

THOMSON REUTERS STREETEVENTS

# EDITED TRANSCRIPT

LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

EVENT DATE/TIME: OCTOBER 26, 2017 / 3:00PM GMT

## OVERVIEW:

Co. reported 3Q17 sales of \$2,646m and adjusted diluted EPS of \$1.96. Expects 2017 consolidated sales to be \$10.9b at midpoint and EPS to be \$8.85 at midpoint. Expects 4Q17 sales to be \$2.8-2.9b and diluted EPS to be \$2.25 at midpoint.



OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

## CORPORATE PARTICIPANTS

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

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

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

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

## CONFERENCE CALL PARTICIPANTS

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

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

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

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

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

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

**Phillip Carter Copeland** *Melius Research LLC - Research Analyst*

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

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

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

## PRESENTATION

### Operator

Good day, and welcome to the L3 Technologies Third 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 Third 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.

---



**OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call**

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

Thank you, and good morning, everyone.

Since 2016, Chris, Ralph and I have developed and executed a strategy of disciplined growth and charted a long-term vision for L3. We are focused on increasing organic growth, making key acquisitions that strengthen our business, improving operating efficiencies and continuing our track record of performance.

As we announced in our third quarter earnings release this morning, we had a 1.18x book-to-bill ratio, one of the highest in our history. Orders grew at 16%. Sales grew by 6%. Adjusted EPS was a solid \$1.96 per share.

We're pleased with these results, which reflect the hard work of our employees around the world, and we thank them for their efforts. We are constantly looking for new and better ways to innovate and to align our portfolio to meet the ever-changing environment. And we are entering new business areas where we can establish leading positions and bundle our capabilities to offer complete solutions to our customers as in prime and emerging areas such as unmanned undersea vehicles.

The CEO transition is progressing smoothly. Chris and I continue to work closely through the end of the year before he takes the reins on January 1.

So now let's review our markets. First of all, defense remains L3's core business. We are advocates for steady, predictable DoD budgets. It's what our industry needs. We'll see what comes out of the ongoing budget discussions. We remain optimistic. We expect this will include additional funding to continue the focus on readiness, new platforms and recapitalization of existing platforms. There's no shortage of security threats, and our adversaries have been gaining ground over the past decade.

Something more than year-to-year funding will enable the industrial base to plan better, invest and deliver for the DoD. L3's comprehensive capabilities in areas such as ISR, protected communications, precision-guided munitions, sensor systems and night vision as well as space and classified programs position us to provide technologies and expertise in support of growing readiness and global special operations markets.

We will continue to pursue prime contractor opportunities and team with strong partners to bring the best possible offerings to our military customers while investing in the longer term.

Our commercial aviation solutions business includes our industry-leading cadet and pilot training businesses as well as our state-of-the-art avionics businesses including in-flight voice and data recorders with navigation systems, all of which work closely and coordinate with our airport security business.

Our total systems approach leverages synergies to provide customers with affordable and innovative solutions, including Power by the Hour commercial flight training. We are making key investments and working with airlines around the world to ensure that they have a steady pipeline of qualified pilots to address their requirements.

Keeping our air travelers and airports safe is a growing business for L3, where we continue to deliver innovations in checkpoint and cabin baggage screening while adding explosives trace detection technologies designed to expedite the check-in process and keep the traveling public safe.

I'd long felt that aviation security is a global priority, and we are focused on developing ways to deliver more value in total system solutions and analytics that provide overall operations.

I'll now turn it over to Chris for a review of our operations.



## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

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

Okay. Thanks, Mike, and good morning, everyone.

Let me first thank Mike for his support the past 2 years. As the next CEO, I will continue to work with our business leaders to execute our disciplined growth strategy, which includes optimizing R&D, fostering the culture of continuous improvement and enhancing our business development process.

We are focused on increasing our organic growth rate, and we are seeing results across 3 of our 4 segments, as evidenced by our strong book-to-bill ratio. We continue to evaluate M&A opportunities that are a good fit strategically and can be integrated into our existing operations. We are investing in growth areas where we can capitalize on new technologies to heighten our competitive advantages.

We completed 2 smaller acquisitions in the third quarter, Doss Aviation and Adaptive Methods. L3 Doss Aviation is the sole provider of initial flight training to the U.S. Air Force. Integrating this business with our Link operations will better position us to support our domestic and international customers' growing demand for trained military pilots.

L3 Adaptive Methods strengthens our position with the pioneering UUV autonomy technology and a systems engineering capability that enhances our prime contractor position in the dynamic and growing undersea market. It also increases our access to the U.S. classified markets.

Coupled with our 2 other undersea acquisitions, we are increasingly positioning L3 for longer-term growth in this area. It's our understanding that the DoD plans to invest as much as \$3 billion in the undersea systems over the coming years.

Let's now turn to operations and allow me to give you an update. Across the entire enterprise, we are undertaking numerous restructuring actions to increase L3's efficiency and productivity and spending significant amounts to accomplish those actions in the near term so that we and our customers benefit in the long term. So let me summarize the more significant restructuring actions we are taking in each segment.

You might recall we are in the midst of consolidating 2 Traveling-Wave Tube businesses in Communications Systems. We began this work in the second quarter of 2016, and it will be completed by the first quarter of 2018. As a reminder, we used the gain from the property sale to offset these restructuring costs.

In Electronic Systems, we are consolidating our 3 avionics businesses into a single division. Also, we are consolidating our power management businesses, combining 6 divisions into 2. We are also relocating a unit of our cadet training business, which focuses on ab initio training, from Arizona to Florida to combine operations and offer more resources to a larger student base.

And in Sensor Systems, we are combining several facilities, and we are also evaluating additional business unit consolidations.

In Aerospace, during the third quarter, we organizationally combined the Greenville and Waco operations, and headcount has been reduced by over 700 people. Additionally, we recently concluded a strategic review of Vertex Aerospace and we have decided to initiate a sale process. While Vertex is a strong player in the maintenance and logistic support market with good prospects, we are focusing our resources on higher value-add and more profitable business.

In the aggregate, across our 4 segments, we incurred \$34 million of severance and restructuring expenses during the third quarter, bringing the year-to-date total to \$60 million. Our total job reductions for the year are approximately 1,000 employees. With these actions, we are resizing our businesses to improve their competitive positions and enhancing our outlook for growth.

In addition to our restructuring actions, we are building common processes and functions that will increase collaboration and knowledge sharing to generate new growth and cross-selling opportunities.

For example, while L3 is positioning itself as a prime integrator in the undersea market, we have also added sensor and communications capabilities in this area. L3 is a subcontractor who will design next-generation communications, mission planning, autonomy, navigation and cybersecurity



## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

capabilities for the U.S. Navy's extra-large unmanned undersea vehicle known as Orca. This is a terrific example of our marketing a solution to the customer as one L3, and we look forward to sharing more examples of how we are bundling capabilities to find the value chain.

In our international business, while we are expanding our base, we are listening to and connecting with our customers and aggressively pursuing opportunities in key markets. Next week, I'll be heading to Asia with several of our segment leaders to discuss the capabilities we offer across the company to existing and potential customers in that region, and we're planning a similar trip to the Middle East in the new year. We have a lot to offer internationally, and we want to ensure the message gets delivered at the right level. Ultimately, this is all part of our effort to build a best-in-class operating enterprise, which has been one of my primary goals for L3 as we become more focused, stronger and a more profitable company.

Before discussing contract wins for the quarter, I want to briefly touch on the Fort Rucker loss. We filed a protest with the GAO in relation to the award and the outcome of this protest is unrelated to our decision to divest Vertex.

Let me now turn to new business and some operational highlights. Starting with Electronics, our aviation security business continues to receive new orders in the global market. We recently received orders for 25 of our new ClearScan systems, with an option for up to 30 more. This new system will allow passengers to more efficiently move through security checkpoints.

We deployed our 2,000 ProVision advanced passenger screening system to Atatürk Airport in Istanbul. ProVision is the industry's leading solution for safe and efficient advanced personnel screening.

We recently delivered explosives trace detections to the airlines and airports worldwide to meet TSA security requirements for U.S.-bound flights.

Also, our CTS pilot training business will provide China's Sichuan Airlines with an A330 full flight simulator, bringing the total orders for the year to 14 simulators. And we will provide simulator time to our longtime customer, easyJet, in our new L3 London Training Center.

Moving to Aerospace Systems, which continues to be our most challenging business, we're not satisfied with the growth rate or the profitability. We talked about some recent actions and this will continue to be an intense focus area for me and my team.

Turning to the brighter side. The final resolution of the Compass Call recap protest at the end of the August has cleared the way for L3 to proceed with this important effort. Our aircraft recommendation was accepted by the U.S. Air Force, and we received an approximately \$150 million contract for the first aircraft.

On the Kenyan Longsword pursuit, last month the GAO released a report upholding our long-standing position that the transaction is consistent with the standard FMS process. We appreciate the GAO's thoughtful analysis in reaching their decision.

We mentioned last quarter that we successfully delivered the third and final Rivet Joint aircraft to the U.K. RAF under the Airseeker Programme. Taken together, the U.K. and the U.S. Air Force fleet form a combined force of 20 aircraft and we will perform future baseline enhancements on this fleet.

And for the U.S. Coast Guard, we delivered the first of 12 HC-130Js for the next-generation Minotaur mission system suite for improving long-range surveillance capabilities.

Let's move on to Communication Systems. We received nearly \$100 million in production orders and a ID/IQ contract valued at \$250 million in support of the MUMT-X program. MUMT-X enables communications and data teaming between manned and unmanned aircraft, which is a transformational new capability for army aviation.

We are supplying Hawkeye III Lite VSAT to the U.S. Air National Guard, which will provide them access to the wideband global SATCOM satellite network. And continuing our long-standing role as the ISR integrator for Coast Guard's fast response cutters, we received a contract to provide integrated C4ISR system for the next 6 cutters.



## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

And finally, in Sensor Systems, our MX-Series EO/IR imaging systems continue to be the gold standard for military and airborne law enforcement customers around the world with more than \$300 million in orders year-to-date. At Warrior Sensor Systems, we received a \$150 million contract to provide specialty night vision equipment to a Middle East ally. We also delivered more than 900 aiming lasers, along with the follow-on order to the U.S. Army for our precision targeting systems.

To increase future growth, we are investing in several areas in the next few years through a combination of acquisitions, joint ventures and increased R&D to enter new markets and expand our existing markets. Our increased R&D and new business investments will allow us to climb the value chain in selected areas with more expansive subsystem offerings.

Let me turn it over to Ralph, and he'll take you through our financial performance and outcome.

---

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

Thanks, Chris. I'll review some details about the third quarter results and our 2017 guidance update.

Overviewing the third quarter, we had solid results excluding the Vertex goodwill impairment charge, with sales increasing 6%, margin expanding 80 basis points, operating income increasing 16% and diluted earnings per share growing 4%. We also had strong orders and free cash flow.

The goodwill impairment charge was \$187 million or \$1.67 per share. We had that risk coming into the third quarter, and we previously explained that it would be triggered if we lost the Fort Rucker recompetition.

My comments on the third quarter and the guidance update exclude the Vertex goodwill impairment charge.

Adjusted diluted earnings per share for the third quarter was \$1.96 and modestly ahead of our expectations, primarily due to lower taxes. Also favorable contract performance offset the \$15 million of severance expenses that we incurred in Aerospace Systems.

Sales grew 6% to \$2,646,000,000, with 4% organic growth. Sales were strong in Electronic Systems and Communication Systems, each growing 7% organically. Electronics sales increased 13% with acquisitions. Areas driving organic growth included aircraft flight simulators, munition fuses, naval power equipment, UAV communications, tactical terminals and classified work. Aerospace Systems sales were in line with our outlook. Sales were softer at Sensor Systems, which only grew 1% organically, and that was due to a letter of credit delays for certain EO/IR turrets and night vision equipment on international contracts, which caused about \$25 million of sales to slip to the fourth quarter.

Third quarter adjusted operating margin was 9.4% and it was affected by restructuring and severance charges of \$34 million, which lowered margin 130 basis points.

Communication Systems margin was 7.8%, and excluding the \$15 million in Traveling-Wave Tube business consolidation expenses, it would have been 10.6%, on track with our 2017 margin estimate.

Aerospace margin was 5.6% and it would have been 7% without the \$15 million of severance expenses there. During the second quarter earnings call, Chris commented that we will look at streamlining Aerospace Systems. Chris just covered those restructuring actions, and to provide further clarity, most of the restructuring reduces the workforce in the aircraft systems sector to address its declining business base and consolidates it into ISR Systems. We renamed the combined sectors Mission Integration.

While our third quarter results were negatively impacted by restructuring charges, these actions will strengthen and improve our future business performance.

Free cash flow was robust at \$262 million, and, as Mike said, orders were very healthy at \$3.1 billion, increasing 16% over last year's third quarter and resulting in a book-to-bill ratio of 1.18 for the third quarter and 1.06 for the last 12 months.



## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

Our orders performance is encouraging and driven by the BD talent upgrades that we have made across the company.

Moving on to our 2017 guidance update. We increased our EPS midpoint by \$0.10 to \$8.85, which is growing 8% over 2016. The increase is driven by lower taxes and higher interest income, and additionally, the favorable contract performance that we had in Sensors and Electronics is absorbing the third quarter restructuring charges of \$15 million at Aerospace Systems.

Consolidated sales guidance remains at \$10.9 billion at the midpoint, which will increase 4% over 2016 with 2% organic growth. We maintained all of our segment guidance ranges for sales.

In terms of end market sales, we increased estimated U.S. government growth to 4%. We also raised commercial growth to 5% organically and 16% with acquisitions. And we lowered estimated international sales to an organic decline of 7%, and that's primarily due to new business delays that we're experiencing in Aerospace Systems. Aerospace still has several international business pursuits that are in flux and their outcome will impact the segment's 2018 sales growth.

We expect consolidated operating margin of 10.3%, and our updated segment margin guidance midpoints are 13.4% for Electronics and Sensors, 10.7% for Communications, and 6.5% for Aerospace. We raised margin for Electronics and Sensors and lowered it for Aerospace.

We maintained our free cash flow estimate of \$875 million and we're working to exceed it.

Regarding capital allocation, after paying dividends, we continue to favor acquisitions. During the third quarter, we invested \$100 million to acquire 2 businesses, bringing our year-to-date acquisitions investment to \$291 million for 5 businesses. We repurchased \$65 million of stock during the quarter and \$91 million year-to-date. For the fourth quarter, we have a \$230 million placeholder from combined acquisitions and share repurchases, after which we expect to end the year with a cash balance of about \$460 million.

Looking at the 2017 fourth quarter, we expect sales of between \$2.8 billion and \$2.9 billion, which will calculate to about negative 6% organic growth. Operating margin, we expect to be in the high 10% range, with diluted earnings per share of \$2.25 at the midpoint of our guidance and free cash flow just under \$300 million.

Finally, to conclude my financial review. We had a solid third quarter and we remain focused on continuously improving our performance. In 2017, we are growing orders, sales and all of our profit metrics before the Vertex goodwill impairment charge. We're also executing our disciplined growth and capital deployment strategies.

We will provide our initial 2018 guidance at our Annual Investor Day on Tuesday, December 5, in New York City. We look forward to seeing you then.

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

---

## QUESTIONS AND ANSWERS

### Operator

Our first question comes from the line of George Shapiro with Shapiro Research.

---

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

I was wondering what restructuring looks like in the fourth quarter. And then, Chris, you were saying that some of it will be done early next year. What does it look like for next year? Or do we assume we're pretty much done?



## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

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

So the only meaningful restructuring charges that we're anticipating in the fourth quarter is to continue to consolidate the Traveling-Wave Tube businesses that we have in California and we expect that we'll incur about \$8 million or \$9 million for that in the fourth quarter, and there will be a little bit more in the first quarter of 2018. And regarding the various consolidations that Chris commented on, particularly those in Electronic Systems sector, we're going to have some severance charges next year, but they're not going to be significant. I'm expecting a few million dollars per quarter. So less restructuring than we have had this year.

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

Okay. And then just one quick follow-up. Are you going to start to report Vertex as a discontinued operation? Or are you going to keep it until the final disposition occurs?

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

We're presently evaluating whether Vertex will qualify for discontinued operations. It looks like it will, but we'll have an update on that at the Investor Day on December 5, George.

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

Okay. And then last, Ralph, the weak organic growth in the fourth quarter reflects the loss of days, that we've had greater days in Q1?

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

That is the primary reason for the weaker organic growth and it essentially accounts for all of the negative 6% organic growth. I also commented on the last call in July that we're going to have some tough sales comparisons in a few areas in the fourth quarter and that's all -- that's accounting for the rest of it, George.

**Operator**

(Operator Instructions) Our next question comes from Cai Von Rumohr with Cowen and Company.

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

So, Ralph, you'd indicated \$34 million of restructuring and severance in the third quarter. My recollection is that's a little bit higher than you'd anticipated -- when you provided guidance. How much higher?

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

Okay. So I commented on the 2 large elements of that \$34 million, which was \$15 million each in each of Aerospace Systems and Communication Systems. In Communication Systems, \$13 million of it was for the Traveling-Wave Tube consolidation that we've been doing for almost 1.5 years now, so that we expected. There was a couple of million to reduce some headcount in a commercial space business where we're seeing softness on the orders side and also sales, and then, the \$15 million in Aerospace Systems, if you recall, Chris said that we would take a look at streamlining those operations in the third quarter and we did that. So that was not -- the \$15 million was not contemplated in our outlook for the third quarter





## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

because we were just beginning to think about what needed to be done in Aerospace. And the rest of the charges, which were about \$4 million are mostly in Electronic Systems for the various consolidations that we're doing across that segment.

---

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

And I'll just chime in, Cai, that philosophically we're all in agreement here that sometimes you have to take some short-term charges such as restructuring and severance to position the company for longer-term growth and profitability. So with 2 new group presidents earlier this year taking a fresh look at the business and all of us collectively challenging our current operating model, we thought it was appropriate to make these restructurings. So I think we're pretty much through for now, but we'll wrap them up in the next 6 months, with a continued focus on growth.

---

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

Great. Just to recap, \$15 million at Aero, \$2 million unexpected at Comm, \$4 million unexpected at Electronics, a little over \$20 million was not in your guide for Q3?

---

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

I wouldn't characterize Electronics as unexpected. That's for the ongoing consolidations that we're doing there.

---

**Operator**

Our next question comes from Richard Safran with Buckingham Research.

---

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

So I heard -- Ralph, I heard your opening comments about 2018 guide and talking about it at Investor Day. But last year, you did provide a preliminary 2018 outlook ahead of your December Investor Day. So I was, first, wondering if you'd care to comment directionally on how you're looking at 2018 and give us a sense of how you're thinking about sales, margins, cash flows, et cetera.

---

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

Yes, Rich, this is Chris. Let me make a few comments from my perspective and then I'll give Ralph an opportunity to give more detail. Communications and Electronics are clearly growing top line and bottom line, and I think we kind of indicated that. And Sensor Systems is growing. In my comments, I suggested that we'll be investing here in the near term, in late '17 and '18, some of our R&D and new business expenditures because we see some very interesting opportunities to grow over the long term. So if you think about undersea, F-35, space and some investments we're making at modeling and simulation so we can do some more analysis, it could put a little downward pressure on our margins in '18 but we should see a big payoff. And I think we've all been pretty forthright on the challenges that we have at Aero. The Vertex divestiture is the first step to get the management team including us in the room here less distracted on that business and focus on our more core businesses. And the Waco-Greenville combination is another way to streamline some of operations. So we have 3 of the 4 growing as I see it, tried to highlight some of those challenges. But maybe Ralph can give you a little more detail, with some numbers, if he so chooses.

---

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

Sure, I will definitely do that, Chris. So I'll give an outline of what next year looks like and we'll have more details on that at our Investor Day. So starting with the top line, given the losses of the Army C-12 contract and the Fort Rucker recompetition, that's going to translate into our consolidated sales being somewhere about flat next year to down 1% versus our 2017 guidance of \$10.9 billion and that assumes that we'll have Fort Rucker



## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

through the first quarter of 2018 because our contract has been extended given the protests that have been filed on that award, including our own protest. So if you take away the sales declines on Army C-12 and Fort Rucker, our sales are expected to grow next year or we see them growing somewhere between 4% and 5%. And we're going to see a difference in the sales growth rates next year like we're seeing this year, again, where the average growth rate for Electronics, Communications and Sensors will be somewhere between the 5% and 7% range and that will be offset by declines in Aerospace Systems excluding the Vertex of somewhere between 1% or 2%. In terms of operating margins, we expect margins to expand by about 30 basis points versus 2017 and that's mostly due to lower pension expense, which I'll come back to in a moment. And at the segment level, we expect margins in Electronics and Communications to expand by at least 50 basis points. Aerospace will be up slightly due to lower pension expense, and Sensor Systems is going to be down probably in the 170 to 180 basis points range and that's due to the incremental growth investments that Chris just talked about that we're making in that area mostly in IRAD and it's approximately additional \$30 million of expense compared to 2017 in that segment. The pension outlook that we presently see today, and these will be updated for what the discount rates are and the actual turns are for the end of the year on December 31st. We see our pension expense FAS net CAS declining about \$36 million next year versus this year, and most of that decline is in Aerospace, with a few million of it in Communication Systems. The tax rate will be somewhere around 27% and our share count will be flat to up 1% depending on what happens with the cadence of our share repurchases and our stock price next year. And that all translates into earnings per share of somewhere in the \$8.75 to \$9 range. So that's presently where we see 2018 starting, and obviously, we're going to work to do a lot better than that. But that's what next year's outlook looks like as of today.

---

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

Okay. Just following up real quickly here. So you had 3 big losses for this year: C-12, SOF GLSS and Fort Rucker, which is pretty unusual for L3 given your historical win rate. I want to know if there's any common thread that you discovered here. Is this a situation where you're just beat out on price or something like that? I'm trying to find out if there's a lesson learned here, for example, maybe just focusing on higher-end services or something like that.

---

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

Rich, all those are obviously in Vertex. As we said, we'd be divesting and we had a strategy going back in '16, which we articulated that we were going to keep Vertex and try to fix it and grow it and that was because over 70% of our backlog was up for recompetition. So to some degree, we really didn't have a choice. And I think we worked reasonably well in getting the RFPs to be best value versus LPTA, lowest price technically acceptable. And the 3 of us here, we're proud of the team and their past performance and the ratings, whether it was CPAR ratings, award fees were pretty darn high, but we weren't going to bid to make minimal profit or to break even. So we submitted the bids that we thought was a fair return to our shareholders. We relied on the best value strategy, and, as you mentioned, we were not successful. So we relooked at our strategy. We're going to focus more on the products, the solutions, maybe back to our core. And we've opted to start the divestiture process. I think there's a lot of people that are very interested in Vertex, and we expect that transaction to obviously close within 12 months. But what seemed to be the common thread and it was great business. I think when we got it, what, 10, 12 years ago and you just look at financial performance trends, in all honesty, by a change in the customer behavior and we're going to move on. So that's how I look at it.

---

**Operator**

Our next question comes from Myles Walton with Deutsche Bank.

---

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

I was wondering if I could just get a little bit of color on the contribution of Vertex and Fort Rucker to this year's cash flow, just so we can kind of conceptualize what the headwind would be there. And also, Chris, from a standpoint of disposition of the asset, it sounds like you see interest in that asset. Do you think you'll be able to offset the bulk of the dilution from the divestiture -- half of the dilution from the divestiture? Just kind of bucket that.



## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

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

So your first question, I'll take, Myles. So this year, Fort Rucker and Army C-12 generated -- will generate combined sales of about \$675 million. The margins on that work, when you factor in the overhead costs and expenses that they absorb, are in the 6% or 7% range. So if you take that and then you reduce it for income taxes, which the marginal rate there is 37%, that tells you what the cash flow impact is, which works out to around \$20 million or so or thereabout.

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

Again relative to the dilution, I think we'll be able to offset at least half of it that comes down to the ultimate proceeds. We're having early meetings with our banker over the next couple of weeks and we'll be putting together a teaser and hopefully we get something out before our investor conference as they get a feel by then. But assuming we just take the proceeds and apply to share repo, I think that will have the most immediate impact on absorbing the dilution or that course we talked pretty openly and candidly about our desire for acquisitions. So I don't think it's going to be significantly material financially in '18 and beyond if we're open for a quick process and look forward to moving forward.

**Operator**

Our next question comes from Seth Seifman with JPMorgan.

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

I wonder if you could talk a little bit about the Detection business. Obviously, it's been an area of investment for you guys, but with M&A down year-to-date, sort of why is that and the prospects going forward.

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

Sure. Hello, Seth. So what's been happening year-to-date in that business, Security & Detection Systems, is that we are seeing a lot of funding delays, particularly here in the United States with -- from TSA with respect to our various products, eXaminer and ProVision, and we just booked some significant orders in the third quarter, so we're confident that we're going to grow our sales in that sector or business area in 2018. And additionally, we've also seen slower order flow in the international market. But again, we see that picking up as we head into 2018.

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

And just as a reminder, Seth, we're changing the whole approach here in trying to provide integrated solutions versus the one-off product, and in our meetings, I think that's being well received. Another part of our strategy is we're meeting with major airlines, and as you can imagine, the airlines are highly motivated to have the passengers get through the security system quickly and efficiently. So we have some interesting, innovative approaches working with airlines to put maybe some pressure on certain airports to allow us to accelerate some opportunity. So as Ralph said, I think '18 is going to be a good year. As Mike said, airport security is clearly a focus for us. I think in all of our lifetime, there'll be more people flying at more airports with heightened security, so I believe we're in a sweet spot in the market and expect some good success in the years to come.

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

Great. And then just as a quick follow-up, Ralph. On the cash flow front next year, can we expect sort of 125% conversion or something in that neighborhood?



## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

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

Yes. And cash flow is going to continue to trend with a high degree of correlation with our operating income growth. So we expect that we're going to grow operating income next year, so that you should also -- that will also mean that we'll grow free cash flow along with it.

---

**Operator**

Our next question comes from Jason Gursky with Citi.

---

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

It's Jon Raviv on for Jason. You guys talked through restructuring costs, but I was curious about the benefits of the restructuring. I mean, the 2018 guidance is very helpful by segment, but longer term, is there a chance to really push margins even higher? For example, the Aero segment has been targeted 7% to 9%. Can you exceed that over time perhaps?

---

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

So let me answer that question, Jon. So the largest consolidation we're doing this year in terms of expenditures, even though the restructuring costs are being offset with a property sale gain pertaining to the Traveling-Wave Tube consolidation in our Communication Systems segment, and what we've said there is that once we complete the consolidation, we'll start to see annual savings of about \$8 million on a pretax basis. With respect to the severance charge that we took in the third quarter at Aerospace, I commented that most of it was to resize the business at the former aircraft systems sector, which was mostly the business in Waco, Texas, to deal with its lower business or sales volume. So that in and of itself doesn't really translate into improved margins. It's more cost avoidance, if you will, given the lower sales volume. And the various restructuring activities that we're doing elsewhere in the company, most of which is in Electronic Systems, we're going to continue to incur expenditures next year. And once we get to 2019, we should start seeing some meaningful savings from those consolidations, somewhere in the \$10 million to \$20 million range pretax at a minimum. So we definitely have some opportunity there, especially once we get into 2019.

---

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

And the additional benefit, we'll obviously be much more competitive on our bids with a lower cost base. So that's going to help us fuel the top line, which also has benefits to the bottom line profitability.

---

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

Sure. And just as a follow-up when talking about something like kind of \$20 million of benefit come 2019 based on the ES restructuring, should we think about that -- in deference to what you said, Chris, should we think about that as a net savings or gross savings that will go back and make you more competitive?

---

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

That's a net savings that falls to operating income.

---

**Operator**

Our next question comes from Carter Copeland with Melius Research.



OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

**Phillip Carter Copeland** - *Melius Research LLC - Research Analyst*

Just 2 questions, one quick one on the investments in Sensor Systems in terms of the IRAD. What's the kind of time line you see for that turning into revenues? And then the second one is a bit bigger picture, Chris. I wondered, you kind of got a lot of elements here in terms of reaccelerating growth and trying to enhance the margin profile and trying to do M&A. But you commented as well about this moving up the value chain to the greatest extent possible, and I wondered if you might give us a little bit more color on that and really specifically how you do it with L3's sort of decentralized structure. Is it -- do you focus that effort in a selected number of BUs? How as L3 do you go tackle a problem like that?

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

Okay. Well, Carter, it's good to hear from you. I'll take both questions. On Sensor Systems, I would say at the end of 2020 time frame that we would start to see noticeable payoffs from the investments. And as I mentioned, undersea and F-35 and space would be the 3 large areas where a majority of that \$25 million to \$30 million of additional R&D would be spent. As far as moving up the value chain, we've spent a lot of time focusing on collaboration. I think one of the things I found in the 2 years here is the quality of the team and the technology is world-class, and the biggest challenge is allowing everybody to know all the different capabilities. So we've identified about 9 or 10 specific initiatives that align with our customers' challenges or desires and we have cross-functional teams that are developing strategies, and in each case, we have at least 3 of the 4 segments working together. And this could be something like sixth gen aircraft or surface maritime opportunities. And we've had some successes this year where we've worked together and submitted, in effect, a single L3 bid, bundling together 6 or 7 or 8 divisions and kind of making them fit and getting more content. So that's how we're doing it. It's increased communication. We've invested in some software and other tools so people can easily access and see everything that we have going on at a corporate level, which allows us to connect the dots. And we're getting good feedback from our customers as well, because, as you would imagine, they're always looking for more competitions and I think we're rightfully perceived as being maybe more affordable, more agile and I'll say more innovative than some of our competitors in certain areas and that's being well received around the globe.

**Phillip Carter Copeland** - *Melius Research LLC - Research Analyst*

And just as a quick follow-up to that. Do you incentivize? Have you changed the incentives at all that incentivize cross-functional outcomes? Or how should we think about that?

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

Absolutely, absolutely. In 2018, people will be duly incentivized for even more collaboration, more growth and more moving up the value chain or food chain, whatever and however you want to refer to it. So yes.

**Operator**

Our next question comes from Noah Poponak with Goldman Sachs.

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

I guess I wondered if it would be possible to -- Chris, you've given some kind of medium- to long-term targets on where you think you can take each of the segment operating margins. I wondered if you might just circle back through that because Aerospace Systems, the question is what does that margin look like once you have done what you are doing from a restructuring perspective? And then also without Vertex, ES, ex restructuring was 15% in the quarter. Is that something achievable on a run rate basis long term? CS is kind of all over the place this year, where does that go? And then Sensors got this investment next year, so how do we think about what happens beyond next year? It'd be great -- with '18, I guess, being kind of a transition year in a lot of ways, it'd be great to frame your updated view on where the margins can go beyond that.



## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

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

Absolutely. Let me start with Electronic Systems. As a reminder, I think Electronics has our highest international content. It also has our highest commercial aviation content, which is the commercial pilot training, the avionics and the airport security and detection. So, I see that in the 13% to 14% range on margins, all while having year-over-year top line growth. So I see that as probably, in the near term, having the highest margin. You're right on Communication Systems. I mean, '17, to some degree, and '18, is a little bit of a transition year, but I kind of see that in the low double digit, say, 11% to 12%. And you have to recall, a lot of that is classified; a lot of that is cost-plus work. So that keeps us in that range. I'll jump to Sensor Systems, as we said this year, we'll be in the 13% to 14%. I think it has the potential to surpass its top line growth with some new and exciting areas. We have some prime opportunities there. If you look at what we're doing with night vision goggles and some of the innovations there, again, 13% to 14%. Maybe next year, as Ralph said, down a little bit, but, again, philosophically, I have no hesitation at all taking charges and spending money in the near term. And I know a lot of people are focused on quarter-to-quarter, and I appreciate that, but we're going to grow this company over the long term and it's going to take charges and severance and R&D to do it. So that's how I see Sensors. But that should be back to 13%, 14% in the 2019-2020 time frame. And as I said, Aerospace Systems, none of us are happy where we are there. We've taken some actions, as we've well-covered. But in the near term, it's a 7% to 9% business, more towards the low end and we're spending a lot of time relooking at the strategy, opening the aperture. I think we can potentially prime some opportunity, even though we are not an OEM when it comes to aircraft. And in recent meetings that I've had with our customers, they're very pleased with the dedication, the hard work of the workforce. Several of the aircraft, which I don't highlight, some are classified, are delivered either early or under budget. And we're going to grow. And when you start to grow, you get more developmental programs, more cost-plus work. We look at the ROIC in addition to the ROS and I'm optimistic that, in the long term, we're going to get AS back to where it belongs, but single-digit margins for now. And...

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

Where does it belong in the long term?

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

I think it should be in the lower double digits, especially as we get some international opportunities. And with the divestiture of Vertex, that's not an unreasonable longer-term goal and aspiration. Absolutely.

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

And what is the immediate removal -- or what does the removal of Vertex do to that 7% to 9% immediately?

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

Probably keeps it in 7% to 9%, unfortunately.

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

Okay. Because it's lower margin, but you have the overhead absorption impact.

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

Exactly. That's really \$1 billion of revenue or so. But we talked about it internally, and if we have to get smaller to get better, we will and we made that decision and we try to make it as clear as possible. But that's what we're going to do.



## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

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

Yes. No, that makes sense longer term. Okay. Ralph, you said next year, revenue flat to down 1% with Fort Rucker and Army C-12 going away. I think you said 4% to 5% if you were stripping those out of '17 and '18. What's the 4% to 5% if I'm stripping out all of Vertex '17 and '18?

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

It's about the same, because Vertex is still going to grow modestly in '18.

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

Got it, okay. So that's not diluting the growth rate.

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

And to clarify that, I mean, obviously, Vertex will not grow when you factor in the losses of C12 and Fort Rucker.

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

Yes, right. On the remainco.

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

It is growing, yes.

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

Yes, got it. And then what would earnings be this year on an adjusted basis excluding restructuring? And then same question for the range you just gave for 2018.

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

So the restructuring charges for this year are going to be roughly \$70 million pretax, but that's before the property sale gain that we had in the second quarter, which was about \$40 million. So let's say roughly \$30 million, and that works out to about \$0.22 or \$0.23 of EPS for this year. What was the second part of your question on that one, Noah?

**Operator**

Noah, if you could give him the second part?

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

Yes, the second part was the same question on 2018.

## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

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

For 2018, probably going to have restructuring expenses in the \$20 million range pretax.

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

And what would that be in earnings per share?

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

In earnings per share, that is roughly \$0.08 or \$0.09.

**Operator**

Our next question comes from Peter Arment with Baird.

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

So, Chris, you've given us a ton of details on the restructuring and it seems like you're in the latter innings on a lot of fronts, but you mentioned the employee headcount reduction, I think it was around 1,000 employees. Is that roughly around 3% of the overall base? And do you see more opportunities there?

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

Yes, it is about 3% including the Vertex workforce, and none of those were at Vertex. So ex Vertex, it's probably closer to 4% or 5%. And I think it's something that we're going to continue to look at. I would expect it's going to be a factor in how fast we could grow, but a couple of hundred per year or more would not surprise me. It's not in the plan at this point and we've got to factor in natural attrition, retirements and such. But in any given year, you're going to have employees leave and new hires. We do a couple thousand out and a couple thousand in each and every year just as the normal course of business. This, of course, was more of a layoff situation. So yes, I would expect that to continue for the foreseeable future, but probably not at that level.

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

Okay. And just as a follow-up, Chris, just on the standardization of kind of different systems. Do you see a big opportunity there? Or is that something where you have to spend a lot of money on in terms of the savings that you're getting to roll out kind of standardizing some systems?

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

Yes, there's opportunities there and we have plan and a strategy as we move forward and these usually have about a 2- to 3-year payback, so we're kind of working them in over time. We've got 3 standard ERP systems and we're migrating people to those systems. And as we consolidate all these entities, we'll, of course, move them to existing systems. So I think it's going to be a journey. We're going to continue to stay on the forefront in the IT world. We're going to use cloud-based storage and computing and we have some interesting technologies, but it does take money on the front end and then the payback's over the next 2 to 3 years. But the goal there is not to do anything that's going to be material to our financial results and we're going to blend it in as our financials allow it. So that will continue.





## OCTOBER 26, 2017 / 3:00PM, LLL.N - Q3 2017 L3 Technologies Inc Earnings Call

**Operator**

We have time for one final question this morning. Our final question will come from Sheila Kahyaoglu with Jefferies.

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

Just to expand on Peter's restructuring question with regards to headcount. But maybe if you could size for us where you are with you announced some business consolidations this quarter, also facility consolidation in the supply chain, where you are with the progress there and what's left to do?

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

Okay. Yes, it was a little hard to hear. But I think on the consolidations, we've identified pretty much everything we want to do in the near term. I think in Sensor Systems, we're going to review a couple of things at the end of the year, so there might be a couple more in that regard. So I don't see anything significant from a facility perspective. On the headcount, like I mentioned, I think several hundred over the next couple years will not be unreasonable even as we continue to grow the top line. But a lot of these will tie into a shared services strategy and consolidation of systems and processes. So, that's pretty much how I see that playing out, and in December we'll give you more detail and will be built into our guidance that we give you for 2018.

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

Okay. Well, thank you. In closing, as we continue through the fourth quarter of '17, we're generating organic growth, strengthening our businesses and improving our margins through increased efficiencies and operational improvements. Our restructuring and continuous improvement efforts, coupled with our business development focus and strategic approach to M&A and R&D investment, will improve our competitive position and better align our capabilities with our customers' missions. We are confident that our disciplined growth strategy will continue to position us well to deliver value for all our stakeholders. We look forward to seeing you at our Investor Day on December 5. Thanks for joining us.

**Operator**

Ladies and gentlemen, that does conclude today's L3 Third Quarter 2017 Conference Call. We thank you for your participation and hope that you have a wonderful day. You may now disconnect.

**DISCLAIMER**

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2017, Thomson Reuters. All Rights Reserved.