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LLL.N - Q4 2016 L3 Technologies Inc Earnings Call

EVENT DATE/TIME: JANUARY 26, 2017 / 4:00PM GMT

OVERVIEW:

LLL reported 4Q16 sales of $3b and EPS of $2.38. Co. expects 1Q17 sales to be $2.4-2.5b and EPS to be $1.70-1.80.

CORPORATE PARTICIPANTS

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Michael Strianese *L3 Technologies, Inc. - Chairman and CEO*

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PRESENTATION

Operator

Good day and welcome to the L3 Technologies fourth-quarter 2016 conference call. (Operator Instructions) Please note, this event is being recorded.

I would now like to turn the conference over to [Mumut Sidik]. Please go ahead.

Mumut Sidik - *L3 Technologies, Inc. - Representative*

Thank you, Marianne. Good morning and thanks for joining us for L3's 2016 fourth-quarter earnings conference call. With me are Michael Strianese, Chairman and Chief Executive Officer; Christopher Kubasik, President and Chief Operating 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 factors that may cause actual results to differ materially from those anticipated.

Please also note that this call is simultaneously broadcast over the Internet.

I would now like to turn the call over to Mike Strianese. Mike, please go ahead.

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Thank you and good morning, everyone. We are very pleased to report a strong fourth quarter, marked by increases in our sales and EPS, as well as healthy orders and the book-to-bill ratio. In addition, our margins improved. This ends a year where we continue our focus on solid performance and program execution, and we continue to make operational progress.

As I am sure you have seen, we started 2017 with a new name, L3 Technologies, Inc. Our new name capitalizes on L3's strong reputation, reflecting broader and more diverse capabilities that extend well beyond communications.

It is hard to believe that it has been -- 2017 will be -- will mark our 20th anniversary of the founding of L3. And, in those 20 years, we have certainly gone way beyond communications systems, so we thought it was time to broaden the name and it looks like it has been well received. That reputation in our annual and quarterly results would not be possible without the contributions of our hard-working and dedicated employees. Their ability to perform, innovate and deliver high-quality solutions to our customers every day contributes to the solid foundation of our future success.

With that, I would like to touch on our recent announcement regarding the leadership transition and realignment of our Electronics Systems business segment. Steve Kantor, President of Electronic Systems, will be transitioning from his role effective March 1 and retiring during the second quarter. We will split Electronics Systems into two separate business segments: a new Electronic Systems segment with sales of about $2.8 billion and our new Sensor Systems segment with sales of about $1.5 billion. Todd Gautier, currently head of our Precision Engagement and Training sector, will run the new Electronic Systems segment. Todd is a 30-year industry veteran and a former military and commercial pilot who has held various leadership positions within Electronic Systems. Jeff Miller, who currently runs our Integrated Sensor Systems sector, will lead our new Sensor Systems segment. Jeff has also been in the industry for 30 years with experience on a range of platforms, including soldier systems, force protection systems, and electronic warfare.

In addition, Curtis Brunson, our Executive Vice President of Corporate Strategy and Development, will also be transitioning from his role March 1 and retiring during the second quarter. Dave Van Buren will become Senior Vice President of Corporate Development, and Heidi Wood will be brought into Senior Vice President of Strategy, and they will both assume Curtis's responsibilities. Both Curtis and Steve are highly regarded industry veterans who have made invaluable contributions to L3's success over the past 20 years. They have been outstanding leaders, great businessmen, and also great friends.

Turning now to our fourth-quarter results, sales were $3 billion, a 4% increase from the same period last year. This increase was driven by organic growth in our DoD business, primarily. Our earnings per share for the quarter with $2.38 of free cash flow was a strong $427 million. Funded owners were $3.6 billion, and our book-to-bill ratio increased to approximately 1.2. Segment operating margins for the quarter were 9.8%, an increase of 90 basis points year over year. This demonstrates that our ongoing efforts to drive disciplined top-line growth, while improving operating efficiencies and margins, as we continue to make L3 a more agile and streamlined company.

As we ended last year with sales of $10.5 billion and operating margins of 9.6%, which yielded diluted EPS of $8.21 and free cash flow of about $900 billion -- $900 million. We made very good progress in 2016. While we still have more to accomplish, we have positive momentum as we enter a new year.

We also increased our 2017 guidance this morning, and Ralph will give you more detail on our outlook later.

Turning to cash deployment, our capital allocation strategy continues to be focused on a disciplined and opportunistic approach to M&A, prudent share repurchases, meaningful dividends, and targeted investment in innovation. Our 2016 acquisition strengthened our portfolio in areas with attractive growth opportunities. Our investments focused on markets and capabilities where we can gain or improve our market leadership positions. In 2016, we completed four acquisitions and announced a fifth in the fourth quarter, Implant Sciences, which we closed on January 5. This brings our total M&A investment to approximately $500 million. These businesses are expected to generate approximately $275 million in sales and $53 million in EBITDA for 2017.

Chris will discuss our recent acquisitions in a little more detail, but they each bring innovative technologies that strengthen our platform for growth.

Turning now to the four segments, we are focused on the areas where we have enabling technologies. Readiness is an increasing priority for our customers, and our businesses have the capabilities to help our customers achieve their missions. In Communication Systems, there is a need for new and old platforms to communicate with each other over secure networks. Interoperability across the services and with our allies is the goal, and our protected communications solutions are integral to that effort.

In Aerospace Systems, we are a lead integrator that can install ISR systems, as well as communication equipment on any platform. We have performed modifications on everything from business jets to large aircraft, and we are well-positioned given the recapitalization that will occur in the coming years.

L3 Sensor Systems capabilities will be together in a singularly focused segment. This will enable us to deliver the best solutions for sharing information. Our sensors are world-class and are adaptable for use in all domains -- land, air, sea and in space.

And, as we mentioned, the new electronics systems will be primarily focused on the commercial and international markets with a priority on training and simulation, avionics, and airport security systems.

Finally, we are continuing to increase our investment in research and development. Driving innovation remains one of our core strategies, and we are directing our efforts towards new enabling technologies that align with our customers' dynamic and evolving priorities.

L3 has performed well on several technology initiatives in 2016. For example, we are now DOD security certified on our M-code GPS receiver and, in November, earned the key governmental approval that enables this equipment to be tested and utilized by the customer.

Also, we developed a high resolution image intensifier for night vision use with the highest performance in the market. We are developing an advanced signal processing engine that is a key enabler for the manned/unmanned teaming known as MUMTi secure communications program. This is where our agility and adaptability come in. At L3, we are positioned to quickly respond to customer needs, providing world-class products and systems with a streamlined culture that drives results.

Last year, we continued to capture new business and secure follow-on work. We extended our leadership positions in ISR integration, data link capabilities, simulation and training, and advanced space programs. We will talk about our fourth-quarter wins later, but let me just give you a few of our new business highlights. We were awarded a contract to deliver power equipment for the US Navy's newest submarine, the Ohio replacement program now known as the Columbia Class. In Australia, we were selected to deliver soldier modernization technology, including specialized night vision equipment to the Australian Army through a $208 million contract. This award demonstrates the growing global demand for our highly advanced capable products and solutions.

The night vision award intersects very nicely with our additional investment and strategic positioning in Australia, as you saw with our Micreo acquisition. The Australian Department of Defense is an important customer for us, and we are making sure that we maintain and foster that relationship.

Turning to the US DOD budget and some of the broader industry trends that drive our business, we can all see this change in the air with the new administration. While there are still more questions than answers, looking at the portfolio, we believe we are very well positioned to address many of the priorities outlined by the new administration. We were pleased that the National Defense Authorization Act passed at the end of 2016 with higher defense spend. While higher defense spending is expected, it is still too early to quantify the timing of increases in the DOD budget. There are multiple budgets scenarios under consideration, and for now we are continuing to focus on operating the business in the normal course and executing on our key strategic priorities. We are staying close to our customers so we understand their evolving needs in all these areas and positioned to react to any of the new demands that may present themselves.

That said, we do have confidence that many of our capabilities are well-positioned under the new administration, including ISR systems, secure communications, sensors, night vision equipment, and naval tower systems.

We also believe readiness support and special operations forces are areas of greater opportunity that we can continue to address. We have close ties with our allies, including the United Kingdom, Australia and Canada, and we are increasing our footprint in all of those countries. We are intently focused on building our business and seeing favorable long-term fundamentals in these areas in which we are operating, including the Middle East and Asia.

With that, Chris will discuss some of our operation initiatives and wins during the quarter. Chris?

Chris Kubasik - *L3 Technologies, Inc. - President and COO*

Well, thank you, Mike, and good morning. I would also like to congratulate Curtis and Steve on their retirement. Over the past year, we have worked very closely and I truly value their insight and support.

We had a good fourth quarter, capping off a solid 2016, and we made progress towards operational advancements while enhancing our portfolio. I continue to conduct site visits and reviews across the enterprise to dig into operations and better position ourselves for growth.

Additionally, throughout last year, we continued to streamline operations to drive efficiencies. We found places where it made good strategic sense to consolidate businesses and facilities. This helps us in several ways, allowing us to streamline back-office functions and maximize real estate benefits. For example, we combined two marine businesses into one, and we recently closed smaller facilities in Louisiana and Vermont.

Our year-end results showed increased organic growth and operating margins, and our increased guidance indicates our confidence as we look ahead to 2017.

Last year, we also strengthened our competitive position with bolt-on acquisitions that enhance our strategic and technological capabilities, advanced our international reach, and strengthened our leadership and growth markets such as pilot training and aviation securities.

For commercial training, we are seeing growth opportunities in this market. The global fleet of large commercial aircraft will double in the next 20 years, and there is a well understood shortage of trained pilots. We like the global aviation security markets, and this year we invested further to strengthen our lead.

As Mike mentioned, in November we acquired MacDonald Humfrey, a globally recognized leader in the deployment of aviation checkpoint security solutions, as well as state-of-the-art process automation and robotic capabilities. This acquisition significantly enhances our ability to deliver scalable, operationally based network security systems that could and are being delivered worldwide.

On January 5, we completed the acquisition of the explosive trace detection business of Implant Sciences, which bolsters our leadership in efficient, scalable security solutions. With these two acquisitions, we can offer airports around the world whole system solutions that make checkpoint security more efficient and passenger friendly. Airports and regulators are demanding faster throughput, as well as increased threat detection for passengers and baggage. Our aviation checkpoint solutions offer safe and effective technologies that help airports worldwide keep pace by protecting passengers while accelerating their movement through the checkpoints. Our aviation security business should grow approximately 50% this year and generate in excess of $500 million in revenue.

Our M&A integration efforts are proceeding as planned, and we expect to capture synergies from these acquisitions.

We continue to have a few opportunities in the pipeline, and I will update you at the appropriate time as those proceed. Of course, growing organically remains the key for us of our disciplined growth strategy. These efforts are focused in key areas, including warrior systems and secured communications, as well as antennas and satcom equipment.

Let me now turn to contract wins and milestones across the businesses. Let's start with defense. In ISR systems, we continue to perform well on the EMARSS program. We are currently executing the U.S. Army's follow-on variation modification on 13 aircraft to transform them into persistent ISR aircraft.

Also, we received a follow-on order for our high-performance diesel engines for the Hercules M88 vehicle, a combat platform we have supported for more than 10 years. We will continue to provide our communication systems to the Army through an ID/IQ contract, which has a ceiling of approximately $500 million. Our initial order for $50 million was received in the fourth quarter.

For the special operations command, we won a $50 million contract for binocular and night vision devices with white phosphorus technology that provides enhanced visual acuity in lowlight conditions. Let me give you an example of our innovation driving new business.

As part of our company funded design initiative, we successfully integrated and performance tested our MK20 EO sensor for the U.S. Navy. This equipment is now planned to be installed aboard Navy cruisers and destroyers, as well as the US Coast Guard cutters.

Also for the Coast Guard, we were awarded an option for the third retrofit, HC-130J. In commercial aviation, we were awarded $115 million contract from Hainan Airlines to provide 11 full flight simulators and training equipment over the next 18 months for both Airbus and Boeing aircraft. Also through the acquisition of Aerosim, we are beginning to recognize additional opportunities in North America.

In December, we received customer commitments for seven full flight simulators valued at approximately $60 million for customers in Asia and Europe with contracts expected to be signed this quarter.

In a technology milestone, L3 is the first company to receive FAA certification for our white phosphorus night vision goggles. These helmet-mounted goggles assist medical rescue and first responder pilots during nighttime and adverse weather conditions. In international markets, we received follow-on awards for the Canadian CF-18 and the CC-150 Polaris programs. We received a follow-on contract valued at $32 million for advanced mortar fuses from an international customer under an FMS sale arrangement. And in the UK, we are executing well in support of a major new communications program for the Ministry of Defense, and the UK continues to be a significant international market for us.

We also continue to expand our presence in key markets, including the Middle East and Asia, by adding resources and personnel to address opportunities and serve our customers.

Finally, as many of you have seen, the DSCA announced that they have notified Congress of a possible foreign military sale to Kenya of an air tractor aircraft, which we will missionize as the prime contractor. We are encouraged by this announcement, and we look forward to a contract award later this year. This effort will be a significant one for our Waco, Texas operations.

So, overall, 2016 was a transformative year when it comes to operational improvements and portfolio strengthening with renewed intensity towards our organic growth initiatives, while closing on a number of attractive bolt-on acquisitions to further our long-term strategies.

Turning to what we see ahead in 2017, we will continue to focus on best-in-class program performance, drive increased productivity and maintain tight controls on our costs. These actions will drive discipline, organic growth and further margin enhancement.

With that, I would like to turn the call over to Ralph.

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

Thank you, Chris. I will discuss some details about the fourth quarter and then review our 2017 guidance update.

With respect to the segment results, my comments about the fourth quarter and the full year 2016 will be based on our existing three segments. However, my comments about the segments for 2017 will be based on the four segments which become effective on March 1 when we segregate existing Electronics Systems segment into two new segments, Sensor Systems and Electronic Systems.

We finished 2016 with strong fourth-quarter results, driven by higher sales and operating income, as well as lower taxes. Free cash flow and orders were also robust.

Reviewing the fourth-quarter results, compared to the 2015 fourth quarter, we grew orders 40%, organic sales 3%, operating income 15%, diluted earnings per share by 10%, and free cash flow 3%. Operating margin also expanded 90 basis points. EPS grew to $2.38 and was $0.28 higher than our midpoint guidance. Fourth-quarter consolidated sales were almost $3 billion and $200 million above our last guidance update with a 4% increase over the 2015 fourth quarter. Underlying the stronger sales was 5% organic growth in our US government market, which is mostly the Department of Defense. International and commercial combined declined 1%, in line with what we expected. Sales were better in all three segments and not related to any single items, highlighting the strength and diversity of our business portfolio. Consolidated operating margin increased to

9.8%, and coupled with the higher sales resulted in about $20 million more of operating income, and this was one of the primary drivers of our higher EPS for the fourth quarter. That is important because, ultimately, we need to grow operating income as it fuels growth in EPS and cash flow.

At the segment level, Electronics Systems' fourth-quarter margin increased to 13.4%, lifting its full-year 2016 margin to 12.3%, which was 20 basis points higher than our guidance. Both Aerospace Systems and Communications Systems achieved their segment operating income guidance with higher sales offsetting lower margin compared to what we guided. The lower margin in aerospace was mostly due to sales mix and a contract modification delay at Vertex Aerospace, which slipped into the first half of 2017.

In Communication Systems, margin increased to 10% for the quarter -- fourth quarter, despite some softness in SATCOM in the Space & Power sector.

The fourth-quarter income tax rate was more favorable, due mostly to higher R&E tax credits, and this added $0.14 additional to the fourth-quarter EPS.

Free cash flow generation was very robust at $427 million, driven by very good collections, especially at the end of December, with several earlier than expected receivable collections.

We also had very healthy orders for the fourth quarter at $3.6 billion, leading to full-year orders of $11 billion with a book-to-bill ratio of 1.05. Fourth-quarter orders benefited a few hundred million, mostly in Aerospace Systems from sooner than expected follow-on funding on a few large DOD contracts.

Before I review our 2017 guidance update, I want to add a few more comments about our full-year 2016 results, which significantly improved over 2015. For 2016 compared to 2015, we grew orders 11%, organic sales 2%, operating income 13%, diluted EPS 19%, and free cash flow 2%. Operating margin expanded 110 basis points with higher margins in all three segments, and free cash flow was just above $900 million or $11.45 per share. Our 2016 sales of $10.5 billion exceeded our initial guidance by about $450 million, mostly from higher sales in our DOD business. The upside we realized in our DOD sales, is consistent with what we should experience in a growing DOD budget environment. And international sales declined 10% and commercial was flat.

Lastly, for 2016, our cash deployment was comprised of dividends of $220 million, debt repayments of $300 million, share repurchases of $373 million, and acquisitions of $386 million. We ended 2016 with cash of $363 million.

Now, turning to our 2017 guidance update, we increased EPS at the midpoint by $0.25 to $8.50. The increase is primarily driven by lower estimated pension expense for this year. We increased our consolidated sales guidance range by $150 million, raising the midpoint to $10,725 million, which is a 2% increase over 2016. We expect our US government sales to grow 1% organically and commercial to grow 4% and international to decline 3% in 2017.

For the segments, we expect 2017 organic sales growth of 4% for each of Electronic Systems and Communication Systems, 3% for Sensor Systems, and this growth will be partially offset by a 4% decline in Aerospace Systems. Our Aerospace Systems sales guidance has some conservatism for the two large contract recompetitions at Vertex Aerospace, which should be awarded in the second half of this year.

We increased consolidated operating margin by 30 basis points to 10.3%, primarily due to a reduction in estimated pension expense of $29 million, compared to our prior guidance. We expect to expand operating margins 70 basis points in 2017 over 2016.

At the segment level, we estimate 2017 margins at 13.3% for Electronic Systems, 7% for Aerospace Systems, 12.7% for Sensor Systems, and 10.6% for Communication Systems. We expect to consolidate operating income to grow 10% over last year.

In the Communications Systems segment, the quarterly margin profile will be affected by the consolidation of our Traveling-Wave Tube businesses in California, which we began last May. This year, we will incur restructuring costs of about $24 million, and they will be offset by an expected gain on the sale of a property that we plan to vacate in connection with the consolidation in the fourth quarter. Consequently, we will have more variability in the Communications Systems' quarterly margins. We still expect to complete this consolidation early in 2018 and, at that time, to begin to generate annual pretax savings of $8 million.

We estimate a 2017 tax rate remains 27.2%. Our free cash flow stays at $865 million, but we increased each of net cash from operating activities and capital expenditures by $10 million. Regarding our 2017 capital allocation or cash deployment, we will continue to opportunistically shift cash deployment from share repurchases to acquisitions like we did last year. After paying for the acquisition of Implant Sciences, which was $118 million, and that closed on January 5, we have a $500 million remaining placeholder for combined share repurchases and acquisitions in 2017.

We expect to end this year with a cash balance of about $450 million, and our last point on the 2017 guidance is that we expect a book-to-bill ratio greater than 1.0.

Now, before I quickly review the 2017 first-quarter outlook, I want to remind you that there is a seasonal pattern to our quarterly results, generally with the second half being stronger than the first half. This year, we will also have the quarterly margin timing impacts at Communication Systems from the EDD/ETI consolidation, which I talked about earlier, as well as a tough margin comparison in the first quarter at Aerospace Systems, where margin was 10.5% for the first quarter of 2016.

That said, for the 2017 first quarter, we expect sales to be between $2.4 billion and $2.5 billion, which calculates to about 2% organic growth. Margin should be in the mid-9% range with EPS between $1.70 and $1.80. Free cash flow will likely be a negative $50 million to $100 million due to the accelerated cash receipts that we had in the fourth quarter of 2014 -- 2016. And, finally, our book-to-bill ratio will be about 1.0 for the first quarter.

Therefore, to conclude my financial review, it is clear that the Company is making progress. We are growing orders, sales, margins, operating income, and EPS, and we are executing on a disciplined growth in capital allocation strategies.

Thank you and we will now begin the Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Noah Poponak, Goldman Sachs.

Noah Poponak - *Goldman Sachs - Analyst*

Ralph, it sounds like you decided to change how you are contemplating the two re-competes in the revenue guidance. So I guess, one, is there something that has changed about how those contracts are going that made you decide to do that? I assume you are referring to Fort Rucker and Army C-12, but perhaps if you could just also give us a rundown on what they are, how big they are in 2017, and when they are scheduled to restart? If we could sort of hone in on a worst-case and a best case range of how those can go for you, that would be really helpful.

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

Okay. So I was referring to those two contracts. You are correct. In our 2017 guidance update, we have about $600 million of sales for those two contracts. The run rate on those two was more like $650 million combined, and the re-competition of award decisions are both expected to happen in the second half of the year, probably early in the fourth quarter. And if that happens, the new contracts probably start on January -- in January of 2018. So we still like our prospects on both of those recompetitions, and we just received the RFP on Fort Rucker at the end of 2016, and we are going to be bidding on that sometime before the end of February. And then it will go into source selection. And the terms on that RFP were a little different than we expected, particularly on the contract type, we were expecting the contract to be cost reimbursable and it is converting to fixed price. So they are both large recompetitions, and we think it is prudent to have a little bit conservatism in the guidance for them. (multiple speakers).

Noah Poponak - *Goldman Sachs - Analyst*

Sorry. But why are we changing the 2017 outlook if they would be starting in 2018?

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

Because there is a possibility that the award decisions could happen sooner and that the contracts start when they are both scheduled to start in the fourth quarter.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. Sorry, Chris. I interrupted you there.

Chris Kubasik - *L3 Technologies, Inc. - President and COO*

That is fair. On both of these we are the incumbent and we have had very solid past performance, and as the incumbent, we know exactly what it takes to perform on these. So, as we have talked about over the past year, these are best value. I think L3 offers the best value, and if the decisions are based on that, we feel good about our opportunities, but we will see how this plays out. I am not 100% confident that we will have the lowest price, but we are not going to bid business that doesn't make sense.

And, just stepping back on maybe an upcoming question, a year ago, when Mike and the team decided to keep Vertex and fix it -- we have talked recently about some of our successes -- but we really looked at it at a high level and said, there are three large service proposals out there. There is the KC-10, SOF-GLSS, and, of course, Fort Rucker, which is sometimes called Army Fleet Support. So those were the big three that we were going after. One kind of keeps us flat, two is great, and three would be outstanding. We already won KC-10, so we got one of the three in the bag, survived a protest, and actually we were all down in Mississippi a couple of weeks ago and the transition is going incredibly well. So there is going to be no issues with the startup there, and I think Ralph did a good job explaining where we are on Fort Rucker. The SOF-GLSS proposal, we have already turned in our proposal. We all reviewed it. I think it is a very strong proposal with some good teammates on it, and that should be awarded August 1. So that is kind of how we approached it. So we are one for one and two more to go.

Noah Poponak - *Goldman Sachs - Analyst*

Great. What is your guys' read on the change in contract type there? Do you think that is very specific to that relatively mature situation, or is that part of a broader trend?

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

I don't know that I would -- it is more of a specific related to this contract that we feel, having been on this contract for quite some time and knowing it forwards and backwards, we believe -- and I strongly believe it is an inappropriate contract type for this type of work. And to bid it in a way I would be happy to bid it would require, I would call it, a nonconforming bid. I would definitely want some level of cost reimbursable line items in there to account for the unpredictable condition that you receive some of these aircraft. You can't possibly assume they are all going to be well-maintained and at the same level of repair when you get them. So I, having a lot of experience in this area, do not want to underwrite the condition of an aircraft that is sight unseen.

Noah Poponak - *Goldman Sachs - Analyst*

Yes.

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

A great formula to lose money. So we are thinking carefully about how to address it. We have submitted questions to the customer on the proposal and how to deal with certain items, and we will make a decision about how we will deal with it. But you could be sure that we are well aware that we would like to improve the margins in this area, and the way this is written is not consistent with that goal. So I would like to get that reconciled.

Noah Poponak - *Goldman Sachs - Analyst*

Can you remind us the margin on Fort Rucker you have been experiencing lately?

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Let me just caution Ralph on this. Given the fact that we are going to be in (inaudible) selection shortly, it is almost like giving away our pricing, and I am not sure that that is a great idea. But maybe, Ralph, could we say it in terms of the composite?

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

Yes. That said, it is less than the company composite. It is also less than the segment composite. I will leave it at that.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. Just one other quick one, Ralph. The contract mod delay at Vertex and (inaudible) out of Q4, what does that mean for Q1?

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

So I said that it slipped into the first half.

Noah Poponak - *Goldman Sachs - Analyst*

Okay.

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

So I am thinking we are presently expecting that we get it in the second quarter. It is possible it could happen in the first quarter, and it is a mod that would change some of the pricing on the pricing per flight hour. So depending on how it goes, we could have some upside in 2017 if the mod is -- not only deals with the retroactive but with the perspective pricing per flight hour.

Noah Poponak - *Goldman Sachs - Analyst*

What did you lose in EBIT dollars on that slip?

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

It was about $8 million or $9 million in the fourth quarter.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. Thanks very much for answering.

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

(multiple speakers) That's the main reason for the lighter margins in the aerospace system segment in the fourth quarter of 2016.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. Terrific. Thank you.

Operator

Robert Spingarn, Credit Suisse.

Robert Spingarn - *Credit Suisse - Analyst*

Mike and Chris, looking at the organic growth, your 1%, and I guess it would have been a little bit higher if you didn't pull some business forward into the fourth quarter, but, obviously, you want to accelerate the growth there. And you are building the business inorganically, but wanted to get your sense, with the new administration coming in -- I know it is early, but from the Army and Navy perspective, it looks like there is going to be a focus -- Navy is really a growth lane here from a shipbuilding perspective, and then Army readiness is going to tick up. What is your early read on how L3 can benefit from that? Where are your growth plans there?

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Well, Rob, in the Naval side, first of all, we are always interesting in growing our content. But everything from propulsion work to communication systems, to integrated bridge equipment, to sensors, to hybrid drive systems, I mean, there is a lot of offering to tote sonars. I mean, go on and on and on. And the question is, how do we maximize the content we have? And I think we have done a good job on the Ohio Class and Virginia Class submarine programs, and that is one of our strategic vectors that we are working on. We have several -- is to increase our content with our naval customers. And that may involve acquiring some additional technology, a little more R&D in terms of system engineering to bring some of our things to a more integrated place, a little more work on user interface to make things easier for the war fighter to use in terms of analyzing and seeing data and navigation gear, et cetera, et cetera, as well as installed ISR capability and the analysis and archiving of that data.

So there are other naval areas that we have identified where the customer is looking for a solution. As I said, we will be pursuing several of these areas as a, quote, thought leader by putting together our own version of a solution, an L3 solution, and submitting it to the customer directly, perhaps, in the form of a white paper to try to stimulate a discussion and create a program, rather than wait for an RFP. And I think that is a good strategy for us where it may not be common knowledge in the customer community on everything that we have to offer and how we can bundle it together and create quite innovative solutions at very attractive price points.

So, in that regard, that is the story for the Naval.

On the Army side, we are very leveraged to the headcount number in Army, given the soldier system type equipment that we offer, whether it is night visions gear, radios, manpacks, satellite comms and the like. So, just by virtue of the increased size that we are seeing in the numbers, we believe that would translate rapidly into growth for L3. And we have been doing a lot of work around integrating those systems to kind of lighten the load that the war fighter has to carry and with the more integration, lighter, less power, more -- less stuff to carry makes for happier soldiers.

So battery technology, of course, is a challenge there at all times. But we think that we have the robust portfolio in soldier systems area, just as evidenced by our healthy sales to SOCOM, who is usually the first customer when there is a new technology out, and that is usually in the field. So, white phosphorus goggles, for example. Those are very innovative, and we are the only ones, I believe, that have that. Those night vision you look through, you see it is green. I mean ours offer a heck of a lot more content in a white phosphorus field of view and a lot easier to identify targets, and this additional R&D we are doing that brings even more resolution and quick response to the war fighter in that regard. So we have a very healthy, robust portfolio that addresses the planned ramp-up in the headcount in the Army as well. So those are two areas I feel very comfortable about our positioning, particularly.

Robert Spingarn - *Credit Suisse - Analyst*

Okay. And then, just quickly, on Air Force. Do you think there might be some competitive opportunity on Air Force One at some point?

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Chris was going to add something, and then I will pick that up. Go ahead, Chris.

Chris Kubasik - *L3 Technologies, Inc. - President and COO*

Yes. Just to go back to your growth, I mean, obviously, none of us are happy with 1% organic growth. But, as Ralph just laid out, three of the four segments are growing about 4%, and the issue that we are all focused on is aerospace. I mean, the other guys are growing. . It is well documented. None of us like that situation. As we look through the pipeline opportunities, I think the team has done a good job opening the aperture, and over the next three years, we probably have about $30 billion of opportunities in aerospace alone. So the team is going to go down there next month and really look at that and see what we can do to maybe jumpstart some opportunities.

And the question you just asked would fall into that category. So I will let Mike answer that one. So I just wanted to point that out.

And then, interestingly, I am sure many people saw that in December the Defense Science Board issued a report on the seven priorities for the new administration, as a suggestion of a lot of senior well-experienced industry and government people. And it is probably worth a read, but it talks a lot about agility and responsiveness and the acquisition process, and we talk a lot about that being one of our differentiators. And you look at what we did with Liberty and SPYDER and some of those things, we have the track record to do that type of contracting. It talks a lot about homeland security and when you look at what we do with detection and some of the investments we made in acquisitions, and then there is a whole section on disaggregation, which Mike has been talking about for years and I have hopped on the bandwagon. And I think that fits right into our sweet spot, whether it is airborne or ground or undersea. So I just quote that document as something that gives us some optimism.

And then the last thing I will just mention -- not to repeat Mike -- but we are doing a better job bundling all these different capabilities and bringing them to our customer as a system or a whole system solution versus sub segments. So I just wanted to point that out. I am optimistic that we have the right team and the right processes to try to jumpstart that organic growth. But we are kind of happy with three of the four segments. Everybody can do better because I am sure they are listening.

So, Mike, do you want to comment on the Presidential thing?

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

I mean, and you could bet, Rob, that the segment that needs attention has our attention. Between Chris and I, we are tag-teaming them, and we will get it turned around into a place that we are going to be proud to talk about in several more quarters. But they have a great capability. I still believe it is a national asset, can deliver things that no one else can, and there was a number of international programs that you know we have completed and had not been, I guess, re -- we have not found alternative programs to refill that bucket.

You were starting to ask a question on Air Force One. I can't really talk specifics on what our content was, other than to say that it would be typically areas in our sweet spot and, yes, that slipped out. And what was the point of your question, though? Is it going to come back or what (multiple speakers)?

Robert Spingarn - *Credit Suisse - Analyst*

Well, what are the opportunities? And then, given the attention that the program has gotten from the administration, might there be more competition on it even from a prime perspective, using a COTS airplane?

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Well, it kind of is a COTS airplane. Really, it is a commercial airplane at its very core that is being converted. So I don't know if you want to go more COTS than that.

Robert Spingarn - *Credit Suisse - Analyst*

What I am simply saying is, this is the kind of work that Waco could do as well, right?

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Yes, and we just delivered what has been referred to as a museum piece to a very happy customer on the other side of the world. So yes, I think that the -- I have had these discussions directly with customers in Washington, and candidly, they view the Waco capabilities as areas beyond what they are interested in. I mean, it is more about capability than fit and finish, I would say. Fit and finish is important, but it is not quite the same level.

But, having said all that, the unique systems that belong on that airplane, we provide. Many of. And they are nothing that can be procured commercially as far as I know. They are very special, robust, survivable, and some of the most important critical systems you can imagine that go on that plane. And that is not something that I would say is going to be subject to any type of commercial competition. In fact, I don't know many other places in the industry where some of this is available. So I feel comfortable that, when this gets restarted, we will be back where we were with hopefully the same level of content and we will move forward.

Chris Kubasik - *L3 Technologies, Inc. - President and COO*

Yes, I think, worst case is the timing issue. I mean, if they re-compete the aircraft, I think every team puts us on their team or what we do is government furnished. So I think it is only a timing issue, and that is clearly outside of our control.

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

And then, further, just from a strategy standpoint, we talked about -- maybe we talked about Army and we talked a little bit about Air Force. But, again, you saw it the other day. There was -- was it the Kenya order that came up that was set. You know, we had international sales in the plan. The timing of that was a surprise, and there is going to be more things that happen like that that will happen -- not only do things happen later, things are going to happen sooner.

As an example, just the other day the State Department approved the sale to Saudi Arabia of 10 PC SD aerostats to include 26 of our MX-20 EO IR systems from the Systems segment, which is a sizable sale. And I believe that the EO IR system -- the turrets that come out of our segment are the best performing in the world. I believe they are on just about any every unmanned platform and most of the manned platforms. And I could see

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that -- the demand there going on pretty strongly for quite a while, given the areas where we are operating and the geopolitical situation and unabating need for more ISR. So, again, we feel pretty good about that, and I am happy to see these two export sales come up so early in the year.

Robert Spingarn - *Credit Suisse - Analyst*

Thank you.

Operator

Richard Safran, Buckingham Research.

Richard Safran - *Buckingham Research Group - Analyst*

In the release, you noted lower SIM and trading services for the Air Force. It was contracts in your completion here. So I am assuming that is going to be a slight headwind in 2017. Now, given -- and you have been talking a lot about the current administration and they do have a relentless focus here on readiness right now, are you expecting SIM and training to the government to really pick up? Is that something where we can see additional contracts in 2017? And, separately, at Electronic Systems, you had 50 basis points of improved contract performance. Is that a contract maturity type of thing where you are just seeing risk retire?

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

Hi, Rich. Let me take the first part of that question. So, for 2017 versus 2016, we presently don't see a reduction in our simulation and training sales in electronic systems for the US military. In fact, we are expecting some modest growth over there. What happened in the quarter is just simply timing items on certain deliveries and certain milestones. So that business is still trending upward for us. And to the extent that there is additional funding in the widely expected FY 2017 supplemental, that is supposed to happen sometime in the spring, we could have some upside there, as well as in our -- in the Vertex Aerospace sector.

Chris Kubasik - *L3 Technologies, Inc. - President and COO*

And on the second part, the 50 basis points, we just talk about the improved contract performance. That is just your traditional risk reduction and good program execution and taking the appropriate accounting step-ups. So nothing unusual.

Richard Safran - *Buckingham Research Group - Analyst*

Okay. And then just finally here, some of your biggest programs -- I wanted to talk about just classified for a second. Some of your biggest programs by sales are classified, and I know you have like one large ISR program. From what you are seeing now, in light of the current administration, do you expect classified program growth to exceed that as a general defense business? And, also, the general rule of thumb has been that classified programs generally come with higher margins and just wondering if that is still the case.

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

I would answer it this way, Rich. From a budget standpoint, that line item is among the fastest growing in the budget. And as long as we can maintain our steady market share content, yes, it should be one of the faster growing pieces within L3.

And, in terms of the content we have, I mean, it is going to be driven by the products that we deliver on these platforms. And you are right. A lot of it I really can't talk about. I don't even want to get close to the edge on any of it. But it is an area where I am happy to say we have a lot of relevant technology and experience, and we are looking to expanding in that area.

But over the past two years, I would say, we have made a concerted effort and set up a special purpose entity that focuses on this market, that has the proper infrastructure around it to be able to play in this very special space, and it has been bearing fruit. And we didn't miss the fact that it was a growth area, and we position ourselves to be able to participate fully in it.

Chris Kubasik - *L3 Technologies, Inc. - President and COO*

And, Rich, this is all driven by the threats, right? I mean, we have heard the prior administration, and I think the current administration are in full agreement that we have Russia, China, North Korea, Iran, and terrorists as a threat. I don't think anybody disputes that, and those threats are still there or even getting more significant. So that is driving the budget, and as Mike said, we are in a good position. So, for those reasons, it will continue to be a growth area.

Richard Safran - *Buckingham Research Group - Analyst*

Okay. Thanks very much.

Operator

Myles Walton, Deutsche Bank.

Myles Walton - *Deutsche Bank - Analyst*

Got a question for you on the new segment breakdown. So Sensor Systems in particular, the implied margin expansion is that 270 basis points or 240 basis points, I guess, from 2016, but it was also around 10% in 2015. Is some of that acquisition-driven better margins? I imagine EOTech or an absence of charges there are helping, too. But if you can describe the margin expansion there. And then, also, what is the potential of that I would imagine hardware sensitive, potentially richer margin business?

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

Sure. I will take that question, Myles. It is Ralph. Hi. So the main reason for the improvement in the margins year over year is EOTech. That is where -- EOTech is part of Warrior Systems, and Warrior Systems is in the new Sensor Systems segment. So that is one of the items.

And then, Mike talked about our Patriot Works initiatives, which are geared toward the US government classified markets. That falls within -- or a lot of it falls within our Advanced Programs sector, which is also in Sensor Systems. And we are spending considerable amounts there on R&D, business development and marketing and selling. So that operation loses money at the operating income line for good reason because we are making investment that we need to make for the future. So that is another reason. For that reason, the margins in Sensor Systems are about 100 basis points lower than they would be otherwise.

Myles Walton - *Deutsche Bank - Analyst*

Right. But I am talking -- I'm sorry. The expansion that is implied in the guidance is 240 basis points in 2017 versus 2016.

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

Yes. A lot of it is (multiple speakers).

Myles Walton - *Deutsche Bank - Analyst*

And that is just EOTech?

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

It is EOTech and organic growth in the business. The only acquisition we made that affects this segment is Micreo, and that is a very small deal with sales that will be less than $30 million in 2017.

Myles Walton - *Deutsche Bank - Analyst*

Okay. And just on the Air Tractor award to Kenya that you mentioned, Chris and Mike, that it came a little bit earlier than expected, I didn't even know it was there, to be honest. So this missionization of aircraft for foreign governments, how do you think about the TAM or the timing, I guess, to make it material to your business?

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Well, the timing is going to be driven really by the government to government discussion of their threat environment and how quickly and badly they need the equipment. So it is very hard for us to get in the middle of those discussions and really know exactly when things will occur. And (multiple speakers) in general terms, what we are seeing here is a push that will help the international hole that was created in our Aerospace Systems group because there is just a push to have more participation by our partner nations. You have heard it from this administration that there is a thought that they should be more active in participating and sharing across these defense systems. And I think that was a serious statement, and I think, to that end, there will be more stimulation of these export type arrangements that can only help us.

Myles Walton - *Deutsche Bank - Analyst*

And what is the size of the order you expect later this year, Chris?

Chris Kubasik - *L3 Technologies, Inc. - President and COO*

$100 million, give or take a few.

Myles Walton - *Deutsche Bank - Analyst*

Okay. Thanks.

Chris Kubasik - *L3 Technologies, Inc. - President and COO*

Probably going to do maybe two more people here on the Q&A, and we will give a few more minutes past the hour.

Operator

George Shapiro, Shapiro Research.

George Shapiro - *Shapiro Research - Analyst*

Ralph, I was just wondering, in December, you had the growth rate in the US government business at 2%. You lowered it to 1%. Maybe it is that slippage -- that acceleration in Q4 you talked about. But it seems kind of odd where last year grew 5%, and we are looking at improving budget growth, and you are highly exposed to the O&M budget, which would increase fairly soon. So I'm just wondering what the thought process was for that.

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

You are talking about 2017, correct?

George Shapiro - *Shapiro Research - Analyst*

Right. 2017.

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

So the thought process, I said we have some conservatism in Aerospace Systems. We also have upside elsewhere in the Company in our DOD business. And it is the end of January. We still don't have an appropriated budget for FY 2017, we are under CR. The budget as requested would only have about 1% growth. So -- and we appreciate that a significant supplemental is anticipated, which would lift the growth rate for 2017. But we want to see that and see the details in it.

Now, if that happens, we should have a nice upside in our DOD business, just like we did in 2016. If you recall, in 2016, we started the year thinking that our DOD business would be about flat, and it ended up growing 5%. And that is 70% of the Company. So that is significant.

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

It is fair to say, George, that our plan is based on an active budget and active budgets and what we know now. Now we all expect these upsides to occur, but there is not enough data for us to really predict how much and when. But the good news is, we hope to have updated guidance every quarter.

George Shapiro - *Shapiro Research - Analyst*

But my point, Ralph, is that in your December analyst meeting, you probably had similar information to what you have now. And, in that meeting, you said the DOD would grow 2%. Now you lowered it to 1%.

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

Well, in 2016, December update, if you will, at the Investor Day compared to when we ended, we did about $200 million more in DOD sales for 2016. So, in our guidance that we updated today for 2017, $100 million of the $150 million increase is DOD business in Comm Systems and Electronic Systems segments. The rest from Implant. So net net, we added $100 million to DOD sales for 2017.

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Chris Kubasik - *L3 Technologies, Inc. - President and COO*

Yes. Nothing lost or fell through the cracks here, George. It was just timing.

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

The comparison got longer.

George Shapiro - *Shapiro Research - Analyst*

Okay.

Ralph D'Ambrosio - *L3 Technologies, Inc. - SVP and CFO*

In fact, we added $300 million to DOD sales for 2016 and 2017, if you do it on an apples to apples basis.

George Shapiro - *Shapiro Research - Analyst*

Okay. Thanks.

Operator

Ladies and gentlemen, we have reached the allotted time for questions. We have time for one more question. Cai von Rumohr, Cowen and Company.

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

All right. Let's do the next one.

Operator

Jason Gursky, Citi.

Jason Gursky - *Citigroup - Analyst*

Chris and Mike, wonder if you could just describe the current contracting environment in general terms, particularly as it relates to recompetes. Not necessarily ones where you are incumbent, but would certainly love to hear your thoughts on those as well. Are the funding levels are coming in at the prior contract levels? And, secondly, the competitive environment on those recompetes generally, is it still pretty stiff and putting downward pressure on revenue streams for everybody as we go through these recompetes? So the funding levels and just the level of competitive environment.

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

I mean, it is going to vary contract to contract, so it is hard to make a blanket statement. But the ones that we have seen, the funding levels have been stable to slightly improved based on -- especially on the Vertex type business where it is fleet management support, and there is a readiness problem. So that is part one of your question.

Part two, in terms of competitive environment, due to the nature of this business, as a low bar to entry, there is a lot of people showing up, qualified or not, to bid. This is a typical business where your workforce would get rebadged to the winner in a recompete. So basically, you have to show up with a management team because you are going to get the workers that actually are on the contract.

The impact isn't so much revenue stream. The impact of that will be on the margin line. Meaning, you get people that want to come in and throw a number at a $4 billion federal contract that typically low numbers that are not realistic given the scope of work. And there is some documented history of companies that have done that and have defaulted pretty early in the contract, which they just were not able to sustain themselves and start losing money early on.

So, from the contracting environment standpoint, I think this contracting environment has gotten a little bit more sophisticated to that type of scenario where they are starting to do a little bit better job of evaluating or assessing the risk from one offerer to the next offerer in terms of experience and past performance, which bodes well for us since we are an incumbent or a very experienced contractor. So it is much better that is not just based on low price. It is based more on best value where past performance and experience counts. So I mean that is helpful.

On the other hand, the more you know, can sometimes work against you because -- which caused us to be a little more intelligent about how to fully bid the scope of work, whereas someone less experienced may miss a lot of things and come up with a much lower bid that is not actually realistic, given the scope of work. So it is kind of a rambling answer, but the contracting environment, I would say, is stable, and the competition on these recompetes, especially the service area, is very -- I would say very robust. And I would tell you the challenge is not so much revenue. The challenge will be margin with people coming out of the woodwork, throwing in very low bids.

Now, the offset to that will be if enough criteria is given to past performance and experience, et cetera, that will offset that low-ball problem that we see from time to time. That is my view on that. (multiple speakers).

Jason Gursky - *Citigroup - Analyst*

Right. So the funding environment is becoming a bit more stable on these recompetes, which is great. Just given your experience in the past, how long do you think it takes before the higher budget authorities that we all hope to see going forward here would allow for the funding on those recompetes to actually be higher than where we are today? What is kind of the typical lag, in your experience?

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Well, we are in a place we have never been before, actually, but it could be six months. I mean, we have to get -- well, our customer -- the government -- has to get a lot of things done and in sequence here such as dealing with budget caps, changing legislation, passing budget -- passing a budget, and then appropriating it to programs, getting the contracting force to get it on contract, going through competitive procurements. And, you know, you are dealing with, I would say, at least a six-month period and possibly a little longer.

Chris Kubasik - *L3 Technologies, Inc. - President and COO*

And most of what we are talking about in the answer is O&M money, which is a substantial part of our funding source, and that is generally the one-year money. And I think as we wrap up, we will just say 2017 is clearly an unusual year. I think Mike and all of us have been consistent for the last year. We look at the current environment, we look at the budgets, we give you the projections, and we are happy to have beat or exceeded those today, and we will continue with that as our approach.

So, a lot of excitement out there, but we have got to look at the reality of what has actually been appropriated and authorized. And that is what we are doing. So I think we will just turn it back to Mike to wrap it up, please.

Michael Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Thanks, Chris. Overall, we are very encouraged by the progress we have made throughout last year. The fourth quarter was very rewarding to see, and we are optimistic about 2017. We are all very pleased with the operational improvements we have made this year, as well as the broadened portfolio of products and capabilities resulting from some of the M&A activity. The trends that are driving our top-line performance in the fourth quarter and the upturn in defense spending all improved the 2017 outlook. I will wrap up my comments by saying 2016 was a strong year for L3. I would characterize it as a transition year, both in our focus, the management team, which I am absolutely delighted with, really working well. At the same time, sorry to be saying goodbye to Curtis and Steve, but they are going to be around for the rest of the year to help in transition roles. So I'm sure we will still get to work together from time to time.

In 2017, you saw us continue solid execution and program performance, coupled with a disciplined and balanced approach to growth and capital deployment, always with a goal of delivering value for shareholders, customers and employees.

So we look forward to a very productive and successful 2017. We are very excited and energized to address it.

So, with that, thanks for joining us this morning, and we will talk to you in a few months.

Operator

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