook for civil remains robust. We need to close out on the healthcare transaction, and we expect to do so by the end of the fiscal year, and finalize that impact, as well. So we'll be providing more insight on all of these in Q4, as we usually do.

Kevin Chiang

Okay. That’s -- I’ll look forward to that. Maybe strategically, you're running about 21, I guess, these past few quarters you've been running kind of low-to-mid $20 million operating income. I'm just wondering, do you think the business is big enough to absorb these type of hiccups? And what I mean by that, it doesn't look like the absolute dollars, the impact from these legacy contract issues is large, but it's also coming off a smaller base.

I'm just wondering, I mean, this risk seems to be something you always have to deal with when you deal with the government and fixed price contracts. Just how do you think about the ability to absorb even small developments that weren't planned, that end up being a little bit more negative than you anticipated and not having any kind of sideswipe margins, where they have the past year or so?

Marc Parent

So, I think the way I look at it is, when we talk about these legacy contracts that we're dealing with here, they're not particularly large, individually, in terms of either revenue or backlog. But to your point, they can and they are and they have introduced disproportionately large costs in a given period, as we work through them. Especially if you do like active efforts that we have to reach a customer settlement or agree to change in terms, things like that.

So -- but we have to remember, as well, that the business is not -- where -- is not the size that we want it to be. So in the end of the day, when you have a hit in any of the quarters, it has material impact, because of the small quantum that you have in the absolute number.

Kevin Chiang

That’s a great point. Okay. Thank you, very much, and best of luck, as you close out this (inaudible).

Operator

Our next question comes from James McGarragle with RBC Capital Markets.

James McGarragle

Hey, good afternoon, and thanks for having me on. So, my question is with regard to how you're looking at deploying capital in the defense segment. It seems like returns on that business right now, they're below your target. Do you think there's enough room to improve margins, to bring returns in defense within your internal targets, or any other things to consider, with regard to how you intend to deploy that capital that's tied up in the defense business?

Sonya Branco

Yes. So we always look at a balanced capital allocation strategy, James, and the first priority is continue -- as we, obviously, continue to deleverage and drive towards a flexible balance sheet, is to invest in accretive growth. And our top priority is to serve the demand that we see on the civil market. And that organic CapEx is highly accretive and drives returns of 20 to 30% incremental, pretax returns within three to four years. So wherever we have those opportunities, that is the first priorities, in terms of capital allocation.

Now, sometimes we do deploy some CapEx on the defense side. Ultimately, if we are to do so, we expect that to be on commercial terms and driving commercial-like margins.

Marc Parent

Yes. And then, maybe I'll just add to that, Sonya. And we've already talked about some of those, like, for example, the U.S. Army, HADES contract, we'll be deploying a global, 6,500 simulator in our existing facilities in the Dothan Training Center, where we already delivered the fixed wing training for the U.S. Army. So -- and in that case, as Sonya said, we’re -- because it's a commercial solution, which we deploy in business aircraft, we can enter into what's called a commercial contract with the U.S. Army, which of course, in that case would be capital that's well deployed, because it's going to be the service with margins more likely get in the kind of civil environment.

So you can imagine that's accretive to our terms. Another example I would give you to that, is a contract that we've talked about for, what was previously called the flight school 21 contract, but we call it is the FTSS contract, where we will be deploying capital to replace all the simulators used by the U.S. Army, at what we call Fort Rucker or Fort Novosel. Not that -- again, we'll be very accretive capital deployment in defense, because we will be able to enter into service contracts on delivery training to the U.S. Army on, again, commercial contracts, which are more favorable to us than traditional contracts in defense.

James McGarragle

And then if we look at the book-to-bill, on the defense side, it came in below one. You did point to some unfunded backlog. So kind of within that backdrop, how should we be thinking about growth in this segment, looking ahead? Is it fair to say you expect top line in defense to be higher in fiscal 2025 versus '24?

Marc Parent

Sonya, you want to take it?

Sonya Branco

To your point, the order intake of 0.9 is slightly below one, but I would look at the overall total backlog, because there is the dynamics of, kind of the first year funding and so on. So you could see the growth in the backlog.

We're expecting some big Q4 awards Marc -- Q4, Q1 awards that Marc spoke about, some large Canadian contracts that we've been selected. And then we're expecting those to come in, and that'll drive some significant order intake and backlog growth.

Marc Parent

Now look, defense is a growth business. As I said in the remarks, we have 20% backlog growth in the last two years. And that doesn't include contracts that we've been selected on, like the future aircrew training in Canada and the RPA training contract -- we've been selected. Those two contracts are really generational in size. We're not under contract yet. So you got to figure, okay, we got to get under contract. Fully expect that to be in the first half of next year. And then, we got to turn those -- start turning those to revenue. So there'll be timing involved. But I mean, there's no doubt this is a growth business.

James McGarragle

And sorry, just one quick follow-up on the defense side, before I turn it over. Are the low margin contracts that are rolling off this -- the eight contracts you've identified, are those EBIT positive? I guess, as those contracts roll off, although they might be accretive to margin, is it EBIT neutral? Or are those losing money right now?

Sonya Branco

We don't necessarily give the details of the contracts, individually. I think it's a mix. And so they will be -- they're not particularly large on the revenue, but have that disproportionate impact on the cost. But I think the best measure to kind of look at it, is a margin.

James McGarragle

Okay. Thank you very much.

Operator

Our next question comes from Konark Gupta with Scotiabank. Please proceed.

Konark Gupta

Thanks, operator. And good afternoon, everyone. Maybe just to follow-up on defense -- Marc, what has the dedicated team that you have deployed for these legacy contracts achieved so far, if you can give any concrete examples? And what is their mandate, going forward?

Marc Parent

The mandate is a successful execution of the contract to deliver what we committed to deliver to our customers -- that's first and foremost. All that, because that's what CAE is about, and we have a critical mission in defense, which it goes without saying, of what to do -- that's first and foremost. And of course, deliver it under the best financial terms that we can. And that's what their mandate is.

So execute on the contracts and get us to the softest landing that we can, with regards to retirement of risk on those contracts. We work with our customers to try to establish win-wins, to rescope those products, descoped those products, move the schedule to provide us with scheduled aviation, get requests for equitable adjustments, where we definitely are entitled to get them, because of the extremely high inflationary environment that we've had that disproportionately affected our costs.

Those are all some of the things that our team is doing. And I could tell you, we didn't just put these teams on overnight. These teams have been working for some time, and they have had good progress in executing and reducing the burden that we're facing here in defense already. So we're already seeing the fruits of our labor here, which allows us to give the more precision that we give you today.

Konark Gupta

That’s great. Because -- thanks. And if I can just quickly follow-up on several -- is there any change in discussion or language from customers, from airline customers, especially, in light of the A320 engine issue that we saw recently, as well as now, the Boeing 737 problems?

Marc Parent

The thing I would tell you is no. Bo, because airlines are scrambling to meet the demand that they see out there. Now, I mean, the impact is real. I mean, the impact of the engine issue that you talked about is real. You can’t have hundreds of airplanes grounded at any given time with not having some effect. So we're watching that.

I would tell you it hasn't affected our business. The airlines that we operate with it, which is a great majority of airlines in the world, but -- are scrambling be able to get alternate lift, whether it be keeping older airplanes on station rather than new ones, leasing -- leasing O1s (ph) that kind of thing.

So we're watching that. We're also watching the delivery delays, specifically, because the math is simple. Right? I mean, we've talked about it many times before. But for every, about, 30 narrow body deliveries that -- because it's a regulated market, it fills up one simulator worth of demand.

So clearly, if this was to go on for a long, long time, then that would have an effect. But for now, based on the discussions that we have with customers, there's still a lot of unmet demand in this market. And you can just see it, with regards, again, to the order intake this quarter. I mean, we're talking about a very strong book-to-bill, on top of 20% growth in revenue.

And what you see there is a testimony to our success in more outsourcings. I'm very, very happy to join another marquee customer like Air France KLM, which historically has not outsourced, outsourcing a portion of their training requirements to us. The growth we have is very large contracts in business aviation.

So, look, to me, we're seeing no -- we're basically seeing those softening in demand. And going back to your question, the conversations with -- that we have with airlines and business aviation customers are essentially like the one I just described.

Konark Gupta

Okay. That's god (inaudible). Thanks for the time, again.

Operator

Our next question comes from Benoit Poirier with Desjardins Capital Markets. Please proceed.

Benoit Poirier

Yes, thanks, very much. And good afternoon. Just to come back on the defense margin, if we strip out the 200 bps impact from the legacy contracts, it implies that the base is running at around 6.4%, which is, obviously, far from double-digit level. So could you maybe give us more color on actions to be taken to bring the base to double-digit? Is it related to delays in funding? Is it a matter of scale, revenue loss, since the acquisition of L3 or higher bidding costs these days to support the high bidding environment?

Sonya Branco

Yes, Benoit. So a couple of points there. So first, on your point of the 200 basis points, as I mentioned earlier on the call, there is a 200 basis points, as a reflection of the impact of those legacy contracts. But there's also the impact of the under absorption that we should consider. So these are the costs needed to achieve scale and support the business, like R&D and SG&A. So that could be another, up to 100 basis points. So I use that basis, the 200 as a -- 300, in total.

In addition, as we've mentioned in the past, the delay of the ramp up of new, expected orders, and especially the transformational ones, because they move the needle. So as these start to come in and start to really reflect through the revenues that we spoke to it last quarter, it was 3%. It's really still minimal representation in the revenue, but 20% of backlog. So as these start to ramp up more materially, that's -- we expect that to step up and drive a meaningful impact.

Benoit Porier

Okay. And what is the strategy within defense business now to ensure that you don't run into contract issues like this in the future?

Marc Parent

Well, I can tell you, Benoit, there's a lot of tuition value to what we've lived this in the last three years. So there's a lot. But -- and they're well implemented. I think the first thing -- and foremost, which is obvious, and we have a lot of commonality with our peers in the defense industry, across the board here, is we're certainly not getting into firm, fixed price development contracts.

Because in a lot of cases, that's what got us into the situation in the first place, where you have development contracts, that again, fixed, firm price, you incur delays because of, well, first, we went through COVID, with everything that goes along with that, with regards to part shortages, with manpower shortages, on top of everything escalating, basically compound escalation, with regard to the inflationary environment, where we have no protection. So those are some of the things that obviously, we're not doing.

There's other things that we're doing, like, for example, making sure that we band the service contracts, establishing the tighter pricing bands, so -- on utilization, so we don't get caught out that, if the customer uses more or less of the demand, that we somehow are disproportionately affected. I would tell you there's a number of things. But that's what we're doing -- and a very tight monitoring of execution at all levels.

Benoit Poirier

Okay. And just looking at the civil margins -- you reached 20% EBIT margin this quarter, which is a step down versus to the 25.4% achieved a year ago, despite having stronger revenue, greater utilization rate. Could you please let us know what drove that, and what makes you confident to achieve the implied 26% plus EBIT margin in Q4, in order to reach the mid-double-digit growth for the year?

Marc Parent

Okay, I'll step right up to say, I didn't tell you 26. You said that. But hey, okay, we said you can do the math. But look, I think, if you go back to what I think what I said to -- in the last conference call, in the last quarter, I tried to point to that. So I would tell you that margins, as I said, are there -- where we expected them to be. And I'll give you some of the components here. A very -- there's -- mix is very much at play here. And we talked about mix before. And yes, this mix looks kind of high. And you don't -- on the face of it, it is high.

But I would point to last year, in Q3, the mix was very favorable, from a couple of perspective. It was from our products business, and it's also what -- from, kind of the new segment that we have, but in other segments, and in part of our civil, which is our software business, because last year, we had a lot of what we called very favorable, on-premise work. And I'll tell you what we mean by that. And -- in our software business, we are actively, as a strategy, going to -- winning contracts, we're trying to move customers from on-premise work to software-as-a-service.

So let me make you an analogy on that. If I was to say on-premise work, it would be like us, in the core business, to sell simulators. You sell a simulator, you get the revenue, you get the contract, literally very fast. Now contrast that with the training market -- going through a software-as-a-service is kind of like we're doing a training, where basically we're going to get paid over time. So, from a much better recurring standpoint, much more longer term, very attractive work, but obviously, it's not going to give you a big SOI bump in one quarter. That's what we see.

And when we look at the upcoming quarter, in Q4, we expect that kind of -- that particular dynamic to be very favorable again. And that's really coupled with a number of simulators we deliver, and utilization in our training centers. That's why we're basically saying we expect a strong Q4, reflecting in the heightened guidance that we gave for civil last quarter.

Benoit Poirier

Okay. And maybe last one for me. If we look at air center, it looks like that there is about $1 million of integration and acquisition costs taken so far. Obviously, the valuation multiple was very attractive, and you knew that it would be a two- or three-year journey. You just mentioned that the IT infrastructure integration will be substantially complete by mid-fiscal year '25. So I'm just wondering if you could give an update on the remaining costs to be taken, and how much the air center could be incremental, in terms of margin and whether it's meeting the -- any color about the return on capital employed, specifically, so far? Thanks.

Sonya Branco

Yes, Benoit, so we continued integration of our customers on our systems to our network. And as I mentioned in the remarks, we expect to be done by mid next year. So there's really good, great ramp-up of migrating our customers out of the previous network and to our network. And so great progress done last quarter. And we expect a lot of great progress this quarter, as well. While we won't necessarily kind of give an outlook on the cost, we expect that to be pretty much finished during -- in the next -- first half of next year.

Benoit Poirier

Okay. Thank you very much for the time.

Operator

Our next question comes from Tim James with TD Cowen. Please proceed.

Tim James

Thanks very much. Good afternoon. Most of my questions have been answered. But just maybe one quick one for Sonya, just looking at some detail here. The depreciation expense in the civil business jumped surprisingly significant amount in the quarter, relative to the second quarter. I'm looking at, in particular, just the sequential change. Is there any particular reason for that? Is this new, or the report of the Q3 rate a good proxy going forward?

Sonya Branco

Well, I think the headline is growth. Right? So we deployed 20 plus simulators last year, 13 year-to-date this year, and we've onboarded several training centers, whether it's Las Vegas, Savannah came online this quarter. We have another extension of our Phoenix training center that came online also this quarter. So you'll see that driving that depreciation expense and some of the interest that I spoke to on the lease liability. It's really deployment of new simulators and new training centers.

Tim James

Okay. So it is just a natural step-up, then, in relation to the assets in the business?

Sonya Branco

Yes.

Tim James

Great. Thank you, very much.

Operator

Our next question comes from Kristine Liwag with Morgan Stanley. Please proceed.

Kristine Liwag

Hey, good afternoon, everyone. Marc, you just reiterated the margins for the next quarter. I mean, it seems like for 4Q '24, to get to your guidance, that implies about 16% revenue growth for the quarter, year-over-year, and margins a little bit north of 26%. So with all the mixed headwinds that you highlighted this quarter, and it seems like some of that goes away next quarter, how do we think about the run rate for fiscal year '25? Is 26% the starting point? And how do we think about that for next year?

Marc Parent

Well, I'm not going to question your math. But we've given you enough. But look, we're not guiding for 25 now. But clearly, I mean, if you look at the order intake that we have, the book-to-bill that we have, and I think you're going to continue to see strong growth.

Kristine Liwag

Okay, great. And Marc, in terms of the software business, I mean software-as-a-service, especially the Sabre, historically, would be a very accretive margin. I mean when you look out a few years, for the composition of software within civil, how large could that be?

Marc Parent

Well, boy, again, you're asking me for guidance that we're not ready to give that at this time. But obviously, we built -- we bought this business to grow it. And I've been very happy with the order intake that we've had from customers. There's a lot of interest from the airline customers. They see -- they -- and I've been quite satisfied with the assumption that we had, from day one, that people would be -- various airlines, specifically, would be very receptive for us bringing CAE's culture into this business.

And we're seeing that. I said customers that have basically moved away from legacy Sabre -- and once we bought it and with the efforts that we've had, the customer outreach, the product development we've had, the investment that we made that they've come back to us.

So look, without giving you a precise -- precision on number, I see this growing. And I see that -- a very strong interest in us delivering what we call our next-gen solution, which is software-as-a-service. And that's going to be pretty good for recurring revenue, going forward. Obviously, we've got to get through the time it takes to move to on-premise, to a software-as-a-service. And there's a lot of history from other companies to do that. But suffice it to say that I'm very optimistic.

Kristine Liwag

Great. Thank you.

Operator

Our next question comes from Anthony Valentini with Goldman Sachs. Please proceed.

Anthony Valentini

Hey, guys, you got Anthony on for Noah today. Thanks so much for taking my question. So I just wanted to ask on the defense business. We're hearing from a lot of the U.S. defense primes that they're shifting their strategy, in terms of how they are bidding on contracts, getting away from fixed price and going more towards cost plus. Is that something that you guys are also implementing into your strategy? Can you just talk about that a little bit?

Marc Parent

Absolutely, absolutely. I mean, look, the impact that we've had on fixed, firm price contracts, that are development type contracts, going through the period that we've had through COVID has been very, very detrimental and impactful, and we see them in our results. And we're going to see them, as we talked about, in these legacy contracts.

Now having said that, we're going to work with our customers all the time. So, although, we might not do that, we're going to be imaginative, and working with our customers. To give you an example, that -- in some cases, and we have entered into new contracts, where the government, specifically, has said, okay, we agree that -- with you that we don't necessarily have to take the costs, which have a lot of inflation relative to do them, and consider them as pass-through contracts.

So basically, the cost will be what the cost will be. So yes, I think we are basically -- we're impacted by the same thing that a lot of our legacy peers are across the industry. And I think we're taking the same kind of actions.

Anthony Valentini

Okay. That’s helpful. As a follow-up there, Sonya, you had mentioned 200 basis points of -- basically like a drag from these challenged programs, and then another 100 basis points of, like the overhead absorption. So if I just kind of use those numbers, that implies something like a 7.5% margin, what's remaining that's going to drive this business to get to those double-digit percentages that you guys have historically talked about?

Sonya Branco

As I mentioned, it's really the ramp-up of the new contracts that we've signed, and especially those transformational ones. They're large in size, accretive, and they will have a meaningful impact on the margin, as they ramp up. They're really nominal right now, in terms of our revenues. And so as those ramp up, they'll have a more meaningful impact.

Anthony Valentini

Okay. Thanks so much, guys. Appreciate the time.

Operator

Our next question comes from Jordan Leone (ph) with Bank of America. Please proceed.

Jordan Lyonnais

Hey, good afternoon. Thanks for taking the question. So just, hopefully, a final one on defense margins -- with the double-digit target, how confident are you in that timeline being 2025, where you start to see that accretion from new contracts, if we still continue to operate under a continuing resolution for this year? And how much downside risk do you guys look at, if we go through a sequestration?

Marc Parent

Let me just start it off. Look, again, as I said, what we're talking about this quarter is no different than what we've been talking about in -- certainly in the previous quarter, where we moved -- we've already admitted moved things out. What we're giving today is more precision, specific on these legacy contracts, to give you an idea of what this represents by itself, and also to give you a feeling that we're quite confident in the core of this business.

This is a strong business that -- we're working through these legacy contracts. So if I try to, maybe give you a little bit more color specific to the question, there continues to be two pieces here -- the growth in the core business, which I feel is very strong, and which is influenced by the ramp-up in the transformative new business that we've talked about, the 20% growth in the backlog that we've had in the last couple of years, at the same time, as the retirement of these legacy contracts, which drag against the overall margin.

So we clearly see, as we said even before that, there's going to be an inflation where these two curves meet. And what we still predict, is that's going to happen in the latter half of next year. There's no change there. But I think it may happen -- I think maybe where we're giving you a little bit more precision, is actual drag impact in this quarter, and introducing the fact that this isn't going to be linear.

There's going to be variability, because of the specific actions that we are taking to retire risk, or depending on the timing of the requirement at risk, and our efforts to retire them as quick as possible is going to affect that. But the trend line driving inflection is -- the one we've been talking to is very much intact.

Jordan Lyonnais

Great. Thank you.

Operator

Our next question comes from Fai Lee with Odlum Brown. Please proceed.

Fai Lee

Thank you. Thanks for taking my questions. Marc, your three-year EPS compound gross rate target hasn't changed from the mid-20% range. And I know you don't really want to talk about the 2025 guidance, since you haven't provided it. But that target implies pretty strong growth next fiscal year. And I'm just wanted to get a sense of how you see that target right now, in terms of whether it's a stretch or do you think you're pretty confident that you'll achieve it. Can you just maybe comment around that?

Marc Parent

Well, look, I'm going to turn it over to Sonya. And I think she answered that question, I think a little bit, a while ago. But look, it's going to -- the bottom line is just -- we're not ready to give that guidance right now. We give it at the same time every year. That's going to be next quarter. But -- and clearly, it's going to be some dependency on the timing of the risk retirement defense, and the pace of new programs are ramping up that -- when we actually sign these generational contracts, such as the one fact that I talked about.

At the same time, the outlook for Civil remains very robust. You just saw the order intake that we signed this quarter, on top of 1.3 -- over 1.3, up to 20% growth in our revenue. So I'll let that be factored. Anything you want to add this on, Sonya?

Sonya Branco

No, you covered it. And we'll provide more insight in Q4, like we usually do.

Fai Lee

Okay. And just another question on the defense outlook -- and it basically sounds like, relative to your expectations and your outlook going forward, nothing really changed from the previous quarter, yet you've provided additional guidance. The market is reacting very negatively -- or additional -- sorry, information on the legacy contracts, market is reacting very negatively around that. What's your thoughts around how the market is interpreting that additional information?

Marc Parent

Well, long ago, we stopped predicting that one. Obviously, (inaudible) run our business. And just -- I know to repeat everything I said, but I feel very confident about -- that we have a business in defense. I'll just go right to the point. This is not a business that's broken. This is a business that's growing, with contracts that are going to be accretive to the margin expectations we have. We have a lot of backlog.

And in my experience, in all my career, the one thing you want to have is backlog, because you have backlog -- as long as your backlog is profitable -- and it is profitable. It's profitable to the aims that we have. We're attacking very specific contracts here, that are all very similar. Although the contracts themselves are different, they all point to the same kind of thing, pre-COVID, fixed-firm price.

And we're attacking them with laser focus, with dedicated tire (ph) teams, while at the same time not keep getting -- keep our eye off the ball of the hundreds of other contracts that we execute in defense, at any given time, make sure we continue to execute those on plan, which we fully expect to do. So with all that, that basically forms my confidence in the defense business, albeit we are where we are.

Fai Lee

Okay. Thank you.

Operator

There are no more questions at this time.

Andrew Arnovitz

Operator, thank you. Given that we're on the hour, I'd like now to open the lines to members of the media, should there be anyone with questions for Marc or Sonya.

Operator

As a reminder, to register a question, please press the 1 4 on your telephone. We have a question from Stephane Rolland from La Presse Canadienne. Please proceed.

Stephane Rolland

Oui, bonjour Monsieur Parent. Merci de prendre mes questions. Vous allez bien?

Marc Parent

Oui, plaisir.

Stephane Rolland

J'ai écouté l'appel mais on enregistre pour nos clients. Peut-être m'expliquer un peu en français les difficultés que vous vivez présentement avec le segment de la défense?

Marc Parent

Ok, merci de la question. Si on regarde au sein du secteur Défense, nous avons huit anciens contrats distincts qui ont été conclus avant la pandémie de COVID-19 ayant une structure de contrat à prix ferme fixe, avec peu ou pas de disposition pour les hausses de coûts, et qui ont été plus lourdement touchés par des difficultés d'exécution et le contexte économique. Bien qu'ils ne représentent qu'une petite partie des activités actuelles, ces contrats ont eu un impact disproportionné sur la rentabilité globale du secteur Défense. Donc, évidemment, on accorde une très grande priorité à l'exécution et le retrait de ces anciens contrats là et la réduction de la pression sur les coûts qui sont reliés à ceci. C'est vraiment ça les enjeux que l'on voit dans la défense en ce moment.

Stephane Rolland

Justement, vous avez parlé d'accélérer la fin de ces contrats-là, comment vous allez vous y prendre et est-ce que cela veut dire qu'on pourrait voir des pénalités un peu plus tôt pour vous libérer plus tard? Just m'expliquez un peu ce que vous comptez faire de côté-là?

Marc Parent

On déploie plus qu'une stratégie pour pouvoir réduire nos risques financiers le plus vite possible. Dans certains des cas, on pourrait envisager différemment terminer le contrat plus tôt ou plus tard, parce que cela dépend des contrats et ils ont différents enjeux. Ce qui voudrait dire que dans certains cas, on pourrait, pour retourner à votre question, on pourrait avoir des enjeux où pourrait avoir des pénalités. Mai si on aurait des pénalités, ça serait un choix qu'on ferait qui ferait en sorte que payer la pénalité est moins que de continuer d'exécuter le contrat et d'encourir des coûts et des risques supérieurs. Il y a un bémol que je mettrais là-dessus : jamais on n'arrêterait de livrer à nos clients, que cela soit de produits ou des services parce qu'évidemment, on a une mission essentielle en défense et à CAE, évidemment, qu'on n'abandonne jamais. Alors, ça ce n'est pas un enjeu qu'on ferait.

Stephane Rolland

Et peut-être une question plus technique pour vous pour votre cheffe de finances. Vous avez parlé d'un impact sur les marges de 200 points de base. Au cours de l'appel, on parlait que cela pourrait allez jusqu'à 300 points de base en tenant compte de certains éléments. Pouvez-vous juste m'expliquer un peu la nuance?

Sonya Branco

Oui, donc le 200 de points de base, c'est l'impact des 8 contrats. L'autre 100 points de base est si on incorpore l'impact de l'absorption des coûts un peu plus fixes, comme les investissements, les coûts de vente etc. et d'administration. Donc, cela implique toujours un coût d'absorption.

Stephane Rolland

Ces 100 points de base là, c'est par rapport au 8 contrats ou c'est quelque chose pour l'ensemble du groupe défense? C'est ça que je n'ai pas tout à fait compris.

Sonya Branco

Non, ça serait l'impact des 8 contrats sur l'absorption. Donc, ces 8 contrats, c'est qu'on prend les coûts directs sur la marge et cette allocation d'absorption aurait un impact total de 300 points de base de ces 8 contrats.

Stephane Rolland

Ok, parfait. Ça conclu les questions que j'avais pour vous. Merci beaucoup de prendre le temps d'y répondre. C'est toujours apprécié. Merci.

Andrew Arnovitz

Operator, if that's all the questions we have, I want to close the call here, and thank all participants on today's call, and remind you that a transcript will be available shortly on CAE's website.

J'aimerais remercier tous les participants à l'appel d'aujourd'hui, et vous rappeler qu'une transcription sera disponible sous peu sur le site Web de CAE.

Operator

Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your line. Thank you.