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HRS - Q4 2018 Harris Corp Earnings Call

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OVERVIEW:

Co. reported FY18 EPS of $6.50. Expects FY19 revenue growth to be 6-8% and EPS to be $7.65-7.85.

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PRESENTATION

Operator

Greetings, and welcome to the Harris Corporation Fourth Quarter Fiscal Year 2018 Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Anurag Maheshwari, Vice President of Investor relations. Thank you. You may begin.

Anurag Maheshwari - *Harris Corporation - MD of Asia-Pacific*

Thank you, Michelle. Good morning, everyone, and welcome to our Fourth Quarter Fiscal 2018 Earnings Call. On the call with me today is Bill Brown, Chairman and Chief Executive Officer; and Rahul Ghai, Senior Vice President and Chief Financial Officer.

First, a few words on forward-looking statements. Discussions today will include forward-looking statements and non-GAAP financial measures. Forward-looking statements involve assumptions, risks and uncertainties that could cause actual results to differ materially from those statements. For more information, please see the press release, the presentation and Harris' SEC filings.

A reconciliation of non-GAAP financial measures to comparable GAAP measures is included in the quarterly materials on the Investor Relations section of our website, which is www.harris.com, where a replay of this call will also be available.

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

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Okay. Well, thank you, Anurag, and good morning, everyone. We ended fiscal '18 on a high note with fourth quarter earnings per share of 19% on revenue growth of 8%, the highest top line growth we've seen in 7 years. Revenue was once again up in all segments and operating margin expanded 50 basis points to 19.6%.

For the year, earnings per share was up 18% to $6.50 on 5% revenue growth, and we generated record free cash flow of $915 million, 160% of net income. Orders were up 18% and increased by double digits for the fifth consecutive quarter, ending the year up 23% with a book-to-bill of 1.2 and backlog of 26%, all driven by our multiyear investment in innovation, strong customer positions, high win rates and an improving budget environment.

Rahul will walk through the details of the quarter and full year financial results, but I want to take a moment to just recap the highlights of the year on Slide 4. Communication Systems had a terrific year with revenue up 9% from strength in DoD Tactical and Night Vision. DoD Tactical revenue was up 46% in the quarter and 35% for the year, driven by more than $100 million of readiness demand from the Army and the Air Force to support deployment of security forces overseas with upgraded software-defined radios. Order momentum was even stronger, up 81% for the year to support readiness and the ramp of modernization programs. Notable wins include the first LRIP order for the Army HMS Manpack; additional orders from the Marine Corps for Manpack radios with meals capability; and a $765 million sole-source IDIQ for Navy and Marine Corps Falcon III and NextGen radios, double the previous contract and aligned with the budget request for Marine Corps modernization efforts over the next few years.

We were also awarded a sole-source 5-year $130 million IDIQ by the Air Force to develop and produce a handheld video data link radio to provide airborne-collected ISR information to forces on the ground, representing the successful execution of our strategy to penetrate adjacent markets like tactical ISR.

International Tactical also performed well with revenue up 10% for the quarter and down less than 1% for the year, as increased demand in the Middle East and Africa to support counterterrorism activity and the ramp of the Australia modernization program in the Asia Pacific region offset the expected decline in Eastern Europe. International orders were up 25% in the year with -- which combined with a robust and diverse pipeline gives us confidence that international will return to growth in fiscal '19.

Overall for the year, Tactical ended the year stronger than we first expected with revenue up 11%, orders up 41% and backlog up 82% to about $900 million, giving us confidence and continued growth in Tactical and the broader CS segment in fiscal '19 and beyond.

In Electronic Systems, after our flattish first half due to the ADS-B transition, second half revenue growth accelerated to 9% with growth across all ES businesses and ending the year above the high end of our 5% guidance range. The key driver was long-term platforms like the F-35, F/A-18 and F-16, which collectively grew by more than 20% as a result of technology upgrades, ramped production and increased content. Two international programs, U.K. Robotics and the UAE battle management, also contributed to strong year-over-year growth in ES.

Segment orders increased 33% to $3.1 billion with more than -- which -- and more than doubled over $1 billion on the F-35, the F/A-18 and the F-16 platforms. In June, we were awarded by $400 million sole-sourced IDIQ to supply electronic warfare systems for international F-16s. It's a key gating item as we work towards capturing an estimated $1.5 billion opportunity.

On the F/A-18, we had our best orders year on record and we received 2 awards totaling $320 million to supply electronic jammers to protect U.S. and international F/A-18 against electronic threats, supporting multiyear growth on this important platform.

We continue to make progress on international pursuits, successfully delivering our first 2 robotic systems for explosive ordinance disposal missions to the U.K. MoD. Achieving this milestone is important as we pursue other international opportunities in the upcoming U.S. DoD Common Robotic System competition. We also leveraged our FAA managed services model to capture a 15-year $141 million contract in the quarter to modernize India's air traffic management communications infrastructure, supporting growth in one of the world's largest aviation markets.

Overall for Electronic Systems, book-to-bill was 1.3 for the year and backlog increased 30% to $2.6 billion. This, combined with a $17 billion pipeline and $4.5 billion in proposals outstanding, gives us confidence that revenue will continue to accelerate in fiscal '19.

In Space and Intel, revenue was up 1% for the year as growth in classified programs from the ramp of smallsats, ground-based adjacencies and space surveillance programs offset the expected headwinds on environmental programs. Investments in R&D and innovation ahead of the customer needs resulted in double-digit growth in classified orders for the year as we strengthened our global leadership in hosted payloads, increased our share of wallet with existing customers and expanded our addressable market from components to now full-mission solutions.

Orders for the segment grew 6% and book-to-bill was slightly greater than 1 for the year. With about 80% of fiscal '19, revenue and backlog and high-confidence follow-on opportunities, a $14 billion pipeline, continued strength in classified space and decreasing headwinds on our environmental programs, we now expect mid-single-digit growth for the segment in fiscal '19.

We continue to maintain best-in-class margins and generate a record free cash flow of $915 million, returning about $550 million to shareholders. We also achieved our post-Exelis debt-reduction commitment of $2 billion and prefunded our pension plan to about 90% with no required contributions until 2025, creating future cash flow flexibility.

But our strong operation performance wouldn't be possible without a relentless focus on operational excellence. This program we call Harris Business Excellence or HBX. HBX is an integral part of the Harris' culture of continuous improvement, and it's contributed to successes across the enterprise. For example, the Night Vision over the last 2 years, we've improved yield and on-time delivery while lowering cost, resulting in significant margin expansion and double-digit growth. This business has moved from being a watched area when we acquired Exelis to a growth driver, and the improved returns gave us the room to increase investment to compete on upcoming U.S. and international modernization programs.

On the F-35 program, we've delivered over a million parts with greater than 99.95% on-time delivery, and we received the Outstanding Supplier Award in our weapons release factory in Amityville. Operational performance and the commitment to innovation has driven increased content per ship set with opportunities to expand it further in the future. And on the F/A-18 IDECM program to franchise with more than $1 billion in orders to date, we've cut factory cycle time by 10% and have been recognized by the Navy for maintaining a 100% on-time delivery record over the past 20 years.

In Space and Intel, you've heard me speak about improved execution on the SENSOR program, and we continue to make progress with on-time delivery increasing from 35% when we acquired Exelis to 90% today, driving 15% revenue growth on the program just this past year.

And finally on GPS III, we corrected the legacy issues and established a proven and reliable production cadence, delivering the fifth payload in March, with number 6 through 8 expected by early next year.

And now with the recently developed fully digital mission data unit, we're well positioned for the upcoming GPS IIIF award and maintaining incumbency.

Overall, we've had an exceptional year in which we returned to growth and generated record earnings per share and free cash flow, meeting or exceeding the targets we set for ourselves. For fiscal '19, we expect to build on that momentum and continue our strong performance, accelerating growth in all 3 segments, increasing margins and maximizing cash. For the year, we expect earnings per share of $7.65 to $7.85 on revenue growth of 6% to 8% and to achieve our $1 billion free cash flow goal.

Let me now turn it over to Rahul to walk through our financial results and additional details of fiscal '19 guidance before I close with a few comments on our medium-term outlook. Rahul?

Rahul Ghai - *Harris Corporation - Senior VP & CFO*

Thank you, Bill, and good morning, everyone. Starting with total company results on Slide 5. As a reminder, discussions today are on a non-GAAP basis and exclude onetime adjustments. Revenue was up 8% in the fourth quarter and operating income increased 11% on higher volume and operational efficiencies, resulting in margin expansion of 50 basis points to 19.6%. EPS grew by 19% or $0.29, and excluding the benefit of tax reform, was up 12% or $0.18. Free cash flow was a record $464 million for the quarter.

Turning to the full year EPS bridge on Slide 6. EPS grew by 18% or $0.97. The expected $0.21 headwind from the ADS-B program transition was offset by disciplined capital deployment. Half of the EPS growth was from higher volume in Tactical Communications, Avionics and Classified space. Solid program execution, productivity and higher pension income offset by lower environmental volume and program mix. The other half came from a lower tax rate, including the benefit from tax reform.

On Slide 7. Communication systems revenue in the quarter was $523 million, up 16% versus the prior year with growth across all the 3 businesses in the segment. In addition to the strong growth of 21% in Tactical, Night Vision revenue was a gain of double digits as the business continues to improve execution. Operating income for the segment was up 11%, $262 million from higher volume and operational efficiencies. Operating margin remained strong at 31% and orders were up 6%, growing for the eighth consecutive quarter. For the full year, revenue and operating income each increased 9% with operating margin up 30%. Segment orders increased 28%, book-to-bill was 1.3 and greater than 1 in each of the 3 businesses in the segment. We've continued to include historical information for Tactical orders, revenue and backlog, as supplemental information at the end of the presentation.

On Slide 8. Electronic Systems revenue was $640 million, up 8% for the quarter, driven by growth in Avionics, electronic warfare and C4ISR. Segment operating income increased 14% to $119 million from higher volume and strong operational performance. Orders grew double digits for the fifth straight quarter, up 38% with a book-to-bill of 1.3. For the full year, segment revenue was up 5% and operating margin was at 18.6% as operational efficiencies partially offset the negative impact of the ADS-B program transition, incremental investment and shifts in program revenue mix.

On Slide 9. In Space and Intelligence, revenue for the fourth quarter was up 0.4% and operating income was up 8% as margins expanded 110 basis points from strong program execution and higher pension income. For the full year, revenue was up 1% as continued growth in classified programs was partially offset by an expected decline in environmental programs revenue. Operating margin expanded 110 basis points to 17.5%.

Switching to guidance for fiscal '19. We have adopted a new revenue recognition standards, ASC 606, using the full retrospective method effective at the beginning of fiscal '19. And often, the new standard requires adjusting the timing of recognition of revenue and associated program costs for a few contracts, treatment of certain expenses, but does not materially impact the total financial results. Our guidance is based on the new revenue recognition standard, and the preliminary recast and historical financials are included as supplemental information on Slide 16.

For fiscal '19, the revenue is expected to be up 6% to 8% over the recasted fiscal '18 base, which is $11 million lower than the reported numbers. So not a material impact. The growth in the year is driven by continued DoD Tactical modernization as well as growth across electronic warfare, avionics, battle management and classified space programs. We expect total company EBIT margins to be between 19.3% and 19.7% from strong growth in higher-margin Communication Systems and Electronic Systems segments.

Fiscal '19 EPS is expected to be between $7.65 and $7.85 and includes a placeholder of $400 million for share repurchases and an effective tax rate of 17%. We expect to generate greater than or equal to $1 billion in free cash flow in fiscal '19, reflecting higher earnings and cash tax benefit from pension prefunding, partially offset by increased working capital, higher capital expenditures and the timing of tax payments. We ended fiscal '18 with working capital of 42 days, a 1-day improvement over 2017, and 2019 guidance reflects continued improvement in working capital performance.

Capital expenditures grew by approximately $35 million to $170 million to support new program starts. We are expecting accelerated growth in each of the segments in fiscal '19. Communication Systems revenue is expected to be up between 8% and 10% with DoD Tactical up mid- to high-teens, Night Vision up double digits and international tactical and public safety up low to mid-single digits.

Modernization growth in DoD Tactical will primarily occur in the second half of the fiscal year, as we start to ship Manpacks for the Army and ramp up production and deliveries of handhelds for SOCOM and the Army.

Segment operating margin is expected to be between 29.5% and 30.5%, reflecting the diluted margin impact of new program starts and incremental systems work that is more than offset by the benefits from operational excellence and fixed cost leverage from higher volume in the Rochester factory.

Electronic Systems revenue is expected to be up between 7% and 8%, driven by strong growth in Avionics and electronic warfare as fiscal '18 backlog converts to revenue and the continued ramp of UAE battle management program. Segment operating margin is expected to be between 18% and 19% as growth from lower-margin program is offset by operational excellence.

In Space and Intelligence, revenue is expected to be up between 4% and 5%. Classified business, representing about 2/3 of the segment is expected to grow high single digits, partially offset by continued modest weakness in environmental programs, which we expect to reach a trough this fiscal year. Segment operating margin is expected to be between 17% and 18%, reflecting the volume increase and operational efficiencies.

Fiscal '19 EPS bridge on Slide 11. EPS is expected to grow between $1.15 and $1.35 from higher volume across the 3 segments: operational efficiencies; lower tax rate, including the benefit of tax reform; and accretive capital deployment.

And with that, let me turn it back to Bill for closing remarks.

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Okay. Well, thank you, Rahul. I want to close with a few comments on our multiyear strategy, including the growth outlook for the medium term. As we recap on Slide 12, in recent years, we reshaped our portfolio to focus on high-growth, high-margin businesses, successfully integrated Exelis and made disciplined investments in the business that led to several new product launches and strategic program wins. We also derisked the balance sheet to give us more financial flexibility. Fiscal '18 was an inflection point for Harris as we return to growth and grew backlog significantly. This, combined with a more favorable budget environment, especially in strategic growth areas, positioned us well to accelerate growth in fiscal '19 in the medium term.

At this time last year, I laid out the medium-term growth drivers by segment, as shown on Slide 14. And over the past year, we've seen the outlook improve in each of them. Communication and electronic systems are now expected to grow high single digits and space and intel at mid-single digits. The higher end of the medium-term range for all 3 segments that we indicated this time last year. In Tactical, we're beginning to see the DoD modernization ramp across all the services, and international has stabilized and is returning to growth as we leverage our incumbency and large installed base and benefit from higher defense spending by coalition partners.

In Electronic Systems, Avionics and electronic warfare are entering a multiyear growth cycle, driven by our position on long-term platforms. And in Space and Intel, classified growth will accelerate, as we maintain high win rates and expand into adjacencies in a growing budget environment, and the headwinds in the environmental business now become tailwinds.

We've been on a multiyear journey to improve margins. And while we made progress in driving productivity and efficiency in recent years, I see much more opportunity in front of us. We're now halfway through standardizing our systems that will reduce the number of ERP platforms from 28 to 3, simplifying our operating environment, driving productivity through growth and shared services, automating core processes and laying the foundation of our enterprise-wide digital strategy. By the end of this year, we will have eliminated 80% of our data centers, and by fiscal '21, the remainder will be fully cloud-enabled.

We recently hired a new Chief Technology Officer, who's fundamentally reshaping how we design and develop new products to get more out of every R&D dollar we invest. We're fully deploying dev ops to streamline software development, which is growing to be more than 40% of our engineering work today and is expected to increase over time. And we continue to squeeze more cost savings out of our supply chain through value engineering and should cause analysis on new products and improving supplier performance and reducing sole-source components on legacy solutions.

Taking together, this relentless focus on operational excellence combined with the leverage on incremental volume that will drive margin expansion and communication Electronic Systems as well as for Harris as a whole.

In summary, we expect higher revenue, higher margin, double-digit earnings-per-share growth and sustained cash generation through the medium term. And with that, I'd like to ask the operator to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Robert Spingarn with Crédit Suisse.

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

I just had a couple of program-related questions. First, on the ES segment. Your -- the midpoint of your margin guidance would be flattish with '18, and I think you call out some lower-margin programs perhaps being offset by operational improvement. What are some of these lower-margin programs or the mix shift that you see here?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Well, first, I'd say on '18, we ended the year at 19.2%, and we're guiding to 19.3% to 19.7%. So at the center point, we're up about 30 basis points before the rev rec goes in place of 50 basis points, including revenue recognition. But as we see growth in our segments, especially in our space and environmental -- in our Electronic Systems business, some new wins like the Classified business is coming in at lower-than-average segment margins, and that's growing pretty healthily. That will bring down the SIS segment a little bit, again offset by operational excellence. And of course, over the Communication Systems segment and Tactical, as we see the ramp of modernization programs, as we said before on this call, we'll see those programs coming at slightly lower than segment or normal Tactical margins, but improving over time as we continue to take cost out of the product as we've done many times in the past.

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

And on F-35, you talked a little bit about higher content as one of the drivers there. Lockheed has been doing some things with the suppliers in order to pursue lower costs and better value, at least on things that are not life of program. Are there further opportunities or risks for your packages on the aircraft?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Rob, we see more opportunities than risks. Though there are some risks that remain today. We're about $2.2 million per ship set, and we provide the math, we provide the common components, we have the bomb release system, the carriage release system. We recently won, over the last year, the PCD EU as well as the Aircraft Memory System sort of -- one of the things that's coming up is the ICP, the Integrated Core Processor, the mission processor, and that will be awarded probably sometime later on this year. We're one of the 3 companies that are on the hunt on that. And over time I think you've heard Lockheed talk about what they might do on the IC&I as well as on the EW platform. And given our progress so far on EW and the work we've done through software-defined EW, a big investment over the last several years, small size and weight in power systems, really improvements in cognitive and the algorithms we have, we think we'll be a player there if they decide to move down the path and recompete that. And so as I look at F-35, it's both integral from a volume perspective. But I think net-net, I see opportunities to increase our content per ship set over time.

Operator

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

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

Bill, you talked, I think, again, about $4 billion in outstanding bids at ES. Could you just talk about obviously the big ones, the chunky ones and the timing around those, when you would expect to hear on those?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Yes, there's -- certainly, a big -- a piece of it is going to be some opportunities we have with the FAA, which is a bridge contract on the FTI program. We should expect that over the next couple of months, that's going to be an important one. But there's a lot of other activities, including some of what I just mentioned on F-35. There's opportunities on F-16. There's opportunities in the near-term pipeline on robotics systems, especially as we extend that platform beyond the U.K. into other international markets as well as U.S. DoD. So it really goes across the gamut of what's in the Electronic Systems business. I don't know if you have any other color, Rahul?

Rahul Ghai - *Harris Corporation - Senior VP & CFO*

The only other thing I would add to that, Bill, is we've got -- I mean, we've been talking about the UAE program, David, and there are lots of bids that are outstanding to expand that program further not only with the land forces, but even beyond that within the country.

William M. Brown - *Harris Corporation - Chairman, President & CEO*

That was a $189 million program in the UAE. We're coming up very close to a mission-readiness exercise in the next month or two, which has gone so far exceptionally well. And as that goes well into August, September time frame as well as pointing out, there's a big opportunity ahead of us in the UAE.

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

So I mean in terms of percentage, are you going to hear -- on the $4 billion, do you -- would you hear 75% of that this year? Or is kind of ballpark, how much are -- what percentage that you expect to hear on this year?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

I think the bulk of it. We should on within the next year.

Rahul Ghai - *Harris Corporation - Senior VP & CFO*

Yes, yes.

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

Okay. All right. Bill, you outlined the potential for margin upside between volume and productivity and all various other things. Currently, the businesses as a whole are laying around 22%. Would you care to frame kind of the margin upside potential you're thinking about here?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Yes. When I look at it, let me take of it from a Harris-wide perspective, you're talking about this seg op margin or segment EBIT margin. This year we're going to be, again, center point of our guidance at 19.5%. So that's up on average about 30 basis points over reported '18, a little bit more than that when you look at the revenue recognition restatement at '18. But if I go out into '19 -- into fiscal '20, I think we should be approaching and not hitting 20%. So we believe with the maturity of our operational excellence program, some of the actions and steps we're taking today. And the way we're going to take cost out of new product launches like in Tactical over the next 12 to 18 months, we're pretty confident margin expansion in '20 and beyond.

Operator

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

Gavin Eric Parsons - *Goldman Sachs Group Inc., Research Division - Associate*

It's Gavin on for Noah. Having taken up the revenue guidance in all 3 of the segments, just kind of how should we think about how much visibility you have into that over the next few years, how much of that is already in backlog given you've had bookings well above revenue past few years or how much of that is contingent upon further budget growth.

William M. Brown - *Harris Corporation - Chairman, President & CEO*

When we look at going into next year, again, we were guiding the 6% to 8% revenue growth. We ended the year with very strong backlog growth. And as I look into next year, Harris as a whole, and I'll really keep my comments specific to fiscal '19, we [weighed] about 2/3 of our revenue that's covered either in backlog or in high-probability follow-up -- follow-on opportunities, which was up from where we were last year, and it's up pretty substantially in the CS business as well as the Space and Intel segment. So we think, just based on where the backlog is, the pipeline we have, the bids that are outstanding, I see more visibility on revenue in fiscal '19 than we would say going into '18 a year ago.

Gavin Eric Parsons - *Goldman Sachs Group Inc., Research Division - Associate*

Okay. And then on the long-term outlook for Manpack, just curious if you could update us on how much you think the IDIQ might be exercised? Do you think you can get more than 50% share? And if so, what do you think your share would ultimately be in that program?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Look, we've been running historically over the last 5 to 10 years at a much higher share than 50%. So we do -- we would aspire to have our fair share of that market, which should be more than 50%. Look, first of all, the funding lines for Tactical as a whole are actually quite strong. They're up in the fiscal '19, NDAA from '18, and '18 was up about 17%, 20% from fiscal '16 and then growing to about $1 billion or $1.2 billion a year over the next several years. So the funding that's supporting the overall Tactical business is very, very strong, including the HMS Manpack. We're doing well. We had a delivery order in LRIP, delivery order for 1,129 units that will be delivered in fiscal '19. We expect that we'll see another LRIP order probably in the back half of our fiscal '19 of some size, leading into operational testing in fiscal '20. So it is all playing out I think very well. It's moving forward as we'd expected. The budget is there, the Army is moving the program. So I think it's all very good news on not just the Army Manpack, but really all the Tactical radio programs as a whole

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Operator

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

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

Bill, I wondered if you might expand a little bit on the -- just the thought process around the R&D pipeline. Obviously, your IRAD investments have had a lot of payoffs -- a lot of attractive payoffs in the last couple of years, and I just wonder if you -- when you think about the incremental dollars and opportunities that you have in that pipeline, is your thought process around these things changing? I mean, you obviously had a lot of success. Just help us with the mindset around what else may be out there given the success you've seen already.

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Well, it's a very good question, Carter. Thank you. In fact, having a new CTO on the team over the last year is really helping us dig in a lot more into where we're spending our money and where we shouldn't be spending our money going forward. I mean, you're right. Over the last couple of years, we've raised our investment in IRAD. This year, we closed just over 5% of revenue, which is above where everyone else in the segment that appears happen to be. It's going to go up again a little bit in fiscal '20. When tax reform was enacted, we took our fiscal '18 number up about $20 million because we sold new opportunities in things like robotics that we invested in. So we continue to look at how we spend money, we look at the return on different programs, we look at how we leverage capabilities across the company. Lots of places around Harris invest in various features of software or waveforms, and we're thinking about how do we leverage the investments we have across the company in a more productive way. So as one of the things our CTO is helping us think about, as I go out a year or 2 or 3 from here, I don't think we'll be substantially higher than -- as a percentage of revenue. So I see it neither as a margin drag nor tailwind on our margins. But if we continue to find good opportunities to invest, invest ahead of the curve, invest ahead of where the customers are going to go. And I think as you look at the results we're pointing out today in very good growth, it really does come from some of the IRAD investments we've made in the last 3 or 4 years.

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

Is there a way to increase the velocity of opportunities that you're identifying them at the segment level, or -- so you can deploy more dollars in that direction?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Well, that's certainly something that we're looking at the very carefully and something that we were focused on as an organization. Certainly, as you deploy tools like dev ops, it's going to help you develop products, which have significant software content faster. The concept is basically be able to integrate your -- continuously integrate and test software builds so that you always have a software feature that you can field and market, and that is something that we have not developed. A lot of the defense companies have not, and that is going to compress the cycle time for software pretty substantially. We've seen at multiple cases where we deployed dev ops. As we go out the next 2 to 3 years, by fiscal '21, we think 85% or 90% of our new starts will be on dev ops. I think it's going to be a key thing, the compressing overall cycle time and developing and launching new products, Carter.

Rahul Ghai - *Harris Corporation - Senior VP & CFO*

Carter, I just wanted to add to what Bill said. So just to give you an example or a couple of different examples, a lot of display keeps the communications systems as a segment. We've been investing a lot on hardware over the last couple of years at SOCOM and the Army, all the products coming in. So even that is kind of coming to an end at this point. With SOCOM Manpack is one big program that we're going to work on next year. So a lot of the attention now is going to shift to waveforms and the software that goes on to those radios and how do we monetize that revenue stream as we've done previously with the newest waveform. So there's a shift of where we're spending the dollars is happening as well within our R&D space.

Operator

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

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

Just a couple of questions. I was hoping you could kind of update us on the pipeline at Tactical RS, DoD international and if you can call out any larger campaigns that you're pursuing.

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Sure. Yes, first, on the international side. Pipeline is actually still very good, it's about $2.3 billion. It's still about the same where we were last quarter. The makeup really looks about the same, about 50% is Middle East and Africa. And Iraq remains a big opportunity, it was pretty substantial in '18. It will be a substantial amount in '19 and beyond. So there's really good opportunities there. About 30% is in Europe, and we're starting to see a little bit of a shift from Eastern Europe to Western Europe from countries like Poland and Romania to NATO countries in Western Europe still a little bit of a shift. And then the balance is going to be in Asia, in Central and Latin America, a little bit in Canada. In Asia, we see Australia, some additional opportunities on the horizon, other smaller countries in Asia. And we see in Central America, we see Mexico being a bigger opportunity in '19 than we had in '18. So overall, the trends I think are very positive in international. We have been having a good year in fiscal '18 in international, a little bit better than we thought, down less than 1%. And a little bit better in Europe than we had anticipated at the beginning of the year. So played out a little bit better than we had thought, and I think we'll be back to low single-digit growth in fiscal '19. You want to cover the DoD...

Rahul Ghai - *Harris Corporation - Senior VP & CFO*

The DoD -- Gautam, the DoD Tactical, it's right, it has actually grown since we last spoke. The DoD Tactical pipeline is now $1.7 billion, which includes about $400 million, $450 million of the modernization pipeline and about $1.2 billion, $1.25 million on the bay side. So that's -- but I think the last time we spoke of it as $1.5 billion, if I remember correctly.

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

Okay, that's very helpful. And just curious if you've seen any sort of potential blowback from some of the more challenged relationships to USS with NATO allies. Is there any -- can you talk about your incumbency there and how much of a -- how difficult it is for some of the NATO allies to switch away from the Harris radios that they already purchased in? I'm just curious, like is there any potential blowback from the friction we're seeing where they may prefer European suppliers or what have you instead.

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Gautam, it's interesting. I see -- we've seen no blowback. In fact, I would say it's going in the other direction. We're seeing more opportunities than we've seen in the past with NATO countries. I think its turning out to be a little bit more of a positive than a negative in lots of ways. We are seeing coalition partners, NATO partners stepping up with more defense spending, and we do see opportunities that are increasing for Harris on the Tactical radio side, not decreasing.

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

Okay. And just one last one from me. You guys have been repurchasing quite a bit of stock, raising the dividend, repaying debt. How does an M&A fit into your medium-term plans if at all?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Well, look, I mean, I think you pointed out. I think we've done a lot of good things on the balance sheet. We'll generate $1 billion of cash this year. We've been paying a dividend that's just under $300 million. We'll evaluate that at our August board meeting and decide if there's an increase and to what extent. We have a placeholder out there for $400 million worth of buyback. We have $300 million of debt that's due at the back end of the year. And over the course of '19, we're going to evaluate that $400 million share buyback placeholder as to whether it's the best place to buy back our stock or to look at M&A. Certainly, as we get beyond '19, you really step up more on free cash and you see any -- in fact, any drag on debt repayments go to 0. We're going to generate more free cash and more optionality on that cash for M&A. Look, we're going to -- we're building our strategic pipeline and M&A. We're looking at a variety of different opportunities, all within core segments and that will bolster our ability to compete, but nothing more to report on today. Certainly with the way we executed on Exelis and how we transformed the business at Harris, I'm very confident that any deal we do will be accretive and will be effective, will be executed and will be strategic to the company.

Operator

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

Jonathan Phaff Raviv - *Citigroup Inc, Research Division - VP*

Can you step us through some of the cash building blocks heading into next year? You went through a couple of them in your prepared remarks, but can you just sort of narrow in on things like working, capital, cash flow, headwind versus tailwind? And then also I know you mentioned CapEx a little bit more on cash flow that blocks towards the $1 billion?

Rahul Ghai - *Harris Corporation - Senior VP & CFO*

Yes, absolutely, Jon. So in 2019, our net income is up about $140 million and we capped the cash tax benefit of about $90 million from the pension funding that we did or prefunding that we did back in '18, and that's getting partially offset by increase in working capital of about $20 million to $40 million. As I mentioned in the prepared remarks, our days come down by 1 day, but we still -- because of revenue growth, we still see some drag on working capital. So there's about $35 million of CapEx growth, and that's primarily to fund new program starts like the FBI India what Bill mentioned. Our ERP investment is a multiyear investment, a litlle bit of step-up in that as well. Classified wins that we got in space this year, that required a little bit of CapEx. So you wanted to put $35 million growth in CapEx, and then there are some cash tax refunds that we've got in '19 from overpayments in fiscal '18 that we discussed earlier, and that's a headwind as well and that won't repeat. So you put all that together, we feel good about the $1 billion. But as we look further out, Jon, and look into fiscal '20, and the big onetime item that we have in fiscal '19 is this $90 million of cash tax benefit from pension prefunding. As we look at fiscal '20, we think there's several offsets to that. The biggest being, we have not yet recovered the Exelis restructuring outflows that we had from the government. It's a proposal to submit the restructuring proposal. It's a multiyear approval process, and we start recovering all the money that we have previously spent, and we recovered that through our cost-plus program. So there's a little bit of outflow in Exelis restructuring that's still happening in the $10 million to $15 million range, that kind of goes away. We do think that CapEx is a tailwind in fiscal '20 because a lot of the program CapEx will be kind of behind us. Also, the ERP implementation starts winding down. And then we're working on several other cash tax savings projects that we kicked off this year, and that will start delivering results in fiscal '20. So you can put all of that together, there's enough to offset the $90 million of onetime benefit that we'll get in fiscal '19, and then earnings drive cash flow growth in '20 and beyond.

Jonathan Phaff Raviv - *Citigroup Inc, Research Division - VP*

Got it, that's very, very helpful. And then just on the investment decisions, Bill, thank you for all the color you offered earlier in the call. Can you show some perspective on what role the customer is making or playing in driving those decisions? You said that customers are desiring to see more investments upfront that you can then deliver a more mature product [at year-end]. Just kind of curious what the customer conversations like when it comes to approaching CapEx and also R&D investments.

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Well, it's a very good question. I mean, it's a bit of a multiyear push by our DoD customers for industry to step up in R&D. And I think we heard that message, that demand signal. We sort of step up on this 4, 5 years ago, and I think that's paying some dividends today. We don't make investments in R&D internally without really understanding the business case, understanding where the customer is going, the messages that we're hearing from them. And we shape our internal investment pipeline accordingly. So it's all very well connected to where we believe the customers are going, input from them. And I think the fact that we've been willing to step up internally has paid dividends for us. And you see that very clearly on what's happening on electronic warfare. It was an area that was under invested in by Exelis. We stepped up dramatically in electronic warfare. And now we not only positioned ourselves to retain our strong platform position on F-16, F/A-18, B-52, but also now we're starting to get into the mix for recompetes on fifth-gen aircraft and proprietary platforms that are being envisioned down the road. So I think one good example of where we're hearing the message, shaping our investments, and I think we're investing smartly on behalf of share-owners. So it's all -- I think it's all pretty tightly connected, and again our new CTO is going to help us shape it even further in the next couple of years.

Operator

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

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

Just on the medium-term targets, there's solid growth outlook across the portfolio. I guess how do you think about the biggest risks, whether its budget related or maybe (inaudible) pursuits in the pipeline?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

A little bit difficult to hear, but I think you were referring to the medium-term outlook. First of all, budget is going to be an important driver to that. What I've seen very positively in the NDAA, which passed the House, it's supposed to be at the Senate this week. It could be signed by the President before we even get out of fiscal '18, which would be pretty unique. I think very encouraging to us as well as all the people who issue procurement decisions in the DoD if the NDAA get signed that quickly and maybe even an Appropriations bill by the end of September, that's even a possibility. So I think these are all very positive indicators. So when you look at Harris, the last time I talked about medium term as mid-single-digit growth plus, I think now it's mid- to high-single digit. You see that coming through at '19. It's really across the segments. I think a very important driver of that is going to be in the Communication Systems segment, where we do see a very strong ramp in DoD, in the tactical radio business. And we've been focusing a lot on commentary around the Army. We see the budgets growing pretty dramatically on the Army over the next 4 or 5 years. But you also see SOCOM growing, you see the Air Force being strong and you see the Marine Corps recap coming in quite substantially. So when I look at our next 5 years, we have about $5.5 billion worth of budget available to Harris in the Tactical radio side that supports our business, cumulative over the next 5 years. So that's very, very encouraging to me. We also see I think great progress on some of the platforms in both Avionics and electronic warfare. I think we're just really starting this big growth. The IDIQ and one on the F-16 EW platform internationally was for $400 million. So we booked an award for Turkey in Q4, that was 60. We had Morocco before that. We have about $1.5 billion opportunity that's ahead of us on international F-16s. F/A-18 is going to grow. The F-35 is going to grow. And again, I think we're on the front end of a nice growth trajectory on the space Classified business. So Sheila, really, as I look at the business and I see even things that have been headwinds turn to tailwinds like environmental, really across the franchise, we're seeing really good growth prospects. Some of it is driven by -- a lot of it are driven by where the budgets are growing, but I think a lot of it is driven by how well we positioned our portfolio and the differentiators we have in our products and our solutions.

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

Got it. And then just one more. You mentioned software as the potential opportunity for yourselves in the defense [primes]. I guess, how do we think about software evolving as a contributor to the top line over time? And where are those opportunities?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Well, it's going to be -- today, it's more than 40% of the work content we do in engineering. So it really is, today, part of the top line. 5 years ago, it would have been half of that or 25% of our engineering content. As we go forward, it's going to be more than 40%. It can grow to 50%, 55%, 60%. I think what's going to contribute to the top line, Sheila, is how good we are at ingesting and maturing dev ops within this company so that we become strategically better than other players in the space. So we can develop software faster with lower defect rates, with better capability. I think the more we can do that, that is where I think it's going to contribute mostly to the top line, as I see that. To me, over the next 4 or 5 years, I think it's going to be fundamental to how we, and probably other players in the space, develop products. A lot of it is going to turn on software. I think the best people in this space are the ones who are going to win.

Operator

Our next question comes from the line of Seth Seifman with JPMorgan.

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

You mentioned that space is driving the higher CapEx. And I wonder if you could talk about, if you can at all, what's underlying that, and then just -- that's an area of the budget where we've seen a lot of additional resources and maybe how you're seeing that play out in terms of what contracts are coming up so far, what areas are most exciting for you guys and then maybe to bring it back around to the CapEx when we look out to fiscal '20 and beyond where you see CapEx overall for the company kind of shaking out.

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Well, yes. I mean, look, on the space side, it's very exciting, a lot of stuff that's happening. We talked the last quarter about $0.5 billion exquisite win that we have to a prime on a missionary that we've had some experience on. It's going to deliver over the next 5, 6 years. Our piece of that is more -- probably more front-end loaded. There's some capital associated with that program. When we've talked over the last year about our positioning on smallsats, we have multiple contract awards on that. That's going exceptionally well, there's some capital associated with that. And as it matures over the next 12 months or so, there's lots of other missionaries and components and capabilities that will be augmenting that smallsat mission that we're positioning ourselves on. It's all, I think, very exciting. Space Superiority is a huge growth driver for the company. I talked about our growth in that area being more than 15% this past year, and we see that continuing to grow. We think we're well positioned for opportunities [falling] ground control systems as well as space situational awareness. So lots of different ways we're competing on, on space superiority. And the last one is on the optics side. With Exelis, we acquired a great capability up in our Rochester facility for optics, and there is a recap of a lot of different capabilities in the space, some are RF-related and some are optics-related. And those recapitalizations sometimes require some additional capital investment. So that all goes together in some of the things we're spending our growth capital on in '19. As Rahul mentioned, we're up to about $170 million in '19. We'll see that mitigate itself a little bit going into fiscal '20, probably down around $15 million or $20 million, as we get through a lot of this sort of onetime growth capital we see in '19.

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

Great. And then just maybe as a quick follow-up, Rahul, as we go through the year, anything we should be aware of in terms of the cadence of the sales or the earnings this year?

Rahul Ghai - *Harris Corporation - Senior VP & CFO*

The -- I mean, our sales are typically a little bit backend loaded as you -- and that kind of -- it's a 48%-52% split traditionally for us. DoD Tactical, as I mentioned earlier, is a little bit backend loaded, the SOCOM and the Army handles their -- they basically don't start until tailend of Q2. So December issue has been to start and then the ramp in the second half of the year. And then Manpack is kind of starts Q2 our time. So a little bit more backend loaded than typical, but -- so other than that, ES and space should be fairly typical.

William M. Brown - *Harris Corporation - Chairman, President & CEO*

We should see the orders that Rahul is referencing on SOCOM handheld and Army handheld, more in the front-end of the year with the execution delivery, the revenue towards the backend of Q2 into the back half.

Operator

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

Joshua Ward Sullivan - *Seaport Global Securities LLC, Research Division - Director & Senior Industrials Analyst*

Bill, so you just mentioned the higher revenue design team, the new CTO consolidating your piece, changing some of the way you approach development. What kind of benchmarking have you done for that? And then what's the time line on some of those efforts? And maybe where we would see the impact first?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

I think broadly over the last 5 or 6 years, as I start to reshape this OpEx program we have at Harris, I've been talking about and what I consider to be a good OpEx program is a program that delivers 2% to 3% net of cost. So 2% to 3% savings net of what's given back to the government, net of inflation, dropping to the bottom line. And we've been running towards the high end of that 2.5% to 3% range really over the last 5 or 6 years, and I expect that to continue and maybe even go above that over the next several years. What's driving it is changing over time, of course, supply chain is important and there's some engineering productivities, labor productivity in our factory. But even through Exelis integration, we continue to see, on top of the savings from Exelis integration, opportunities to just get better every day at what we do, and that's going to be continuation. So that was from my experience at UTC and what I see other companies doing. So I think that is generally pretty good. In terms of benchmarking on ERP systems, it's hard to say, but I can tell you 20 systems today is too many and 3 is about the right number. We've got a government business, we've got a commercial business and one -- it's fairly unique, which is why we're at 3. But really, what we're doing is we're bringing people into the company in senior roles either in IT or technology or other places that have experience outside of Harris that really look at what we do and bring best practices from their experiences here, and that is what's giving us some shine in the light on some new opportunities that really are in front of us. And as I said, as I look into the future, I see as much opportunity ahead of us as I've seen we captured in the recent past. So I think the ground is pretty fertile on continuing to get better, drive efficiency and productivity really across our business in the next couple of years.

Joshua Ward Sullivan - *Seaport Global Securities LLC, Research Division - Director & Senior Industrials Analyst*

Okay, great. And then just with the next medium targets -- the new medium-term targets. Can you update us on the Rochester facility utilization and maybe where you see that utilization going over the next 2 to 3 years? I know you just mentioned in the previous question some opportunities in optics, does that change the paradigm at all?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

It doesn't, no. In fact, in our Rochester Tac, we've got mobile facilities up in Rochester. On the Tactical, we've been running in the low 60, 60% utilization. There are plenty of opportunity to grow in that Rochester facility without any additional capital. It's about 6 years old, but even as we go to multiple shifts, there's opportunities to do something different with some of the components we've made there. So I see no capacity limitations on the horizon in our Rochester tactical facility. And for that matter, really in any other facilities, we do a lot of optics work and some other things up in Rochester. And I don't see any limitation there. I think the spike we're seeing this year on capital is really on specific programs and program capital, not on -- basically not an infrastructure capital.

Operator

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

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

Going to Slide 13 and the medium-term guidance, Bill. It may sound a bit pedantic, but your commentary, you said you expect the revenue growth rate to accelerate up to high single digit. Well, you're kind of going to get there in 2019 if everything goes to plan. So do you see the potential to go faster than what you're guiding to in 2019? And then relation to that, how sustainable do you think this sort of growth rate is? It is sort of 1 or 2 years and it slows. Have you seen this as being as a 3-, 4-, 5-year effect?

William M. Brown - *Harris Corporation - Chairman, President & CEO*

Well, first on that slide the -- in Electronic Systems and Space and Intel, there is an acceleration from what we see in fiscal '19 over fiscal '18. So there's some acceleration there. We see CS and Communications to continue to be at a high single-digit range. Frankly, I think, as I look back on '18 and when we started our guidance on '18 -- keep in mind we started at -- I believe it was 15% or mid-teens on DoD Tactical, and then we went up to 20 or low 20s and we ended at 35%. So I'm not so sure I'm really sort of calling it accurate. Really, I think we're being more conservative than aggressive in our assumptions. And hopefully, we're in the same place today in '19, and hopefully, beyond there as well. As we see opportunities placed -- put on order a lot faster than we saw over last couple of years, and this is a pretty remarkable phenomenon, orders are being placed, dollars are being obligated at a much faster rate, not just in DoD, but also in the intelligence community, certainly from where we were a year or 2 ago. And that's been a very positive surprise. And like I said, the NDAA getting approved out of the House and maybe even getting approved by the President before we even hit September is pretty unique. And I think what's happening with things like that happening, it gives you encouragement to people who issue procurement decisions to obligate dollars faster. Their confidence goes up. So I continue to see opportunities in '19 and beyond. So what's medium term? Medium term to us is 3 to 4 years because I look at it and we look at our positioning, the amount of unused dollars that aren't yet committed where the budgets are growing. And what we see in the budgets that we can actually see over the next 5 years, there's a lot of opportunity to continue really robust growth across Harris going out in that 3-, 4-, 5-year period, Rob.

Anurag Maheshwari - *Harris Corporation - MD of Asia-Pacific*

Thank you, everyone, for joining the call this morning. And please do not hesitate to get in touch with me for any additional questions. Have a great day.

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.
