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AIR.N - Q2 2023 AAR Corp Earnings Call

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CORPORATE PARTICIPANTS

John McClain Holmes *AAR Corp. - CEO, President & Director*

Sean M. Gillen *AAR Corp. - VP & CFO*

CONFERENCE CALL PARTICIPANTS

Joshua Ward Sullivan *The Benchmark Company, LLC, Research Division - MD & Senior Equity Research Analyst*

Kenneth George Herbert *RBC Capital Markets, Research Division - Analyst*

Michael Frank Ciarmoli *Truist Securities, Inc., Research Division - Research Analyst*

PRESENTATION

Operator

Good afternoon, everyone, and welcome to AAR's Fiscal 2023 Second Quarter Earnings Call. We're joined today by John Holmes, President and Chief Executive Officer; and Sean Gillen, Chief Financial Officer.

Before we begin, I would like to remind you that the comments made during the call may include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from the forward-looking statements.

Accordingly, these statements are no guarantee of future performance. These risks and uncertainties are discussed in the company's earnings release and the Risk Factors sections of the company's Form 10-K for the fiscal year ended May 31, 2022, and Form 10-Q for the fiscal quarter ended August 31, 2022. In providing the forward-looking statements, the company assumes no obligation to provide updates to reflect future circumstances or anticipated or unanticipated events.

Certain non-GAAP financial information will be discussed on the call today. A reconciliation of these non-GAAP measures to the most comparable GAAP measures is set forth in the company's earnings release.

At this time, I would like to turn the call over to AAR's President and CEO, John Holmes.

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Great. Thank you, and good afternoon, everybody. I appreciate you joining us today to discuss our second quarter fiscal year 2023 results.

Sales for the quarter were up 8% from $437 million in the prior year quarter to $470 million and adjusted diluted earnings per share from continuing operations were up 30% from $0.53 per share to $0.69 per share. Our sales to commercial customers increased 21% and our sales to government and defense customers decreased 12%. Sequentially, sales to commercial customers increased [6%] and sales to government customers increased 3%.

I'm pleased that we continue to see progress in the recovery of our commercial volumes, notwithstanding the fact that global flights are still down approximately 20% from 2019 levels. In particular, in our Parts activities, we saw sequential improvement in the demand for both USM and new parts distribution. While this is encouraging, we have been more encouraged by the opportunity for further improvement as the volume in these activities is still down over 20% from our FY '20 levels. On top of this, we expect the full ramp-up of our new distribution agreements and the increased adoption of USM to provide growth opportunities beyond the market recovery.

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In MRO, we were able to generate sequential growth driven by facility optimization and growth in the non-hanger portions of our MRO operations. Our government sales continue to reflect the prior wind-down of certain programs, including Afghanistan, and I'm pleased that we returned to sequential growth this quarter.

With respect to margins, we delivered another strong quarter as our operating margin was 7.6% on an adjusted basis, up from 6.1% last year and 6.9% last quarter. This reflects our commitment to cost discipline, a mix shift towards parts, which is our highest margin activity, and outperformance on certain programs.

We do continue to experience labor market tightness, but that appears to be stabilizing and the programs that we established years ago to create a proprietary set of labor pipelines continue to serve us well. In addition, we are engaging with our customers regarding price increases for calendar year 2023 in order to address the higher labor costs we are experiencing.

As we indicated during last quarter's call, we had compelling opportunities during the quarter to invest in new long-term business and in attractive USM assets. These investments totaled approximately $60 million in the quarter, which drove a use of cash and operating activities from continuing operations of $46 million. We also repurchased $28 million of stock in the quarter under our share repurchase program. Even after the investments and the share repurchase, our net leverage was 0.9x EBITDA, and we continue to have significant balance sheet strength and flexibility.

Among the investments in new business or new long-term business that we announced during the quarter was the expansion of our distribution relationship with Unison. This significant new agreement broadens our long-term distribution of select units and igniter plugs, ignition leads, harnesses and related spare parts to now cover all aftermarket customers worldwide.

Also during the quarter, we announced a new multiyear flight hour component support agreement with flydubai, which expands our support to include the new additional aircraft in flydubai's growing fleet of 737 MAX aircraft.

Finally, we signed a new Airinmar agreement with Philippines-based low-cost carrier, Cebu Pacific to provide a full suite of services covering both aircraft, warranty management and value engineering.

Before I turn it over to Sean, I would like to comment on the inclusion in the DoD's FY '23 National Defense Authorization Act of a provision stating that the Navy and Air Force will implement processes and procedures for acquiring used serviceable material to support their commercial derivative aircraft and engines.

Historically, the U.S. government has acquired mainly new aircraft and new aircraft parts. This legislation institutionalizes the process for the DoD to consider the use of USM as a better value solution whenever it's available and is an initial step in the unlocking of a significant untapped market for our used parts offerings. Over the years, we have found great partners in Congress on a variety of initiatives, and I would like to thank them for their work on this important opportunity to drive taxpayer value.

With that, I'll turn it over to our CFO, Sean Gillen, to discuss the results in more detail.

Sean M. Gillen - *AAR Corp. - VP & CFO*

Thanks, John. Our sales in the quarter of $469.8 million were up 7.6% or $33.2 million year-over-year. Our commercial sales were up 21%, while our government sales were down 11.7% due to the completion of certain government programs, including our Afghanistan contracts. Sequentially, our commercial sales were up 6.2% and our government sales were up 3.5%.

Gross profit margin in the quarter was 18.3% versus 18% in the prior year quarter and adjusted gross profit margin was 18.8% versus 16.7% in the prior year quarter. Gross profit margin in our commercial business was 18.4% and gross profit margin in our government business was 18%.

The increased margins in the quarter reflect continued strong performance in our parts supply and MRO activities as well as favorable cost performance on certain commercial and government contracts driving higher contract profitability in the period.

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SG&A expenses in the quarter were $52.8 million. This figure includes continuing investments in our digital initiatives as well as $1.1 million related to investigation and remediation business.

Net interest expense for the quarter was $2 million compared to $0.4 million last year, driven by higher interest rates and borrowings. As John indicated, cash used in operating activities from continuing operations was $45.9 million, driven by investment in new long-term business wins and the acquisition of inventory to support our USM activities.

In addition, we bought back approximately 700,000 shares or $28.2 million, which is higher than prior quarters as we took advantage of favorable market dynamics in our open window. We have the balance sheet strength to continue to invest in our business as well as to continue to execute on our share repurchase program on which we have $57.6 million of authorization remaining.

We ended the quarter with net debt of $149 million and net leverage of only 0.9x. In addition, last week, we extended the maturity of our revolving credit facility for another 5 years and increased the size from $600 million to $620 million, which gives us significant liquidity. We appreciate the continued support of our bank group and executing that extension and upsizing.

Thank you for your attention, and I will now turn the call back over to John.

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Great. Thank you, Sean. Looking forward, our largest North American airline customers continue to be confident about demand resiliency and expansion. We are also encouraged by recent signs of demand improvement in Europe, and early indications are that the easing of lockdown restrictions in China, where flying activity is still down 70% from pre-COVID from 2019 levels is already leading to an increase in flight hours.

In addition, we are beginning to see signs that engine green time availability for certain carriers may be dwindling, which will lead to increased engine shop visits, which are an important source of demand for our USM parts. We've been anticipating this inflection point for some time, and we are now seeing early signs that is occurring.

With respect to our government business, we expect long-term contract and short-term procurement wins to continue to contribute for the balance of this fiscal year, leading to continued growth.

Overall, we expect sequential sales growth in Q3 to be consistent with the increase in Q2, and we expect further growth in Q4. We expect margins in Q3 to be in line with levels we have seen over the last few quarters. In the medium and the longer term, we believe that we are exceptionally well positioned for growth for several reasons.

First, commercial market conditions are favorable including strong leisure and business travel demand, the reopening of international markets following the relaxation of travel restrictions and OEM production challenges that are extending the life of the existing fleet; second, our parts volumes although recovering are still well below pre-COVID levels, and we have every reason to believe that they will not only fully recover but also grow based on increased acceptance of USM and the maturation of several recently awarded new parts distribution contracts; and third, our government programs offering is consistent with the best value commercial best practices support that the U.S. government is increasingly seeking and the new NDAA language facilitates the government's ability to act on more of our offerings.

Further, we are supplementing these growth initiatives with investments in digital efficiency, which, along with improved operating leverage and a mix shift towards parts to continue to drive margin expansion.

With that, I'll turn it over to the operator for questions.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Robert Spingar with Melius.

Unidentified Analyst

John, wanted to open with maybe a higher level industry question. But there's some discussion at the slower-than-expected OE ramp from Airbus and Boeing will drive an extended aftermarket cycle for the next couple of years. I wanted to ask your thoughts on this, John.

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Yes, we would agree with that. And we think that's one of the core favorable trends that gives us confidence in the growth we're talking about in as much as the platforms that are bread and butter for us are going to be flying longer than people anticipated originally.

Unidentified Analyst

And then you talked a little bit about USM. I was going to ask perhaps for a little bit more color on where the USM market is today? And then -- and maybe you could segue that into your comment on the NDAA and talk about your reach into military USM versus commercial where you clearly have a strong track record.

Sure. The U.S. market in general, we talked a couple of quarters ago about anticipating an inflection point in the recovery of that business, and that was related both towards the demand as well as the supply. The demand out of customers has taken a bit longer than we anticipated at that time to come back. And there have been a number of factors driving that, but most recently, what we have seen and heard from our customers is that they were still utilizing a lot of green time on engines. In other words, they had aircraft that were parked, in many cases, due to pilot shortages and then we're moving engines around to defer maintenance.

For key customers that we support, that green time is dwindling and those engines and that deferred maintenance is now coming due. And so the engine shops, for example, that we support we are seeing signs of increased demand as they look at their input schedule for 2023. So we believe that inflection point in terms of demand we're at the beginning of that.

Coupling that with surplus material availability, it has been a very tight market. We have just recently started to see things come available for certain asset types that we support. And that was one of the reasons we put out the capital this quarter was to move quickly to acquire that material. And we are seeing, even as we look into early next year, more opportunities to put capital to work to acquire materials to support that anticipated increased demand for USM.

So that's the commercial market. The government market we've had success here and there in terms of selling used material to the government. In some cases, on a small parts basis, but in other cases, in a whole aircraft basis like we did a couple of years ago with C-40s. But we haven't ever had a structural change in the law, which is what's reflected in the NDAA language that compels services like the Air Force and the Navy to consider USM.

So for commercial derivative aircraft like the C-40 of the PA, which are 737,and the C-32, which is the 757, we think this could be the starting point of meaningful opportunities for AAR. How much and how long, I think, is the question, but we're really encouraged by the fact that, that language is now part of the NDAA.

Okay. And then, Sean, if you're able to, can you parse out the 21% commercial aero growth in the quarter across the sub business lines?

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Sean M. Gillen - *AAR Corp. - VP & CFO*

Yes. I think 21% really across all commercial activity that say we saw outsized performance in our distribution business, which reflects some of the new business wins over the last several years. And then also within our commercial PVH, which is a flight hour driven a little bit more international than some of our other commercial activities, we saw improved flight hour activity, which drove that top line. But strength across all commercial that highlight those two is driving some of the outperformance.

Unidentified Analyst

Okay. And then just how do you expect with maybe continued investment in distribution, how should we think about cash flow in the second half of the fiscal year?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Yes. I think if you look at our cash performance over the last 8 or 9 quarters, we're really proud of the cash that we've generated. And obviously, that's reflected by the low leverage ratio on the balance sheet. The inventory positions we had have been a source of cash. But as we look forward, we would expect to be more in investing mode in the back half of this year the way we were in the second quarter.

Operator

Our next question comes from the line of Ken Herbert with RBC.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

John, I just wanted to start out maybe on the usage of working capital this quarter. Can you parse out maybe how much of that was for maybe to support distribution agreements versus assets on the USM side. And on the USM side, guessing it's maybe more engines versus other systems. What are you seeing in terms of pricing? Are you seeing a significant uptake in what you're having to pay to acquire the assets just considering the tight supply? How should we think about that?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Yes. As the -- so the first part is the capital breaks down, it was slightly more towards the USM side. If we think about the 2 areas, USM and new parts distribution agreements, we're skewed slightly more towards USM but fairly equal between the two. And then on -- and then on the new parts [distribution] agreements, I mean those are our initial provisioning inventory buys that go on with these contracts when we take them on. And obviously, we worked down those positions over time as the contracts mature.

As it relates to pricing in USM, I wouldn't want to get into that, in particular, for competitive reasons, but it remains a tight market, and we're able to achieve the right spreads between the prices that we pay for material and the prices at which we sell material. So we're kind of market in, market out as it relates to these USM buys.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

Okay. That's helpful. And as we think about moving forward, you've obviously been extending some agreements like with Unison. It seems like you're bringing in some new OEM customers. What's the landscape like for additional OEM partners as you think about incremental distribution agreements. It sounds like there's more out there considering your comments regarding sort of cash usage in the second half of the fiscal year?

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John McClain Holmes - *AAR Corp. - CEO, President & Director*

Yes. We see a lot of opportunity in distribution. We see opportunity to expand agreements with our partners like Unison, and we're real proud of that expansion. It's a big one for us, and that's a 10-year-old relationship, and we're still finding more things to do with them. And we have a number of other long-term OEM relationships that are in the same category where there's opportunities to expand as they rethink their approach to aftermarket coming out of COVID.

And then there's new areas. The -- we've got an agreement with Leach that we announced that we expanded. That's a new market for us. That's electronics distribution. So we're selling piece parts into production line. So that's a new market for us and Leach is the launch deal there, which we've extended and we see more opportunity in that market.

There's also opportunities in the BAGA market. Obviously, a lot of interest in BA coming out of COVID that's been a very strong market in general, and we think that our way to participate in that market is through distribution. And so that, again, would be a new focus for us, but a number of OEMs that we're talking to have interest in leveraging our distribution network.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

Okay. Very helpful. And you've often talked in the past about sort of seeing a step change ideally in aviation margins. As you start to see the recovery in the parts business, specifically, I guess, surplus material being one of the higher margin pieces of the business. How do we -- how should we think about margins in that segment in the second half as you're starting to see this acceleration in some of the agreements here and obviously availability of USM and increasing demand?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Yes. I think margins in general, we had a very strong quarter this quarter. I think margins in general in Q3 from the immediate term would be consistent with the last few quarters that we've delivered. And again, you've seen some pretty consistent performance there. That's in the immediate term.

Beyond that, to your point, as the mix continues to shift towards parts as we recover and grow in that business and we start to get some efficiencies in MRO as a result of some of these digital initiatives, in particular, that we've been investing in, we would expect continued expansion beyond that kind of 7% level as those things take hold over the medium and the long term.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

Okay. Helpful. And just one final question. In the past, I know you've got a cost reduction effort going on. In the past, I think you had a target of sort of getting SG&A down to 10% or under of sales. And I know it's not something you've talked about recently. But how do you think about the cost opportunities moving forward? Is it on the SG&A line? Is it other parts of the business? Where should we look for you to sort of have more cost opportunity over the next few quarters and into fiscal '24?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Yes. Great. Great question. We see -- so first of all, getting to that 10% or below SG&A as a percent of sales is still a goal. We believe that a more significant contributor towards reaching that goal will be the recovery in the top line. We took a lot of costs out there in COVID as you know, made a lot of structural changes to the business. And our focus right now is just staying disciplined in terms of preserving those changes as we grow.

So as top line continues to recover, we expect that percentage to come down. The other thing I would point out is we are making investments, particularly in the digital area that we do expense and so they flow through those lines. Those investments are very much -- we're in the thick of

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those right now, but they're projects. They've got a beginning in the middle of an end. And as we wrap up those projects, we would expect those expenses to come down and the efficiency as a result of those projects to start to kick in.

Operator

Our next question comes from the line of Ciarmoli.

Maybe just on that SG&A, I think you were up about maybe 5% or so, almost $3 million sequentially. Was there anything specifically that drove that in the quarter? Or was that kind of all part of the digital investment and expensing some of those items you were just talking about?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

It's predominantly that. It's predominantly that. I mean, we have, in certain areas, we've seen people costs go up as well. And so that's contributing to it. And that some of the relief ultimately, we hope to get through some price adjustments to offset that, but it's those investments in those projects and then certain labor costs that are flowing through that line.

Michael Frank Ciarmoli - *Truist Securities, Inc., Research Division - Research Analyst*

Got it. Got it. And then maybe just back to kind of Rob's first question on kind of the -- just the more broader trends in the aftermarket. Is there any validity to maybe the thought that we could see a low in aftermarket activity when we look at claims coming off warranty? I mean, if we go back to the 2018 period, planes coming off. There's obviously going to be this period where we have fewer new planes coming off the assembly line, maybe those first-time shop visits. I mean, is that something you guys are looking at as you get out into '23 and '24? How that dynamic plays out?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

I think that's definitely a dynamic to pay attention to. However, from where we sit, the more powerful dynamic is the extension of the current fleet as a result of those production delays.

Michael Frank Ciarmoli - *Truist Securities, Inc., Research Division - Research Analyst*

Yes. Okay. Okay. Got it. Last one I had, Sean, just the government looks to be trending down. I guess it will be maybe 15%, 17% in terms of revenue for the year. Is that kind of the right expectation? Or are there any new wins or things ramping up that might create a little bit of an inflection here?

Sean M. Gillen - *AAR Corp. - VP & CFO*

Yes. I think we saw some modest sequential growth from Q1 to Q2. And as John mentioned in his cost, I think we'd expect to see a little bit of that modest growth continue over the balance of the year as some of the longer-term contracts that are replenishing things that had ended as well as some more short-term procurement activity for the government will show up in the results over the second half.

Operator

Our next question comes from the line of Josh Sullivan with Benchmark.

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Joshua Ward Sullivan - *The Benchmark Company, LLC, Research Division - MD & Senior Equity Research Analyst*

On the green time availability comment, how are you measuring that? Or maybe what metrics are you tracking to give you so much confidence that we're hitting this critical crossover?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

It's really driven by the key customers that we support and their shop input schedule as they look over the next 6 to 12 months. So you haven't seen the engine overhauls come through in a way that we expect to see them now based on what we're talking -- or based on what we're hearing from our customers. So shop inputs would be the key metric.

Joshua Ward Sullivan - *The Benchmark Company, LLC, Research Division - MD & Senior Equity Research Analyst*

Got it. And then just on the labor kind of question, how are airlines looking at their internal labor availability or cost versus the outsourcing option to air? Does it take -- excuse me, does the tight labor market help the outsourcing dynamic for you?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

I think it's a challenge for everybody. So I think it's really a level playing field. So I don't know that it necessarily changes the calculus at the airlines in terms of whether to bring in work or outsource work. I think that's a relatively stable relationship. So our discussions are all positive in terms of the amount of work that they -- would like to continue to outsource to companies like ours.

Joshua Ward Sullivan - *The Benchmark Company, LLC, Research Division - MD & Senior Equity Research Analyst*

Got it. And then just one last one. As we exit COVID here into change markets, you're making the digital investments, you're reestablishing some relationships with fly-to-buy and others. But what do you think the long-term kind of strategic vision or positioning is for Air? It's been a while since we had an Investor Day. Do you see any changing in that positioning? Or just curious kind of on the longer-term outlook.

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Well, I think, first of all, we anticipate now that we can all be together again, we do anticipate getting back at a regular cadence with Investor Day this next year. So we're looking forward to that opportunity. But as it relates to the overall strategy, certainly, we want to wait until we have an opportunity to discuss that more fully. But as you can tell, I mean, we remain very focused on building out our parts capability. We're having a lot of success there both on the USM and on the new parts distribution side.

Our MRO portfolio is operating at a level of efficiency that we hadn't experienced prior to COVID, so we want to make sure that we preserve that, and in areas where we can expand MRO where we have long-term customer interest and long-term access to labor, we expect to do that and look for ways to grow in that business.

You mentioned digital, digital, there's elements that benefit us internally from efficiency, but then also digital offerings like Airinmar and AIRVOLUTION that drive new sources of revenue for us. And then we continue to look at ways to bring areas of IP, whether it's through PMA parts or DER repairs into the portfolio to drive continued margin improvement.

And finally, we remain in a very strong position with the U.S. government. We've really built a meaningful portfolio of past performance that allows us to bid on a variety of contracts. We've got a very strong pipeline of bids there and work as well as bids that are with the government right now. And so we feel very good position to continue to be successful as a prime contractor there.

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Operator

We have a follow-up question from the line of Ken Herbert with RBC.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

John, it sounds like you've got a pretty significant set of organic investment opportunities as you think about USM, distribution and other areas and what you just went through. Should we assume that M&A or meaningful M&A is off the table? Or how should we think about that in terms of capital allocation?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

No, great question. And no, I certainly would not want to suggest that M&A is off the table. Our framework for capital allocation is organic investment first, inorganic investment M&A second and then returning capital to shareholders. And the balance sheet remains very strong. We're still less than 1x levered. So we believe we've got the opportunity to deploy capital in the first area, organic investment but then also keep options open for M&A. And there are a number of companies out there that could be very interesting to us. Some are new, some we've been following for years. And to the extent that we find an opportunity where evaluation and our strategy align, we absolutely would pursue M&A.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

Okay. And just finally, you did just call out PMA again. You haven't been talking about PMA as much recently, and I know it had been sort of identified as a growth opportunity in the past. It seems like through your distribution agreements and everything else, you were becoming maybe a little bit more OEM aligned with the business strategy. Is PMA something, I think, that's still seriously in the mix? Or how do we think about that in terms of priorities for you?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Yes, I think it's very much in the mix. And it's a big world out there, and we do see opportunities on a selective basis where we would not, in any way, be in conflict with our OEM partners to pursue PMA. We have an internal effort underway. It's very small. I was actually visiting the team a couple of weeks ago, and there are some really exciting things that they're working on. But it's relative to the total of AAR, it's a small operation. But we do expect to scale it over time. It's just -- it's going to take a while. But the initiatives are around coming up with PMAs that are only available to us for use in our own repairs as well as PMAs that we could offer to third parties.

Operator

I'm not showing any further questions in the queue. I would now like to turn the call back over to management for closing remarks.

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Great. Well, we really appreciate everybody's time and interest, and I want to wish everyone a happy holiday and look forward to being back and discussing Q3. Thank you.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.

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