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LHX.N - Q2 2021 L3harris Technologies Inc Earnings Call

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OVERVIEW:

Co. reported 2Q21 EPS of $3.26. Expects full-year 2021 organic revenue growth to be 3-5% and EPS to be $12.80-13.00.

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PRESENTATION

Operator

Greetings. Welcome to the L3Harris Technologies Second Quarter Calendar Year 2021 Earnings Call. (Operator Instructions) As a reminder, this call is being recorded.

It is now my pleasure to introduce your host, Rajeev Lalwani, Vice President of Investor Relations. Thank you. You may begin.

Rajeev Lalwani - *L3Harris Technologies, Inc. - VP of IR*

Thank you, Rob. Good morning, and welcome to our second quarter 2021 earnings call. On the call with me today are Chris Kubasik, our CEO; and Jay Malave, our CFO.

First, a few words on forward-looking statements and non-GAAP measures. Forward-looking statements involve risks, assumptions and uncertainties that could cause actual results to differ materially. For more information, please see our press release, presentation and SEC filings. A reconciliation of non-GAAP financial measures to GAAP comparable measures is included in the Investor Relations section of our website, which is l3harris.com, where a replay of this call will also be available.

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

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

Well, thank you, Rajeev, and good morning, everyone. I'd like to thank the entire L3Harris team for a job well done as we began our third year as a new company.

We are executing the integration plan and have exceeded many of our targets despite challenges such as the pandemic. The high-performance culture and leadership team we've created are set to carry this momentum forward, which is reflected in today's results.

We reported a strong second quarter. Organic revenue was up over 6%, with growth across our key end markets and all 4 business segments. Funded book-to-bill was 1.0 for the quarter and 1.05 year-to-date. Margins increased to 18.6%, resulting in EPS of $3.26, up 15%. We had solid free cash flow of $685 million, which contributed to shareholder returns above $1 billion dollars, including repurchases of $850 million in the quarter and over $1.5 billion year-to-date.

Our first half performance, coupled with our expectations for continued execution in the back half, more than offset the divestiture headwinds and supports another raise to our EPS guidance, which Jay will cover. Execution against our strategic priorities, that are on Slide 3, continue to deliver results and create value for the company's stakeholders as we make progress and build momentum with top line opportunities, operational performance, announcing and closing divestitures and delivering on our capital return commitments.

In terms of the top line, we had our best quarter since the start of the pandemic, with progress against our key end market growth objectives, while seeing data points that validate our focused R&D strategy. Our government businesses were up 6% in the second quarter, driven by double-digit growth internationally. Our international revenue benefited from increased aircraft ISR and radio sales to regions in the Asia Pacific and Europe.

And on the domestic front, the growth was broad-based with our responsive space and maritime programs as well as land modernization for night vision and SATCOM products leading the way. Our strategy to deliver end-to-end mission solutions utilizing the capabilities and scale across the broader organization continues to gain momentum. Our space business strategy is working as we grew 10% in the quarter, capturing classified awards totaling over $300 million for ground and responsive satellite solutions. These awards are also part of the revenue synergy capture efforts and bring awards to date to over $700 million on a win rate of 70% from our growing $7 billion-plus pipeline.

Turning to our Commercial Aerospace and Public Safety businesses, they were up over 5% in aggregate and were led by our Commercial Aerospace business up double digits off a low base and from strength in product sales. On the Public Safety side, there was a modest decline, but with sequential improvement and increased bid and proposal activity from a more stable backdrop.

Our solid top line was accompanied by backlog growth as we continue to win strategic programs that includes several prime roles. Backlog increased 7% organically year-over-year to over $20 billion, with notable award activity across all domains.

On the space side, our revenue synergy awards came from combining electronics and optics capabilities across the company to deliver solutions for an increasingly contested environment. These are incremental to the pathfinder programs we previously won, which have billions of dollars of potential over time. Customers are viewing L3Harris as a trusted disruptor. They see us as a company that understands the complexity of the mission and can offer fresh and creative solutions. With a 3-year space pipeline of nearly $20 billion, there's more opportunity for continued growth.

Within the air domain, we strengthened our existing F-35 franchise with initial production awards for the Aircraft Memory System and the Panoramic Cockpit Display Electronic Unit under the TR3 program. This brings total orders year-to-date on the platform to about $500 million. We're progressing on all 3 TR3 systems through integration and qualification this year, and in support of the planned lot 15 cut in of the production hardware. We also secured a roughly $100 million IDIQ with SOCOM for infrared EO sensors on rotary platforms furthering our modernization opportunities across L3Harris.

Moving over to the land side. We signed several key contracts that touch both international and domestic markets. First, we received a $3.3 billion 5-year IDIQ for foreign military sales to a range of partner countries from our new broader portfolio of products, including radios and SATCOM terminals. This replaces our prior 5-year $1.7 billion contract, which supports and validates the continued modernization across geographies and expands our product scope.

Second, in the U.K., we received a logistic support contract covering legacy Bowman and future Morpheus radios, positioning us well for a $1 billion modernization opportunity in that country.

And third, we won a competitive 10-year IDIQ to supply the U.S. Air Force with our T7 multi-mission robots, further expanding our customer reach. After launching the T7 with the U.K. a few years back, we're now pursuing other international opportunities in the robotic area.

Within the sea domain, our team was successful in extending its leading prime position in undersea sensor systems and warfare training for a range of the U.S. Navy platforms and support of distributed maritime operations. This undersea warfare training range program, called USWTR, has an award value of nearly $400 million and further builds our credibility to pursue additional domestic and international opportunities.

In the cyber domain, while limited in what we can say due to the classified nature, our $1 billion Intel & Cyber business received over 250 million in orders for complex mission solutions and specialized communications for both domestic and international markets, leading to another quarter of book-to-bill above 1.0 for this business. We also had a key award in an adjacent market with our Public Safety business with a 15-year $450 million contract from the state of Florida to upgrade and continue operating its law enforcement system for first responders.

Moving over to the budgets. While the process is ongoing and we await a FYDP, we were pleased with the initial request for the FY '22 budget as it supports stability in the DoD, NASA and FAA spending and is aligned with our capabilities and investment priorities.

For the DoD, it's focused on continues to revolve around and addressing near-peer threats through high-value technology, which Congress is reviewing. And when we look at the portfolio and the relevant line items, our programs are well supported. This builds on the trend we've seen in international markets where there's a broad stability in military spending, including key countries such as the U.K., Australia, Canada, Japan, amongst others. We're also seeing growing demand for the type of defensive systems we offer for our alignment with the U.S. export policies to ensure partner security. Our most significant opportunities remain for ISR aircraft missionization and other upgrades, land force modernization and enhanced maritime systems. All in all, as we consider the trajectory of our top line over the coming years, we remain confident in our ability to outgrow the budget and deliver sustainable growth through our domestic positioning, revenue synergies and international expansion that drive a large pipeline of opportunities underpinned by our leading R&D investments.

Shifting to operational performance. We continue to surpass milestones for priority programs. For example, at SAS, the team completed a successful preliminary design review for an advanced EW solution called Viper Shield that can deliver self-protection capability for Block 70 F-16s. At IMS, we advanced our unmanned maritime strategy with several customer engagements and demonstrations, highlighting differentiators in predictive autonomy on USVs as well as a submerged Torpedo tube launch and recovery for our small UUVs. We also successfully completed a prototype demonstration for SOCOM multi-role aircraft in a variety of challenging conditions, while utilizing the breadth of L3Harris offerings.

And financially, we had another quarter of strong margins as the team continues to offset mix impacts from early-stage programs with E3 initiatives, including program excellence and factory productivity, allowing us to flow through cost synergies totaling an incremental $27 million in the quarter. In addition, the first half synergy run rate is now $350 million, driven by progress on facilities consolidation and IT efficiencies. We see this as the minimum level we'll deliver on this year, up from the $320 million to $350 million range we discussed in April and still a year ahead of schedule. Any upside from here will be incorporated in our E3 program, with our integration blending into operational excellence initiatives. On margins for the year, this leaves us at about 18.5% for the top end of the prior guide and a level we'll look to build on in the years ahead.

Next, on capital allocation. Today, we announced the sale of 2 small businesses within our Aviation Systems segment for $185 million in cash, and these should close before year-end. When combined with the roughly $2.5 billion divested under our portfolio shaping initiative, total gross proceeds are set to be $2.7 billion. We have now divested nearly 10% of our revenues. And with the completion of a few others in process, our portfolio shaping program announced in 2019 is largely complete.

Proceeds from divestitures, including those from the recently completed military training and combat propulsion businesses, will be part of our capital returns program consistent with our shareholder-friendly capital allocation approach. Our expectation now is for buybacks to be roughly $3.4 billion this year, up versus our prior guide of $2.3 billion. When combined with dividends, capital returns will be about $4.2 billion in 2021.

So to wrap up, I'm pleased with the execution against our strategic priorities, confident in our ability to consistently deliver double-digit EPS and double-digit free cash flow per share growth, and I'm excited about the next phase for L3Harris.

With that, I'll hand it over to Jay.

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Thank you, Chris, and good morning, everyone. First, I'll provide more color on the quarter. I'll cover the segment results and finish with our updated outlook.

Starting with the second quarter. Organic revenue was up 6.2%, with a return to growth in all 4 segments. IMS led the way up 12%, followed by a return to growth at AS of 4.7%. Margins expanded 40 basis points to 18.6%, primarily from E3 productivity, program performance and integration benefits, partially offset by higher R&D. The sequential decline in margin was also due to timing of R&D as expected. These drivers, along with our share repurchases, led to EPS being up 15% or $0.43 to $3.26, as shown on Slide 5. Of this growth, volume, synergies and operations contributed $0.18, a lower share count contributed another $0.18 and pension, tax and interest accounted for the remaining $0.07.

Free cash flow was $685 million, while working capital days stood at 57 due to receivables timing. And shareholder returns of over $1 billion were comprised of $850 million in share repurchases and $207 million in dividends. Of note, our last 12 months of share repurchases have totaled over $3 billion at an average price of $195 per share, well below our current share price.

Now turning to the quarterly segment results on Slide 6. Integrated Mission Systems revenue was up 12%, led by double-digit growth in ISR aircraft missionization on a recently awarded NATO program. In addition to mid-single-digit growth in Maritime from a ramp on key platforms, including the Virginia-class submarine and Constellation class frigate. This more than offset the low single-digit decline in our Electro Optical business that was due to the timing of WESCAM turret deliveries, which we expect to increase in the back half.

Operating income was up 2%, while margins contracted 150 basis points to 15.3%, reflecting expected mix impacts, including a ramp on growth platforms and programs. Funded book-to-bill was 0.81 in the quarter and 1.06 for the first half with strength across the segment.

In Space and Airborne Systems, organic revenue increased 3.2% from our missile defense and other responsive programs, driving 10% growth in space, along with mid-single-digit classified growth in Intel & Cyber. This strength outweighed the impact from modernization program transitions in our airborne businesses, the F-35 Tech Refresh 3 program within Mission Avionics and F-16 Viper Shield advanced electronic warfare system.

Operating income was up 7.7%, and margins expanded 90 basis points to 19.7% as operational excellence, including program performance, increased pension income and integration benefits more than offset higher R&D investments. And funded book-to-bill was over 1 for both the quarter and first half, driven by space.

Next, Communication Systems' organic revenue was up 3.2% with mid-single-digit growth in Tactical Communications that included international up double digits, driven primarily by modernization demand from Asia Pacific and Europe and an anticipated decline in DoD from last year's second quarter 40%-plus growth. U.S. DoD modernization continued to benefit the integrated vision and global communication businesses, leading to high single-digit and double-digit growth, respectively. Conversely, broadband was down low single digits on lower volume for legacy unmanned platforms due to the transition from permissive to contested operating environments, as expected. And public safety was down 7% from residual pandemic-related impacts.

Operating income was up 8.3% and margins expanded 170 basis points to 25.5% from higher volume, operational excellence and integration benefits. And funded book-to-bill in the quarter and first half were about 1.3% and 1.1%, respectively.

Finally, in Aviation Systems, organic revenue increased 4.7%, driven primarily by our commercial aerospace business that was up 20% from recovering training and air transport OEM product sales. We also saw mid-single-digit growth in Defense Aviation from a ramp on fusing and ordnance programs and emission networks from higher FAA volume. Operating income was up 17% and margins expanded 200 basis points to 14.5% from operational excellence, integration benefits and higher volume. Funded book-to-bill was about 0.9 for the quarter and first half.

Okay. Shifting over to our 2021 outlook. Overall, organic revenue growth is unchanged at 3% to 5%, with our top line trending as expected at 4% for the first half and supported by a 1.05 funded book-to-bill year-to-date. Our U.S. government businesses are expected to accelerate in the back half, driven by space, tactical communications, integrated vision solutions and classified growth within Intel & Cyber and Defense Aviation.

On the international side, we continue to expect mid-single-digit plus growth for the year as a strong first half, led by aircraft ISR and international tactical radios, moderates. And lastly, the encouraging results in our commercial businesses in the second quarter build confidence in a flattish outlook for the year, with double-digit growth in the back half.

Consistent with our overall guidance at the consolidated level, we've also maintained our segment sales guide as well. And as we think about the second half of the year, our key watch items will be the timing of awards, the continued performance of our supply chain and the pace of the commercial recovery.

Turning to margins. We have raised our outlook to approximately 18.5%, a 25 basis point increase to the top end of the previous range, due to our strong performance to date and confidence in our ability to execute on cost synergies, E3 and program deliverables. We do continue to expect margins to move lower in the back half due to higher R&D investment and stronger growth on new earlier-stage programs.

From a segment perspective, we're holding to our prior margin guidance ranges across the board, but we're expecting IMS and SAS to be at the upper end of their ranges, given their strong performance to date and are holding AS and CS steady at their midpoints given divestiture dilution at AS and expected mix pressure at CS.

On EPS, we're raising our full year guide to a range of $12.80 to $13, with the midpoint now toward the upper end of our previous range and reflecting 11% growth from 2020, delivering on our double-digit commitment in spite of dilution from divestitures. As shown on Slide 11, the increase of $0.05 from the prior midpoint is driven by $0.13 improvement in operations and synergies and $0.19 from a lower share count at 203 million shares, along with a lower tax rate of about 16%, all of which more than offset divested earnings of $0.31. On a stand-alone basis, we expect about $0.15 of net dilution from divestitures.

Moving to free cash flow. Our guide of $2.8 billion to $2.9 billion is intact, despite divestiture-related headwinds are roughly $80 million. It continues to reflect the 3-day working capital improvement from year-end to around 49 to 50 days that's now adjusted for divestitures. CapEx is expected to be about $365 million, $10 million lower versus the prior guide due to completed divestitures.

Our guidance also now reflects approximately $3.4 billion in share repurchases, an increase of $1.1 billion from our prior guide to account for net proceeds from recently closed divestitures. All told, we expect to return about $4.2 billion to shareholders this year.

So let me sum it all up. We delivered strong performance in the quarter and first half, solid revenue and book-to-bill growth, further expansion of industry-leading margins and consistent cash generation and deployment, all enabling another guide raise as we continue to execute on our strategic priorities and drive double-digit annual growth in earnings and free cash flow per share.

With that, Rob, let's open up the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

And our first question is from Doug Harned with Bernstein.

Douglas Stuart Harned - *Sanford C. Bernstein & Co., LLC., Research Division - SVP and Senior Analyst*

I wanted to understand a little more about the outlook for Communication Systems. I mean you already had strong growing positions on radio modernization and night vision. And then you got some big awards in Q2, and those should add to growth, and I would expect this should be high margin as well. And so when you look at the longer-term growth here, look at the revenue trajectory over the next 3 to 5 years, how do you see that now? And is there a potential to take margins up above their current 25% levels here?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

Yes, Doug this is Chris. Thanks for the question. And yes, you absolutely got it right. We've been quite successful in the communication segment of late, with some of those wins, not only here domestically, but internationally as well.

So I think what we're seeing is some upward pressure for revenue growth and margins over the longer term, like we've talked about before. We had a great quarter when you look at the book-to-bill and the continuation for modernization of the land forces, whether it's the radios, the night vision goggles, SATCOM, we're really in a good position. So maybe I'll throw it over to Jay to give you a little more color.

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Sure. Just -- maybe just another quick comment on revenue growth over the medium term. Doug, if you recall, if you look at the future, it's somewhat similar to what we had this year. If you look at our segments, we had SAS at [4 to 6], IMS at 4 to 6 , and now it's followed by CS and AS. If you look to the future, we would expect the 2 -- those 2 top segments to continue to be the leaders in growth.

I will say, as Chris mentioned, that this gives us more confidence in the CS outlook, but we probably expect those 2 to drive a little bit higher growth than CS in the medium term. On the margin profile, you see this year, we are taking, from the first half, we are going back a little bit, and that's really a reflection of the mix on the new programs. We have the Army -- the HMS modernization programs. We also have in our broadband communication, the next-gen jammer program. So we have some pretty sizable programs that are actually margin dilutive.

The good thing about that is the team has a track record of being able to take cost out, drive the margins better over time. So if you look at the first half, it shows you what the potential of the segment could be. And so when we end the year this year, we'll be in that, say, 24 -- but right now, we're saying 24.5% at the midpoint. We delivered over 25% in the first half of the year. That gives you kind of a view of what the medium term could look like over time.

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

And I'll just chime in that yesterday, we signed a contract with the Mid-East country for the first phase of a multiyear next-gen SDR standardization program, and this has the potential for up to $1 billion over the next several years. So a lot of good positive momentum.

Operator

Our next question comes from the line of Kristine Liwag with Morgan Stanley.

Kristine Tan Liwag - *Morgan Stanley, Research Division - Equity Analyst*

Chris, in space, can you provide more color on the competitive landscape, the available programs for bid and how you're performing?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

Absolutely. Now we've had a good run in space. And as I mentioned, we had a good quarter. Book-to-bill in space was 1.2 so far this year. And we've been successful in winning 10 of 18 prime positions just in the last 18 months. So that's something that we're quite proud of, and we've also moved into the missile defense arena.

So maybe a little longer answer. The approach we're taking in space is similar to what we've done in all 5 domains, and it's really understanding the customers' mission. We have 47,000 employees and 20,000 engineers and 20,000 employees with clearances. So we're looking at our capabilities. We're looking at how we're spending our IRAD. We're trying to develop solutions and alternatives that meet their needs.

We've talked a lot in the past, as you know, about our responsive sats where we were able to develop and launch satellites within 20 months. So that's helping us win a lot of these prime positions. We understand the mission, we have innovative solutions. The focus is on the payload and the integration and speed. So strategically, I think that has been a needle mover.

When I look at the exquisite satellites, we continue to have some of the best payloads out there. So we're working with partners, usually, the larger primes, and that's contributed to some success, and we have some awards coming up in the next few months that are classified.

And then we're working collaboratively with some of these new entrants, just like we do with the traditional primes and find where we can partner, where we can compete and it seems to be working. So very proud of that team and the outlook is quite positive in space, and the budget is clearly supporting this growth as well.

Operator

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

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

Chris, just wanted to ask about the margin side. You're hinting at the idea for further margin upside from here. Can you just talk about the different drivers you see? How much of the margin upside that you see from here is dependent on volume versus kind of what's under your own control from an E3 perspective? And then also what you're assuming for pension when you say higher margins from there?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

Thanks, David. I mean a small part of the margin improvement does come from volume, and we've talked about organic growth trajectory so that's a contributor. But the big driver is ultimately E3. And we talked about the synergies, which are a year ahead of schedule, and we've committed to a $350 million run rate. A lot of this takes more than just 2 or 3 years that we've talked about, and each and every function is developed and executing a transformation plan. It takes investment sometimes in systems and processes, but we believe there's continual upside. We've proven it. We're focused on this, something Jay and I review on a regular basis. So we see no reason why the E3 program can't continue. I'll let Jay jump in on the pension assumptions. But again, the execution has been what's helpful in driving the margins. We're able to control our EACs and the commitments that we sign up to with our customers. So Jay, a little more color.

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes, sure. Just to confirm on the margins, the absorption is a little benefit, but that's typically factored in when we talk about the mix headwinds, and that's usually coming in these new programs with thinner margins.

As Chris mentioned, E3 is the key driver. It's going to drive us, and we talked about 20 to 25 basis points per year over the medium term of being able to continue to drive expansion, and we feel pretty confident in that. The pension, if you think about this year, all-in, between FAS and CAS benefit of about $470 million on an absolute basis. We expect that next year, the CAS element to decline a little bit as a result of the ARPA legislation or if it was enacted earlier in the year that pushed out funding requirements for pension, our recovery for CAS will come down a little bit. But that should be offset by some FAS income so net-net, I would expect the year-over-year pension to be pretty much flat.

Operator

Our next question is coming from the line of Robert Stallard with Vertical Research.

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

Chris, it's probably one for you. You mentioned that the disposal process is now pretty much done. I was wondering how the prices on the assets that you've sold have compared versus your expectations? And do we now see maybe a shift in strategy and perhaps start to look again at acquisitions?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

No, thank you for the question. No, we've had numerous transactions that comprise the $2.7 billion. I went back and looked at our original estimates, and we've -- generally to answer your question, been able to meet or, in some cases, slightly exceed what we had projected. We talked way back about maybe about $2.8 billion of gross proceeds from all these divestitures, we're at 2.7. And as I mentioned, a couple of small ones. So we'll will clearly get that within the range of our expectations.

On the M&A front, we did come out of the box 2 years ago and said we really were going to stand down on M&A and focus on the integration and the divestitures. And as I've highlighted, that's gone very well or maybe even better than expected. But even during that 2-year period, we watched the market. I'm highly confident we didn't miss anything in that 2-year period.

So we'll continue to survey the market. We're looking at anything that is a "must-have" as we call it. And when I look at the portfolio, as we've said over the 2 years, we're in all 5 domains. I don't really see any glaring needs or gaps. So we'll either proactively approach companies or respond to inbound calls, but we're really going to continue to hold the discipline, look at things strategically, look at them operationally, make sure the financial hurdles make sense. So not really in a rush and very pleased with what we've been able to win organically. So hopefully, that gives you some insight, Robert. And we'll let you know as things progress.

Operator

Our next question is from the line of Myles Walton with UBS.

Myles Alexander Walton - *UBS Investment Bank, Research Division - MD & Senior Analyst*

I was wondering if you could comment a bit on the second half implied step-down in SAS margins. I think you talked in the past about R&D and mix. And maybe just quantify those? And also, Chris or Jay, could you just update us on Next Generation Jammer? I know the second protest has been -- or is being adjudicated, I guess, by GAO, and I guess that's due for a decision here in the next couple of weeks. Would that have a swing factor on this year's top line or guidance anyway?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

Yes, I'll take the Next Gen Jammer one first, and then ask Jay to chime in on SAS. No, you're right. It's going to be mid-August when we hear the results. We're very supportive and confident in the process that the U.S. Navy ran. And we're assuming that we began work in August, and that's built within the model and the guidance. So no additional upside from that, but a huge win, and we're looking forward to getting started and delivering those capabilities.

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes. On the SAS margins, Myles, first half, about 19.5% in that ballpark. The back half of the year does step down to 18, maybe 18-plus in the guide range at the high end of 18.75%. The key driver is really mix on the new programs, particularly in the space. We've got to step up on these missile defense programs. There's a number of other classified programs that we've already won and that we anticipate winning here in the back half of the year, which will continue to put some pressure on the margin in the back half. But again, those are things that we had contemplated coming into the year when we set the guide originally, and we're pretty impressed by the fact that we're able to go to the high end of the guide now based on these same new programs.

Operator

Our next question comes from the line of Richard Safran with Seaport Global.

Richard Tobie Safran - *Seaport Research Partners - Research Analyst*

The international market for defense is always dynamic. And I thought I'd follow up on some of your opening remarks here. Could you give us an update on the overall international outlook, the opportunity set, where you're seeing demand coming from? And for what types of systems, etc.? In your answer, Chris, you have this reputation being able to drive and improve relationships with government customers. And I was just wondering in your answer, if you could discuss where you see the opportunities for L3Harris?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

Okay. Well, there's a lot of questions there. I'll go backwards. Yes, I mean, I try to encourage my team that we got to spend time with our customers, listen to their challenges and such. So actually, this evening, I'll be headed to D.C. and have 3 days of meetings in the Pentagon with a whole variety of customers from OST in the services and obviously, bringing the key P&L leaders with me. So we like to listen to our customers and see how we can help them and work collaboratively with them on the budget process and such. So I think everybody does it, but that's something I'm focused on.

International, we came out of the chute and said, this was one of the areas we thought we could do better. And I think we said we were underperforming as a combined company, and we were probably right around 19% of our revenue, maybe 20% on a pro forma basis back in 29 -- or 2019. So far this year, we're at about 22% of our revenue coming from international. So we're seeing a little, little positive movement, as you know, is a little lumpy. As I mentioned, maybe somewhat surprising, the budgets have really been stable across the globe, consistent with the U.S. So I think that was a pleasant surprise, given the threat environment, when you think of U.K., Australia, Japan, Canada.

And so our approach and strategy that I've talked about is really twofold. We have the 10-focus countries where we have executives, either local country nationals or expats there day-to-day understanding the process, the threats and bringing in our P&L leaders, at least, when the borders open to try to close on deals. So that seems to be working well.

And then more on the traditional product side, we use the distributors and the reps, and we've been able to use previous relationships to expand the portfolio. I mentioned that IDIQ for FMS, as an example, that now allows all the products of the new company to come through, not just the traditional radio. So I think that's a positive.

A lot of what we do is focused on more defensive systems. We're hearing from our international customers. It's ultimately, they want situational awareness and the ability to communicate in a contested environment. So I look at our portfolio and the things we're doing on ISR aircraft, whether it's something like a river joint to a business jet and in some cases, to a single prop aircraft. We have a broad portfolio that allows them to get situational awareness. We've talked quite about -- a bit about our resilient comms capability, our waveforms library, which is second to none. And relative to the regions, it's the usual place, the Mid East, the Far East and Asia Pacific, and we're seeing growth opportunities in all those areas. So that's probably a longer answer than you wanted, but we're optimistic, and I think we're in a good position and executing on the strategy we laid out 2 years ago.

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Just to quickly add to that, Richard, our growth framework, we had laid out a target of mid-single-digit plus growth over the medium term for international. We feel very comfortable with that. Obviously, we're going to be doing that this year, if not, a little bit better. And it's kind of what Chris said some of these capabilities. The ISR aircraft missionization, if you recall back in our March investor briefing, we've talked about taking the exquisite Rivet Joint capability, bringing that to business jets is also bringing it to pod capability based on customer affordability, and there's a significant amount of demand around the world for that.

If you look at Tactical Communications, we see a lot of these foreign countries following the same DoD modernization path. And so we see opportunities there. And I'd say the other area is maritime, both in manned and unmanned requests for support in the capabilities that we provide, both, in say, electrical distribution and power control as well as things like autonomy. And so we just continue to see a growing pipeline there. We're pretty comfortable with our growth objective over the medium term.

Operator

Our next question is from the line of Gautam Khanna with Cowen.

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

Wanted to ask just a follow-up to an earlier question on RF tactical and sort of the prospects for growth in '22 and beyond. Maybe if you could frame for us the international and domestic pipeline, and then what do you expect kind of rates of growth to be beyond this year? And then I have a follow-up on IVAS. If you could talk about what your view of that program is as a potential threat or opportunity to the legacy night vision?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

Okay. Let me do a high level on the first question, and Jay can give you some more color on TACOM, and then I'll come back and answer the IVAS question. So specifically, domestically, we've talked about some upcoming awards that should be occurring here domestically, the HMS Man Pack, HMS Leader. Those are coming forward here, hopefully in the third quarter.

In the fourth quarter, the marines have a handheld competition that we're also looking forward to getting the results of. And then, of course, internationally, we have a pretty good increase here later in the year. And again, the focus there is going to be in Europe, the Mid East and the Asia Pacific region. Again, we've had good success in the Mid East that I just mentioned from yesterday, some Australian orders and really a pretty strong pipeline. But I'll let Jay give you a little more color and numbers as it relates to TACOM.

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes. Gautam, I think overall, probably in both cases, both DoD and international, you're looking at probably low to mid-single-digit growth over the medium term. Part of the reason, particularly in DoD, is that while we have strong growth on the modernization programs, it does cannibalize a piece of our base business. And so you have a little bit of a reduction there with growth -- solid growth on the monetization programs, Army being the largest program that's really in the early innings. And we've got the start of full rate production here coming in the back half of this year.

Internationally, Chris mentioned that before. There's a demand around the world for some significant upgrades as far as modernization. And -- but again, I would put the growth rate right now in that low to mid-single digit. As new countries come on, other countries fall off. And so obviously, we're going to drive that to more of a mid-single digit. But for now, I think that's the best way to think about it and look at it.

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

And then going back to IVAS. I think when you look at our ENVG-B program in IVAS, I wouldn't say that they're kind of going head to head, maybe battling a little bit for budget money, although both were funded. And our focus is clearly to deliver, which our team has done a great job on schedule and meet all of our commitments. I think ultimately, there's going to be a question of how these get split. I think there are several hundred thousand devices needed and they have a slightly different capabilities and mission sets. So I would think over time, there's going to be a split between the 2. We've been talking a little more publicly about some of the augmented reality capabilities within the ENVG-B, the real focus on the night vision capabilities. So different capabilities, different mission. And I would think that 2 converge at some point, and we'll see how the Army wants to play that out. But right now, we're just focused on delivering and making sure we meet our commitments.

Operator

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

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

On IMS, maybe can you talk about some of that deceleration you're seeing? You're forecasting 5% growth for the year. And you had 9% robust growth in the first half, it implies flat for the second half. So what are some of the puts and takes?

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes, Sheila, what's happening with IMS in the back half of the year, they had strong growth in the ISR business, which was mostly these international customers. That will moderate and abate a little bit here in the second half of the year. And so the growth rate is just going to normalize back to what we are expecting really for the full year. That's really the key driver, really strong international in the first half. That moderates really in the second half for the business back to a normal rate.

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

Yes. I think of all of our segments, Sheila, this one is a little more lumpy based on the large significant procurements of aircraft or deliveries. And so you kind of get these up and down quarters, but I'd much rather be coming out of the chute strong and having a fourth quarter hockey stick. So that's what happens in IMS, mainly in the ISR sector.

Operator

Our next question comes from the line of Rob Spingarn with Credit Suisse.

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

Chris, it's kind of funny how things change because now we're actually reading about commercial pilot shortages. And I think Jay talked about recovering training sales, but I'm curious if you can quantify how big the increase was, either year-over-year or sequentially. And what the latest overall recovery expectation is? And whether or not this business is core or non-core?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

Right, Rob. Great, great questions. We did see some good recovery, double digit in the second quarter, driven a little more by the products then the actual training. I think there's a slight lag there. We have a variety of training models from academies where the cadets actually come into our facilities for an 18 -- 12- to 18-month period. That's been a little challenged due to some of the border closures. So that's a little lagging. I think as the borders open up, we'll see an uptick there. Of course, the Delta virus has kind of thrown a curve ball in everything compared to what we thought it would be. So the recovery is lagging a little bit.

The simulators, as you said, is a pilot shortage. People we need to get the training refreshed or a lot of pilots may have retired, and there's now going to be some new pilots that are going to need the simulator training. And then, of course, for the actual manufacturing, we had a slow start to the year, as you would expect, not a lot of people buying simulators. But so far, in the third quarter, even though it's early August, we've already been awarded 2 simulators and we'll be converting those to contracts here in the next 30 to 45 days. So we are seeing an uptick, and it's going to drive growth in the second half. We're assuming -- I'll have Jay give the exact numbers, double-digit growth in commercial aviation. So it is a good market. It's got good technology, and we're going to continue to run that business and evaluate and determine strategically what we want to do with it. But it's part of the company now, and it's contributing and we're excited about the uptick. So Jay?

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes, we step up in the back half of the year to about 30% growth in the commercial business from 20% here in the second quarter. This is consistent with what we had expected coming into the year. The trends that we've seen or have seen thus far really in the month of July support that. And so we've got some pretty good demand and a lot of activity going on in terms of simulator sales. And we're also seeing just increased leads as far as new cadet training in our academies. And we're also seeing it in the simulator training. As Chris mentioned, the one thing to keep an eye on it for us, just more maybe company-specific, is that we do operate our simulator training in these regions that have been a little bit mixed as far as lockdowns opens up and lock back down. And so -- but that's the smallest piece of our business. Overall, we're pretty confident with this 30% growth based on what we're seeing.

Operator

Our next question comes from the line of Michael Ciarmoli with Truist.

Michael Frank Ciarmoli - *Truist Securities, Inc., Research Division - Research Analyst*

I don't know if this is Chris or Jay, but is it possible to quantify either kind of this year on the top line organic growth or even breaking down your bookings, kind of year-to-date? How much of the growth is coming from new programs? And I guess what I'm getting at is what kind of dilution on either new start programs are you trying to offset or deal with? And I guess, Goutam kind of hit on it. Are you seeing any more pricing pressure -- competitive pressures from new start commercial players like what we're seeing in the IVAS program?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

Yes, Michael, thanks for that. It's a great, great question. I mean as I said, 6%, 6.2% organic growth. When I look at -- as we go through the planning process and build up our annual operating plan, we start the year, and we usually have pretty good visibility into what's already in backlog. So a lot of -- it's kind of in the 70% range as we look forward. So going back to December of 2020 when we put out our guidance for '21, a pretty good visibility, 70%. There's maybe 10-ish or so of follow-on. So to answer your question, I guess you could say maybe 15%, maybe 20% at most is revenue derived from new business to give you some idea on the -- driven by new programs or new contracts is kind of how I look at it.

And as you suggest, some of those, especially the -- with the DoD start out as cost plus contracts, then migrate into low rate production and full rate production. So it's no secret that the cost-plus margins tend to be lower than what we're currently realizing. So it's dilutive on that front. And then even on the fixed price contracts, I think we're generally pretty conservative in how we start booking those until we retire and mitigate that risk. So maybe that answers your question there. As far as competitive pricing pressures, nothing new or different than what we've had over the last decade or 2 in this industry. The selection criteria varies by program. And I think our customers are very sophisticated and they look at the technical solutions. They look at past performance. They look at the management team. They look at cost. They look at schedule. So they're taking all those things into consideration. And like I said earlier to an earlier question, we try to find ways to work collaboratively with these new entrants when and if they can add value and increase our probability of win. So I don't know, Jay, anything further or...

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Really, yes. I mean it varies year-to-year. I'd say on the mix headwind, maybe at a gross level, you're talking anywhere around 25 basis points or so of headwind from year-to-year. And our challenge is really to offset that with about 50 basis points of productivity so that we have a net 20 to 25 basis points improvement year-to-year. But again, it just -- it will vary. I'd say that probably be -- that's like an average to think about.

Operator

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

Unidentified Analyst

It's Tyler on for Seth. Just have a couple of quick ones here. Can you just speak through the remaining schedule on that, maybe the execution risk on TR3? And just touching on the F-35 growth ramp ahead?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

Yes. Yes, let me give a quick F-35. We've talked about before, we're a top 10 supplier, talking at it just the other day. We deliver about 1,500 parts per jet. But the main focus has been TR3, where we have 3 components. I mentioned 2 of those 3, we were successful in getting a production contract, which I think is indicative of the progress we've made. Where we are right now is going through the safety of flight on these 3 products. One has completed the test. One is just about to start later this week, and the third starts in October. So it's all per schedule. We're committed and focused on making sure we're ready for the lot 15 cut in. That's a big focus of both Lockheed and the [JPO]. And I'd say over the last 6 months, the teams have made a lot of good progress, we're communicating. We understand the schedule. We understand the risk. So I feel good about our piece of the great program and contributing to Lockheed and allowing them to deliver their jets. So as usual, in any development program, there's directed change, there's government dependencies and stuff that we're used to and accustomed to and manage and work around. So I'd say probably feel better about the program now than I did in April.

Operator

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

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

Jay, if you could go through the working capital days you expect for the end of the year, the goal I thought had been 52 days. This quarter, it looks like working capital actually was up like about $135 million on a sequential basis. So just looking where you're going there. And then just to verify, the $400 million reduction in sales was all due to the divestiture?

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

That's exactly right. I'll take the second question first, George. The 2 businesses -- the multiple businesses that we divested at the end of the quarter were about $800 million of combined sales. So half year, about $400 million impact for the second half, and that's what's driving the reported sales to come down by that amount.

On the working capital, it's also a good observation. We reset again with the impact of these divestitures, George. So at the end of the second quarter, on an adjusted basis, we're at 57 days, and we're trying to get now to around 50-ish days. Part of this was planned where we had some program deliverables in the first half of the year, and those receivables will turn into billings and collections in the back half of the year. We also had in the second quarter, just high receivable balance, with the timing of sales. And so that will just normalize. We'll collect that cash here in the third quarter.

And really, for us, the working capital reduction is the same as it's always been, really for the year. It's really driving down the inventory. Two elements, as I mentioned, one is just delivering on our key program milestones, so we can turn those into billings and into collections. And then second element is really delivering on our working capital initiatives. And these are the things that we've been talking about as far as reduced cycle time, improving our forecasting process. So a big second half for us, but it's essentially the way we had planned it, and we believe that we're on track for that. And I'd say that at the end of the year, George, is really kind of 49 to 50 days on this new adjusted basis, taking out these divestitures.

Operator

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

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

Chris, I want to kind of end here with a higher-level question on just strategy. The -- when you came to L3, 5 years ago, and think about where you've got now in terms of organic growth, inorganic growth, the divestitures, the simultaneous integration, you're now at a point where you said you're done with the divestitures. You're not in a hurry on M&A. When you look at the next 5 years and try to maintain that internally disruptive mindset, what's going to drive the next leg of the value creation formula? Is it about R&D and development and customers and products more so than the value creation elements we've seen over the last 5 years? How do you continue to have that kind of mindset in creating value over the next 5?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

All right, Carter. Well, you've got a good memory. So thanks for that. And clearly, it was a great team effort to get to this point.

I've talked somewhat about where we're trying to position L3Harris. And if I listen to all the questions throughout the day, I'll try to explain the vision here. We have our traditional primes, which are some great companies with a lot of cash and employees and processes. There was a couple of questions about these new entrants, which are maybe a little more commercial mindset, a little more agile, maybe a little more creative. And what we're trying to do is put L3Harris right in the middle of these 2 and take the best of the both and position ourselves to listen to our customers and be a trusted disruptor.

I don't want to underestimate the importance of understanding the mission. So we know the mission. We know the customers. And can we take that with our industry-leading R&D investment and position ourselves for growth? JADC2 is something that's out there that we can talk about more in future calls, but we really want to position ourselves to help our customers solve their problems and focus on the organic growth, focus on the margin improvement, the double-digit free cash flow per share metrics, I think, are all going to drive value. So look, I ultimately want to be the most valuable defense technology company in the mind of our shareholders, in the mind of our customers, and that's not necessarily the largest. And that's what the team is off executing on.

Operator

Our final question comes from the line of Peter Arment with Baird.

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

Chris and Jay, nice results. Chris, just thinking about your E3. I guess it's becoming kind of ingrained in the culture now. Outside of kind of the operational excellence you're driving, is there any kind of other buckets that still you see as the greatest opportunity to kind of show incremental savings?

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman & CEO*

Yes, Peter, thanks for that question. We've actually taken E3 to be our operating model in the broadest sense. So a lot of times, people think of it as just on the continuous improvement initiative. But the approach we've taken on E3 is much, much broader. It encompasses EH&S. It encompasses the supply chain, ESG, continuous improvement, all those aspects, quality, rolled throughput yield, everything that drives our performance, including our performance on our programs, where we look at our customer ratings. We look at award fee scores. We look to earn value management.

So when you look at all those things holistically, each and every one contributes to our cash flow and our profitability. So if we can bring down lead times or cycle times, improve the quality, we look at cost of port quality, get the yields higher. Each and every one of those as part of our E3 umbrella, and that's really what's driving the success we've had to date and the optimism we have for the future.

So with that, I think I'll just kind of wrap it up. I appreciate everybody taking time to call in today. Hopefully, as you heard, we have a strong quarter and the performance and the operational momentum is all positive. That obviously wouldn't be possible without my great leadership team and the 47,000 employees. So thanks again to them. We feel good about the opportunities ahead. We're going to continue to execute and look forward to talking to everybody in the months ahead as we focus on growing L3Harris. Again, thanks for joining the call.

Operator

This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.
