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EDITED TRANSCRIPT

LHX.N - Q2 2020 L3harris Technologies Inc Earnings Call

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OVERVIEW:

Co. reported 2Q20 YoverY organic revenue growth of nearly 2.5% and non-GAAP EPS of $2.83. Expects 2020 organic revenue growth to be 3-5% and non-GAAP EPS to be $11.15-11.55.

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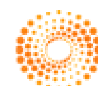

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PRESENTATION

Operator

Greetings, and welcome to the L3Harris Technologies Second Quarter Calendar Year 2020 Earnings Call. (Operator Instructions)

As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Rajeev Lalwani, Vice President, Investor Relations. Thank you. You may begin.

Rajeev Lalwani - *L3Harris Technologies, Inc. - VP*

Thank you, Michelle. Good morning, and welcome to our second quarter 2020 earnings call. On the call with me today are Bill Brown, our CEO; Chris Kubasik, our COO; and Jay Malave, our CFO.

First, a few words on forward-looking statements and non-GAAP measures. Forward-looking statements involve risks, assumptions and uncertainties that could cause actual results to differ materially. For more information, please see our press release, presentation and SEC filings. A reconciliation

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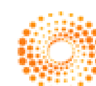

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of non-GAAP financial measures to comparable GAAP measures is included in the Investor Relations section of our website, which is l3harris.com, where a replay of this call will also be available. And to aid with year-over-year comparability following the L3Harris merger, prior year results will be on a pro forma basis.

With that, Bill, I'll turn it over to you.

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Okay. Well, thank you, Rajeev, and good morning, everyone. I want to start by thanking L3Harris employees for their hard work and dedication over the last several months. The pandemic has challenged us all to find new ways of working effectively, and our team has responded well to ensure we continue to meet the mission-critical needs of our customers, even as the virus spreads across southern states where we have a large presence. And as the environment evolves, the health and safety of our employees will remain our top priority. All of our facilities are up and running and adhering to well-established protocols such as daily health screenings, face coverings, social distancing and adjusted work schedules. Our work-from-home policy remains in place for about half our workforce, and we are prepared to operate under these conditions over the coming quarters.

We continue to pay close attention to our supply base and monitor our risk position daily, and we've successfully implemented mitigation plans where needed, including developing alternative sourcing, providing on-site assistance and working with local authorities to secure closure exemptions. In addition, we accelerated nearly $250 million in supplier payments within the quarter, and we plan to continue that support through year-end. We're also doing our fair share to support our communities, health care workers and first responders through the pandemic, and we continue to hire aggressively to meet our growth needs, adding about 300 -- 3,000 employees through June and bringing on board our largest cohort of interns and new college grads ever. Chris and Jay will walk through the details in a minute. But as you saw earlier today, we reported second quarter results with non-GAAP earnings per share of $2.83, up a solid 13% against a tough backdrop. Company margins increased 150 basis points to 18.2%, and adjusted free cash flow was $785 million, all above expectations.

Reported revenue was flat, but adjusted for divestitures, was up about 2.5%, a strong 8% growth in our core U.S. government-related businesses more than offset a modest decline on the international side and a 35% drop in our small commercial businesses, consistent with what we anticipated. Total company-funded book-to-bill was 1.09, with funded backlog growing about 5% since the beginning of the year when adjusted for divestitures. Our strategic priorities have remained the same since we closed on the merger a year ago, and we're proud that our nearly 50,000 employees quickly aligned as one operating company. And we're pleased with how well the team is executing and avoiding operational missteps despite the many moving parts. Integration continues to progress well with net synergy savings of $60 million in the quarter and $115 million year-to-date.

We have not seen a slowdown in activity due to COVID and now believe we can deliver $185 million in net savings this year, up $20 million from prior estimate, largely due to a steady ramp in savings from the supply chain, shared services and benefits. Our integration road map is very methodical and rigorous with a weekly cadence of top-down reviews, and we continue to expect to achieve $300 million in cumulative net savings in calendar '21, 1 year ahead of our original plan. We're making good progress in driving a culture of operational excellence deep into the company. And through the quarter, we continue to hold training sessions and conduct Lean assessments, quality clinics and value engineering events despite the inability to travel. As we've said before, E3 savings are additive to synergies and were a key part of the margin expansion we achieved in the quarter and year-to-date, but more importantly are essential to expanding margins beyond the integration window. Investments in technology and innovation remain at the top of our agenda and are key to long-term revenue growth.

Since the closing, we fully implemented a rigorous stage-gate process called CheckPoint and cut 30% of IRAD projects to sharpen our focus on key strategic themes around spectrum superiority, actionable intelligence and warfighter effectiveness, while positioning for the shift to an integrated network battlefield. We are investing heavily in multifunction software-defined open architecture systems that allow us to deliver mission solutions independent of the platform. These investments are evident in our increasing traction on revenue synergies. We've now been down-selected on 13 out of 23 proposals and continue to build on our multibillion-dollar pipeline. While we're still in the early innings, the collaboration we're seeing across segments is really impressive, with the process to identify new revenue synergy opportunities nearly self-sustaining.

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On portfolio reshaping, we are set to close today on the divestiture of EOTech, a small consumer-facing business, bringing total transactions to date to 4 with proceeds exceeding $1 billion. We're now about 1/3 of the way toward our bottoms-up estimate of divesting 8% to 10% of revenue, with more progress expected in the coming quarters as we increase our focus on businesses where we're best positioned to win.

And on maximizing cash generation, we delivered $785 million of free cash flow in the quarter and about $2.7 billion on an LTM basis, growth of over 20% on a per share basis. Our strong performance, along with divestiture proceeds, drove a cash balance of $2 billion at quarter end and supports our prior commitment to return capital to shareholders in the third quarter.

Longer term, we see a clear path to achieving $3 billion free cash flow in calendar '22, driven in part by continued improvement in working capital. In the quarter, we achieved another 2-day sequential improvement with solid momentum toward a calendar '22 goal of sub-50 days from 68 at merger close, adjusted for divestitures and accounting items.

Slide 4 illustrates the opportunity ahead of us. 10 businesses account for about 75% of our working capital, 6 of which have more than 75 days on hand. Driving those 6 to current company average of 55 days would generate nearly $0.5 billion of cash flow, with the largest opportunity tied to lower inventory, shorter cycle times, better forecasting, product rationalization and part commonization, vendor-managed inventory and improved supplier delivery performance. The levers are clear, we've done it before, and the team is focused and motivated to get it done.

Finally, we're all watching carefully the progress towards a '21 defense budget and signals from Congress, the Biden campaign and the Trump administration on the budget trajectory in '22 and beyond. We're encouraged by the bipartisan support in advancing the fiscal '21 National Defense Authorization Act through the House and Senate, and we believe that the heightened threat environment will drive the trajectory of U.S. military spending regardless of the election. And while we're conscious of the risks surrounding elevated deficits, we believe our technological capabilities and opportunity set position us well over the coming years. Recent House and Senate mark support this as we saw ongoing strength in areas like tactical radio, aircraft ISR, F-35 and space, and classified budgets are also well supported. So between budget positioning, revenue synergies, margin expansion potential and shareholder-friendly capital deployment, we remain confident in our ability to sustain double-digit earnings and free cash flow growth per share in the medium term.

And with that, I'll now turn it over to Chris to discuss segment results. Chris?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

Okay. Thank you, Bill, and good morning, everyone. I'd like to highlight the quarterly segment results, starting on Slide 6. Integrated Mission Systems increased revenue 7% from growth in our Electro Optical and Maritime businesses, with ISR relatively flat in the quarter but expected to pick up in the back half of the year. Operating income was up 38%, and margin expanded 370 basis points to 16.8% from integration benefits, operational excellence and cost management. Order momentum at IMS was broad-based with a funded book-to-bill above 1.0 in each business, resulting in an overall segment book-to-bill of 1.19 for the quarter and 1.12 since the merger. A highlight in recent months has been the traction we've seen in our Maritime business. In the quarter, we received an order from a classified customer for an unmanned surface vehicle. And just this month, we were selected as the prime contractor for the medium unmanned surface vehicle for the U.S. Navy. We're also in the process of finalizing our position on the U.S. Navy's frigate program as a system integrator. This initial 10-ship contract has a potential value of over $300 million. So clearly, we're seeing positive momentum in this business.

On Slide 7, Space and Airborne Systems revenue increased 4% in the quarter. Growth in Avionics from the production and modernization ramp of the F-35 and increased classified work at Intel and Cyber were partially offset by program transition timing and a tough compare in the space business. Segment operating income was up 3%, and margin contracted 20 basis points to 18.8%, as operational excellence and integration benefits were offset by program mix from increased developmental work and investments in earlier-stage technologies. Overall, funded book-to-bill was 0.94 for the quarter and just below 1 since the merger, with particular strength in space, which delivered a book-to-bill over 1.0 in the quarter.

As a reminder, in our space business, we are transitioning from a legacy exquisite payload provider to a full end-to-end systems provider for responsive satellite and ground systems. A recent launch for the U.S. Air Force demonstrated this capability. We designed, developed and built satellites within a couple of years and are now providing the tasking and the command and control for these on-orbit spacecraft. This speed to

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market is a significant differentiator compared to legacy systems to take nearly a decade to become operational. As warfighting capabilities accelerate in the space domain, we are well positioned to participate and capture new business and have a strong pipeline that exceeds $10 billion to support growth in the medium and long term.

On Slide 8, Communication Systems revenue was up about 2.5% for the quarter, as DoD tactical and Integrated Vision Systems benefited from modernization demand, both were up double digits. This strength was partially offset by international tactical radio sales timing and headwinds in our Public Safety business, both of which were down in the mid-teens, consistent with prior expectations. Segment operating income was up 11%, and margin expanded 190 basis points to 23.9% from integration benefits and cost management.

Turning to orders. DoD tactical modernization momentum continued with a $95 million award for an additional low-rate production contract on the U.S. Army's HMS Manpack program. After completion of the operational testing early next year, we anticipate a full-rate production award against the previously announced IDIQ of nearly $13 billion. This will support continued revenue growth.

Lastly, on Slide 9, Aviation Systems organic revenue decreased 7% in the quarter, with commercial aviation down about 50% due to the pandemic, in line with our expectations. This headwind was partially offset by continued growth within the classified areas at Defense Aviation Products, which was up in the mid-teens. Operating income was down 8%, primarily due to the impact of divestitures, but would have grown 4% otherwise. Margins expanded 120 basis points to 12.5% from operational efficiencies, integration benefits and cost actions, partially offset by COVID-related headwinds. Orders significantly outpaced sales, leading to a funded segment book-to-bill of 1.26 for the quarter and 1.13 since the merger. We saw considerable traction on the defense side for airborne radars, ground vehicle systems and training solutions as well as within the classified arena. One of the key wins in the quarter was a $900 million single-award IDIQ to develop and manage simulator requirements and standards across the Air Force's training portfolio. This solution will leverage open systems architecture and set common standards for the Air Force and aligns with the DoD move towards multi-domain operations and ties to the program direction of JADC2. It will also position us well for future military training offerings.

So before handing it over to Jay, I'd like to echo Bill's comments and thank our employees for their dedication, focus and hard work during the pandemic. We'll continue to prioritize your health and safety as we move forward. With that, over to you, Jay.

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Thank you, Chris, and good morning, everyone. I'll begin with a recap of second quarter results, then provide an update on the impact of COVID and then wrap up with guidance. In the quarter, organic revenue was up nearly 2.5%, as 8% growth in our U.S. government business more than offset the commercial decline. EBIT increased 9% on 18.2% margins, resulting in EPS growth of 13% or $0.32, as shown on Slide 10. Of this growth, $0.22 came from synergies; $0.15 from operations, including cost management; and $0.13 from share count, pension and other items, including divestitures; partially offset by pandemic-related headwinds of $0.18, mainly from our commercial businesses.

Free cash flow for the quarter was $785 million, and we ended the period with 55 working capital days or 2 days better sequentially after adjusting for divestitures and purchase accounting adjustments. Versus the prior year and our expectations, we benefited from accelerated customer collections and ongoing inventory management, while continuing to support our suppliers. Margins in the quarter came in at 18.2% or 150 basis points higher than last year and ahead of our internal views. Most of the expansion or 140 basis points came from the $60 million synergies drop-through. We also saw benefits from our cost management efforts and tailwinds from reduced expenses such as for travel and trade shows, along with operational efficiencies, which more than offset 60 basis points of COVID headwind. While some of the expense tailwinds are temporary, our margin performance highlights the portfolio's resiliency during a tough environment and our future earnings potential.

Next, let's turn to Slide 11 for details on the guidance outlook. Organic revenue is unchanged at up 3% to 5%, with top line trending as expected, and overall COVID impacts still sized within our prior range. For our core U.S. government business, representing about 75% of sales, we expect the 8% first half growth to carry over to the back half as well. And for our commercial aerospace businesses, which was down about 50% in the quarter, it's generally tracking to our previous forecast for the year and in line with broader industry forecasts. In Public Safety, the business was down in the mid-teens in the quarter, and we now expect that business to decline around 15% from 10% previously, reflecting the slow pace of

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new awards. On international, we're holding our flattish view for the year based on our second half visibility, with upside opportunity in ISR. So overall, relatively minor changes with a clear line of sight to our sales outlook, which is supported by a funded book-to-bill of 1.1 in the first half.

Shifting to margins. We've increased our outlook to 17.5% plus, with the plus indicating potential upside of 10 to 20 basis points versus the prior guidance of 17.5% due to performance to date, cost synergies, E3 progress and expense management. Margins stepped back in the second half versus the second quarter due to higher R&D investment as well as a placeholder for higher COVID-related mitigation costs or disruptions but still, continued margin expansion progress on the full year of nearly 100 basis points. On EPS, we're holding the full year guidance range of $11.15 to $11.55 with the contingency at the midpoint from the margin upside to account for the uncertain backdrop amid the pandemic's progression. On capital allocation, we're in a strong cash position and should remain so after completing our committed repurchases with divestiture proceeds here in the third quarter.

Beyond that, we'll continue to monitor market conditions for deployment opportunities such as capital returns and employee pension plan contributions.

Moving to free cash flow. Our guide of $2.6 billion to $2.7 billion remains intact, with similar upward pressure from earnings upside, working capital traction and lighter CapEx. Finally and briefly on the segment outlook. We've maintained our guidance for all line items, but for margins at IMS, where we see likely upside. The improvement is coming from synergy drop-through and operational excellence via E3 productivity, both year-to-date and going forward. So a great example of the merger benefits.

So to put it all together, a solid growth outlook supported by our year-to-date performance and forward visibility, with an upside bias assuming a stabilizing environment. And with that, I'll ask the operator to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Seth Seifman with JPMorgan.

Seth Michael Seifman - *JPMorgan Chase & Co, Research Division - Senior Equity Research Analyst*

Bill, you talked in the slides about the potential for cash flow growth beyond '22, and you mentioned the working capital. I just wanted to confirm, a, is that the chief source of cash flow growth in those out-years, number one? And b, are there others? And if so, kind of what are they? And if you could speak a little bit, maybe qualitatively to the magnitude and relative importance of those other drivers.

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Yes. So Seth, thanks for the question. So between now and '22 time frame, mid-single-digit plus type of revenue growth that we expect because we're seeing good visibility in the '21 budget, which we think is going to get passed some time in the next 6 months or so. Our programs are very well supported there. A lot of unspent dollars from prior years, good opportunities on revenue synergies, growth opportunities international. So we see the top line continue to improve. Margins coming up. We're doing very well at margin progression this year. Jay just talked about some of the upside drivers here in calendar '20. We see continued momentum on margins over the next couple of years. It's certainly not going to end as we get to '22. There's going to be opportunities even certainly beyond that.

Working capital is a driver. We've made great progress down 13 days since the close of 55. We see getting to about 50 days or below 50 by the time we get to calendar '22. But Seth, the way we look at this from a bottoms-up perspective, Harris was at 41. We can see our ability getting down into that 40, 41 days. So even as we had 50 days in '22 and extra 10 beyond that, it's about $350 million worth of cash, which has great opportunity to

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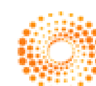

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deploy it in the near term, certainly in the next year or so towards share buyback that will reduce our share count. So overall, you put all those pieces together, we continue to see double-digit growth in free cash per share.

Operator

Our next question comes from the line of Robert Stallard with Vertical Research Partners.

Robert Alan Stallard - *Vertical Research Partners, LLC - Partner*

I think it's a question for both Bill and Chris. I mean also a lot of talk out there about what the trajectory of the DoD budget could be over the next few years. But I was wondering if both of you could maybe frame how different the merged company is today versus what you saw in the last defense downturn and how things could play out.

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Well, I mean, I'll start, and I'll let maybe Chris jump in here, Rob. So it's a great question. Look, I think part of the reason why almost 2 years ago now, Chris and I contemplating putting the company together, was really to build a more scaled mission solutions prime. And Chris talked a lot about become a sixth prime. When we sit there, in fact, when we talked about our merger back in October of 2018, we talked about our presence connecting across all domains a C4ISR powerhouse company, mission solutions prime company. And you can see based on the progression we've seen to date, clearly moving in that direction.

Certainly, as DoD moves towards connecting all of their platforms, all sensors, all shooters across all domains, I see us really being in the sweet spot of that. We won 7 IDIQs on ABMS. There's a lot of players on the team, but I think it's testament to the capability that this organization has overall in spectrum superiority, spectrum dominance across what we do in electronic warfare, waveforms, communications, ISR, all those pieces come together to help realize that vision of where the DoD needs to move to in order to fight the next fight. You can see really across all domains, the progress in space, the progress in unmanned, both airborne and maritime. So we're really, I think, realizing that vision. And I think we're a much more resilient organization today. We would have been several years ago, with a tremendous opportunity to gain share in a market that may flatten or come down over time. So I think we're just a fundamentally different position today we were a number of years ago. I don't know if you want to add on that, Chris.

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

Yes. Maybe I'll just add a little bit, Rob. We talked a lot about leveraging the scale of the enterprise. And I think in this industry, scale matters. And if you look at this new company with close to $700 million of R&D, that positions us well for these new markets and next-gen opportunities. So we're starting with a clean sheet. I believe we're pretty agile and responsive.

The National Defense Strategy talks about disaggregation. Bill mentioned autonomy and some of the capabilities we have there fit nicely with these large platforms and then the ability to connect them. And if you look at our ability to attract and hire college grads and others, there's a lot of excitement with this new company. People see that we're growing 8% in the government business. And I think we're ahead of schedule and going better than I would have expected after 13 months.

Operator

Our next question comes from the line of Carter Copeland with Melius Research.

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Carter Copeland - *Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense*

So I wondered -- or Chris, I wondered if you might tell us a little bit more about this -- the comments on trimming the IRAD pipeline or narrowing the focus of that IRAD pipeline. Just help us think through the prioritization in that thought process. Are you looking to prioritize capabilities or ROIs or customers? Any granularity you can give us on how you're thinking through that process?

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Carter, it's a great question. And really, I'm glad you asked it because I think it's a fundamental part of the value creation story that we have in front of us. We've been talking about this for a couple of years of taking, as Chris has mentioned, $700 million worth of IRAD that previously was distributed very deeply and broadly across the company, not centrally coordinated, no clear business rationale across the individual investments. And through the work that the CTO, Ross, has done here to really get at and categorize where all that money is going, we looked at it, and we saw 30% of the projects that were -- didn't have a business case or were overlapping, were duplicates. And we've provided to investors some examples of that. So it allows us to focus that firepower that's pretty potent on a smaller set of opportunities really around the areas around multi-function open systems architecture, software-defined everything. That really is the heart of what we're trying to do.

In spectrum superiority, sensing solutions delivering actionable intelligence, that's where we're really focused. And as I think about this, that is going to enable us to continue to invest in these new opportunities that we're seeing coming through in revenue synergies. We've won quite a few here. They're small today in terms of revenue impact. They'll grow over time. But the pipeline is large, it's getting bigger and really positions us in, I think, in a fundamentally different way. So when you think about value creation potential into the future for a technology company, we call it L3Harris, this is fundamental to the value creation story.

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

Yes. And I'll just chime in, Carter. I mean this is what we've been talking about for almost a year. And internally and externally, this is about optimizing the enterprise, the greater good of L3Harris versus optimizing the divisions. And this is part of the transition from more of a holding company to an operating company. And when we look at things holistically from the top down, we're able to prioritize those to get the greater growth and the greater returns. Same process applies to CapEx and everything else that Bill, Jay and I look at on a regular basis. So that's the origin of the 30% that Bill referenced.

Operator

Our next question comes from the line of Noah Poponak with Goldman Sachs.

Noah Poponak - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

I'd love to get a little more specific on the capital deployment plan and, specifically, the intent to buy back stock just given the large cash balance at the end of the quarter and how much free cash you're set to generate moving forward here and if there's going to be even more proceeds from divestitures. One, will you restart in the third quarter on an underlying basis even before the Leidos proceeds? Like are we just buying back stock again now or not? And when I add up all those pieces, it looks like you could be buying back several billion dollars a year going forward. Is that a reasonable assumption?

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Yes. So Noah, look, in Q3, we will use the proceeds we received from the sale of SDS to Leidos. So the $1 billion we closed that out in Q2, we'll deploy that back to owners as we've always said we would. In Q3, we sold an asset and we're buying back an asset, happy to be our stock. As we

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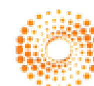

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look to the back end of the year with $1.3 billion, $1.4 billion-ish in free cash generation in the second half, we'll end the year with a pretty strong balance of cash in the $1.7 billion, $1.8 billion kind of range. So still opportunities beyond that for deployment.

As we've been talking a lot, we see that growing to $3 billion by '22. There's no debt paydown requirements at all. We'll refinance some debt, but at a 1.7 going to 1.5 leverage ratio. We've got, I think, a good leverage basis. We don't see any significant M&A on the near-term horizon. So it gives a lot of opportunity to deploy upward to $3 billion every year in free cash generation back to owners as we said we would. And that, just to remind everybody, is after significant investments in development internally, hiring people, training people, spending investment on capital; driving IRAD to close to 4%, as Chris mentioned a couple of minutes ago; significant investments inside the company, even with that give us an opportunity to deploy that cash effectively with shareowners.

Operator

Our next question comes from the line of Gautam Khanna with Cowen.

Gautam J. Khanna - *Cowen and Company, LLC, Research Division - MD & Senior Analyst*

I wanted to ask, Bill, if you could maybe numerically express the revenue synergy opportunity in some reasonable time frame. So whether it's '22 and '23, what should we be anticipating what you're going to get incrementally from some of these captures you're pursuing that combine the capabilities of L3 and Harris? And how do you see that playing out over the next 5 or 10 years? If you could just give us a quantification of it.

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Yes. So again, we won 13. It's in the tens of millions of dollars, and it's actually growing. It's -- we're seeing good traction there. It's -- you'll see it a little bit in the '20 results, will start to grow in '21, a little bit beyond that. The pipeline itself is north of $5 billion, and it's growing every time we meet with the team. And it's pretty substantial. The opportunities that we won are in the $1.5 billion to $2 billion of lifetime revenue. So I would expect -- I don't want to commit to Chris and Jay to something here, so maybe I'll let Chris jump in here. But I would expect that it will be something growing north of $100 million a year. But Chris, maybe you could...

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

Yes. No, I'll sign up to at least $100 million a year. And would you say 10 years from now? No. As Bill said, it's growing better than we expected. And we have a very strict definition of what we're calling revenue synergies. These are bids that neither company would have submitted had we not merged together. So we're getting the momentum. A lot of these are the initial wins, some from DARPA, some from Rapid Capabilities Office. And then we got to win from 4 to 2, 2 to 1, but we like the momentum. And I would expect that this will contribute to our top line growth for the foreseeable future. And we'll quantify it for you as we start to move up and get some of these wins.

Operator

Our next question comes from the line of Doug Harned with AllianceBernstein.

Douglas Stuart Harned - *Sanford C. Bernstein & Co., LLC., Research Division - SVP and Senior Analyst*

If I think back, Chris, to what L3 look like not that long ago, and you had all of -- with an 80-or-so businesses with overlapping overhead functions and the sense of need to rationalize the supply chains and facilities. And if we roll forward, where does -- where do things stand today in terms of addressing a lot of the opportunities on cost that you had before? Because I'm just -- you continue to find new cost synergies. So I'm trying to figure out what the pathway looks like in terms of the things you've gotten done, the things that are still to go here and where you can potentially be.

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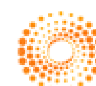

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Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

Yes. No, that's a great question, Doug. And I'd say we made really good progress in the last 13 months. But a lot of the progress we made was a result of starting early, even premerger. I'd say we're ahead of schedule on the synergies that we talked about. But everything that we've looked at shows continued margin upside and cost takeout opportunities well beyond the initial 3-year period. The facility consolidations are ongoing. Those will take the most time, as you would expect. I think we've made great progress on the supply chain. And that's just something we're going to continue to work on year after year. And also not only on the value capture, but improving the resiliency given some of the recent challenges in the COVID environment.

So if this were a baseball game, we're probably in the second or third inning, as I see it holistically and really hitting the ground running on day 1. The benefits of the HR and all those initiatives were done on the first cycle, which was pretty impressive. So I think there's a lot more to go. And we see this as part of our culture of operating excellence, and it's just going to go year after year, and I think there's a lot more to go.

Operator

Our next question comes from the line of Sheila Kahyaoglu with Jefferies.

Sheila Karin Kahyaoglu - *Jefferies LLC, Research Division - Equity Analyst*

Bill, I think you mentioned 6 businesses with high working capital, and you quantified the opportunity, which is quite big at $500 million. I'm guessing the size of these businesses might be fairly large. But is there anything structurally different about them? And how do we think about that working capital drive-down contributing to intermediate results?

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

There's nothing structurally different about them. What's happening is we're getting into a lot of detail of what's driving the working capital to be where it happens to be. And as I mentioned, a lot of it is inventory. Sometimes, inventory is north of 100 days. And it's about just prudent management, improving forecasting, improving the performance with suppliers because of lack of confidence in when a supplier is going to deliver a component drives management to increase buffer stock. It's managing better the development of new product so that you are leveraging components that exist across other products. So you reduce sort of both SKUs as well as the parts that go into the SKU. So it's really across all of those fundamental pieces.

Chris, and I and Jay have a weekly -- and just right next to our integration meetings is the focus on working capital, and we've been doing this since day 1. We've got dedicated teams focused on this. It's driven by the general managers themselves. The teams are incentivized to improve cash. We incentivize them to drive working capital. So we expect to make a big achievement in those 6 businesses, but the reality is we have 19 different sectors, all of which have opportunities to improve working capital, and we're going after every single one of them. That's what gives us confidence of taking the 55 to below 50 and hitting 40 over the next couple of years.

Operator

Our next question comes from the line of Richard Safran with Seaport Global.

Richard Tobie Safran - *Seaport Global Securities LLC, Research Division - Research Analyst*

So Bill and Chris, I thought -- I had another question on your revenue synergies. I thought you might try to explain the driver of the revenue synergies. And if they continue, why the potential is north of $5 billion and why they've come so much earlier than expected? To me, Pentagon is giving

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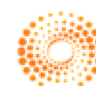

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awards to nontraditional players in major platform markets. You have SpaceX with launchers and you recently with Maritime. So is that the driver here, why you stand to benefit? Is the Pentagon looking for more competitors and bringing in nontraditional players? And I guess, is there room now for moving LHX to the next level as a sixth prime?

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

I think the DoD is looking for more competition, more company suppliers that can bring unique mission solutions that can simplify what they're doing, bring additional capability that's driven through technology investment. I think what we've proven is the ability to, a, invest the technology dollars and then find ways of delivering new capability from those investments. So I think that's clearly the direction that the DoD happens to be moving into. But I think we have just a great opportunity across our portfolio. We've had -- from day 1, people getting together in classified spaces and open spaces, sharing ideas. And when you have a good sense of what the mission need is and you put technologists in a room to try to look at what we can do differently, there's just lots of great opportunities that come from the capabilities that being brought by this new entity. So we're still early days. This is only 1 year in. It's moving faster than we had expected.

There's been a lot of resonance with the customer, as you can see by the wins we've had so far. We've got to follow through. We've got to win some of the down-selects, move some of the studies that Chris mentioned or with DARPA into actual programs of record. But that happens over time with continued focus and investment. And if anything, the opportunity set is getting bigger than small. A lot of it is coming in the classified side as well. I mean keep in mind, too, in the classified domain, a lot of these things are relatively stovepipe and the larger companies have a broader view across multiple different programs. So what we're now doing is getting more visibility across multiple different types of programs, classified programs, and we're bringing different mission solutions.

Operator

Our next question comes from the line of George Shapiro with Shapiro Research.

George D. Shapiro - *Shapiro Research - CEO and Managing Partner*

This is probably for Jay. I was curious as to how much incremental cash you got from the change in progress payments. I noticed that accounts payable were down $328 million, so you obviously gave some of that back. At the same time, receivables, inventories and contract assets were down $447 million. So maybe just expand on that. And then what you would expect it to be for the year? And is that a potential increment to the cash flow guidance that you have?

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Okay, George. So I'll just go to the quarter and then the year. In the quarter, the progress payment benefits were in the range of $100 million, and that was pretty much flowed down through to the suppliers. Separate from that, we did have customer payment accelerations that also we benefited from in the quarter, in the range of say, $150 million or so. The flow-through of that to the full year is really dependent on what the customers do. If the customers continue on that type of prepayment schedule on the nonprogress payment type of payment schedule, then we would see a potential upside in the year. If not, and they go back, we'll probably see a snapback, and it really would just be a pulling into the second quarter. So it could be upside. We have to kind of just monitor the customer behavior over the back half of the year as far as these accelerated payments. I mean the progress payments right now, we're expecting those will continue. But those could shift as well. But as I've just mentioned, that's been basically flowed down to the suppliers.

Operator

Our next question comes from the line of Peter Arment with Baird.

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Peter J. Arment - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Bill, I want to circle back on the budget kind of topic. We get a lot from investors about maybe L3Harris' exposure to kind of the OEM -- O&M side of the budget, and I think it's reasonably high. How should we think about that part of the budget if that -- if the overall budget starts to compress, how that impacts you? I know there's a lot of ISR missions and activities that flow through there. But maybe just some color on how we should think about that.

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Well, it's -- I think we size it in the 40%-ish range of our business is O&M funded. I think in this year, the DoD is underrunning the spending on O&M. So it does create actually some additional opportunities for O&M dollars. And you mentioned that exactly right, some of that does fund some of the ISR missions that we happen to have here. So we think we're well positioned on that. I don't think it's a major concern as we go into '21. I don't know, Chris or Jay, if you have any thought on that but...

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

No. I think it's just good diversity in various sources of colors of money, I think, is actually a strength. So yes, I echo what Bill says. We're -- I think we're in good shape.

Operator

Our next question comes from the line of David Strauss with Barclays.

David Egon Strauss - *Barclays Bank PLC, Research Division - Research Analyst*

Bill, I wanted to follow up, you mentioned E3. If you could maybe talk about what kind of organic margin upside you've seen so far from E3. How much further do you think it can go? And then on the synergy side, you said a bunch of times, there's upside to $300 million. Any sort of quantification of how much upside there could be beyond that?

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

So David, look, we're making really good progress on E3. In fact, at L3, Chris instituted a program called L365. We had our own program here at Harris HBX. The combination of it, I think, has yielded a process, internal process that's been driven deep into the organization. We typically would expect something like 2% to 3% net of inflation that are given back to the customer as well of cost coming out. And we're seeing E3 in that range. Over the course of the year, it's getting a little bit better. I think we would sustain that in '21 and '22, so that sizes it a bit.

As we get beyond the calendar '22 time period and integration starts to wind down in terms of that focused process, the drive to achieving cost savings will continue. It all merge into what we now call E3. So we do expect to hit $300 million net in '21. We do see opportunities beyond that. Some of the things that Chris mentioned a minute ago about facility rationalization, they do take a bit longer. They won't be fully complete in '21. So we'd see a little bit of step-up in -- beyond '21 on just the consolidation of the facility. So we can't really size it today. As we get further down the path, we'll continue to update investors on this. But as you think about where we've been over the last 6 months, we started out the year guiding to about $115 million net. We went up to $165 million and now we're at $185 million in an environment that's very uncertain with the COVID pandemic. So we continue to make great progress here, great progress on E3. And all of this is going to drive us north of 18% margin next year with some upside beyond that.

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Operator

Our next question comes from the line of Pete Skibitski with Alembic Global Advisors.

Peter John Skibitski - *Alembic Global Advisors - Research Analyst*

Just on the really strong second quarter margin rate at IMS. Was there any one-off benefit in there? And it looks like guidance is assuming kind of a lower rate sequentially in the second half of the year. Jay kind of touched on it a little bit. But any color that you could add there?

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Sure, Pete. Really strong synergy drop-through, over 200 basis points. They do have a benefit of pension running through because that's predominantly legacy L3 business. But they also had strong productivity, E3 productivity dropping through which pretty much offset any mix headwinds, and a little bit slower on R&D there. And as I mentioned, we expect R&D to step up in the back half of the year. For the full year, they're just -- they're doing well. We originally had 13.5%. It does step down, as I said, for the R&D as well as a little bit of a mix as we induct some aircraft. But bottom line there, you're going to see some solid margins there, around 14.5% for the year.

Operator

Our next question comes from the line of Michael Ciarmoli with SunTrust Robinson Humphrey.

Michael Frank Ciarmoli - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Maybe just to stay on that R&D. Looking at the second half margins, they obviously come down a bit. You talked about that COVID placeholder, and I think you called that out maybe as a contingency in the earnings bridge. So maybe that's $10 million or so. But how big -- how do we think about the R&D step-up? And I guess I'm thinking about it too in the context, you're talking about 30% of IRAD, but it sounds like cutting 30% of that IRAD, but it sounds like some of that's just going to be reinvested. Is that the right way to think about sort of the reprioritizing of the IRAD and kind of funneling it back into higher areas of opportunity?

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes. A lot of the reprioritization occurred as part of our planning process for the year. We're going to step up around 3.5% to about 3.7% in the back half of the year. And what we're talking about as part of the CheckPoint process is really just a process for defining and prioritizing those projects. There might be some timing differences here and there, and we continue to monitor them as part of that process. But there's not been any type of effort to actually reduce R&D spend as we dealt with some of the headwinds with COVID, and that's really been more other expense type of discretionary spend items that we've been dealing with. And so our goal has been to hold our R&D and protect the investment and for all the items and revenue synergies that Bill referenced before.

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

And I'll just chime in with the 1.19 book-to-bill in IMS specifically. A lot of these, as you know, start out as more developmental programs. And then over the course of the life of the program, you get into low-rate production and ultimately, production and the margins increase. So a little bit of the second half pressure is coming from some of these recent maritime wins, which are good margins but dilutive in the near term, but will ramp up as we continue to deliver on them.

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Operator

Our next question comes from the line of Robert Spingarn with Crédit Suisse.

Robert Michael Spingarn - *Crédit Suisse AG, Research Division - Aerospace and Defense Analyst*

I wondered if we could disaggregate the space group, space and airborne a little bit. Just the primes are having such strong growth there. And I'm wondering if you're seeing higher growth in space and airborne, if you could talk about that a little bit. And then if longer term, on the space side, you think you can potentially outgrow the market just given the share gain opportunities that you have in front of you.

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Yes. So we feel very encouraged by the space business as a whole. Just in the quarter, we had a couple of programs that are transitioning, and just the year-over-year comp was particularly difficult in the second quarter. Last year in 2019 Q2 which, as you recall, was Q4, the last fiscal quarter of Harris, we had sort of 18%, 19% growth in that space segment. So it was quite strong and the comp was kind of difficult just on a year-over-year basis. So a little bit of impact on just calendarization. We had good book-to-bill in the first half of the year, just over 1. We're very confident about that business. Very strong pipeline of opportunities coming out of in space as we transition from an exquisite provider to an end-to-end responsive mission solutions prime.

Chris talked about that in his remarks, that's both ground -- both space capability and ground support for space capability. The pipeline in that business is quite large. It's about $10 billion. We have about $1 billion of proposals outstanding that are pending awards. So as we look at this, we expect towards the back end of this year, we'll see some recovery. But overall, through the technology investments we've had, some of the revenue synergy opportunities that will come through in the space domain, we feel very good about the opportunities in space. So that space segment also has airborne and airborne has been quite strong for us as a lot of the F-35 growth, it's modernization, it's production, it's some sustainment growth there as well. So we see in our classified part of that space business is growing quite well. So look, we feel very confident about space. It will come back towards the back end of the year and be a driver of getting into '21.

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

Rob, I'll just chime in. One of the things that was very exciting about this merger was space. And of course, premerger, you couldn't look at it due to clearances. But once we got all the clearances set up and I got into the program several months back, I got to say I'm even more impressed now than what I thought or suspected we had. So I think we're in good shape. We just got to continue to win and perform. And I think there's some long-term growth here that's going to be pretty impressive.

Operator

Our next question comes from the line of Myles Walton with UBS.

Myles Alexander Walton - *UBS Investment Bank, Research Division - MD & Senior Analyst*

So I wanted to ask Jay, other guys in the space and people in the space have sized the R&D tax amortization in '22. I'm curious if you can do the same. And then secondarily, on the segments, I know that the pension adjustment being made there was $98 million in the quarter. Bill, is there any assumption about how much pension helps or hurts that you have to absorb going forward over the next couple of years in your comment about 18% margin next year and beyond?

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Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

So on taxes that the impact in '22 is north of $500 million if the loss stays as it is. As you know, others as well as us believe that, that wasn't necessarily the intent of the legislation, to penalize R&D investment. And so that's something, obviously, we're continuing to work. But just to answer your question specifically, it will be north of $500 million.

On pension, if you look at gross pension this year, it's about $300 million of benefit. Year-over-year, it's about $60 million. It's $100 million in the FAS pension benefit that's offset by about $50 million of lower cash recovery. And so net-net, you're talking about $50 million, $60 million. Right now, we're not expecting any significant changes in pension benefits next year. If we were to strike it right now, we'd be generally in line with that. I mean a little bit worse, obviously, on the returns, but that gets amortized. So right now, we're pretty much holding the line there for what I told you about, $300 million FAS and $60 million of CAS.

Operator

Our final question comes from the line of Jon Raviv with Citigroup.

Jonathan Phaff Raviv - *Citigroup Inc., Research Division - VP & Analyst*

So when you're talking -- Bill and Chris, you're talking about transition, obviously, to an operating company while the industry itself, it is in some transition. We know what the NDS wants for capabilities. But can you talk about how it's acquired, how those things are changing, like investment requirements, business models, partnerships, leveraging commercial. You've got a big prime out there with new leadership talking about new ways of doing business like 5G. Some of it sounds like stuff that you do. So can you just expand on what the next generation of defense industry you think looks like here?

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Well, Jon, I'll start and maybe Chris can jump in here. But the way I look at this, without commenting on what other players in the space happen to be doing, we're very unique in the sense that we've got this opportunity that can only be created by this significant transformation driven by a merger. It's a seminal event, allows us to drive a clean sheet and take a fresh approach about how you drive connectivity, cooperation, collaboration across the enterprise. And that's what we talk about when we drive towards an operating company is, from a technology perspective, is making sure all of the pieces are connected across the enterprise.

We believe success in the future is going to come from driving our business as operating entities, not as disconnected pieces of an overall organization like a holding company would have. So we have an opportunity to drive that as part of the DNA that's being created in the organization that we're building. We're not trying to start from an existing large position, but we've got good momentum that's built here and we feel pretty good about our ability to compete and win based on that particular model.

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

And I'll just say from the customer perspective, and I will throw out, the customers have been great here during the pandemic. I mean Bill and I have had unfettered access to them, and there's been a lot of creativity accepting a lot of our products using video and virtual means and inspecting the products. But the customer talks a lot about speed and they have rapid capability offices. They're using OTAs as an example. And I think we've been pretty good in responding in quick terms and winning some of these new business opportunities, several of which are revenue synergies. And again, I think the mission systems are becoming more and more important and the customers are looking at maybe procuring those directly from companies like us. And there are several initiatives in that regard, ABMS and others. So I think we're well positioned and we can adjust to the customer as they change their buying patterns. And if there's new business models, I think we're more than capable to support that. So...

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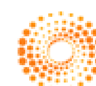

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William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

And certainly, there's not -- we're not beholden to a platform. There's not a loss -- risk of loss of revenue from moving from proprietary to open systems. We're building the organization from the start with a focus on open systems architecture, which we believe is an opportunity for us and certainly what we're geared to do.

So I want to thank everybody for joining the call today. And I'd like to close by, again, thanking our employees as well as the leadership team for their hard work, for their dedication as we wrap up our first year as L3Harris and for continually meeting customer commitments during these very challenging times. So thank you to everyone and be safe. Thank you.

Operator

Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.

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