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LLL.N - Q1 2018 L3 Technologies Inc Earnings Call

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OVERVIEW:

Co. reported 1Q18 sales of $2.370b and diluted EPS from continuing operations of $2.34. Expects 2018 consolidated sales to be about $10b at midpoint and EPS to be $9.50 at midpoint. Expects 2Q18 sales to be approx. $2.5b and diluted EPS to be $2.35-2.45.

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PRESENTATION

Operator

Good morning, and welcome to the L3 Technologies First Quarter Conference Call. (Operator Instructions) Please note, this event is being recorded.

I would now like to turn the conference over to Mahmoud Siddig. Please go ahead.

Mahmoud Siddig - *Joele Frank, Wilkinson Brimmer Katcher - MD*

Thank you. Good morning, and thanks for joining us for L3's 2018 First Quarter Earnings Conference Call. With me today are Christopher Kubasik, Chief Executive Officer and President; 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 to Chris Kubasik. Chris, please go ahead.

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Okay. Thank you, and good morning, everyone.

A few months ago, I shared with you our vision of transforming L3 to become a best-in-class technology leader in the aerospace and defense industry. This is a multiyear journey that requires us to invest in our core capabilities, revitalize our culture and establish a deeper strategic relationship with our key customers. I have no doubt L3 will emerge a stronger company with higher sales growth, improved margins and increased cash flow.

We are in year one of our transformation, and any transformation is normal to have some bumps along the way, but I am singularly focused on having everyone at L3 executing towards our long-term vision.

We recently completed our first employee survey with a greater than 80% response rate, more than double the industry average. This illustrates the growing enthusiasm and engagement across the company for our new direction. Employees are energized, and everyday, I see our people gaining confidence and striving to achieve more.

Let me review our 3-stage path that I highlighted in our Investor Day in December. 2018 is a transition and investment year where we focused on integration by laying the groundwork and building our infrastructure. We're optimizing our processes, our technologies and our talent to position us for future growth. In 2019, we expect these investments and our increased R&D to drive incremental organic sales growth. And our ultimate goal is to have the scale and capabilities to compete for programs as the nontraditional 6th Prime.

I would like to highlight the progress we made in Q1 towards our key priorities. Integration of the company is our most important priority this year. We are making progress towards upgrading our technology platforms, which will provide better visibility into the business, enable information sharing and collaboration and extract deficiencies.

We recently won the prestigious 2018 Innovation Award from SAP for our cloud-based enterprise data platform, one of the many leap-ahead technology initiatives that will drive better business performance.

We continue to sectorize business units and divisions to drive greater integration across the enterprise. The goal is not just to reduce costs, but to innovate faster, become more efficient and better serve our customers in a coordinated and collaborative way. Our shared services platform also continues to expand.

As we highlighted during the Investor Day, we are progressing with indirect procurement, IT service tests and ERP systems into the platform this year. In addition, through various L365 activities, our commitment to continuous improvement is being advanced throughout the enterprise and across every functional area.

Now turning to our workforce initiatives. We've had a busy quarter. We are implementing an action plan to ensure that we attract and retain the best talent in the business. We have many phased initiatives to drive increased employee collaboration, and to better align employee activities with customer priorities. We changed our incentive compensation plan to add organic sales growth as a metric for the first time and created a mixed bonus pool to incentivize collaboration.

As a reminder, last December, we made the decision to freeze our salary pension plans effective January 1, 2019. We estimate this action will reduce pension expense by at least $25 million beginning next year.

We continue to add great new people to our team. As you may have seen from our recent press release, Melanie Heitkamp will be heading off our HR Department as Senior Vice President and Chief Human Resource Officer. Melanie's more than 20 years of industry and consulting experience will contribute greatly to our L3 3.0 initiatives.

Also, John Kim just joined us as Vice President of Investor Relations and Analytics, and he will be working closely with Ralph and Heidi.

On the top of good customer relationships, my team and I have been on the road extensively, actively listening to our Defense, Homeland Security and commercial aviation customers. We have been introducing them to the new L3, explaining our strategy and offering solutions to their needs and challenges.

In the U.S., we have been spending time with key members of Congress, OSD, the Army, the Navy and the Air Force. And internationally, we visited customers in Taiwan, Japan, Singapore, Saudi Arabia and the United Arab Emirates.

Turning to our performance for the quarter. We exceeded our guidance and were pleased to report a strong 1.1x book-to-bill ratio, with all 4 segments above 1.0. We recently won the Royal Australian Navy's SEA 1180 program, where we will supply and integrate a solution from the Communications, Electronics and Sensor segments. This is an example of improved collaboration and strategic positioning in the international arena.

Other growth areas, such as our Security & Detection Systems and classified programs, had strong order bookings in the quarter. We also showed positive momentum in our commercial aviation business as we were awarded more flight simulator orders in this quarter than all of 2017, demonstrating our competitiveness in the growing pilot training market.

Two of our segments, Electronic Systems and Sensor Systems, demonstrated solid sales growth of 6% and 16%, respectively. The focused R&D investments are beginning to contribute to our sales growth. The new leadership team installed at these segments last year are executing well. The growth at Electronic Systems and Sensors is broad-based, and we expect growth to remain strong the rest of the year.

I was, however, disappointed with the results in our Communication Systems for the quarter. I expect the leadership team under the new President, Andy Ivers, to make progress as the year unfolds.

Turning to Aerospace Systems. Their financial performance was consistent with expectations. Our free cash flow is negative $85 million in Q1, in line with our internal plan and normal seasonality. We expect full year free cash flow to be consistent with prior guidance of $900 million and in line with our goal of approximately 120% free cash flow conversion.

In terms of our capital allocation strategy, M&A continues to be a priority. Last year, we invested over $300 million in acquisitions. Today's pipeline remains robust, and I expect our acquisition investments to be higher this year.

Equipped divestiture update. As you saw this morning, we announced the deal to sell Vertex and some smaller aerospace units for $540 million cash. This transaction is expected to close sometime this summer. We will record a gain from this transaction with after-tax proceeds of approximately $400 million, which we will put to use based on our strategic priorities.

In closing, this quarter was the first step towards creating the new L3 3.0. There's a lot of work to do as we strive to make L3 an agile, leaner and more innovative and customer-centric company. I want to thank the entire L3 team for their commitment and dedication to this transformation and to the success of L3 and our customers.

Now let me turn it over to Ralph, who will take you through the financial performance and outlook.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

Thank you, Chris. I'll review some details about the first quarter and our 2018 guidance update.

Reviewing the first quarter, our operating results were ahead of our outlook with strong orders, higher sales and operating margin, lower income taxes, which drove higher earnings per share.

First quarter diluted earnings per share from continuing operations increased 21% to $2.34. Lower taxes were the largest component of EPS growth versus the 2017 first quarter, adding $0.27 to EPS. This occurred because of U.S. tax reform as well as increased stock option exercise related to retiring executives.

You may recall that most of our tax deduction for stock-based compensation occur in the first quarter of each year due to our equity award vesting dates. Additionally, the higher first quarter stock option exercises is a nonrecurring item for the first half of 2018.

First quarter sales increased 2% to $2.37 billion. Sales growth was strong as Sensors and Electronics with each increasing 16% and 6%, respectively. Within Electronics, sales also grew 14% in Security & Detection Systems. At Aerospace, sales declined 1%, which is slightly better than our full year estimate. At Communications Systems, sales were lower than we expected, decreasing 8%, primarily due to lower production volume on UAV contracts. Also in Communication Systems, consistent with our outlook, commercial SATCOM sales declined modestly because of the continued soft market demand for new satellites.

First quarter operating margin increased 40 basis points to 10.6% and operating income increased 6%. Segment margins are tracking to our full year estimates.

Communication Systems margin lagged in the first quarter at 7.5%, primarily because of lower sales and $5 million of restructuring expenses, which together lowered margin in the first quarter by about 270 basis points. We expect Communication Systems margin to increase the rest of this year due to increasing sales, particularly in the second half of 2018, which will carry higher incremental margins, plus declining restructuring expenses and cost savings beginning to be realized from our restructuring actions.

Sensor Systems margins declined to 12%, primarily due to higher R&D expenses. And as Chris explained, those are for our planned incremental growth investments this year.

Free cash flow was a negative $85 million for the first quarter due to seasonal increases in receivables and inventories that will reverse later this year. We also made deposits for aircraft purchases on new ISR recap programs for which we will be paid later this year. And we're also increasing capital expenditures this year versus 2017 to support growth in our simulation and training businesses. And that increase in CapEx is pronounced more in the -- earlier in the year.

First quarter funded orders grew 10% to $2.6 billion. And as Chris noted, the book-to-bill was 1.11x, which supports the accelerating quarterly sales growth that we expect this year.

Now moving to our 2018 guidance update. We increased EPS by $0.10 to $9.50 at the midpoint, primarily for lower taxes. Excluding the 2017 tax reform onetime gain of $0.99, we expect EPS to grow 12% for 2018 compared to 2017.

We maintained our sales and operating margin guidance ranges. We expect consolidated sales of about $10 billion at the midpoint, with 4% growth over 2017.

At the segment level, sales are trending above the guided midpoints for Electronics, Aerospace and Sensors. Aerospace guidance also contemplates the divestiture of the Crestview and TCS businesses, which were sold with Vertex.

Conversely, for Communications, sales are presently trending to the low end of guidance due to slower U.S. military awards and orders on next-generation C3 systems, protected communications and tactical communication terminals, which is pushing some sales to next year. Additionally, this year, our broadband communications sector is beginning new work on several next-generation LPI, LPD and MultiLink secure communications, which are high in engineering and development content, and initially have lower volumes before they transition to production in the future.

We also expect to book new production orders in the second half of 2018, including for UAV communications, that will generate sales in 2019.

On the operating margins, we continue to expect consolidated margin of 11.2% for 2018, which will increase 40 basis points compared to 2017 with operating income growth of 8%. Our 2018 segment margin guidance midpoints remain at 13.7% for Electronics, 7.9% for Aerospace, 11% for Communications and 11.8% for Sensors.

I also want to provide a quick update on our business integration and restructuring. As you know, this is a focus area for Chris, me and our segment presidents and CFOs. We still expect to incur about $30 million of restructuring and services expenses this year, with an offsetting $15 million of cost savings from our restructuring actions. Additionally, depending on the outcome of new business pursuits in Aerospace, we will need to take additional action there later in the year, and our current guidance margin covers this potential additional restructuring.

Below the operating income line, we lowered our tax estimate to 19%. That is a 19% tax rate factoring in the lower first quarter taxes. And we continue to expect free cash flow of $900 million for 2018. Our guidance now includes $10 million more of operating cash flow offset by $10 million more of capital expenditures.

Regarding capital allocation. After paying our dividends and repurchasing stock to offset growth and shares outstanding, we continue to favor acquisitions. We repurchased $119 million of stock in the first quarter, and we plan to repurchase $300 million for 2018. We have a strong balance sheet, with ample resources to make acquisitions. And recently, both Fitch and S&P affirmed their BBB- credit ratings and stable outlooks for L3.

Additionally, our guidance update does not include benefits from deploying the proceeds from the sale of the Vertex businesses, which we announced today. And as Chris explained, we expect net cash proceeds of about $400 million.

Looking at the 2018 second quarter, we expect sales of approximately $2.5 billion, which calculates sales growth of 4%, operating margin of 11% and diluted earnings per share between $2.35 and $2.45.

Regarding our second quarter margin, it will be lower than what we reported in the 2017 second quarter, because it included -- we had a property sale gain in last year's second quarter of $42 million, which increased consolidated operating margin by 180 basis points. Excluding that 2017 property gain, we expect 2018 second quarter margin to increase by approximately 50 basis points.

Finally, to conclude my financial review, our first quarter was a good start to the year. We grew orders, sales, operating income and earnings per share. We also increased margin by 40 basis points while investing more in R&D. We remained focused on improving our operational and financial performance. For the full year 2018, we expect to grow orders, sales, all the profit metrics and cash flow. We are also strategically allocating capital and have ample liquidity to support our growth strategy.

Thank you, and we'll now begin the Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from Richard Safran with Buckingham Research.

Richard Tobie Safran - *The Buckingham Research Group Incorporated - Research Analyst*

So first off, Chris, I guess I want to ask you this first question on some of your opening comments on management and the things you're changing. I know you've been pretty busy making organizational leadership changes. I thought you might comment on how far along we are there, if you're going to continue to make executive leadership changes? And when you think you might have your team in place?

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Yes. Thanks, Rich. I'd say we're more than halfway through on the changes. I mean, 3 of the 4 segment presidents have been in their position a year or less. And you heard some of the announcements I made today and throughout the year. So I think by the end of this calendar year, we'll have the entire team in place and ready to go. But I'd say it's 70%, 80% already done. And some of this is just a natural attrition and retirement. The company is 21 years old, and we've got a great team, and we're continuing to make it better. So I'm pleased to have so many people wanting to come on and join L3 and execute on our vision.

Richard Tobie Safran - *The Buckingham Research Group Incorporated - Research Analyst*

Okay. And then just second thing here. Just the Communications, Ralph, if you said it and I might missed it, I apologize, but -- so I heard your comments or some of your comments about sales and margins, et cetera, and you maintained your guide. I was just wondering if you get a bit more specific about what changed, what's allowing you to maintain your guide there at Comm Systems? I was just curious as to what's new that allowed you to maintain your guide despite some disappointing results there.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

Well, it's essentially 2 items. One, it's based upon our orders that we had in the first quarter and the order flow that we expect the balance of the year, which we expect to increase. And with respect to the margins, I talked about how the increasing sales, and most of the increase in sales is going to happen in the second half of the year. We're probably going to be down again on the top line in the second quarter. But within Communication Systems, our incremental gross margins are about 26%. So if the volume increases, we have a lot of flow-through, if you will, to operating income.

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Yes. Rich, I'll just add that I believe it's a growth market. I think we have the right solutions. We've been investing for over a decade in some pretty unique solutions. I think we have some of the top talent in the nation, especially in Salt Lake City, working on these communication challenges. And I think there is a customer awareness that this is one of the biggest challenges facing the country, and it's not unusual for the communications to lag the platform procurement. But I think it's pretty well-known and documented that fourth gen and fifth gen aircraft can't communicate in a covert way. And if you look at our national defense strategy and some of the challenges that have been laid out, this is clearly an area that's going to get attention. So it's a long year. We've got one quarter behind us. As I said, it wasn't as good as I would've liked. But I think with new leadership and our technologies, and some of the development work that we won early in the year, we're well positioned for the long term. And it's the -- every time I'm in the Pentagon, the discussion on multidomain command and control is on the top of everybody's mind. And I think we're uniquely positioned to help in that challenge.

Operator

Our next question will be from George Shapiro of Shapiro Research.

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

One is for you, Chris. If you could just update us on some of the contract awards. It looked like you lost that P-8 contract, you talked about on our first call and some of the others haven't come out. So kind of just update where we are on that, and then I'll have one for Ralph as well.

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Yes, we were clearly disappointed to lose the P-8 contract. I guess the next large award that we're waiting for in Waco will be the C-130 AMP award. Throughout the rest of Aerospace, we had a pretty good quarter, a lot of classified additions. There's some additional aircraft that will be coming through the budget process, either major modifications to existing aircraft or some new aircraft. So I think we're looking pretty good there. On the international trips, there's a lot of interest, especially in the Mideast for our ISR platforms. So if you see some of the national defense strategy, there's a lot of talk about ISR and the need for that capability. And of course, that's in our sweet spot. And the Canadian F-18 that we've talked about for a year or so exercised their second option, and we also got a E-6B work down in Aero. So seems like things have stabilized and started to position us for longer-term growth in Aero. And then on the other segments, Electronics and Sensors, we talked a little bit about. But Electronics, very, very good quarter on orders with Security & Detection, having growth as we have been successful with various airports around the world. A lot in the classified arena that we have in procession engagement systems and even with the Navy on our Power & Propulsion solutions. In Sensors, we have a couple that again close to being announced during the second quarter, but again, they had a great quarter, 16% top line growth. A lot of interest in our airborne turret systems, our infrared detection systems and our electronic warfare countermeasures. So the R&D that we're spending in those areas are starting to pay off and couldn't be happier with 1.1x book-to-bill ratio to start the year and bodes well for the rest of the year and 2019.

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

And then for you, Ralph, the organic growth, you increased to 4% from 3%. Ostensibly, it looks like you hadn't factored in the $100 million from the Crestview and TSC (sic) [TCS] going with Vertex. What is making the revenue somewhat higher on an organic basis than in Aerospace?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

Well, I commented that the Aerospace guidance now formally includes the divestiture of those 2 small businesses that will be sold -- or have been sold with Vertex. And when we came into the year, those were already held for sale. So I had conservatism, but we had conservatism in the guidance that factored it in, and that what's -- now that we've declared the sale, we're just declaring that the organic growth is going to increase in that segment despite those 2 small divested businesses. So...

Operator

Next up, we have Rob Spingarn with Crédit Suisse.

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

I wanted to ask you, Chris, a couple of questions. One is on your contract structure. You're one of the higher fixed price compositions in the group. And obviously, you're working on the margins, and you talked about that a little bit earlier. But how do you -- given that opportunity, you're really built for much higher margins. So I wanted to see if you go in to -- perhaps give us a little more color on how you're going to get there. And then the second question is on transformational M&A. Should we be looking for you to do something more significant at some point? It seems to me that you're leaning more in the direction of the Navy. Could something happen there?

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Okay. Well, thanks, Rob. No, you're right on the contract structure we tend to have more fixed-price work than maybe the other companies. So there's really 2 opportunities. The #1 way to improve margins, in my opinion, has always been to increase the denominator and to grow. And I think volume is the best way to improve your profitability. And that's why we've rolled out our disciplined growth strategy. And myself and my team and others have been aggressively out their meeting with customers, both as a supplier to the primes and directly to the end users to try to jump-start the growth. So the volume will improve the profitability. And then, of course, as we continue to reduce costs, I mean, this year, we're investing, and that's a lot in our IT systems, I mentioned the SAP award, which we're quite out of. We'll start to see those pay off in '19 and beyond. So it's kind of the old-fashioned cost reduction and more top line sales will improve that profitability. And the team is focused on that, and we're making progress. Unfortunately, we had -- have a rift in Salt Lake City, eliminated up to 140 positions, which again is part of our Comm segment. So we'll continue to do that where the business make sense and as we continue to consolidate our divisions and our sectors.

On the second question, I think we've been consistent in saying that we can easily make $1 billion of acquisitions a year and still protect our investment-grade credit rating. So whether it's a $1 billion or 2 $0.5 billion or 10 $100 million, we're looking at everything. We continue to look at it strategically, and I think we're doing a pretty good job aligning our portfolio with the defense strategy. I give Secretary of Defense, Mattis, credit. I think it was the first time the DoD has -- had a strategic review in 20 years, at least that's what he's been quoted as saying. So we all see where he's going and what capabilities he needs. And we'll be happy to do larger acquisitions if they make sense strategically and operationally and financially. And...

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

Are the specific areas of interest would ship building be one?

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Like all -- have to align with customer needs. We did -- I always call them small ship building with our Unmanned Undersea Vehicles. So everything's on the table. And if it makes sense, we'll pursue it. But right now, we're just continuing with our pipelines, which just probably has a dozen or so opportunities. Like I said, I'm pretty confident we'll spend more than $300 million this year, even though it was a slow first quarter. A lot of things are in work, and the main focus was obviously on Vertex in that time frame. So everything's on the table, and we'll do what we think is in the best interest of our customers and our shareholders. Ralph, do you have anything to add to that?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

With respect to the operating margin.

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Transformational M&A?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

I think you covered the transformational M&A. I think on the operating margins, you talked about the integration and restructuring actions that we're taking this year and we've taken last year. And we are starting to realize savings, in 2018, I said $15 million. There'll be more savings, probably another $15 million next year. So we're definitely on the path to continued increases in our operating margin. And we said that we would get to at least 12% by 2020, and I would underscore the words at least because we're going to try to do better than that.

Operator

The next question will come from Cai Von Rumohr with Cowen and Company.

Cai Von Rumohr - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

So refresh my memory what's your book-to-bill target was for this year going in and what you factored in for the FY '18 budget? It looks like it was bigger than most expected.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

Well, when we came into the year, we expected that we would have a positive book-to-bill ratio, probably about [1.02x, 1.03x]. (corrected by company after the call) And now we expect the book-to-bill to be at least 1.05x and possibly higher. So we're expecting an increase in the book-to-bill ratio, which means more orders given the higher budget for 2018. The timing of those orders, and we're already 6 -- the budget was appropriated 6 months into the fiscal year. So there's a lot of contracting activity that needs to occur over the next 4 months -- 4 or 5 months. So...

Cai Von Rumohr - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

And yet, your first quarter book-to-bill, despite the CR was better than expected. So I would expect some of that to flow through to the revenue line. And if the quarter was better than you expected, how come the full year guidance hasn't gone up a little bit?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

Okay. So I explained that within the sales guidance across the segments, we're trending to the higher end in 3 of the segments, offset by going to the low end at Comm Systems segment. And if you look at our book-to-bill ratio for the first quarter, it was strongest in Electronic Systems and Sensor Systems, and that's probably where we have more sales upside relative to the current guidance ranges. So it's only May 1st, and we'll have another update on our guidance at the end of July. But things are definitely trending in the right direction, particularly in those 2 segments.

Operator

Our next question comes from Michael Ciarmoli with SunTrust.

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

Maybe just on the line of Cai's question there. I mean, are you guys seeing more bookings or contracting strength right now from O&M funding given your exposure there? And I mean, should we expect those procurement programs to pick up later in the year? Maybe if you could just kind of break out where the booking strength was, maybe what type of -- what budget line items they were coming from, one stronger than the other.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

So Chris highlighted several of the strong booking areas for the first quarter. And new orders -- I mean, I'm sorry, the budget that is growing faster in the investment accounts than in the operations and maintenance account. So where we saw a particular strength in Electronic Systems, it's mostly coming out in the procurement accounts and the RDT&E accounts as well as increases that we're seeing in terms of replenishing or refilling munition bins, if you will, and some of that comes out of the O&M account as well. So I guess more of it is going to come from the investment accounts, and we're about 50% now investment versus O&M.

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Yes, Michael. The R&D budget had an uptick. And given some of the focus we've had in the classified arena, we saw some pretty good bookings in that area, as I suggested. And so I think we have some unique capabilities that are making a difference, and it's been an area of focus. And again, 15-or-so percent of the company is in the commercial aviation market, and all those trends are positive, not only in the airport security arena, but with the commercial pilot training. So all those things are contributing to the strong performance.

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

Got it. And then just while I'm thinking about it and you brought it up the R&D. Chris, I mean, is there an opportunity for you guys in the world of hypersonics as we continue to hear more about the DoD's priorities there? I mean, is that -- do you have specific opportunities in those markets?

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Nothing significant to be honest with you. I mean, that is one of the areas that's highlighted. But at this time, nothing, nothing that would move the needle. I think we might have some components, some telemetry, some ancillary things that are relevant, but not in a big way.

Operator

The next question comes from Seth Seifman with JPMorgan.

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

Looking at the Communications business, you highlighted UAVs as a drag in the release in the first quarter, and it seems it's going to be a driver of growth towards the end of the year. If you talk a little bit about what's changing there. And then maybe bigger picture, within Communications. And, maybe more broadly, your strategy in UAVs given investment in some new platforms there.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

Seth, so on the UAV communication work, what's happening there is very simply a cadence or a timing issue of orders and completing existing backlog and then shifting to new orders that we expect to happen later in the year. So it's a timing dynamic.

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Relative to the strategy is one of making sure we have dialogue with our customers. Like I said, I don't think there's anyone who doesn't understand or appreciate the significance of being able to communicate in a covert way. And I think this is well documented, and we're working closely with our customers to talk about different alternatives, and how to address, not only new platforms, but existing platforms. So I like the investment that we've made for over a decade. We're doing demonstrations, live demos, flying aircraft, showing how these different products can work in a contested environment. And the results have been rather impressive. So it's kind of day by day, moving it forward and making sure that the need is known, the requirements are written and ultimately an opportunity will present itself. So we have confidence in this market, and we like where we are.

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

Great. And then as a follow-up. The outcome on the P-8 competition, how much tougher do that make it to bring the top line back to positive growth in Aerospace Systems in 2019?

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Yes, I don't think it was going to be financially significant in 2018 or 2019. There were 2 awards. We would have obviously wanted to have one of those. We just reviewed kind of a modified strategic plan for Aerospace, and we'll be opening the aperture. I think we have some incredible capabilities, and there's a need to be presented to different clients within the DoD beyond our traditional Air Force customers. So we're going to take a different approach as to how we grow this enterprise. It would've been nice to have it, but we have a backup plan that will work in real time.

Operator

The next question will be from Jon Raviv with Citi.

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

Ralph, you mentioned the 12% target in 2020. Is -- in that context, I guess, for both of you, Chris and Ralph, now you've had more time to get your hands into the business. Can you give us a sense for what do you think maybe a fair margin might be for the business mix that you're approaching and some of the steps you can take to get there just because the -- you're already relatively close to 12%?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

So well, as I said, at least 12% and then higher in terms of a fair margin. And if you look at the margins in our segments that we have presently, we're almost at 14% in Electronic Systems. We're about 12% in Sensor Systems, and that's after spending about $30 million more this year on R&D for incremental growth. We said that that's not going to be a recurring incremental spend. So if you factor that in or factor that away, if you will, the underlying normal margin in Sensor Systems is also approaching 14%. So the -- we have the most work to do in the other 2 segments with respect to the margins, and it's obvious. We're focused on it. And then across the entire company, Chris talked our various initiatives, including the L365 continuous improvement, the consolidation and integration that we're doing across the sectors in terms of not only ERP platforms but also various support and administrative functions. And those initiatives are going to continue to provide operating income that we'll use for a combination of margin expansion and for reinvestment into the business in R&D and business development and marketing and selling.

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Yes. Jon, I think this is a great question, and I think I try to be consistent on this, and I think it's important to clarify, and I fully appreciate the importance of margins, and we're working hard in that regard. But first and foremost, we are a growth company. We're trying to grow the top line. We're trying to grow the bottom line. We going to have $1.1 billion of EBIT this year. My goal is to get $1.2 billion in 2019 and continue to grow and get more earnings. I think we all know generally in this industry and especially at L3, the earnings does impact and burden the free cash flow. I think as I've looked back, we've averaged 120% free cash flow conversion rate, one of the better rates in the industry or the industrials. So ultimately, we're a compounder of free cash flow, and that's consistent with our strategy. We're going to make acquisitions. Some of these will be early-stage companies. Some of these will have amortization of intangibles, which will artificially lower the margins maybe in the near term. R&D, we've been very aggressive in R&D. It's no coincidence. Sensors grew 16%, and it's just 1 quarter, but they could be -- that -- have a great year. And I think it was the third quarter of last year, as I have said, we're increasing in R&D, and we're starting to see it pay off. We made investments in Security & Detection and the equipment, allowing people to carry on liquids and laptops. And now we're starting to see orders there. We've made investments in our simulator business, and we're really on a roll in that regard. So the focus -- everything we decide, it's a balanced approach. But as I've said before, we're going to do what's in the best interest of the company long term. I have no problem taking onetime charges for severance, for restructuring, investing in R&D or making acquisitions that may dilute the margins in the short term but positions us in long term. But notwithstanding that, we're committed to the 12% target in 12, and we'll keep going with more volume and some of the transformational investments we're making on our internal systems will accelerate that. So that's how we're looking at it. That's how we're running the business, and that's how we're going to continue to succeed.

Operator

The next question comes from Noah Poponak of Goldman Sachs.

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

I'm actually going to follow up on that myself. Ralph, isn't it the case that your 2018 segment operating margin guidance, excluding the incremental IRAD and excluding the restructuring is 12%?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

I think that math is correct.

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

Okay. So it sounds like the longer-term target of 12% has been in place. You're improving the business, you're maybe outperforming in certain places, and there's certainly upside potential to that, maybe significant given the savings you still have to come, the volume absorption you have to come, but you want to leave yourself room to maybe incrementally invest in the business or just given the uncertainty around the mix and other things like that. Is that a fair...

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

That's also correct. And Chris explained what those investments could be.

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Yes. I thought those explanations are actually better than mine. But I'll second what you said, Noah.

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

Okay. Now I really just wanted to make sure I wasn't missing some other benefit in this year that goes away or some other moving piece. And then on the capital expenditure increase this year, 2 questions around that. One, where does that go beyond this year? And then secondarily, I think you specified it's for the simulation and training business. How big is that now for L3? And how quickly do you think that can grow over the medium term?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

Okay. So I did say that the incremental CapEx of this year is -- we're investing it in both our U.S. military and our commercial training and simulation businesses. Those 2 businesses, particularly on the commercial side, tend to be more capital-intensive, and we're growing very rapidly there. And we recently were awarded some new business. It's close to being -- turning into a funded order that is going to require us to make more investments in flight simulators that will use to sell Power by the Hour type services to our customers. The good news is we actually manufacture those flight simulators ourselves, so that gives us a cost advantage, if you will. And beyond 2018, we don't expect that the CapEx is going to increase in terms of dollars from what we're investing in 2018. But there'll probably be different focused areas next year depending on where we see the incremental emerging growth opportunities. And it's possible that CapEx can also decline slightly next year to where it's been the last several years before 2018.

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

And Noah, there are some new tax laws in place that will make capital expenditures more favorable. So it doesn't bother me that we've increased the CapEx, especially when you see the direct linkage to our growth. And the focus on the commercial pilot training is something we've been doing for years. And I think we're in a real unique position from our cadet training, our live training, our full flight simulators, there's some innovative things out there that we're working on. And I think we have the great reputation in the airlines around the world, respect what we've been able to do. And so I'm very optimistic about what we've done and what we're going to do in that market.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior VP & CFO*

And also, Noah, you did ask what the size of our training and simulation businesses are for L3. And combined, the military and commercial businesses will be about $1 billion in sales this year.

Operator

Our next question comes from Pete Skibitski of Drexel Hamilton.

Peter John Skibitski - *Drexel Hamilton, LLC, Research Division - Senior Equity Research Analyst*

Chris, to follow up on, I think, on Cai's question earlier, sorry if I missed it, but I think most of your peers have talked a bit to kind of out-year revenue growth after this big '18 Omnibus Appropriations Bill. So I'm just wondering if you guys do maybe 4% organic growth this year as a result of that bill, do you have the visibility to think that you can accelerate revenue growth organically in '19 and '20?

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Yes. I think for '19, what I said is the growth rate should be more than '18. So if I said 4% for '18, I'll sign up to at least 5% for '19. And things are still being awarded and negotiated, and we'll be doing our detailed plan in a few months. But that's clearly our expectation is more revenue in '19, higher margins in '19, more EBIT, and accordingly, more cash. So I think that's the positive trends that we see. And that's all organic obviously, and anything we do in M&A would be additive to that.

Peter John Skibitski - *Drexel Hamilton, LLC, Research Division - Senior Equity Research Analyst*

Okay, great. And one follow-up on Aerospace post Vertex and TCS and Crestview. It seems like you're kind of necking down to be more kind of an ISR-upgrade type of a segment. So I'm wondering, as you think about kind of the restructuring you've hinted about there, do you go further? I mean, do you guys still need to be in the VIP completions business? And something in Canada that's maybe not ISR related, how are you kind of thinking about the whole business as a whole given that ISR part is clearly kind of your highest margin portion?

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

I think we're always looking at our portfolio, are there existing products and capabilities we can take to new customers or are there new products we can take to existing customers or some combination thereof. I think with all the focus on ISR, especially in the national defense strategy and special ISR missions that that's our sweet spot. We're platform agnostic, so we work on business jets, we work on really just about any platform. Fixed wing, we're looking at rotary wing, we're looking at other services beyond the Air Force. Internationally, like I said, there were some great interest, especially in the Mideast, with our capabilities. And as some of these countries have conflicts and aren't using the U.S. platforms, they see the importance and the need to have these world-class ISR capabilities. So I think that's going to be the strategies for the most part. I don't see a lot of head of state, VIP type work in our future. If it is for the President or some of his aircraft, clearly, that's in our sweet spot with the focus on Comms. But that's how I see it rolling out. And maybe on upcoming call, we'll give you a little more insight as to what you have in mind strategically. But at a high level, that's what we're thinking.

Operator

Next up is Peter Arment of Baird.

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

Chris, I'm just thinking about your commercial portfolio. You mentioned about 15%. And you've got some -- obviously, some really nice tailwinds going on there in Detection and also on the training side. How do we think about that from your approach on the M&A when you mentioned over a dozen kind of companies or firms that you're looking at on the M&A? Do you -- is there a desire to kind of -- is there M&A opportunities when we think about your commercial portfolio? I know you did a bolt-on over a year ago there.

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Yes. I think, Peter, absolutely. I mean, as I look at our pipeline, it covers all of our markets. I think we've had 2 or 3 just in the last couple of years in both Security & Detection and in the commercial pilot training. And as those have been integrated and performed and met their expectations, the way we run the company with the segment Presidents as they make acquisitions and we achieve our expectations, then we open up the wallet for more. So commercial training, we're #2 by all counts. And we're not adverse to joint ventures or some creative structures. I think a lot of the airlines are looking at outsourcing or selling their training school houses or capabilities and putting those pilots to work generating revenue and looking for companies like L3 to take overlap. So we have a couple of those that we're in discussions with that could require some upfront capital. And Security & Detection, we're always looking there. We have a new leader starting this past January. And with the Implant acquisition, the Mac H acquisition, we filled in some gaps. And I know he's looking at some opportunities that he's going to bring forward to someone -- some capabilities. And again, those could either be geographic or technological. So yes, I have no issue. And I think Ralph and I are in full agreement. If it makes sense, we'll acquire commercial to supplement our defense portfolio.

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

Okay. That's helpful. And just a quick follow-up. Just as a clarification, did you -- you mentioned that some of the ERP efforts that are going on, does that wrap up all in 2018? Or is a lot of it's spilling to -- over the next couple of years just given the way it gets implemented?

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Yes, it's a couple of year process. We've narrowed down to just a couple of solutions, and we're migrating the divisions and the entities basically to 1 or 3 platforms based on whether it's high-volume production, low production services or such. So the systems are up and running. It's more of a migration. I don't anticipate any significant issues. In fact, it'll ultimately be cost savings and allow for more common processes and policies and efficiencies. So should be nothing but good news.

Operator

Our next question comes from Carter Copeland of Melius Research.

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

Chris, I wondered in your prepared remarks, you mentioned right upfront bumps in the road, but we haven't really covered any of those and you mentioned all of the -- the employee survey, the conversations with customers, the team getting out there hitting the road. Maybe elaborate for us, have you discovered anything along the way that you could put in sort of buckets that you need to react to or have maybe changed your thinking on the strategy or taste or anything? Well, anything you've uncovered that you can shed some light on would be helpful.

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

No, I appreciate that. Well, the employee survey, I was quite excited to see that kind of response rate. I mean, it just surprised all of the professionals who do this for a living. But one of the things that I was most proud of was this category that they call sustainable engagement. And we were above industry standards. What basically means our employees have a sense of purpose, they enjoy working and they're willing to go the extra mile, and that's the hardest thing to change. So when you have such a high score in that regard, you know you've got a great workforce and you know they love what they're doing. Everything else was focused more on the need for consistent tools, more integration, a refresh on talent and how to move amongst the company to just to continue your career. So probably couldn't have asked for better results from the employee survey, but we still got to go ahead and develop an action plan. And with Melanie joining us, we're going to lay that out and move forward. I guess I like to go generally pretty fast in everything I do. And I get the sense that the team wants to even go faster than me, which is exciting. We keep bringing in new people, and they just see the opportunity and the excitement. And you know some of the external hires we've had and there's lots of options, but people want to jump on the L3 bandwagon because what we're doing is unique and different and makes a difference. So it's just a general comment, we're doing a lot in the IT world. And I don't want to overplay, but to get that SAP award, I was quite proud of. And again, we like to be a leader. We're the first defense contractor to be on Office 365, which is a secured government cloud. So no other contractor has done that. We're going to save money. We have better capabilities. We have more security. And we're also work in IaaS, which is an Infrastructure as a Service, and we cut a 5-year deal with Microsoft. So we're dealing with all the leaders in technology. They like working with L3, and we're willing to take the risk and the chance to go with these new innovative leap-ahead technologies. And I think it's very exciting and the team is excited about it. And I'm pretty sure others are trying to figure out what we're doing and how they can replicate it. And it's good to be a leader, and I'm sure others follow.

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

That's great. And then on the growth front, I mean, clearly, if you look at the rolling book-to-bill over the last year, it's shown a pretty measurable acceleration, and you talked about a lot of opportunities, but to -- in the spirit of data-driven, is it possible to quantify what these efforts have had in terms of an impact on the pipeline of opportunities that you're out there tracking? Do you -- is that something you look at? Is it something you can see the magnitude of or anything? Is there something there that you can shed light on for us?

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Absolutely. We actually just went live earlier this year with our first-ever opportunity management tool, and it's quite exciting for everybody in the company. So I may not have a benchmark, but the pipeline of opportunities that was populated was pretty impressive and encouraging. And again, the challenge and the focus is the collaboration and the coordination. I mentioned just 1 or 2 wins, and we're seeing more and more of these cross segments and sectors, and we're getting the bigger piece of the pie in a coordinated way, usually working for the primes. And I think they like our new approach and they like L3 coming to them as a single entity with a portfolio of solutions. They get better pricing. We get to sell our capabilities in a coordinated manner. So I think it's all good. Our gut tells us that we have more opportunities in the pipeline today than we did. We've opened the aperture. And it's obviously in the tens of billions of dollars, but now that's just a opportunity pipeline report. It's pretty full at this time, both domestically and internationally.

Operator

Next question will be from David Strauss of Barclays.

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

Chris, just one question on productivity. So you talked and touched on that a bit at the Investor Day. How do you think at this point L3 stacks up from a productivity perspective relative to your larger peers? And do you think there's anything structurally different about the business or your portfolio that you couldn't see the same kind of productivity levels as your larger peers?

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Well, I guess your second question implies, but I'm going to answer the first question that it's not as good as our peers. So...

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

Based on how I look at, at least.

Christopher E. Kubasik - *L3 Technologies, Inc. - CEO & President*

Yes, and I guess I should have said this is probably -- this is our last question, not probably, it is our last question. But notwithstanding that, we can always do better. We're starting to measure a variety of productivity tools, whether it's a sales per employee, profitability per employee, sales per square-foot, some of the more traditional basic things. We can, of course, compare it to our peers as our -- as we define them. And we're not as good as we could be or should be. And what we're looking for is year-over-year improvement. Whatever the number is, we want to get better. That's why we focus so much on L365. That's why we're focusing on quality. A lot of these -- a lot of take the start and finish with quality for delivering top-notch quality products the first time, a lot of the other metrics fall into the right place. So yes, we do measure them. It's a starting point, and we're going to get better. And you've got the same data I do, and we don't look for excuses. We just look to improve. And that's the mindset of me and my entire team. And you'll see those metrics improve in the years ahead, it is my expectation.

Okay. Well, with that, I just want to thank everyone for joining us on the call this morning. For the shareholders on the call, I hope we see you next week at our Annual Meeting. And for the rest of you, we'll look forward to speaking to you again in July. Thank you for your time.

Operator

And thank you, sir. The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.
