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LLL - Q2 2017 L3 Technologies Inc Earnings Call

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OVERVIEW:

Co. reported 2Q17 sales of \$2.7b and diluted EPS of \$2.54. Increased 2017 consolidated sales guidance by \$50m to \$10.9b at mid-point and 2017 EPS guidance at mid-point by \$0.15 to \$8.75. Expects 3Q17 sales guidance to be approx. \$2.7b and diluted EPS to be \$1.85-1.95.



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CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good day, and welcome to the L3 Technologies Second Quarter 2017 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 2017 Second 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 Michael Strianese. Mike, please go ahead.



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Michael T. Strianese - *L3 Technologies, Inc. - Chairman & CEO*

Great. Thank you. Good morning, and thanks for joining us on today's call. As most of you already know, during our regularly scheduled board meeting last week, I informed the board of my plan to retire as CEO at the end of this year.

We've always been strategic in the way we do things at L3, and we apply that same principle to our management succession planning. I'm pleased the Board selected our President and COO, Chris Kubasik, to succeed me as CEO, and I look forward to continuing to contribute to L3's success as its Chairman.

It's amazing how fast time goes by when you're building a company, and these past 20 years have been both challenging and gratifying. Our team has accomplished great things, and I'm very proud of what we achieved together. It's truly been a privilege to lead this incredible organization, and I know that everyone here will continue to give Chris their full support.

Since joining the company in 2015, Chris has traveled extensively to our businesses, meeting with our management teams, employees and customers and worked closely with our operations and our team at every level to implement new ideas that are already having a positive impact.

As you know, Chris is an accomplished executive and a proven leader. I have known him for most of my career, and I'm confident that L3 will continue to make great strides under his leadership.

The company is strong, and our outlook is good. We've worked hard to position L3 for growth by executing a business strategy that is yielding positive results.

Turning now to the business at hand. We had a solid second quarter with increased sales, strong operating income, margins and EPS. Our results exceeded our expectations and further validate our strategy.

I'd like to thank our employees and management team. These results and our accomplishments over the quarter show their efforts and their commitment to our customers and the company. We have a positive momentum that is the product of our agility, program performance and entrepreneurial spirit.

Let's take a look at our performance during the quarter and review our strategy and our major markets. We're executing while strategically receiving awards and winning business in each of our defense, commercial aviation and security markets, which together strengthen our leadership positions and expand our business base.

In defense, our capabilities as a world-class ISR Systems integrator continue to generate interest both from U.S. and our global military customers. This is a core capability for L3. We're proud of our ability to address customer missions and deliver value, and we've demonstrated a very strong performance in this regard. We have a record of on-time, on-budget performance for all our U.S. and foreign military partners on programs such as EMARSS, and our track record speaks for itself.

With regard to the DoD budget, the President proposes increases to the defense budget focused on readiness as well as new platforms. However, as you're all aware, these increases are subject to several legislative processes before the government's fiscal year ends on September 30.

While we are still in a wait-and-see mode, we expect this intense budget debate over the next few weeks and months to yield positive results for defense spending. Any increase will likely be heavily dependent on the use of OCO funds and probably not be enacted until late fall or early next year. We expect this increase will include additional funding to continue the focus on readiness, new platforms and platform reset.

Specifically, as it relates to L3 strengths, priority areas include modernized ISR, protected communications, precision-guided munitions, sensor systems, power systems and night vision as well as space and other classified activities.

Moving to our international defense outlook. We're expanding our business base with new orders and customers in the defense markets. And we recently received approval from the U.S. State Department for a foreign military sale to Australia of up to 5 aircraft with our airborne ISR and electronic warfare mission systems.

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We certainly look forward to working with the U.S. government to provide the government of Australia with this important capability.

We're seeing that L3 products address a number of unmet needs and that many of our offerings cannot be matched by international competitors, including our ISR work, data links, night vision equipment, simulation and training and EO/IR sensors.

Our diverse and leading market lines position L3 very well in international markets. We are encouraged by the administration's efforts to increase global military spending.

Overall, global military sales present growth opportunities as advanced capabilities, readiness and interoperability are sought after by our allies.

In commercial aviation, Commercial Training Solutions keeps winning new business globally and making advances in market share. Our strategy of offering total training solutions, which integrate simulators, academies and cadets is proving to be highly desired by our customers. Overall, our objective is to deliver the most advanced training opportunities for our customers at the best value.

In security, beyond our market-leading aviation security products, a business we've built from the ground up, we're taking a big-picture view of this global market. This means we are continuing to innovate and network our leading screening systems for maximum capability, efficiency, safety and convenience of experience.

Our cabin baggage screening system known as ClearScan has gone into operational testing in the U.S. at Phoenix Sky Harbor Airport, and we're currently working with a major airline to install ClearScan at another U.S. airport this summer.

There have been additional deployments internationally as well. Currently, our systems are used in Turkey, the Netherlands, Singapore and South Africa.

We are one of the leaders in this area, and we are responding proactively to be in step with or ahead of our customer's needs and the security issues that they are confronting. ClearScan is a good example of this approach and represents a long-term growth area for L3.

Across our business segments, we are focused on positioning L3 for additional strategic pursuits and opportunities. We're focused on expanded levels of cross-segment collaboration to put us in a stronger position to win new business by vertically integrating to provide the best value to our customers.

Turning to capital allocation. We continue to take a thoughtful and pragmatic approach to deploying our capital with M&A being a priority along with R&D investments and returning cash to shareholders when the other two growth options aren't as attractive.

We continue to carefully evaluate M&A prospects and make acquisitions that further enhance our core capabilities and promote collaborative opportunities. We see real compelling opportunities for L3 to be a significant player in the emerging undersea market. This is a new strategic area for us. Our acquisition earlier this year of L3 OceanServer provided us with a key Unmanned Undersea Vehicle, or UUV, platform.

In May, we acquired Open Water Power, which further strengthens our undersea capabilities. These additions provide new pull-through opportunities for our core businesses in our existing and adjacent markets.

R&D is at the root of innovation, and we're increasing our investment and initiatives significantly with an emphasis on both immediate needs as well as longer-term requirements that address future threats in emerging markets.

For example, in our Aviation Products business, we recently announced a new crash-protected Cockpit Voice and Data Recorder that addresses the European Aviation Safety Agency and International Civil Aviation Organization requirement to extend the duration of voice recording to 25 hours.



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We have our finger on the pulse of the marketplace and the ability to move quickly and get things done faster than the competition. This enables us to be first to market with innovations that deliver measurable value and keep us moving forward.

In conclusion, we have the right strategies in place and the flexibility to stay ahead of the evolving threat environment by creating game-changing solutions that will keep us growing and leading in our markets. We exceeded our expectations for the past quarter, which reflects the successful execution of the strategy.

Now Chris will share his view of our operations. Chris?

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Thanks, Mike, and good morning, everyone.

It's a great honor to be selected by Mike and the Board as L3's next CEO, and I want to thank them for their confidence and trust.

Perhaps it's worth a moment to reflect on Mike's impressive accomplishments. As only the second CEO in L3's history, he's been one of the longest-running CEOs in the aerospace and defense industry with more than 11 years as our leader. And as you know, he was with L3 from day 1. We are pleased that Mike will continue to contribute to L3's future as our Chairman, and we're excited to continue to execute our shared vision for growth.

Since joining L3, I have met and worked with many employees across our business, and they have impressed me as being talented, motivated, innovative and entrepreneurial. This drive and energy will enable us to grow and serve our customers' needs.

Earlier this year, we realigned our segments to sharpen our customer focus and strengthen our competitive position. As you can see in today's release, that decision is paying off.

We are moving at an accelerated pace to optimize the business. By leveraging L3's agility, we are analyzing customer's needs and market dynamics to make quick decisions and put ideas into action. I am proud of the progress we've made so far, and our positive momentum continues.

Let me now give you an update by segment. Let's start with Aerospace Systems. Along with the Australian ISR award Mike mentioned, we delivered the third and final Airseeker aircraft to the U.K. All 3 aircraft were delivered ahead of schedule. These accomplishments are further evidence of our reputation as the leading ISR systems integrator for the global military market.

We were also one of the multiple recipients of a basic ordering agreement from the Naval Air Systems Command. This will allow us to compete for work under the AIRWorks Lead Systems Integrator project.

In Canada, we received an award for the renewal of the Royal Canadian Air Force avionics support contract for the CP-140.

Let me now give you an update on where we stand on a number of key competitions taking place this year. The nearest term one, which we should hear about in a few weeks, is SOF-GLSS, where we should have a decision in mid-August. Next is Fort Rucker, where we are the incumbent. We expect to have a decision in September. And finally, on the P-8 depot maintenance program, we expect to hear in October.

On the C-12 program, we were disappointed that we lost this recompetition. As the incumbent, we were performing well. We knew the scope and hours required to do the job, but we were underbid. When Ralph and I approve proposals, we make sure they create value for L3, and therefore, we won't bid a contract to knowingly lose money.

Operationally, we're focused on improving aerospace growth by upgrading our business development effort and personnel. These significant changes were made earlier this month.

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I've also asked Mark Von Schwarz and Ralph to take a hard look at all aspects of our Aerospace costs. And in the months ahead, I will get an out-briefing on potential plans to further consolidate operating units, with the goal of lowering costs to a leaner structure and improving operating efficiencies.

In Electronic Systems, we have great momentum in L3's broadest segment. Our CTS pilot training business continued to grow in Q2, winning contracts valued at more than \$75 million. This includes two A320 Full Flight Simulators for China's Spring Airline and additional international sales for training, resourcing and simulation solutions. Year-to-date, we've been awarded contracts for 13 Full Flight Simulators with 23 awarded over the past 12 months. Additionally, we're forecasting 1,000 cadets to enroll into our airline academy.

In Aviation Products, we were recently selected to equip the next-generation Airbus H160 helicopter with our specialized T3CAS system. This marks the first time that this system has been chosen for a rotary platform, and we continue to make strides in our aviation security business with our ClearScan baggage screener.

As Mike mentioned, the L3 is on the cutting edge of this technology and we are -- as we highlighted on our last call, ClearScan has received European aviation certification to allow passengers to keep electronics in their carry-on bags. Now we are well on our way to receive an additional certification to allow liquids to stay in our bags, further expediting the screening process.

Also, we were encouraged by the DHS chief's comments last week in support of CT technology and his view that it will have widespread use in the next year or 2. The funding plan for it needs to be worked out in the near term. If you'd like to see this exciting new technology in your local airports, I'd encourage you to contact your representative or senator.

This is a great example of how we accelerated our R&D efforts to create state-of-the-art technologies that help keep people safe while growing our business. We continue to make operational improvements in electronics by streamlining the segment. There are consolidations in process, which will result in 11 divisions becoming 4 by the end of 2018. We are flattening the organization, saving money and getting closer to the customer.

Moving to Communication Systems. We were awarded a contract to upgrade the comms for 6 Australian subs and the training system to support networked comms for the Royal Australian Navy.

We also remain a key partner for communications hardware and field service support for unmanned aircraft systems. We continue to provide production hardware, support and spares for the Predator for multiple customers, including the U.S. Air Force and foreign militaries.

And for the U.S. Army, we received a \$60 million contract for Gray Eagle production hardware and logistics. This brings our award total for Gray Eagle-related programs to approximately \$100 million in 2017.

We also received contracts for our ROVER technology as well as orders for military-protected SATCOM equipment. And last year's announced EDD/ETI consolidation is going well. Equipment and tooling is in the process of being moved, and we remain on schedule. We also sold the land earlier than expected at an attractive price.

Finally, in Sensor Systems, our Warrior Sensor Systems business received a number of contracts, including an award for night vision goggles and holographic weapon sights in support of a regional ally. We also received a U.S. Army contract for our aiming and illumination laser devices as well as a contract for ground-based electronic warfare systems for an international customer. We signed additional contracts with the MX-15 EO/IR turrets, advancing our international growth strategy and strengthening relationships with OEMs.

This new segment is delivering solid performance and growth, and L3's recent acquisition activity has been in this segment with 5 acquisitions in the last 2 years. Our latest, Open Water Power, when combined with L3's OceanServer, enables us to meet the increasing demand for smaller and significantly longer-range UUVs.

With these businesses, we have now taken a stake in growing an all-new undersea capability as a prime, as an innovator and as a product supplier that addresses our customers' needs and the evolving threat environment. We are already demonstrating these new capabilities to the Navy.



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So in closing, we're making great progress and capitalizing on L3's strength. We are focused on program and operational performance, and we will continue to move quickly and take decisive actions to implement initiatives and make acquisitions and investments to drive growth.

I'm looking forward to my new role with L3, and I'm confident that we will maintain our leadership position as we execute on our disciplined growth strategy.

Now Ralph will take us through our financial performance and outlook.

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

Thanks, Chris. I'll discuss some details about the second quarter and review our guidance update for 2017.

But before I review the results, I want to congratulate Mike on his upcoming retirement and thank him for his leadership and stewardship in building L3 into a great company. I really enjoyed working with Mike.

I also want to congratulate Chris on succeeding Mike. It's a natural and logical culmination of a transition process that began nearly 2 years ago when Mike brought Chris on to our management team. I also really enjoy working with Chris. He will do a great job leading L3 as our third CEO. I look forward to continuing to support and partner with him to increase shareholder value, and I'm very enthusiastic about L3's future.

With respect to the second quarter, we had solid results. Diluted earnings per share was \$2.54 and included a \$0.33 gain on a property sale, which we were targeting to happen in the fourth quarter. It's related to a facility we will vacate early in 2018 following the consolidation of our Traveling-Wave Tube businesses, which Chris mentioned.

Excluding the property gain, second quarter EPS would have been \$2.21 and was ahead of our expectations, primarily driven by higher sales, healthy margin and lower taxes.

Sales grew 3% to \$2.7 billion with 1% organic growth and sales were very strong in 3 of our 4 segments. In the aggregate, with electronics, communications and sensors grew 10% organically. Areas driving sales growth in those segments included aircraft simulation equipment, munition fuses, UAV communications, tactical terminals, classified work, EO/IR turrets, night vision equipment and space payloads.

In Aerospace Systems, we previously explained the tough second quarter sales comparison, which was that in last year's second quarter, we delivered 2 aircraft on an ISR contract for an international customer, which added about \$90 million to sales. Those sales did not repeat in 2017 second quarter. Nonetheless, that is an international contract that is large, important and a multiyear contract for ISR Systems, and we expect sales on it to grow the next several years.

Consolidated operating margin, excluding the property gain of \$42 million, was in line with our outlook at 9.9% and increased 60 basis points compared to the 2016 second quarter.

Segment margins continue to track to our full year estimates, and we had very strong margins in Electronic Systems at 13.7% and also in Sensor Systems at 13.4%.

In Communication Systems, margin of 15.5% was abnormally high because of the property gain. Adjusting to exclude that gain and the related restructuring expenses of \$9 million for the Traveling-Wave Tube business consolidation, margin would've been 9.5%. We will incur restructuring expenses of approximately \$39 million this year for that consolidation, and that property sale in the second quarter retired a significant risk for this year because it is essentially paying for all those restructuring expenses.

Aerospace Systems margin increased 70 basis points to 6.8%, primarily due to cost management and improved contract performance at Vertex Aerospace.

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Second quarter free cash flow was robust at \$274 million, and it included \$64 million of proceeds from the property sale.

Now turning to our 2017 guidance update. We increased EPS at the midpoint by \$0.15 to \$8.75, which is growing 7% over 2016. The EPS guidance increase is primarily driven by lower taxes and higher sales and operating margin for Communication Systems.

We raised the consolidated sales guidance at the midpoint by \$50 million to \$10.9 billion, which will increase 4% over 2016, including 2% organic growth. The sales guidance increases for higher DoD sales, partially offset by lower commercial SATCOM sales.

Our Aerospace Systems sales guidance continues to have conservatism for the Fort Rucker recompetition and a few new contracts that have been delayed. Additionally, the Army C-12 recompetition loss reduced some of our second half sales upside. With respect to Fort Rucker, if we don't retain that contract, we'll incur a goodwill impairment charge at Vertex Aerospace.

Consolidated operating margin is increasing 70 basis points this year to 10.3% with the margin returning to double

digits. We modestly increased our free cash flow estimate to \$875 million.

And regarding capital allocation, after paying our dividends, we continue to favor acquisitions. During the first half, we invested \$191 million to acquire 3 businesses and we only repurchased 26 million of our stock year-to-date. For the remainder of the year, we have a \$425 million placeholder for combined acquisitions and share repurchases. After which, we expect to end the year with a cash balance of about \$435 million.

Looking at the third quarter, we expect sales of approximately \$2.7 billion, which calculates to about a 6% organic growth, operating margin in the mid-9% range and diluted earnings per share between \$1.85 and \$1.95, with free cash flow between \$150 million to \$200 million.

Regarding the third quarter margin, we expect Aerospace Systems to decline compared to the first half of 2017, primarily due to certain contract price modifications at Vertex sliding into the fourth quarter and sales mix and ISR -- in ISR and aircraft systems.

Finally, to conclude my financial review, we had a very good 2017 first half, and we remain focused on improving our performance. In 2017, we expect to grow orders, sales and all of our profit metrics. And we are executing our disciplined growth and capital deployment strategies.

Thank you. We'll now begin the Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from the line of Myles Walton with Deutsche Bank.

Myles Alexander Walton - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Congratulations to Mike and Chris on the moves. A number of the competitions you listed, SOF-GLSS in August, Rucker in September, the P-8 depot, I guess I was less familiar with in October, could you give the size of that as well as the kind of structure you anticipate? And then corresponding to that, Ralph, you mentioned contingencies still exist in aero. Is it full contingency for the rest of the year on whatever outcome there is on Fort Rucker?



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

Sure. Myles, so your first question was on the P-8 depot maintenance, so that's a new program that we're pursuing out of aircraft systems in Aerospace Systems segment. We're hoping that over time, it will replace the legacy work that we've done there on the P-3 aircraft. And as you would expect, that program is going to start out relatively small because the P-8 fleet is very young and new, but it's one that we expect that will grow over time. And we're encouraged by the opportunity to do sustainment work on that aircraft. With respect to the guidance that I talked about for sales in Aerospace Systems, it covers any outcome with respect to the Fort Rucker recompetition, which Chris said we expect to hear on sometime in September. So we'll see what happens. In all likelihood, we probably will get an extension on that contract, which could take a period of performance into next year. We'll see what happens and we look forward to learning about it in September.

Myles Alexander Walton - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Okay. Got it. And then, Chris, you mentioned having the teams go and look at cost structure and restructuring and consolidation effort. You've been -- you're kind of going down that pathway for a better part of 1.5 years or 2. How far do you think you are in terms of leaning out the organization, if you put it in baseball terms, what inning?

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

I would say we're probably in the sixth inning. We've identified a lot of things. The biggest one we've ever done in our history is the TWTA consolidation, which affects hundreds of employees and tens of millions of dollars of equipment and such. So as I mentioned, that one is progressing well. Electronics has the 11 divisions that they've identified that they're starting to roll out. And the one I just want to take another hard look at is Aerospace. And again, we're looking at backroom operations and some of the administrative functions and how to optimize those. We most recently did it in the business development function in aerospace where we've elevated all those resources to a segment level, so you can look across the multiple locations and leverage the customer relationships in order to grow. So I'm pleased with the progress we've made. We have 2 new leaders who've been in their job 4 months running 2 of the 4 segments. They're both doing a great job and there's a lot of energy and a lot of new ideas coming forward.

Operator

Your next question comes from the line of Richard Safran with Buckingham Research.

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

Michael, Chris, congrats from me. Wishing both all the best.

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Thank you. Mike's got a bigger smile on his face than I do.

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

First off, with management changes comes a look at outlook and strategy. Chris, we know that you've been focused on M&A. I know you've made some opening remarks there. So with respect to M&A, you've been pretty clear about the placeholder and you're looking at companies in the \$50 million to \$200 million range. Could you comment on the pipeline now and also discuss if you're considering any changes here in capital deployment with M&A? Is that something you're going to be looking at? Just something that you think would happen when there's a change in management.



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Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Yes. Thanks, that's a great question. Recall, I've been here almost 2 years and the nice thing when I joined, I think it was my first day, I was thrown right into the fire here. So I've been integral, as Ralph and Mike will tell you, to developing the strategy and also executing it. So we are focused on growing L3. And with the changing budget environment, the organic growth opportunities are looking good and the inorganic opportunities are equally looking well. We've had 7 acquisitions in the last 18 months, as you know. And 2 of those were international, 2 were focused on undersea. We had a couple in the airport security area and we had 1 in the commercial pilot training. So it's been rather broad. As of today, we were actually just looking through this. Yesterday, we have about 20 companies in our pipeline. They range from tens of millions to a couple hundred million. And we have the ability, obviously, to spend probably close to \$1 billion a year annually on M&A and still maintain our investment grade credit rating. So I'm pleased with the process. I'm pleased with the pipeline and I'm pleasantly surprised how many people or founders will actually call us and -- who want to be part of L3. I think we have a unique culture and ability to integrate these companies, surprised how many of the original founders, who received large paychecks are in here, working every day, even after selling their company. And we do a great job being -- balancing the benefit to being a \$10 billion company with the autonomy and entrepreneurial spirit. So hopefully, that answers your question. But M&A, as we've all said, is our priority for capital deployment. And when there's nothing attractive there, we have other alternatives that are still available to us. So it's an exciting time. I think our prior strategy makes sense as the budget environment is shrinking and now we're going. And I think we're one of the first to publicly announce and change our strategy and starting to take advantage of it. So that's what we're going to do.

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

Okay, Chris. Ralph, one question for you. Free cash flow conversion better than 100% has been a -- pretty much of a hallmark for L3. So I wanted to ask you about that. Could you discuss what's going to continue to drive that going forward? And how free cash -- how you're looking at free cash flow conversion trending over the longer term?

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

Sure. So I expect our free cash flow conversion for the next several years should continue to be at least 120% of net income converting to free cash flow. And what's driving the strong cash flow conversion are a few items. Number one is that the businesses as a whole are not very capital intensive. So our capital expenditures are less than 2% of our sales. And secondly, we do have a lot of noncash expenses, including many that -- many of which derive from the way that we're able to structure many of our acquisitions, which -- certain of which come with tax shields. And that those tax shields effectively reduce tax cash payments and increase cash flow. And this year, those are about \$65 million. They're going to trend down slightly over the next couple of years, but that assumes that we don't make additional acquisitions, which we could structure with tax shields, and that is a poor assumption as Chris just talked about. So I continue to see that as an enduring element of our strong free cash flow. And then additionally, the acquisition activity also brings with it book intangible amortization, which, as you know, is a noncash expense. And then lastly, we were able to finance most of our sales with a good terms of trade. So we don't have any very onerous working capital requirements anywhere in the business. And I expect that, that will also continue. So that all spells solid, strong free cash flow conversion for the future.

Operator

Your next question comes from the line of Robert Spingarn with Credit Suisse.

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

Congratulations, Mike and Chris. So I want to follow up on something earlier in terms of some of the streamlining, Chris, and restructuring you've done. Can you just reconcile the idea between splitting up Electronics into 2 businesses with the concept of consolidating, I guess, smaller business units? I'm not saying that they -- they're in opposition. I just want to understand a little bit better how you're deciding to do each.



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Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Yes, sure. I mean, the old Electronics segment had an excess of 50 divisions covering things as commercial pilot training, military pilot training, security, weapons, sensors, and it was rather, rather diverse. So what we're trying to do and what have we done is flatten the organization. We split them into what we thought was logical buckets based on the customers, the capabilities and, to a lesser extent, geography. And both Todd Gautier, Jeff Miller have now worked with their teams to look for ways to optimize the operations, taking advantage of some of the backroom operations, some of the more common strategy and business development resources and looking for opportunities to take out costs. So I think it's working well and it's something that I think a lot of people have wondered about and talked about at least in my couple of years here at L3 from the outside world. And where it makes sense, we're making the tough calls and we're starting to see the results. So that's what we've been doing and we're taking a hard look at Aero to see if there's more opportunity in that business.

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

Okay. And then moving to, I guess, a higher level. I wanted to ask you about this move by the White House, this executive order, the defense industrial base review to identify critical single paths to failure within the supplier base. The reason I'm asking the question now is just given L3's position as the largest subsystem merchant supplier in the defense industry. So what do you think the types of immediate space, ground, airborne, maritime subsystem capabilities? What are those that DoD should focus on as they go through this review?

Michael T. Strianese - *L3 Technologies, Inc. - Chairman & CEO*

Well, just from past experience, that night vision capability is one that came up about having at least 2 suppliers in the industrial base. We are one of them, of course, and it was very important to them that we keep -- even though volumes were dropping to a point where we had to question keeping the facility open, we did get their attention when we brought that forward that this was a critical part of the industrial base and that they wanted to sustain it. The second one is any area where there's a sole source supplier. So in our case, think about our work on the Bradley fighting vehicle -- and as a producer of engines and transmissions probably the only place -- no, I know we're the only place you can really buy a Bradley transmission to upgrade or refurbish these Bradley's. Well, that would represent a critical area in the supply chain that needs to be focused on and maintained. Meaning there needs to be some constant level of production to keep that facility humming along or they need to stand up another supplier. So -- and I'm sure there's pockets of things like that all over the country, but those are the 2 that come to mind because we've had recent experience in those areas and...

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Yes, and I would just chime in that the -- on maybe more of the policy perspective. I mean, a lot of the primes are vertically integrating, and that's putting stress and pressure on the supply chain and whether a lot of these subsystems or systems are being competed is probably a question and a policy question, again, with the customer ultimately wanting the more capable and affordable solution. So maybe there'll be more opportunities for companies like ours. And then maybe implied in this is the Buy American clause and concept because, I think this Executive Order was focused a lot on the U.S. And when there's items like assured access to space or national security concerns, I would think in a couple of cases, Traveling-Wave Tubes, being a very specific case, where there's a U.S. provider, namely us, and a foreign supplier, you'd want to have the U.S. supplier on critical military satellites, as an example. So I'm hopeful that those types of issues are addressed and appropriate policies come out to allow us to have the best national security that we can at the most affordable cost to the taxpayer.

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

So should I conclude from what you both said that you see this review as a favorable development for L3?



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Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Absolutely.

Michael T. Strianese - *L3 Technologies, Inc. - Chairman & CEO*

By all means. Yes.

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Absolutely. I think we've -- actually, Mike and I have already been contacted to be interviewed for this study. So we'll be prepared and have our thoughts together.

Operator

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

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

Congrats, Mike and Chris.

Michael T. Strianese - *L3 Technologies, Inc. - Chairman & CEO*

Thank you.

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

Is it possible to bracket what percentage of your revenue would relatively directly benefit from an increased focus on readiness?

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Sure. Ralph, do you want to take a swing at that?

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

Well, starting at the very highest level, readiness is -- for the U.S. Military is funded out of the operations and maintenance accounts. And when you look at our DoD business, about 2/3 of it is funded from O&M, which works out to a little more than 40% of our consolidated sales. So that would be the largest number that I can conceive that benefits from readiness funding. So the answer is it is a substantial part of our business that should benefit from higher readiness spending, Noah.

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

Yes, okay. Maybe a little bit more specifically, the 2 -- 2 of the kind of newer things you went through in detail that sound reasonably exciting from a growth perspective, the new offerings in baggage screening and then the business you put together for undersea unmanned, is it possible to quantify how big each of those is currently and how big you think they could get over time?



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Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Yes, I'd say those are 2 hot areas and Ralph can give you the current revenues or outlook maybe for '17. I mean, aspirationally, on the baggage screening, this is an area we've talked about for years even before I arrived and all the macro trends here are positive, right? More travelers, more airports, more security threat and desire for an expedited process to get through security and get on the plane. So we've made the investments, we made the technology able to comply with the current rules. Me, I'm generally in favor trying to double everything, so I'm going to say I'm aspirationally trying to double that business. Ralph will say either 3 years or 5 years or somewhere in between, but that's directionally where we're going. The undersea is a new area that has minimal financial contributions here in the near term. But again, we identified the threat. The Navy is very concerned about the undersea threat, and we decided to move up the food chain in prime. And even though we have content on large subs, we thought having our own Unmanned Undersea Vehicle with some unique and interesting technologies will put us in a great position. But initially, that's pretty small. But that could easily be hundreds of millions of dollars in the years ahead. But Ralph is probably better qualified to give you the more precise numbers.

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

So sure, Chris. On those 2 new products that we've introduced in security screening, together this year, they'll do about \$45 million sales, which is up about \$15 million or 50% compared to a year ago. And as Chris said, those sales could easily double, triple, if not more than that over the next couple of years as the TSA and other airport authorities around the world begin to introduce new, more capable security screening equipment.

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

That was ClearScan specifically, but the total business is approaching \$0.5 billion.

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

The total business is a little more than \$0.5 billion this year.

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

And in how many airports is ClearScan in?

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

I think it's at about 5 right now. As Mike said, it's being tested in Phoenix. There's another airport that should be announced here in the U.S. and then we have a couple abroad. So I'll be hopping on a plane later tonight and I'm hoping I can keep my laptop and liquids in my bag at some point in the future.

Operator

Your next question comes from the line of Cai Von Rumohr with Cowen & Company.

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

So the fiscal '17 O&M appropriation was up 6%, a little bit more than weapons. And usually, that money is basically obligated by the end of the fiscal year. So what does that mean for your bookings in the third quarter and the fourth quarter and your overall book-to-bill for the year?



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

Sure. I'll take that question, Cai. The short answer is that we're expecting our orders and the book-to-bill to improve considerably in the second half of this year compared to the first half. And we -- first we expect that, that will translate in the full year calendar '17 book-to-bill ratio of about

1.03 or so and could be possibly better than that depending on the outcome of some of these new competitions, new contracts, many of which are in the Aerospace Systems segment, and we've talked about those. I will tell you that the fact that we didn't have an enacted FY '17 budget until the early part of May, which was 7 months into the fiscal year, has definitely slowed down the contracting activity and the obligation activity within the DoD. And they are still also working on filling several positions in the Pentagon, and that has definitely resulted in a slowdown. So we are expecting a significant pickup in the contracting activity in the second half of the year, Cai.

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

And in terms of your assumptions of the 1.03x or higher, what does that assume for things like Fort Rucker, the Kenya air tractor contract, the other big ones that you got out there. Assumes you win them, assumes you don't win them, factors it heavily -- how should I think about that if we have come up with a range around that 1.03?

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

So number one, it assumes that we retain Fort Rucker. And our objective is to retain that contract. With respect to the other pursuits, you mentioned Kenya, those are all significantly factored. So depending on whether they're awarded and to what extent they're funded, and they're typically funded at full contract value, that would give us some upside. So it's what I talked about in terms of the book-to-bill ratio.

Operator

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

Benjamin Efram Arnstein - *JP Morgan Chase & Co, Research Division - Analyst*

This is actually Ben Arnstein on for Seth. I wanted to ask about Aerospace Systems for a little bit. The soft book-to-bill in the quarter, and it seems like bookings have been pretty weak over the past year or so. And then how should we think about maybe the business x the competitions, and the opportunities there, like the kind of the core business getting back to stable or growing next year?

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Yes, Ben, I'll take the first shot and then maybe Ralph will chime in. I mean, none of us are happy with the book-to-bill for the company, let alone Aerospace. And over the last 2 years, I think they got right to 1.0. Clearly, our aspiration is to grow, and this is x and out maybe the Vertex business. We're trying to make some of the fundamental changes to focus on growth, starting with personnel changes, doing a little more on the cross collaboration and getting some of the unique capabilities we have at a place like Comms West in Salt Lake City and some of the other entities integrated into some of the offerings that Aero have. There's a lot going on in the classified world, probably about as much as I can say. But I think we're optimistic and hopeful that on the 2019 timeframe, we can get the core Aero business growing year-over-year, and that's clearly been our focus. And I think we've taken the right steps to do it. Again, there've been an unusual amount of delays. We haven't really lost much in the core business, so we still have those opportunities, whether they're international like the SPYDR being on the JSTARS team, Kenya we've talked about and some of the other ones that are coming down the pipe. Ralph, any more you want to add?



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

Our LTM book-to-bill ratio for Aerospace Systems is 0.93. So clearly not anything that we're happy with. And this year is unusual because we're recompeting a large amount of the business base in Vertex and we have a couple of individually significant binary items, with the recompetite on Fort Rucker, the new pursuit on SOF-GLSS. But as Chris said, we're making a lot of progress on new ISR platforms. And we've been saying for a while that we expect that new ISR work to accelerate the growth in the segment as we get to the latter part of this decade, and that has not changed. And everything we're seeing continues to support that assumption on the ISR side.

Operator

Your next question comes from the line of Jason Gursky with Citi.

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

It's Jon Raviv on for Jason. Can you talk to the -- of the improvements you're making at ES, the streamlining or the CS consolidation? How much of that flows to the bottom line, in your view, versus how much of that goes toward making offerings more competitive or more affordable?

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

That's a good question. I mean, the majority of what we have in ES is non-governmental, especially in the commercial pilot training, the aviation products and the security and detection. So we don't have the issues and challenges that you do in a traditional defense business where most of the it goes back to the customer. So we do have the opportunity to bring it right to the bottom line. But again, we are making investments to grow. And the aviation products, we now have this new deployable data recorder that you've heard about. I covered a lot on some of the investments we've made in security and detection and the new equipment and integrating the 2 acquisitions that we got, especially the trace detection. And on the pilot training, we've really gotten much more aggressive in this cadet airline academy. And there's a little capital there to get it started and some investments and some software and processes. So we're balancing the 2, I'd say, roughly half of it comes in to the bottom line, which you see in our guidance and you'll see in our outlook for '18 and beyond and the rest is invested to grow. And just like the undersea business, some of these things are longer-term growth and we're trying to balance the near-term challenges and desire for growth with the longer-term investments. And I think that's something that this corporation has done as well as anyone over the last decade or 2, and we plan to continue with that strategy.

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

And then just, Chris, just a little more on the AS review that you might be conducting. Just give us a sense for what the potential menu of options is. I feel like at some point in the not too the distant past, the company had talked about not -- a potential monetization opportunity, not holding on to businesses that were deemed to be underperforming. Can you talk a little more about your menu -- the menu of options you're looking at for that business?

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Yes, we -- so the divestitures, there's not a lot out there. I mean, there's -- I mean, we're talking a handful of things that are millions or tens of millions of revenue at most. So we're pretty much done with the divestiture program. I think there might be one very, very small entity at Aero we might consider, what we're really looking at is a change in our con ops. And where we have locations that we call sectors, they historically have been stand-alone relative to the support and infrastructure and used the business development function as something that Mark and I and the leadership team talked about recently. And instead of having business development at a sector-by-sector level, why not elevate it up to the Aero segment, get a new leader, be able to look across all the businesses and optimize the relationship with our customers. So we're going to go function by function and see if that same model yields some potential savings and synergy and such. So I don't see physical locations moving or changing



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given the size of them, but maybe how we staff them, approach them and lead them could result in a more cost-effective structure, and elimination of layers of management. That's what we're taking a look at, and I'd be disappointed if we don't come back with something to implement.

Operator

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

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

Mike, Chris, congratulations. Hey, just a quick one. Most of the questions have been asked. Back to Cai's question on the orders, Ralph. You started this year with an extended CR. If you get a CR in the end of the year, how does that play out on the bookings that you've -- for the guidance you've given?

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

You're talking about FY '18 now, so it could have some impact on the fourth quarter orders. But most of what I was talking about is, to the extent it's in the DoD, is funded out of the FY '17 enacted budget. So there could be some negative impact, but I don't expect it to be significant, if it's a CR for FY '18.

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

Right. Yes, that's what I was alluding to. Yes. And just, Chris, on -- back to kind of the flatter organization. On ES, so you said 11 divisions down to

4. Is that the timeline? And then just clarifying for that, is the end of '18 you said?

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Correct, end of '18. All right. I think we'll probably do maybe 2 more people.

Operator

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

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

Again, Mike, congratulations to both you, Chris and Mike.

Michael T. Strianese - *L3 Technologies, Inc. - Chairman & CEO*

Thanks, George.

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

Ralph, I wanted to pursue that you said organic growth in the third quarter would be 6%. It's been 6% in the first half. Your guide is 2% for the year, which would imply fairly substantial double-digit decline in the fourth quarter. So if you could just run through why that would occur.

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

Sure. George, I knew you would ask that question. So I'm glad you asked it.

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

I'm glad I didn't disappoint you.

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

You never disappoint me, George. So anyhow, if you recall, our fiscal accounting calendar is a little unusual this year in that in the first quarter of '17 compared to the first quarter of '16, we ended up having an extra week. So that week reverses entirely in the fourth quarter, which is roughly 7%. So that's one of the reasons that we're going to have a lower organic growth rate in the fourth quarter. And at the midpoint of our guidance update and considering what I said about the third quarter, that would imply a fourth quarter organic growth rate of minus 8%. I know you'll do the math, so I'm telling you what it is, George. So minus 7% of that comes from the week dynamic, one less week in the fourth quarter. And then I talked about some of the conservatism we have in Aerospace Systems. We also have upside opportunities in the other segments. So we are working hard to do better than that in the fourth quarter. But -- and then lastly, some of the growth drivers that we have and have had for this year actually began growing in last year's fourth quarter, and we had a very big fourth quarter in sales in 2016. So the comparison is getting a little tougher on sales once we get to this year's fourth quarter. That's what's happening with the organic growth in the fourth quarter, George.

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

Okay, that's a good answer. A couple of other quick ones. There's a big drop implied in Sensor margins in the second half relative to what you've done in the first half. So what's driving that?

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

So in the first half, we have had some favorable performance improvements on a number of contracts, that's number one. Number two, Chris talked about the investments that we're making in the UUV space. So we're putting a lot more dollars into IRAD and business development in the second half of the year, and that's where the UUV business is mostly -- it's in Sensor Systems, that's where those 2 acquisitions reside that we made. So that's the second part. And then thirdly, we have some conservatism there, and I would say I talked about -- when I commented on the margin for Aerospace Systems dipping in the third quarter, I talked about some contract price modifications sliding into the fourth quarter. Well, we originally expected that those would happen in the early part of this year. So it's not inconceivable that those don't happen at all in 2017, and that's another reason why we're carrying some conservatism with respect to the margin and the operating income in the other 3 segments, including Sensor Systems.

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

Okay. Then, one last minor one. In your guide to the third quarter, what's assumed for the restructuring at Communications?

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

\$13 million. And then there would be about \$8 million in the fourth quarter. And that takes us to \$39 million for the full year following the \$9 million that we had in each of the first and second quarters.



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

And one last nitty one. The \$15 million divestitures that we saw in the second quarter, is that kind of the run rate?

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

In terms of sales?

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

Yes. To get to organic growth, you took out obviously the \$15 million divestitures you had in Q2. So would that be dissimilar in Q3 and Q4?

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

It's a little less due to the timing.

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

All right. Let's have this be our last question.

Operator

Our final question comes from the line of Howard Rubel with Jefferies.

Howard Alan Rubel - *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst of Aerospace and Defense Electronics*

First, Mike, most people would say nice quarter. But I guess we could say nice decade, so well done. And Chris, good luck.

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Thank you.

Howard Alan Rubel - *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst of Aerospace and Defense Electronics*

Just 2 quick things. First, Ralph, typically the pension plan has been a little more heavily equity weighted than not and the market has been pretty good. Where do you stand in terms of performance? And if we were to stop here, how would that sort of influence and affect both your pension, income and funding for next year?

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

Okay. So our year-to-date return on the pension assets as of a few days ago was almost 9.5%, which is comfortably ahead of our full year estimate of 7.9%. So that's very positive. And the sensitivity to next year's pension expense is that approximately every 100 basis points or 1 percentage point above our assumption of almost 8% is about \$5 million of lower pretax pension expense in the succeeding year. So if the 9.5% were to hold, it's roughly \$7.5 million of lower expense next year.



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Howard Alan Rubel - *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst of Aerospace and Defense Electronics*

And then on second, the fuse business and some of the precision munitions world has been very strong and that's been, I think, a very important market for you. Chris, what are you doing to sort of take advantage of both the volume and focus technology to improve your market position?

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

So we're doing quite a bit in there, George. We actually...

Howard Alan Rubel - *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst of Aerospace and Defense Electronics*

Howard, you mean.

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

I'm sorry, Howard. Sorry about that.

Howard Alan Rubel - *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst of Aerospace and Defense Electronics*

You're not that old.

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President & COO*

Thinking about retiring already. I just haven't even got there. So we got a contract from the Army for about \$230 million in the quarter. We're now working 2 shifts. We were reviewing a request to expand the facility and take advantage of the growth, specifically in the fuses, but we're also looking at some other classified opportunities that we've been investing in for a couple of years. And we've had some good success, maybe not more strategic success than financial initially, but we are very excited about the positions that we currently have, and our strategy has been executed quite well. So that's another part of electronics I didn't highlight today and maybe I will in the next quarter. But with everything going on in security and training, I just wanted to limit the prepared remarks. But we're very, very pleased with how we're doing in that line of business.

Michael T. Strianese - *L3 Technologies, Inc. - Chairman & CEO*

Great. Well, in conclusion, we enter the second half of 2017 with solid strategies and a tightened focus on customer needs. I remain excited about what's ahead, and I know our team, Chris, Ralph and myself, are ready to move forward together along with our deep bench of talent. Our businesses are aligned with the realities of the marketplace and we're well positioned to grow and deliver value to all of our stakeholders.

We look forward to speaking with you again in October. So thanks for joining us this morning.

Operator

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



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