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LLL - Q4 2015 L-3 Communications Holdings Inc Earnings Call

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OVERVIEW:

Co. reported 4Q15 net sales of \$2.9b. Expects 1Q16 sales to be \$2.3-2.4b and EPS to be \$1.50-1.60.



CORPORATE PARTICIPANTS

Mahmoud Siddig *L-3 Communications Holdings Inc - IR*

Michael Strianese *L-3 Communications Holdings Inc - Chairman & CEO*

Ralph D'Ambrosio *L-3 Communications Holdings Inc - SVP & CFO*

CONFERENCE CALL PARTICIPANTS

Robert Spingarn *Credit Suisse - Analyst*

Cai von Rumohr *Cowen and Company - Analyst*

Myles Walton *Deutsche Bank - Analyst*

Seth Seifman *JPMorgan - Analyst*

Robert Stallard *RBC Capital Markets - Analyst*

Carter Copeland *Barclays Capital - Analyst*

Richard Safran *Buckingham Research - Analyst*

Howard Rubel *Jefferies LLC - Analyst*

George Shapiro *Shapiro Research - Analyst*

PRESENTATION

Operator

Good day and welcome to the L-3 Communications fourth quarter and full-year 2015 conference call.

(Operator Instructions)

Please note, this event is being recorded. I would now like to turn the conference over to Mahmoud Siddig, please go ahead.

Mahmoud Siddig - L-3 Communications Holdings Inc - IR

Good morning and thanks for joining us for L-3's fourth quarter earnings conference call. With me are Michael Strianese, Chairman and Chief Executive Officer, and Ralph D'Ambrosio, Senior Vice President and Chief Financial Officer. After their formal remarks, Management will be available to take your questions.

Please note that during this call, Management will reiterate forward-looking statements that were made in the press release issued this morning. Please refer to this press release as well as the Company's SEC filings for a more detailed description of the factors that may cause actual results to differ materially from those anticipated.

Please also note that this call is being simultaneously broadcast over the Internet. I would now like to turn the call over to Michael Strianese. Mike, please go ahead.

Michael Strianese - L-3 Communications Holdings Inc - Chairman & CEO

Thank you and good morning, everyone. The fourth quarter reflected our continued focus on successfully reshaping our portfolio, expanding margins, enhancing our management team and returning our top line to growth. The biggest action was the sale of NSS to CACI International for



\$550 million in cash. We are pleased with that price, which represents an attractive EBITDA multiple. We expect the sale of NSS to close next week and have reported NSS as a discontinued operation in our fourth quarter and full-year results.

We also divested Klein Associates, a small side scan sonar business during the quarter. These actions reflect our commitment to repositioning our portfolio and improving our financial performance by focusing on our core defense electronics, communications and ISR markets where we have leading positions and strong technical discriminators.

As we continue to prudently evaluate potential acquisitions and further divestitures, we're taking market considerations, market conditions into consideration, consistent with best practices. There are a number of key factors that go into our decision making process including return on capital and improvement of L-3's competitive position. Both will make us better equipped to create value for shareholders as well as customers.

In the quarter and for the year as a whole, we had strong performance on our recompetes and program execution across our business. I want to thank all of our employees around the world for their contributions and for their continuing support to deliver the best we have for our customers.

Things are progressing well from an operational standpoint. Chris Kubasik is advancing our strategic plan and operations. Specifically, he's focusing on improving our margin on organic growth profiles in coordination with our segment presidents, as they continue to restructure business units. He's identifying opportunities for consolidation including in supply chain and back office operations. He's also actively engaged in our portfolio shaping as well. We are already seeing benefits from our refined strategy, margins are improving at a nice pace in all three segments and we anticipate that our top line, particularly organic growth, will continue to improve.

Turning to our fourth quarter results, we had net sales of \$2.9 billion, a decrease of 3% year-over-year. Net sales for the year were \$10.5 billion, a 5% decrease from last year. Our organic growth for the quarter was \$40 million or 1%. Consolidated segment operating margins came in at 8.9% for the quarter. Funded orders were \$2.6 billion for the fourth quarter and we ended the year with a book-to-bill ratio of 0.94%.

During the quarter and over this past year, we continued to generate robust cash flow which has been one of L-3's long-standing strengths. We anticipate this will continue into the future. In 2015, we repurchased \$740 million of our stock and paid \$214 million in dividends, returning an aggregate almost \$1 billion in cash to shareholders. Through a balanced method of capital allocation, we maintained an efficient capital structure with ample liquidity.

We also committed to maintaining our investment grade credit ratings, which is critical to our shareholder value creation strategy of dividends and share repurchases. This disciplined approach enables us to return cash to shareholders and strengthens the Company by providing resources for strategic M&A opportunities and investments in growth areas.

Before I address key awards for the quarter, I'd like to discuss a few important investment and portfolio integration initiatives. In 2015, we invested \$260 million in research and development and consequently, have seen some important advances in our R&D program. Our growth investments are focused on three key goals; enhancing our product lines, growing future sales and developing new products and competitive discriminators.

For example, our efforts in physics-based modeling and simulation are notable. Here, we leveraged technology from the gaming and visualization industry to develop L-3's ideation facility. This unique project enables a full mission simulation, capturing capabilities from the undersea to the space domain, and will enable our customers to clearly visualize the effectiveness of systems in an anti-access area-denial, or A2AD, environment. This is an area where L-3 is leading in technology development for this marketplace. This is a good example of the innovation and thought leadership that we at L-3 have embraced.

And there's more to come. We're developing smaller lighter SATCOM terminals that maintain a high level of performance as well as future communication capabilities that improve the probability of intercept and detection. We also continue to upgrade our night vision products, specifically in the development of full digital night vision capability. These R&D advances reflect our position as an industry innovator and open the door to new sales opportunity.

Our portfolio integration efforts are proceeding beyond our expectations. For example, FORCE ICS is increasing L-3's capabilities and technologies by working internally with Wescam, our communication systems West and unmanned systems businesses, to provide enhanced sensor and imagery solutions to our customers. Additionally, the combination of CPC aviation and Link UK is successfully expanding that business base.

We also completed our MITEQ acquisition by acquiring Advanced Technical Materials, now called L-3 Narda ATM. ATM develops and manufactures specialized coaxial and waveguide RF microwave products and fits in well with our Narda MITEQ product lines. We are performing well on key programs. At platform integration we continue to make progress towards the completion of the first VIP aircraft and are working closely with our customer.

Now, let me address a few significant wins at our defense, commercial, aviation and our international business. From a macro perspective, the DoD budget has resumed growth and we've seen improvement in our DoD organic sales growth rate. The DoD's third offset strategy also presents opportunities for L-3 and we are following it closely. L-3 has many capabilities that will enhance our ability to help our customers achieve their goals and objectives.

In the fourth quarter, we received a major contract to provide a power node control center, or PMCC, for enabled destroyers. This is an advanced and effective power management system and we see further opportunities for expanding its applications across other US Navy platforms, including carriers, amphibious assault ships and littoral combat ships. Our ISR integration business continues to be robust and we received new business awards for a major programs, including EMRs, as well as the classified program.

In addition, we were selected to provide US Special Operations Command with binocular night vision equipment. We also received additional funding for a wide range of legacy programs featuring our missile defense work, users, (inaudible) mission air crew training systems, C-130 displays, photonic mass work and Gray Eagle UAS work, which includes our innovative new composite maintenance systems trainer.

Also in the training arena, we received a contract to upgrade our F-18 tactical operation flight trans for the new US Navy. This award improves the fidelity of the training equipment and provides a new immersive experience for pilots. Finally, we received follow-on funding for programs such as Army Fleet support as well as a variety of modification and sustainment projects, including the rivet joint, among others.

For commercial aviation, this is a sector with strong growth potential and as evidenced by our recent awards, we are capitalizing on opportunities and increasing our market share. Our commercial flight simulator and training business continues to be strong. We received orders from Turkish Airlines, Air China, Spring Airlines and Delta Airlines for a variety of simulators. The Delta order is particular notable because it expands our market.

In addition, our security and detection systems business remains solid and in the fourth quarter, we received orders for a variety of products including ProVision, checkpoints screening systems. In the US Capitol building, we also received orders for our new ClearScan aircraft baggage screening system from Singapore, as well as a maintenance contract with the TSA for our examiner systems.

In the international area, despite the ongoing lumpiness in that market, we remain focused on building our business and are pleased to report several developments. We've been increasing our resources by adding personnel and in country offices to support business development activities. These efforts are paying off. We've been selected to supply night vision equipment to the Kingdom of Saudi Arabia. Additionally, we received sales for our traveling wave tube equipment from several customers in Asia and China, as well. Wescam is also doing well supplementing its solid defense business with several international awards.

In terms of our outlook for 2016, as you know, 2015 was a transformative year for us. As we look ahead to 2016, we expect to maintain our positive momentum as we drive margin improvement and continue to reposition the portfolio. Our focus remains concentrated on growing our business and capturing additional market share. And we continue to move towards higher margin areas, pioneer innovative technologies through targeted R&D investments and strengthen our core business through strategic M&A.

Our approach to M&A remains the same. We regularly monitor and evaluate companies that might meaningfully contribute to the strength of our business, pursuing accretive acquisitions with strong margins and high growth rates. Smaller acquisitions will be fully integrated into our existing operations wherever possible.

Our strategies for growth combined with our strong balance sheet and thoughtful approach to capital allocation, position us well for success in the coming year. With that, let me now turn it over to Ralph for a more in-depth look at the financials and then we'll be happy to take your questions. Ralph?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Thank you, Mike. I'll discuss some details about the fourth quarter results and then review the update to our 2016 guidance. First, I want to remind everyone that we reclassified NSS to discontinued operations for all periods. As Mike said, we expect to complete that sale over the next week, so my comments will only concern L-3's continuing operations which do not include NSS.

We had solid performance for the fourth quarter with adjusted diluted earnings per share, sales and free cash flow coming in better than our outlook. It was driven primarily by higher sales and lower taxes due to the reenactment of the R&E tax credit. Adjusted diluted EPS excludes losses on business divestitures and non-cash goodwill impairment charges including the fourth quarter goodwill impairment charge for logistics solutions.

Fourth quarter sales were just under \$2.9 billion, and grew organically by 1%. Sales were about \$90 million above the midpoint guidance that we provided, driven by higher US Department of Defense sales, mostly in communication systems. We believe our fourth quarter sales demonstrate that the sales growth rate for our US Government and DoD business is improving and we expect it will continue to improve this year in 2016.

Consolidated operating margin was 50 basis points below what we anticipated for the fourth quarter and 10 basis points below what we expected for the full-year 2015, with lower margins in electronic systems and aerospace systems. The electronic systems margin was 11.3% for the fourth quarter and 11.5% for the full-year, and it was impacted by a \$20 million refund liability provision for our EO Tech holographic weapons sites. Aerospace systems margins was about 15 basis points lower than what we expected and that was primarily due to higher material and labor cost on fixed price per flight hour CLINs at Logistics Solutions. Communication system's margin was better than we expected, driving its full-year margin 25 basis points higher than our guidance.

Fourth quarter free cash flow of \$406 million was also very solid, bringing the full-year to \$829 million, which was \$19 million better than we expected and essentially due to the unexpected reenactment of the R&E tax credit. As we recently have explained, we invest a significant amount each year in R&D to sustain and grow our business and that R&D also creates valuable cash taxes reductions for the Company.

Moving on to 2016. Compared to our initial guidance that we provided at the Investor Conference on December 8, last month, our 2016 guidance includes increases for EPS, free cash flow and operating margins, primarily due to two items. First, the R&E tax credit which was permanently reenacted by Congress last month, and secondly, pension expense will be \$32 million lower than our initial estimate. These changes each increased 2016 EPS by about \$0.25, lifting the EPS guidance range at the midpoint by \$0.50 to \$7.50, which is an increase of 9% compared to 2015 adjusted diluted earnings per share.

The lower pension expense also raises consolidated operating margin guidance by about 30 basis points with corresponding increases in each of the segment margins. We made no other changes to 2016 sales and margin guidance.

Our consolidated sales guidance remains at \$10.05 billion at the midpoint for 2016. With 2015 sales coming in a little higher than we expected, our 2016 guidance now assumes an organic sales decline of approximately 2.5%.

We expect our US Government, including the DoD business, to be down 2% organically versus 2015, commercial to grow about 8%, and international sales to decline about 14% versus 2015. With respect to the US Government and DoD business, the final runoff of the Afghanistan drawdown sales in 2016 is expected to reduce sales by about \$135 million and without it, our sales in the US Government and DoD markets would be about flat in 2016. We hope to have some upside with our US Government sales in 2016.

We increased the consolidated operating margin guidance to 9.8%, which is 130 basis points of an increase over 2015, with margins increasing in all three segments.

Our diluted shares outstanding estimate stays at \$77.5 million for 2016, which is 5% lower than last year and it continues to include share repurchases of \$750 million for the year.

We increased our free cash flow estimate by \$15 million to \$825 million, and that is comprised of three changes. First, the R&E credit will add about \$20 million, slightly better working capital performance adds \$15 million, and then we're increasing our investment in capital expenditures by \$15 million and that nest of the increase. The cash flow guidance for 2016, continues to assume about \$100 million of pension contributions.

With respect to our capital allocation, in addition to the planned share repurchases of \$750 million for 2016, cash dividends will be slightly above \$200 million and we intend to repay \$300 million of debt. We also acquired a small microwave components business that Mike talked about. That closed last week and that was for \$27 million and we are integrating that into our Narda-MITEQ division in the communication systems segment. After these capital deployment actions, we estimate that we'll end 2016 with a cash balance of about \$325 million.

Our capital allocation and financing strategy continues to include our commitment to maintaining our investment grade ratings. I want to underscore that we don't view the ratings, the investment grade ratings, as transitory.

And for the last point on our 2016 guidance, we expect our book-to-bill ratio to be about 1.0. Looking at the first quarter of 2016, we expect sales to be between \$2.3 billion and \$2.4 billion, with an organic sales decline of about 2%. Margin will be about 9% for the first quarter, with EPS between \$1.50 and \$1.60, free cash flow coming in somewhere between zero and \$50 million, and the book-to-bill ratio between 0.9 and 1.0.

So to conclude our financial review, L-3 is in a process of positive transition. We are focused on program performance, expanding margin and returning our top-line to an organic growth position. We are also strengthening our business portfolio to structurally improve our competitive positions, sales growth rate and margin expansion profile. We continue to generate solid free cash flow and are allocating it to increase shareholder value. We recognize that we have more work to do. We know what is to be done and we look forward to updating you on the Company's progress throughout the year. Thank you and we'll begin the Q&A now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Robert Spingarn, Credit Suisse.

Robert Spingarn - Credit Suisse - Analyst

Good morning, guys. Mike, I don't know if this is fair, but when I look at the three segments, it seems to me that the one that's giving you the most challenge is aerospace systems. When I think about last year, some of the execution at Waco, the impairment at logistics, and you mentioned the soft international bookings there in the release this morning in regards to the book-to-bill. How do you -- strategically, how do you go about tackling this segment and getting this thing where you want it?

Michael Strianese - L-3 Communications Holdings Inc - Chairman & CEO

Well, you're right, Rob, and it certainly is a fair question in my view. So we are not satisfied at the performance at aerospace from both a margin and orders standpoint, and sales of course, sales growth. That said, there are strengths in the business and we do see opportunities to improve results.



We've identified a number of new program opportunities and in fact, customers have indicated they would like to see L-3 as a bidder and in fact, we continue to get certain amounts of work sell source just because of the capability of that business unit are unmatched in the country. Unmatched. However, they've been through a difficult cycle. So as we anticipate an improving budgetary environment ahead, we believe that there will be opportunities that can lead to better top line growth as well.

So in terms of allocating resources, it's something that I've deployed Chris on to monitor closely, as well as Dave VanBuren. These are programs that both are very familiar with, including all of us. We've made several visits to the business unit during the last quarter and we have all eyes focused on getting it improved, getting that. Now, unfortunately, there are a number of sizable international contracts that had completed last year. Some of them a little bit earlier than had been anticipated such as the Airseeker program, and we're not backfilled, if you will, with new work because of a slowdown internationally.

So those are significant programs. So that's causing a bit of a dip in the numbers and there are opportunities again, internationally, to bring more work in house there as well as on the US Government side. I think a few more quarters of work on it and we will start to see some results in getting new work in house. But I believe that's the first step in getting that to turn around.

Robert Spingarn - *Credit Suisse - Analyst*

Right. And so, when you think about the international softness, is there a regional component to it? As you look forward, is the Mid East not participating as much as they have and where -- what regions do see some of the opportunities that are in front of you?

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Well, the growth has been Mid East and Asia, and yes, you're right, the Mid East has slowed down and Australia as well. Asia continues to be a growth area for us. Of course, you have the oil price issue in the Middle East that is I think putting a bit of a crimp in spending.

Since many of these countries have survived without some of these platforms in the past, whether they're sophisticated ISR signals intelligence platforms that require not only the aircraft, but ground stations and operators and processing and the like, and they're very big ticket items. So while we're seeing that slowdown, we're seeing an uptick, if you will, in Asia.

Some of the things we've been focusing on is partnering internationally with platform manufacturers or other in country industrial partners to help in that regard and it's been working out pretty well. We have a few aircraft under contract in Japan, for example, that we talked about last year. More in Korea. And there's more that I don't want to talk about for competitive reasons, but we are actively pursuing -- in pursuit of several major platform type programs where L-3 will be the prime systems integrator of typically sophisticated ISR systems on commercial type platforms. Which is really where this business has been going over the last several years.

Robert Spingarn - *Credit Suisse - Analyst*

Okay, and then just to finish on this. You talked about the growth pursuits in the segment. Any more on divestitures or portfolio shaping here?

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

We continue to evaluate all operations that aren't meeting our objectives. And there are a couple ways to deal with it, whether it's working harder to improve the business or an outright divestiture as you saw in the fourth quarter. But the portfolio shaping does remain a core element of our strategy and we will continue to focus on our core defense electronics, communications and ISR markets as we've been saying.

However, as we continue to evaluate the portfolio, we are taking the market conditions into consideration. The NSS transaction demonstrates our commitment to acting when we see the right valuations available. And we will continue to be opportunistic and will consider value enhancing

opportunities. But right now, as you know, the debt market for, I guess you would call it high-yield or private equity, is not really there as it's been. So, it's caused a bit of crimp in valuation and we're not really looking to give things away.

We're dealing, one particular business with well over \$1 billion in sales where the offers are very disappointing in terms of numbers that have been dancing around. I know there was a piece that was out last week and we're not interested in pursuing that kind of a transaction if it's not value accretive to shareholders.

Robert Spingarn - *Credit Suisse - Analyst*

That makes sense.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

We'll stay focused.

Robert Spingarn - *Credit Suisse - Analyst*

Makes sense. Thank you, Mike.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

You're welcome, Rob.

Operator

Cai von Rumohr, Cowen and Company.

Cai von Rumohr - *Cowen and Company - Analyst*

Yes, thank you very much. Mike, on Raytheon's call, they said, their Chairman I guess was just in the Mid East and he said, he's not seeing oil as a problem and they had good bookings in the fourth quarter internationally. They looked for higher bookings this year. Is part of the issue there that maybe you guys are smaller and therefore, can't have the same kind of sales presence in those countries? And secondly, I think you'd mentioned a couple of potentials for growth in international next year. If you could update us on those? Thanks so much.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Well, I would relate it more towards the type of system that's being evaluated, not necessarily the size of the companies selling such a system. Some things that are just needed more than others, particularly in the missile defense area, which is very critical in that region.

So we have been making progress on areas such as aviation training and simulation, advanced avionics equipment, night vision equipment, sensor systems, tactical SATCOM, airborne ISR, which are the more bigger ticket items where the slippage is apparent as programs again, completed like Airseeker and others, and have not been backfilled, if you will. So that goes also with multi-mission type aircraft, where we have been working on systems where one platform can fulfill multiple missions addressing a tighter budgetary environment. Where some of these customers do not want to buy a separate aircraft for every single mission, whether it's airborne ISR, maritime patrol, search and rescue, et cetera.



They're looking more from our experience, from my experience, with aircrafts that are rapidly reconfigurable to meet the mission so they only have to buy it once and buy multiple sensor packages that can plug in. Military simulation systems are active, security and detection systems as airports are upgraded and built out and antisubmarine warfare. So those are all areas we are seeing some growth. And I would say, it's not there are no sales but the sales cycle is certainly a longer proposition right now.

Cai von Rumohr - *Cowen and Company - Analyst*

Thanks so much.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Thank you, Cai.

Operator

Myles Walton, Deutsche Bank.

Myles Walton - *Deutsche Bank - Analyst*

Good morning. Could you comment on where the incremental CapEx is going in terms of the strategy? It's interesting to see the drop through of the benefit of some of the cash coming in and going back to reinvesting in the business. Just curious where you're seeing the biggest payoff?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

The incremental investment is going largely in three areas, Myles. ISR systems; two, training and simulation; and three, in our advanced programs business area, which addresses the classified market space.

Myles Walton - *Deutsche Bank - Analyst*

And I guess is it a signal that if they had more, they'd be doing more and that you're trying to balance what you're generating in terms of free cash flow to investors and that there is a real hunger inside for more investment?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Well, we're definitely increasing the investment where we see good opportunity for growth the next several years and it's simply that. We don't hold back CapEx to drive up free cash flow. We have a very balanced approach and we're spending additional money here because it makes sense and we see it paying off in the next few years.

Myles Walton - *Deutsche Bank - Analyst*

Okay. And then could you update us on the Head of State effort and where we are? And also on that book-to-bill of one -- sorry I guess Rob's question, does Arrow become an equal weighted contributor to that book-to-bill in 2016? Thanks.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

On the Head of State, Myles, we've made very good progress on that program. We've completed a project that are currently working with our customer on some follow-up requests as part of their final inspection process and we expect to deliver to the customer soon. Importantly, there been no changes to our estimates as we previously provided and we remain on budget.

So we've all been very focused on that program due to the problems last year, and we've brought in additional talent in terms of program management and with that expertise. It's moving along very well as far as we're concerned and we expect to deliver shortly. So that one seems to be moving along. Ralph, you want to take the book-to-bill question?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Sure. So we expect the book-to-bill ratio in electronic systems and communication systems to be slightly above 1.0 for this year and aerospace just under 1.0. Now, there's a lot of opportunities, some that Mike talked about, that we're pursuing in aerospace and to the extent that we can capitalize on them, that book-to-bill ratio in aerospace systems could move to 1.0. From what we're seeing today, I have it just under 1.0 for 2016.

Myles Walton - *Deutsche Bank - Analyst*

All right thanks

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Thank you

Operator

Seth Seifman, JPMorgan.

Seth Seifman - *JPMorgan - Analyst*

Thanks very much and good morning. I wonder if you could talk a little bit about L-3 was a key recipient of a lot of funding in the late part of the last decade and the early part of this decade when the op tempo was very high. And we're seeing a faster op tempo now and I wonder if you could talk about the impact of that? I know what's going on. You've outlined what's happening in Afghanistan, but their op tempo in the rest of the Middle East?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Well, presently we do see some opportunities in the ISR space as well as in sensor systems and warrior systems. So in my commentary, I said that we hoped to have some upside in our 2016 sales in the DoD area and that's part of the upside, Seth.

Seth Seifman - *JPMorgan - Analyst*

Okay, great. Thanks very much.



Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Let me tag onto that just so we could recall. The types of things that were leading in the op tempo, if you will, was getting the unmanned systems fielded. So there's a lot of data links, cameras, Rover systems for the troops on the ground, night vision equipment, ISR capabilities, et cetera. And as things ramped up, that played into our areas very well and we were growing along with it. And as you know, that has slowed down. Now, we are seeing more activity this year than we have in the past so far, but it's really hard to peg where we're going to end or how much it's going to drive the numbers at this point. It's a little early in the cycle.

Seth Seifman - *JPMorgan - Analyst*

Okay, thank you.

Operator

Robert Stallard, Royal Bank of Canada.

Robert Stallard - *RBC Capital Markets - Analyst*

Thanks so much. Good morning. Mike, maybe just to follow up on that. Ralph mentioned that the Afghan sales are down \$135 million in 2016. Does that essentially take them to zero?

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

No, not quite zero.

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

It doesn't take us to zero, Rob. You may recall that the last time we talked about our exposure to Afghanistan, we explained that in 2016, we were anticipating our sales would bottom somewhere between the \$300 million and \$400 million range, which actually is going to be about \$400 million, and that's what our guidance contemplates after the \$135 million reduction that I talked about. And the reason that it doesn't go to zero is that we do some things that I think that need to be continued, to be supported and performed by the US military. Some of it's special operations related, but that business is not going to go away. We think were hitting bottom as we anticipated the last couple of years in 2016. I think that answers your question.

Robert Stallard - *RBC Capital Markets - Analyst*

Yes, so it shouldn't be a headwind in 2017, if we're looking at it that way?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Correct. I said it was the final runoff in 2016.

Robert Stallard - *RBC Capital Markets - Analyst*

Mike, maybe a follow-up. You mentioned some of the things that are going on in the export market. I was wondering if you could comment on what you're seeing in Europe and whether there's been any sign of improvement and whether foreign exchange might be an issue there?

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

We historically have not been a big player in the European market as they tend to be able to meet their own needs on many things or compete head-on with the US. However, there are increases in budgets, as it relates to Ukraine and countries in that area, and the NATO countries. There's still limited investment rates of about 2% GDP. A lot of countries don't even meet that.

But again, it's similar systems; night vision, comms and things that L-3 provides that are unique to L-3 and are not readily available in that region of the world. I don't expect that to be a big driver unless there is a major event that were to transpire at this point. But we continue to stay focused and we have partners in particular countries that we work with to keep us ahead of developments and get us on their teams where necessary, or where needed, is more of a way to say it. So it's not going to be -- I would say the leader internationally for us, we are still very focused on Mid East, Asia, as being a bigger driver for our business.

Robert Stallard - *RBC Capital Markets - Analyst*

Okay, thanks so much.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Thank you

Operator

Carter Copeland, Barclays.

Carter Copeland - *Barclays Capital - Analyst*

Hey, good morning, guys. Just a couple of quick ones. Mike, I wondered if you could just expand a little bit? You commented on the back office supply chain stuff. I realize these efforts are still early days and Chris is still exploring a lot of this stuff with the rest of the team. But are the opportunities you're uncovering, at least initially, focused on one business area versus another? Or any granularity you can give us there?

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

It's really focused across the Company and unfortunately, Chris is not here today. He had something prior. He's not on the call, but if you have questions for him, feel free to follow up at a later date.

It's really across the Company. We're seeing the biggest increases right now in comm systems and the electronic systems segments. And he is also focusing on the ISR, the aerospace area, as well. It's everything from complete consolidation of business units, to again, as I said, the back office type operations or things that could be shared among business areas.

And of course, the goal is to get the most bang for the buck in terms of being able to consolidate and drive our margins even higher and that involves a lot of things. I think we'll have much more granularity as we get further on in the year. We have very focused goals in this area and I expect that at some point we'll be accelerating those efforts and bringing them in sooner than we had originally planned on.

Carter Copeland - *Barclays Capital - Analyst*

Great. And on just to take the high yield valuation comment and flip it on its head, I mean historically, you guys have been very acquisitive and I know the focus is on cost and portfolio shaping right now. But could that impact on valuations and some of the assets that are sitting inside private equity provide some opportunity on the acquisition front that you maybe weren't thinking about a quarter ago?

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

I haven't seen that yet. We haven't seen it yet, but it certainly could. And we are always looking for a good deal that will help improve L-3 that fits well, that brings customers, technology, et cetera, to us. We've had some great success with a number of recent bolt-on type acquisitions that have provided us with those new products and capabilities that drive value for customers and are contributing to a margin improvement profile, since they are driving higher margins. So with that in mind, we'll continue down that path. It's worked for us very well so far and we continue to do some more -- plan on doing some more, if you will.

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

And also, I think a lot of those assets are service type businesses. So a lot of those we would not be interested in, in terms of acquisitions, Carter.

Carter Copeland - *Barclays Capital - Analyst*

Okay, that's fair. And just as a final one. Ralph, on the comm systems outlook, it looks like that's a little bit worse despite the pension tailwind. Is that a mix reason behind that?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Well, I said that we -- excepting the pension improvement, we held all the sales and margin guidance unchanged. So our biggest upside in sales in the fourth quarter came in comm systems.

Carter Copeland - *Barclays Capital - Analyst*

Okay.

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Particularly in the broadband communications systems area, which is the CSWest business, which is doing really well. Remember, we had some issues there in the new ERP system a couple years. But those have been resolved. The bookings there are very strong and we see that being a nice grower over the next several years. So at this point, I'd like to think that the margin guidance and the sales guidance for comm systems is conservative and we should see some upside there. Like I said, we didn't change the outlook. We held it constant except for pension.

Carter Copeland - *Barclays Capital - Analyst*

Great. Thank you, gentlemen.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Thank you

Operator

Richard Safran, Buckingham Research.

Richard Safran - *Buckingham Research - Analyst*

Hi, good morning. Ralph, Michael, I'm always interested in your commentary on defense budget. So the bipartisan budget agreement now done, the President's FY17 request coming out. I wanted to get a sense of how your thinking about FY17, what you're hearing? Do you expect any effort to raise the FY17 spending cap? Do you think we could see another double-digit increase in investment accounts? Just be interested in any commentary you have there on 2017.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

That's a lot of speculation, Rich, but happy to speak. Obviously, what's new is that we have a two-year deal, which is great. It's helped one of the most significant problems we as an industry have faced, which is lack of visibility. So even directionally is a good thing, but you're asking little more.

We think most of the movement is going to be in the classified area. I think some of the comments made by Secretary Kendall pointed to that as well. The overseas contingency fund, OCO account, may grow as well. As you know, a lot of the growth will be driven by international events as they unfold and as you know, there's a lot going on all over the place. So I'd say more likely upside than downside there.

And we've also been listening very carefully to some of the commentary by those in the building, particularly Secretary Kendall and the acquisition chiefs, in terms of the types of capabilities or investments they are looking for. But they have been specifically asking the industry to be a little more forward leaning on R&D. And as you've seen, we have been trying to respond in that way because there are things that we do that fit some of the requirements they have and it would certainly be good to start to grow a little more organically in that space.

So we have been trying to meet those requests and develop more, especially in the classified space, where we are doing very well right now. And that's why you see numbers like our R&D growing a little bit and we hope that we know that will be well spent in terms of our investments in future growth.

Richard Safran - *Buckingham Research - Analyst*

Okay, thanks for that. And just switching to commercial aerospace here and following up on your comments here about commercial aviation potential. Do you intend on expanding this business with acquisitions at some point? I know you're expecting 8% growth this year, but I also want to know if you could comment on what you see as a sustainable long-term growth rate at commercial? Could we see above 8%?

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

You could, but I mean you've heard some of the OEM commentary this quarter where things seem to be taking a bit of a breather. We are in operating in a couple of markets, whether it's the training and simulation area, where there is a huge pilot demand because of retirements. And the number if you research it, is I believe it was 0.5 million pilots over the next, could be 10 years or so.

And then you have our avionics businesses, which have historically done very well. The problem in that space is that anything that were to come online for sale is typically very expensive and hard to make a good business case for. We've looked at several companies over the years and where we see something that fits well with what we do, particularly something that could be consolidated and a lot of overhead saved, that's usually requisite to be able to make those numbers work.

Because they're typically higher growth, higher margin, and other things that we would see in the defense space and they command higher prices. As you know, you have to pay a lot for growth in this marketplace these days. So yes, we'd love to grow the business and we'd love to grow it through acquisitions. But right now, we've seen the better deal for us being investing in our own products and developing things rather than acquiring them right now. And we could also pursue that as a strategy.

We are the next gen system. We have equipage there and we continually work on developing more avionics for the general aviation marketplace where we continue to do very well. And for the large transport, that seems to be more regulation driven, whether it's a requirement for a new recorder or a revision to the key test system. But we keep a robust R&D program that will help us with the growth and should the deal present itself, we will certainly be all over it.

Richard Safran - *Buckingham Research - Analyst*

Thanks very much, Michael.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Thank you.

Operator

Howard Rubel, Jefferies.

Howard Rubel - *Jefferies LLC - Analyst*

Thank you very much. A couple things. Ralph or Mike, in the guidance or last year, you had a number of what I'll call one-off items, and they range from severance to, I'll call it, satisfying some legal obligations. How did you think about -- first, how did you think about severance in the upcoming year or how did you allow for that in the margins? And related to that, how did you factor -- there's clearly some benefit in not having these one-offs for this year we are in now.

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Okay, with respect to the severance, we incurred about \$18 million in 2015, and we expect to incur about \$10 million in 2016. So some reduction there for sure. And you're correct, we did have a few or maybe several one-off items in 2016 -- I mean 2015, that we don't expect to recur in 2016. I think you see that in the margin expansion that we are guiding to and anticipating which is happening in all three segments. And as Mike said, particularly with respect to Aerospace, we're not satisfied at all with where those margins are presently and that's where we have the most work to do in terms of lifting the margins.

Howard Rubel - *Jefferies LLC - Analyst*

On the other hand, it is quite notable that you had said some time ago you'd be able to gain some recovery on the C-12 and your customer recognized that work. So there is an ability to track your costs and the value you're delivering your customer and actually get paid for it. So there's some benefits there that's probably still yet to be recognized?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

We have some small upsides there.



Howard Rubel - *Jefferies LLC - Analyst*

Just two other things. One, you did allude to the balance between investment-grade rating and I'll call it, running and optimized balance sheet. How do you think about that going forward and --?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

I'm not sure I would call it a balance. We said that we are committed to maintaining the investment grade rating, Howard.

Howard Rubel - *Jefferies LLC - Analyst*

Yes.

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

We think we can do that and still grow the business and we now are beginning to see that we'll start to grow operating income and EBITDA. We expect that to happen in 2016 and more so thereafter. So that's going to have a natural deleveraging effect as well.

Howard Rubel - *Jefferies LLC - Analyst*

Is there some target? I mean the rating agencies are obviously going to tell you what they want, but how do you think about where your leverage is today versus where you need to be to make sure that you don't get or you avoid a downgrade?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Okay, so each of the rating agencies calculate leverage slightly different and they explain and publish how they do it. But if you look at our debt to EBITDA, we are expecting that we'll end this year at about 2.8 times. And I think our target is that we want it to be about 2.7 times or slightly under that. So we are trending in that direction. We do have some covenant requirements in our existing debt arrangements but they allow for -- they're not a problem in terms of maintaining them.

Being investment grade versus non-investment grade is not a trivial decision. I mean you don't flip the switch back and forth between those positions. We've been investment grade since 2009. Even though we're investment grade, we do have a very aggressive financial policy in that we deploy most of our cash and we have a good amount of leverage on the balance sheet. And that's responsible in terms of delivering better returns to our shareholders.

Howard Rubel - *Jefferies LLC - Analyst*

On comfortable with that. I understand it and I appreciate it. And finally, I noticed at year-end, you landed a fairly significant ISR contract with a couple of -- for a couple of G5's or 550s. This seemed to be a new line of business or something that I hadn't seen before. Is there anything more you can elaborate on that in terms of what you see with some global opportunities there? Or else you can take that platform and add your capability?

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Howard, that is the trend in this space right now. You're going to see more and more of this. I use the term cross-decking, but some of the big heavyweight ISR platforms to more affordable business jets. This one you saw is very representative of the trend in many countries in how they're

looking at their ISR mission requirements. And we sit well in that space in terms of being able to do that missionization work which includes racks and racks of electronics and the precise placement of antennae systems to increasing range for being on station which could mean auxiliary fuel tanks in systems and putting in a refueling capability and the like.

All of those things are in our wheelhouse and we have excellent performance to show for it over the years in delivering these systems. So when customers think about that cross-decking model, they call L-3 first as I'd like to say. I mean we do a good job. Part of it has to do with the fact that we make a lot of the subsystems, whether it's data links or the sensors, cameras, et cetera, and we're able to pull through our own products in these models which also helps the whole business.

If you get on one of these and it's not only the integration work, but it's pulling through data links in cameras and the like, that is how we intended this model to work. It's being able to pull through L-3's systems and subsystems on these platforms. But given the economics of operating a business jet versus a wide-body commercial platform, I think this is a trend of the future.

Howard Rubel - *Jefferies LLC - Analyst*

You might call this marquee award then.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Sure.

Howard Rubel - *Jefferies LLC - Analyst*

Thank you.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Thank you. I wanted to make a comment also to follow up with Ralph's comment on the investment grade. If you look at the way I tend to think of it, is we will always want to operate with a credit facility. I think it's prudent that companies have credit facilities should an M&A come up or any other matter where cash is needed in a short-term. You run the assumption that yes, we'll always have that. Then you get to the question of well, what's the difference if you're investment grade or not?

As you may know, that if you're investment grade, you don't have the restrictions on the payment of dividends and share repurchases and M&A. You have that quote, restrictive payments basket issue. So, it's really a question of -- we're looking at investment grade versus not, you could look at it as you want a credit facility or not because we would not be able to operate with the cash deployment objectives that we embrace with a non-investment grade credit facility. It just wouldn't work for us and everybody would be unhappy, including me.

And so, I think it's not a far stretch to keep that investment grade rating now and it's typically the leverage ratio that is the operative one that gets more restrictive because of the way the numbers work. And I believe it's, in terms of rating agencies, Moody's is the more restrictive of the three. So, that's the one we're watching. Ralph made a comment also, is that we get back to growth in EBITDA or in margins, that should have a natural deleveraging effect which would give us some more headroom, and we won't be having this discussion. I just wanted to give you my perspective on why that is important.

Howard Rubel - *Jefferies LLC - Analyst*

Thank you very much.

Operator

George Shapiro, Shapiro Research.

George Shapiro - *Shapiro Research - Analyst*

Yes, good morning. One specific one and then one general one. Ralph, you mentioned in the aerospace systems that there was a 60 basis point unfavorable contract adjustment at Aircraft Systems. It sounds like from Mike's comment that wasn't on the Head of State plane. Could you just tell us where it might be then?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Yes. Hi, George. Correct, that did not pertain to the Head of State aircraft modification jobs. We're still on track or inline with the estimates that we had from the second quarter of last year there on the Head of State work. But we have a variety of other programs in aircraft systems and there were some adjustments on a couple of international jobs and then some items at our Crestview operation. Those are individually small items and as well as the aggregate, I think it's only \$5 million or so. Nothing alarming or particularly unusual there.

George Shapiro - *Shapiro Research - Analyst*

And then you get delivery at one Head of State aircraft this year and the other one in 2017?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

One this year and the other two next year.

George Shapiro - *Shapiro Research - Analyst*

Okay. And then one more general one for you, Mike. I look at obviously the goal of improving aerospace systems, but it seems like there's a lot of headwind to me. Revenues were down last year. They're down this year and it looks like the revenues are declining in programs that are probably pretty profitable. What can Chris or you do really to kind of overcome that headwind and get those aerospace margins higher?

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Well, we also see that they are the contractor of choice when there's a big job to develop at ISR platform. So some of the things that we've been doing are things we could bring from corporate are one, that we have or could we bring in more business development folks to the international side?

Number two, we are developing more international partnerships either with aircraft OEMs or with other equipment suppliers or with other industrial players. So we have a seat at the table in these countries that are going to go forward with these systems. We are the world leader in ISR manned platforms and I believe that that will continue to be a market that will grow.

And it's also not one of the more margin constrained marketplaces because again, these are one-of-a-kind platforms and we are not usually bidding to a low price. We are usually bidding to a technical capability and we are not interested in low price technically acceptable in this space. We are interested in developing and delivering state-of-the-art platforms at good margins.

So, I again, pointed to the fact that some significant international work had been completed and new work had not been brought in to fill that hole. And also there are under US side, new platforms that will be coming out that have displaced some of the life cycle sustainment that had historically been done across that business. So there are a couple of holes that need to get filled and this is an area where I want everybody focused on getting this business area back on track where from a margin standpoint and from a growth standpoint. The execution to continues to be excellent.

George Shapiro - *Shapiro Research - Analyst*

Okay. Thanks very much and good luck.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman & CEO*

Thank you. So in wrapping up, the current geopolitical environment is volatile but presents new opportunities, both in country, domestically, and internationally, and we are well-positioned to capitalize as we move through 2016. We continue to execute our strategy of strengthening our portfolio, investing in businesses that we know well and leveraging our strong cash flow generation to invest in the Company and at the same time, return cash to shareholders.

Our investment in R&D and our market-leading positions make us ready to accommodate the short-term needs of the US Government and to adapt and ship according to its longer-term third oil offset strategy. We are seeing benefits from our refined strategy, margins are improving in 2016, as is our top line, and we will be moving forward with these efforts well into 2017.

And we're planning on keeping the margin expansion front and center for several years to come until we are satisfied with doing the best we could possibly do across the Company. We're committed to strategic growth and performance and as always, we will work to enhance value for shareholders. Thanks again for joining us this morning and we look forward to speaking with you again in April.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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