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LHX.N - Q3 2021 L3harris Technologies Inc Earnings Call

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OVERVIEW:

Co. reported 3Q21 EPS of $3.21. Expects 2021 organic revenue to be up about 2% and EPS to be $12.85-13.00.

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CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

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

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

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

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

Richard Tobie Safran *Seaport Research Partners - Research Analyst*

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

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

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

PRESENTATION

Operator

Greetings. Welcome to L3Harris Technologies Third 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, Investor Relations. Thank you. You may begin.

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

Thank you, Rob. Good morning, and welcome to our third 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 comparable GAAP 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*

Okay. Thank you, Rajeev, and good morning, everyone. As you've seen throughout the week, no company is immune, including L3Harris, to global supply chain pressures, a risk we highlighted on the last earnings call. In recent months, shortages of electronic components began adversely impacting our company at a time when demand (added by company after the call) our product is strong. Our updated full year guidance now accounts for these impacts. We revised our organic revenue growth expectations to approximately 2%, primarily due to delays for these components weighing on the CS segment. Absent such delays, we would have comfortably been within our prior 3% to 5% range. Ultimately, this is a timing shift with no anticipated effect on our industry best market position for radios. And with our broad and diversified portfolio, along with continued

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execution elsewhere, especially on the margin front, we've increased our range on EPS to $12.85 to $13 per share and still expect to deliver free cash flow per share of around $14, up double digits on both accounts.

Shifting over to the third quarter. Following organic revenue growth of 6% in the second quarter, we saw a decline of 1% due to timing associated with supply chain delays at CS and an ISR aircraft award at IMS. While I'm disappointed by the soft top line results, I'll note that the order momentum remains strong with a book-to-bill of 1.07, and we delivered record high margins at 19.6%. EPS was $3.21, up 13% versus the prior year, with solid free cash flow of $673 million that contributed to shareholder returns of $1.5 billion in the quarter. Our execution against the company's strategic priorities have been a key factor in value creation for all stakeholders in spite of the pandemic. And we made progress in the quarter by advancing top line opportunities, improving operational performance, wrapping up portfolio shaping and returning capital to our owners.

Starting with the top line. The revenue decline in the quarter fell short of our internal targets largely due to 2 timing factors. At CS, the global electronic component shortage has led to a supply chain disruption for our product and electronics-focused businesses, notably Tactical Communications. In the third quarter, the impact was nearly $100 million or approximately 2 points of revenue. And in the fourth quarter, our expectation is for the backlog of unfilled orders to grow. And all told, we foresee a roughly $250 million to $300 million revenue impact for the year, implying another step-down in the fourth quarter. This is the primary driver of our revenue guidance adjustment at CS. Having said that, we do not anticipate any impact to our bookings nor our win rates and expect the segment to end the year with a book-to-bill well over 1x.

In addition, despite the supply chain challenges we faced in Q3 and ongoing headwinds, we were able to meet delivery requirements on all of our key U.S. DoD modernization programs and are on track to continue to do so in the fourth quarter, including deliveries on the recently awarded HMS full-rate production contract with the U.S. Army. Second, at IMS, we had a follow-on ISR aircraft order with a NATO customer that booked late in the quarter, causing revenues to slip to Q4, representing roughly a 2.5 point shift between quarters. While the supply chain headwinds limit upside opportunities to our revenues for this year, I've been pleased with the team's traction against our strategy of delivering end-to-end solutions to global militaries as a trusted disruptor across all domains. And it's reflected in our order activity and operational milestones.

Within the space domain, on the classified side, we continued to advance our responsive and exquisite satellite business with several earlier-stage awards, both with the Intel community and DoD, which have follow-on opportunities of nearly $2 billion. And on the unclassified side, following the imager award in Q2, NOAA is progressing on the recapitalization of its GEO weather satellite system and awarded us a study contract for a sounder payload as part of a $3 billion opportunity over the next decade. On the operational front, we completed the preliminary design review and the development of the Missile Tracking Satellite prototype for the Space Development Agency, progressing towards a launch over the coming years and reflecting yet another significant accomplishment for L3Harris.

Moving to the air domain. Key awards within the quarter spanned both legacy and next-generation aircraft. On the B-52, we received a 10-year $1 billion IDIQ that has the potential to expand our scope on the program to include EW hardware upgrades such as radar warning receivers, building on our existing software sustainment work. In addition, on the international front, we were awarded an initial $100 million contract to provide capabilities on 12 multi-mission aircraft for the UAE, with the potential to double these amounts, further demonstrating the breadth of our ISR capabilities that range from turboprops, to business jets, to large aircraft.

And in the land domain, we were awarded several contracts with the U.S. Army to advance its modernization priorities. Under the Army HMS program, we received over $200 million in awards for the manpack and leader radios, taking a majority share on both products. These are the first full-rate production awards out of a multibillion-dollar IDIQ and represents less than 15% of the acquisition objective, pointing to considerable runway ahead. We also won a majority share on the second program of record for the ENVG-B program with a $100 million order, setting us up to ramp production on the Army's next-generation field-ready goggles. So we were 3 for 3 on strategically significant programs in the land domain this quarter.

Within the maritime domain, the team continues to progress on the U.S. Navy Constellation-class frigate, with follow-on awards for the next shipset of electrical propulsion and navigation systems as part of a several hundred million dollar opportunity for L3Harris.

We're also awaiting decisions on 2 major prime awards over the coming months. One, to provide electro-optical infrared capabilities on a broad range of the U.S. Navy surface combatants and another with an international ally, highlighting our superior undersea sensor capabilities. Both

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could expand our market reach in this domain. Operationally, the team delivered Power Conversion suite hardware as part of the Virginia-class Block V upgrade and completed qualifications for a portion of the power distribution system on the Columbia-class, advancing the U.S. Navy's top priority.

We also had a key award within our Mission Networks business. We leveraged the air traffic management capabilities we provide to the FAA, winning a new international franchise with the Australian government to modernize the nation's air traffic control and surveillance networks. This program is an over $300 million opportunity and strengthens L3Harris' long-standing relationship with Australia.

Finally, we received a strategic award on the revenue synergy front as we signed a $130 million contract with a Mid-East customer to provide modernized software-defined radios through a localized joint venture. And this customer channel synergy award opens the door to a long-term opportunity for up to 50,000 radios. When combined with other orders in the quarter, revenue synergy awards to date totaled roughly $900 million on a win rate that remains at 70%. With a pipeline of over $7 billion, these synergies will be a notable contributor to our top line growth.

These wins supported another strong quarter for a book-to-bill of 1.07 and 1.06x year-to-date, increasing our organic backlog to $21 billion or up 9% from last year and 4% year-to-date. This is validation of our internal investments in leading R&D spend as well as confirmation of our alignment with government priorities.

Shifting over to the outlook for budgets. We're pleased with the progress made on the FY '22 defense spending bills that continue to prioritize near-peer threats, notwithstanding another CR. The plus ups from the HASC, SASC and SAC-D, along with steadiness from HAC-D, combined with recent global events, provide a degree of comfort that we should expect stability in military spending over the coming years. And in my personal discussions with senior leadership of the administration and Congress, I have consistently heard of a growing need for innovative, resilient and affordable solutions, which we're focused on providing.

All in all, as we consider the trajectory of our top line, we remain confident in our ability to deliver sustainable growth through our domestic positioning, revenue synergies and international expansion that stem from a pipeline of opportunities well in excess of $100 billion.

Pivoting to margin performance. Our team delivered a stellar quarter at 19.6%, the best post-merger result and an indication of the company's potential over the next couple of years as we further build a culture of operational excellence. Our performance was the result of delivering another $15 million of incremental cost synergies, and we're well on track to hit our $350 million target. We continue to manage our overhead costs and drive our e3 program to more than offset supply chain headwinds. Due primarily to our year-to-date results, we now see margins for 2021 exceeding our prior expectation of 18.5% by 25 basis points. Beyond 2021, our e3 program will remain a key contributor to steady expansion in our operating margins, net of inflationary pressures. This program is one of our key discriminators.

And let me highlight just a couple of examples. First, is factory optimization that represents half of this opportunity set. Through streamlining and simplifying our manufacturing processes, be it from a redesign of a factory's layout or integrating automation tools, we can shorten cycle times, increase labor efficiency and continue to drive out cost. A great example is a pilot program in our Amityville facility in New York, where an augmented reality assembly aid that electronically displays and validates our processes helps reduce cycle time by 25% and higher first-pass yields by several points. And we're in the early stages of our strategy with a 3-year rollout ahead of us.

The other half of our opportunity comes from the engineering excellence and supply chain. On the former, through the deployment of our digital ecosystem, front-loading our program activities and enhancing training for our roughly 20,000 engineers and 1,500 program managers, we're able to increase commonality and better manage cost and schedule across the company. These have been key with some of our standout wins within the space domain, enabling a foray into missile defense as well as with driving favorability in our EACs.

On supply chain, the global disruptions we've highlighted have been largely contained to about 15% of the company and are temporary in nature. The focus we've had, be it on reducing the number of suppliers or leveraging our roughly $7.5 billion spend as an enterprise, remain in place, with further opportunities in the years ahead.

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Moving over to the portfolio. We put a bow on the post-merger shaping activities in the quarter and closed on the Electron Devices divestiture for $185 million, while announcing the sale of 2 small businesses within AS for a combined $130 million, bringing total gross proceeds since the merger to $2.8 billion. And as we consider our portfolio moving forward, we'll be opportunistic with our balance sheet as a buyer and a seller, focusing on long-term growth and value creation. Having said that, we don't see any gaps in the portfolio, nor is there any urgency at this time.

Consistent with our prior commitments, proceeds from the divestitures will be part of our capital return program. Our expectation now is for buybacks to be roughly $3.6 billion this year versus our prior $3.4 billion. When combined with dividends, capital returns will be about $4.5 billion in 2021. So overall, I'm pleased with the L3Harris team's ability to execute against our strategic priorities and deliver bottom line results despite unanticipated setbacks.

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 and starting on Slide 4, I'll provide more detail on the quarter before I get into segment results and our updated outlook.

In the quarter, organic revenue was down 1%, lower than our internal expectations by about 4.5 points from the supply chain delays and ISR aircraft award timing. IMS and CS were down 3% and 5%, respectively, and absent these impacts would have been up closer to the mid-single-digit range for both. The SAS segment was up 3% and led by strong growth in our responsive space business, while AS was up 1%, including the benefit from recovery in Commercial Aerospace. Margins expanded 170 basis points to 19.6%, with the most notable drivers being from e3 performance and cost management, which more than offset volume-related supply chain headwinds. We exceeded our internal expectations by more than 100 basis points from favorable mix related to award timing and strong e3 performance. The team continues to drive margin upside by delivering on e3 improvements that lead to outperformance in scheduled milestones, costs and retirement of risk.

These drivers, along with our share repurchase activity, drove EPS up 13% or $0.37 to $3.21 as shown on Slide 5. Of this growth, synergies and operations contributed $0.39. A lower share count contributed another $0.20. And pension and tax accounted for the remaining $0.08. That more than offset a $0.14 headwind from divested earnings and a $0.16 headwind from supply chain delays.

Free cash flow was $673 million, and we ended the quarter steady with working capital days at 56. This supported robust shareholder returns of $1.5 billion, comprised of $1.3 billion in share repurchases and $202 million in dividends.

Now let's turn to Slide 6 and discuss quarterly segment results. Integrated Mission Systems revenue was down 3%, driven by follow-on ISR aircraft award timing from a NATO customer that would have contributed 8 points of growth, for which revenue has now been booked in October. Revenue was also impacted by the expected timing of WESCAM turret deliveries from a completed facility move. By contrast, our Maritime business grew in the mid-single digits from a ramp on key platforms, including the Constellation-class Frigate and classified programs.

Operating income was up 4%, and margins expanded 110 basis points to 16.6% from operational excellence, integration benefits and pension. Funded book-to-bill was 1.04 in the quarter and 1.05 year-to-date, with strength across the segment.

In Space and Airborne Systems, revenue increased 3%, driven by double-digit growth in space, primarily from our ramping missile defense and other responsive programs. The Space growth more than offset headwinds from the production transition of the F-35 Tech Refresh 3 program within Mission Avionics as well as program timing in Electronic Warfare and Intel and Cyber. We expect an overall ramp in the fourth quarter for the segment.

Operating income was up 5%, and margins expanded 30 basis points to 18.8% as e3 performance, increased pension income and integration benefits more than offset higher R&D investments and mix impacts from growth programs such as in space. And funded book-to-bill was about 1 for the quarter and 1.05 year-to-date, driven by responsive and other space awards.

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Next, Communication Systems organic revenue was down 5%, due primarily to product delivery delays within Tactical Communications that stem from the global electronic component shortages, creating an approximately 8 point headwind year-over-year and versus expectations, as well as lower volume for legacy unmanned platforms and broadband due to the transition from permissive to contested operating environments. In addition, the Integrated Vision and Global Communications Solutions businesses were impacted by delivery timing and contract roll-offs on international programs, respectively. Conversely, our public safety business was up double digits versus the prior year and sequentially on strong radio sales following the State of Florida Law Enforcement System award in the prior quarter.

Operating income decreased 1%, and margins expanded 130 basis points to 26.3% from operational excellence, including program performance within broadband, favorable mix on public safety radios and integration benefits that outweigh supply chain impacts and higher R&D investments. And funded book-to-bill was above 1.1 for both the quarter and year-to-date from strong product bookings within Tactical Communications and Integrated Vision for modernization alongside key state-level awards within public safety.

Finally, in Aviation Systems, organic revenue increased 1%, driven by our commercial aerospace business, that was up over 40% from recovering training and air transport OEM product sales. This growth was weighed down by flattish sales in Mission Networks as well as lower Fuzing and Ordinance systems volume due to contract roll-offs along with delayed awards within Defense Aviation. Operating income decreased 13% primarily due to divestitures, while margins expanded 140 basis points to 14.4% as expense management, the commercial aerospace recovery and integration benefits more than offset divestiture-related headwinds. And funded book-to-bill was 1.1 for the quarter and about 0.9 year-to-date.

Now shifting to our updated 2021 outlook. Organic revenue is now anticipated to be up about 2%, with the difference versus our prior guide largely attributable to supply chain delays. At a segment level, we've maintained our sales guides, but for CS, where we now anticipate revenue to be down 2.5% to 4.5% versus our prior range of up 2.5% to 4.5%. This is largely due to the global supply chain disruptions, mainly within Tactical Communications that will now be down about 10% versus our prior view of up in the low to mid-single digits.

For the remaining segments, we expect IMS to be in the upper half of the range based on traction with international ISR aircraft, while SAS will likely be around the midpoint and driven by growth within Space and Intel and Cyber. And at AS, we expect the segment to be at the lower end of the range due to award timing slipping to the fourth quarter within our classified business.

By end market, our U.S. government and commercial businesses are now expected to be flattish to up in the low single digits, while our international businesses are expected to be up mid-single digits plus. This implies fourth quarter sales growth will be in the 1% to 2% range for the company, which includes CS down in the mid-teens and our other segments up in the mid- to high-single digits on average.

Turning to margins. We've raised our outlook to 18.75% from 18.5% due to performance to date, e3 progress and favorable mix from award timing. Margins will step back in the fourth quarter due to increased supply chain delays, along with mix effects on new earlier-stage programs, but still strong progress for the full year.

From a segment perspective, we've improved the outlook for each with CS above the prior midpoint of its range and IMS, SAS and AS above the top end of their prior ranges. On EPS, we're raising the lower end of the prior guide by $0.05 to $12.85 to $13 per share, reflecting 11% growth from 2020 at the midpoint, delivering on our double-digit aspiration in spite of dilution from divestitures and supply chain headwinds, which otherwise would have put us at or above the top end.

As shown on Slide 11, the midpoint is now at $12.93. That's $0.55 from improvement in operations and other items, including the release of contingencies, offset by additional divested earnings of about $0.03 and $0.49 from supply chain delays. As mentioned previously, we continue to expect about $0.15 of net dilution from divestitures.

Moving to free cash flow. Our guide of $2.8 billion to $2.9 billion remains intact. However, due to prior divestiture headwinds and now supply chain delays of over $150 million in the aggregate, we'll likely be toward the lower end. On working capital, we expect to end the year in the low 50s in terms of days, reflecting a 3- to 5-day sequential improvement in the fourth quarter. And CapEx is now expected to be around $350 million, about $15 million lower versus the prior expectation, primarily from completed divestitures.

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Lastly, our guidance now reflects approximately $3.6 billion in share repurchases, an increase of $200 million from our prior guide to account for net proceeds from recently closed divestitures. Net of these puts and takes, we're in a position to deliver free cash flow per share in the double digits in 2021.

Okay. Let me make a few comments on 2022. The L3Harris business fundamentals are sound, and we continue to succeed in our strategy of moving up the value chain to capture more prime positions on core and adjacent applications. Examples include our leadership positions in Space missile tracking, ISR aircraft missionization, DoD and international soldier modernization, undersea sensing and cyber resiliency. These and others will lead to solid growth for the foreseeable future.

As we look specifically at 2022, we are expecting supply chain impacts to persist into the first half of next year with recovery starting in the back half. As visibility improves over the coming months, we will provide a more comprehensive update on these expectations in January. For now, we are expecting some of the shortfall will be recovered by the end of next year, and we'll monitor other watch items, including the timing of awards, vaccine mandates and tax rules.

Having said that, we remain focused on delivering sustainable revenue growth, steady to rising margins and leading cash flow conversion on a declining share count. So to sum it all up, we've managed the pandemic-related headwinds for a seventh straight quarter and delivered strong bottom line performance and remain on track to meet our commitments for the year and beyond in a dynamic environment.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Sheila Kahyaoglu with Jefferies.

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

Jay, you baited us right there, so I have to ask. In terms of the recent guides we saw from peers in both supply chain issues and program headwinds they noted, how are you guys thinking about 2022 revenue growth specifics and the multi-year revenue outlook, just given you've previously talked about mid-single digits and now peers are calling for flat to low single-digit growth?

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

Sheila, it's Chris. Let me make a couple of comments and then I'll lateral it over to Jay. And I think you said it right. This is clearly the key question for the week. So I want to go back probably 3 years when we were talking about the strategic rationale for the merger. And there were 2 items of note that I want to go back and reinforce. And one was the complementary nature of the 2 businesses and, after the merger, how we're well positioned in all 5 domains. So when you look at the threat environment, which changes on a regular basis, you look about and read a lot about China, China, China. I mean, our positioning in space and maritime, I think, puts us in a good position to support the war fighter. Our cyber capabilities really are applicable not only in China, but all conflicts. I like what we've done in the air domain, while there's applicability in China, it also allows for situational awareness globally. And I think that's critical as we look beyond just the China threat.

And the land domain is still a key part of our national security strategy, especially with the focus on resilient comms. So I like the fact that we're well positioned in all these domains. And I think you see that reflected in our results and what we're going to tell you a little bit about 2022.

The other one was the revenue synergies. And again, like most of the goals that we set on this merger, we're ahead of schedule. And as I said just a few minutes ago, $900 million of orders earlier than we thought, and I think there's a lot more to come. So the framework that we laid out 3 years

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ago and have talked about each year remains the same. We think we're well-positioned with the DoD in all domains. We have a great revenue synergy opportunity and process. And our international growth has been a bright spot over the last couple of years. So as you would expect, we're going through our strategic planning process. As of today, I see all 4 segments growing in 2022, with the overall company coming in, in the low to mid-single digits on an organic growth basis.

We'll obviously give you more details in January. But let me hand it over to Jay to maybe give you more detail by sector and also emphasize the $800 million of headwinds as a result of divestitures when you're doing your comparison. So Jay?

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

Sure. Thanks, Chris. And just to follow up on that and maybe just a little bit more color on next year, when you think about low to mid-single-digit framework for next year, what I'll do is I'll maybe just take you around the horn of our segments. And I think Chris said it well as far as broad growth across the portfolio.

I'll start with IMS. And this year, we had a guide of 4 to 6 we said that will be probably towards the upper end of this year. And we see a lot of the same going into '22 that we've seen here in 2021. The ISR business has been a strong grower for us on the back of international aircraft missionization. We will see fewer aircraft procurement inputs next year, but that will be more than offset by the ramp in actual throughput related to missionization in the aircraft. You may recall that Chris, in the second quarter call, I talked about 19 aircraft in various stages of missionization. So that will be a source of growth for that business. And that business can certainly deliver low to mid-single-digit growth next year, if not more.

On the EO business within IMS, Chris mentioned a few awards of electro optical sensors for the Navy. We're bullish on that. That would be a source of growth for us next year. And again, very capable of being able to deliver low to mid-single-digit next year.

And the final business within IMS is Maritime. Maritime has had a strong record over the past, really since the merger. And we see more of the same there as well. We talk about the Constellation-class Frigate. We've won some awards on the classified side, undersea sensors. And we continue to expand our capabilities and applications in maritime, and we expect that to deliver, frankly, mid- to high single-digit growth next year. And so when you look at that segment in total, it's very well positioned to do a low to mid-single digit, if not more.

When you look at Space and Airborne Systems, very similar. We continue to expect Space to grow as it did this year. And so you would see something in the -- maybe in the range of mid- to high single digits growth there. Same thing with Intel & Cyber. We continue to see growth in demand in the classified areas in both of those businesses. That will be tempered a bit by our airborne businesses. We've seen this year that the transition, particularly Mission Avionics on the F-35 from development to production, we'll see that again next year as well as some program transitions in Electronic Warfare, particularly in the F-16 program. But nonetheless, even with a flattish to slightly down business in the airborne, we'll see Space and Intel carry that segment forward very easily being able to deliver something like in the low to mid-single digits.

I'll go next to maybe AS and the remaining businesses that we have there. The Commercial Aero business has moved pretty much in line with the commercial aerospace industry. We continue to expect traffic growth next year, and we expect that business to grow in line with that. So you can expect to see some double-digit growth in that business.

Mission Networks, Chris mentioned the Australia award. That will be a source of growth for us next year. And again, really in the low to mid-single-digit range there. And then our Defense Aviation is seeing a little bit of the delays related to award timing. But even with a flat budget (added by company after the call) projection for next year, that business can deliver, the segment can deliver low to mid-single-digit growth.

And then finally, CS. We've talked about Tac Comm, the supply chain pressures there. This year, that business will be down about 10%. And we see if you think about Tac Comm, we expect growth even next year off the lower base that we have this year. This year, we're going to be impacted in the third and the fourth quarter. We expect to be impacted again in the first and the second quarter, with recovery in the back half. With that recovery in the back half, we believe the business can grow in that low to mid-single-digit baseline from this year.

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And it's really similar with the BCS business, our Broadband business, our Integrated Vision Solutions business and PSPC, which will also just benefit from industry recovery. And so as Chris mentioned, again, I'll close with that, we really see a broad-based growth in a low to mid-single-digit kind of initial framework is the right way to look at it really across the portfolio.

And one last thing, Chris mentioned about $800 million. It's right. On a reported basis, we'll see about $800 million of revenue headwind due to the divestitures next year. But again, starting with the organic, really low to mid-single digit is probably the best place for us to be until we solidify our expectations, and we'll do that in January for you. So hopefully, I went around the horn and gave you some color within each of the segments and really give you the source of why we feel confident and are gaining confidence in our ability to deliver that type of growth.

Operator

Your next question comes from the line of Robert Stallard with Vertical Research.

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

Thanks for that detail, Jay. That was very helpful. The question I have, though, is around supply chain, obviously facing a few issues at the moment. I was wondering what your plans are to mitigate these pressures over the next, say, 6 to 12 months and what the implications could be for, say, your revenues and margins.

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

All right. Thanks, Rob. Let me kick it off. And again, Jay will give you some more details on the numbers. I think it really hit as we were preparing for this call, the last few days, when Jay said that we've been through 7 quarters of the pandemic. I mean it's probably been a blur for all of us. But we really started back in February of 2020 focusing on the supply chain challenge. Just 8 months after we closed the merger, we set up our COVID war room. And the real focus there was on the first-tier suppliers that we had in the Far East. Obviously, since then, we've learned a lot about the second-, third- and fourth-tier suppliers and some of the risks in the chain and the resiliency. So I just want to acknowledge that this is something we've looked at for 7 quarters.

Of course, we shifted. And I would say, we always focus on the supply chain. We added in remote working, IT connections, vaccines, all the challenges that we've gone through in the pandemic. So it's been a little bit of a rollercoaster, but the key has been getting our systems consolidated from the merger, getting data, getting visibility. And all of that has improved over the last several quarters. So I think that's what gives us confidence to kind of make some of the projections and talk in a little more detail today.

Back in early August, we were probably feeling much better about the year. And August was the high point for the Delta variant spiking around the globe, and that really kind of threw the delays that we're seeing for the rest of the year. So we're assuming and our baseline is kind of a 12-month delay until things get back to normal with the supply chain. I know there's different time frames out there, but that's kind of the baseline that we're focused on.

I will mention, as a defense contractor, we have the benefit of what's known as DPAS ratings, which are the Defense Priorities and Allocation System. And that's something we've been focused on the last several quarters. And even on the other end of it, the supply chain, a lot of our suppliers are aware of this and are still putting in systems and implementing it, but they've been very supportive in prioritizing our defense products. And I think that's given us a little more confidence and visibility. So -- but that is kind of an overview. I'll ask Jay to maybe give you some of the details on the numbers.

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

Sure. And just maybe a couple of other items that we're pretty focused on, Rob. Obviously, I think we're probably no different than others in terms of making longer-term commitments of 12, 18, 24 months in certain cases. we've redeployed resources to make sure we're managing this at lower tiers in the electronic component value chain. And we secured alternative sources as well as alternative parts and qualified them. We're redesigning parts in products and electronic components to really ensure that we can have adequate source of supply going into next year. And we're making progress across each of these areas, which, again, is where we're gaining confidence that we'll be able to grow in this business next year.

As far as supply chain specifically, the supply chain escalation is certainly going to be a cost for us. When you think about 2022, right now, the way I'm thinking about it is about 25 basis points of margin pressure associated with escalation costs. I would say that that's something that we're considering, that's something that we've got baked in and that's something that will be part of our plans to deliver on our e3 productivity. Our goal will be, as it always is, to offset the headwinds from mix as well as supply chain and deliver at least flat margins, if not higher. And next year will be no different. The pressure is going to be a little bit higher. But nonetheless, we believe that we're going to have a solid path to be able to offset it.

Operator

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

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

I guess if I could slip in kind of 2 quick ones here, either for Chris or Jay, if you could just address maybe cash flow next year, your $3 billion target, and thoughts on cash flow growth per share thereafter. And then maybe, Jay, the guidance for the integration costs kind of stepping up. So it seems to imply a fairly high level in the fourth quarter relative to what we've seen in the past. So maybe what's driving that at this point and where those go from here on out?

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

Okay. Maybe taking a reverse order, Seth. On the integration costs, we actually saw a step-up here in the third quarter. We'll see a little bit higher again here in the fourth quarter. It's really mainly due to two things. One is, as we work through our facility consolidations, we've seen an uptick in cost. We expect to see continued spending in that area probably through midyear next year as we complete those factory consolidations.

The other element is really IT harmonization. We've talked a lot about harmonizing our ERP systems. There were just various systems beyond just our ERPs. We've been working through and incurring the costs on -- related to integration. That will carry over, I would expect, into next year as well some -- for a period of time, again, probably through the first 6 months.

On your question on $3 billion of free cash flow, for us, the formula really remains the same. We need to deliver annually, including next year, about 3 to 4 days reduction in working capital. And that will offset the growth that otherwise would take place in working capital from just the increased use of assets. And so if we're able to do that, we should be able to at least hold the working capital flat, if not become a source of income -- or source of cash flow. And then we can have that added to drop-through of net income. And so it really remains the same. As far as our working capital, when you go back and look, we've got -- we ended the quarter at 56 days. We've got 7 sectors who are above that average, which comprises about 2/3 of our working capital. A lot of that is sitting in inventory, and we've talked about this in the past. And we're really -- again, it's just blocking and tackling, focusing on fundamentals as far as inventory reduction. These include things like just ensure that we execute against our program milestones. We're synchronizing our forecasting and planning with our supply chain. Continue to work -- and Chris mentioned it -- on cycle time reductions and automations in the factory as well as just negotiating better terms on our contracts, getting more advances where you look and maybe compared to some of our other peers, their percentage of advance is a little bit higher than ours. And so that creates an opportunity for us to ensure that we can match cash receipts with cash disbursements on the inventory side. So we're opportunity-rich here. 2/3 of our working capital

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is prime for us to continue to work down. We feel good about that. And look, from a free cash flow per share, we're very confident in double-digit growth there for the foreseeable future.

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

Just real quick on the integration cost. With the pandemic, we stayed agile and made some changes to strategies. And I'll just say in the IT world, we had laid out an architecture. And with the need for remote work and hybrid work, we reprioritized and made some changes, which caused us to accelerate some of our expenditures in Q3, Q4.

Same thing applied to supply chain. We had a whole strategy, and one of those was to hit the end of '22, start investing in the risk dashboard to give us more visibility into our supply chain and identify risks using publicly available data, whether it's stuff such as wildfires or financial stability of the supply chain. We obviously accelerated that into this year and are rolling that out in Q3 and Q4. So some of those things seem to make business sense to increase the cost and accelerate the expenditures based on what was going on.

Operator

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

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

Chris, Jay, Rajeev, I wanted to ask you about two of your programs, if I might. First, that recent GAO decision on the Next-gen Jammer. I'm curious as to what happens now. If you think the program gets recompeted, do you think changes are made to the program?

And the second program I'd like to ask about is the F-35. We had some long-term guidance come from Lockheed this week. I was just kind of curious if you could discuss a bit how you think that might impact you where that was relative to expectations, that sort of thing.

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

Yes. Sure, Rich. Let me go with your Next-gen Jammer question. I mean, just to refresh everyone's memory, we won that program back in December of 2020, almost a year ago. The Navy has affirmed 3 times their choice to select L3Harris, including, most recently, using an independent reviewer. So there's been a lot of media, a lot of discussion on this. We were very proud of the fact that we were rated technically outstanding. And that aligns with our strategy and the R&D investments that we've made in moving up the food chain. So I think we just let the process proceed. It's somewhere between Navy and Department of Justice and the other company as to what they're going to do next.

But our team is ready. There was a stop work order put in place, which is pretty standard. And whenever that's decided to be lifted, we're ready to go. Or whatever other legal actions occur. But again, we're very confident in our solution, as is the Navy as they continue to reaffirm their selection. So we'll stand by and look forward to supporting the Warfighter when we can get started.

F-35, I think we've talked about this on every call. Let me give you a quick update. We're obviously a key player on the F-35. We have a strong position on the platform, about $3 million per shipset. Our overall F-35 revenue is decreasing in '21, decreasing in '22 and then starts to grow again in '23. That's really a result of the TR3 transition from development to production.

And where that may differ a little bit from what you saw from the prime is the fact that we'll be retrofitting several hundred aircraft. So that's what allows us to grow in '23 and beyond. Not only are we going forward with the new aircraft, we're also going to retrofit. And again, the main focus for us is the AMS, the Aircraft Memory System. We just completed safety of flight certification. So that was quite exciting. A lot of positive e-mails from Lockheed and the customers. So good progress on AMS.

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The Panoramic Cockpit Display is entering qualification testing. And then, of course, the integrated core processor is the most complex. And again, we're making progress there. Everybody understands the critical path. And as we've always said, the hard parts ahead of us here is the integration testing that's going on. So I think, as I've said the last several quarters, the teamwork is much better than I've ever seen. Everybody is aligned. Everybody understands the goals, the challenges and the critical path. And we're honored to be on that platform and look forward to delivering on our commitments.

Operator

Our next question comes from the line of Gautam Khanna with Cowen & Company.

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

I was wondering if you could give us some color on the tactical RF backlog, where it stands now, kind of the longer-term outlook in that business. I know you gave a view on '22. But just longer term, what do you have in the pipeline, both domestically and foreign? And any color you can provide there?

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

Yes. Let me take a first shot at this one. Well, first of all, we have a record backlog of $1.2 billion, and that's the best we had in the past 10 years. So relative to that, there is no issue relative to demand. Book-to-bill in the quarter was 1.7, year-to-date we're almost at 1.2. So there's absolutely 0 issue with the demand. I highlighted some of the significant wins that we had recently with the Army. You're well aware of those large IDIQs and how there's a lot of runway to go relative to those. So we're feeling really good on the demand and the outlook. We're going to see growth in '22.

Internationally, I think there continues to be lots of interest for this year. Asia Pacific region and Central and Latin America are growing. Europe and the Mid-East is a little flat. But as we look further out in '23 and beyond, I see that trend switching. So I think Jay did a good job.

But just highlighting it, we look like -- we do about $400 million -- if I go back to 2020, we're doing about $450 million roughly per quarter in revenue. In '21, the first 2 quarters, due to our growth, we were closer to $475 million. Third quarter, we came in at $400 million. And the fourth quarter, we're probably going to be in that $300 million to $400 million range, depending on supply chain.

I see that trend continuing for the first 2 quarters of next year, the $300 million to $400 million range, and then maybe ramping up to $500 million-plus for the second half of '22. And the first 2 quarters of '23 will make up for the shortfall. So trying to give you some color there based on what we see in backlog and the opportunities that we have around the globe. So I don't know, Jay, if there's more.

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

Yes. Maybe just a little bit. Chris mentioned, I think, in his remarks as well as far as a Middle East customer. What we have here, these are $1 billion-plus-type opportunities with this Middle East customer as well as in the U.K. and Australia. And what we've been able to do in each case is win front-end type of contracts. And so right now, with this particular country, we won about 5,000 radios. That could be potential up to 50,000 radios over a number of years. And so being on the front end will position us well for that longer-term opportunity.

The same thing goes with the U.K. We just won an opportunity to do tech refresh on current radios, and that positions us well for what could be also another opportunity of 50,000 radios, $1 billion-plus program. And similarly Australia, you're looking at potentially 35,000 radios in our ballpark. We also won an opportunity there to do some crypto modernization on installed base. And so winning these early awards puts us -- positions us very well for these long-term large programs in each of these countries.

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We've got a DoD opportunity coming up either this quarter or next quarter with the Marine Corps. We feel confident in our positioning there in our product offering for that. And so we're confident and bullish about the opportunities for the tactical radio in radio business going forward and our positioning as well.

Operator

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

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

Chris, segment margins were 19.5% in the quarter. I mean rounding you're at that 20% margin you've been targeting, but your full year 2021 guide implies a step-down in 4Q. So can you provide more details on the puts and takes and how we should think about margins going into 2022? I know it's too early for a 2022 guide, but is 20% a floor?

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

Well, it's good to see you on a Friday -- nobody's lost their sense of humor. So no, it's -- as I said earlier, everything related to the merger is going quicker and better than maybe anyone had expected or planned. And we talked about a 25 basis point increase year-over-year. So the way I look at it is we're a year or 2 ahead that target. And the goal for '22 and beyond will be to, at a minimum, maintain these margins, but look for ways to increase it. I mean some of the things that contributed -- and I'll let Jay give you more details on Q3. We've really been focusing on our discretionary spend, the SG&A. I think this was one of our lower quarters since the merger as a percent of revenue.

We continue to invest in the IRAD at about 4% of revenue, which I think has been positioning us for this growth that we talk about going forward. And the mix from these new awards. I talked about some of these awards being delayed. I think you know most of these new awards initially are dilutive to margins as you win, especially if they're cost-plus or even if they're fixed price, just being conservative. So with those slipping to Q4, I think that accounts for some of the shift between the 2 quarters, but we look at it kind of on an annual basis. And year-over-year progress is looking good, and we're not going to give up and we're going to continue with our e3 initiatives.

I mean the e3 focus is really what's making the difference. And I tried to highlight some of the things we're doing relative to labor productivity. I mean we're using collaborative robots and augmented reality and some interesting technology that's just going to get our products to market quicker. We've talked about the supply chain and some of the things we're doing there, value engineering, more and more focused on making our products even more manufacturable. We talk about designing for manufacture, design for supply chain. All those initiatives are ongoing and getting better each and every time. So I don't know, Jay, if there's you want to give.

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

Yes, just on Q4, as you mentioned, we'll see some just new awards which have lower margins on it. And then the Tactical Communication business steps down in Q4. So that will put pressure on the margins from a business mix perspective. And so that's really the driver for Q4.

Operator

Our next question comes from the line of Doug Harned with Bernstein.

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

You've talked a lot about supply chain today and a lot of companies have -- a lot of industrial companies, whether they're in defense or not, have talked about it. But I'd like to -- what I want to understand is -- and the supply chain issues have clearly held you back some in Communication Systems this year, and you talked about the first half of next year. But unlike some commercial businesses, I wouldn't expect any of the deliveries and revenues that you were expecting to have gone away. And when you think forward, should we expect a snapback eventually here where you've just -- you've built up -- you've got a building up of sort of a backlog of demand and we should actually see a what I would think it was kind of a surge when we get into 2023 when you're finally delivering on things that have been delayed?

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

Yes. No, Doug, that's a great question. I think you hit it. I tried to maybe too subtly suggest that this is a timing impact. And I think you're absolutely right, what we're seeing is these deliveries basically being deferred or sliding to the right. About 25% of our business we forecast to demand, the rest we forecast the programs, which is easier to do and less risky. So on the quick turn or the more product businesses, you're forecasting demand. Jay mentioned we're now making commitments 12 to 18 months out versus a couple of months in advance like we used to in the past.

So when you look at the supply chain challenges, to the extent it's a product or something that we recognize revenue upon delivery, you're absolutely right, you'll see that as a bow wave. A majority of our company, and I think the whole industry, uses percent complete or over time accounting. So in that case, you're maybe not going to see the revenue hit, but what you're going to see as a potential delay in ultimately making a delivery, which maybe causes companies to miss their milestones, which could be pressure on billing and cash to the extent it's tied to a milestone event.

So I think you're absolutely right. We view this as a delay and a deferral. I mentioned the ability to use the DPAS ratings to get our parts. And as I mentioned, we haven't missed any commitments relative to our contracts, and that's something that's very important to all of us, and we'll continue to find ways to deliver to those commitments. The revenue shortfall was our focus on overdriving and challenging the team to get year-over-year growth. But as far as the contracts, we're tracking and we're in constant communication with all of our customers, and they understand where we are. So I don't know if that helps you, Doug, but that's a long way of saying I agree with you.

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

Yes, Doug, you got it exactly right. I mean, 2022, I mentioned it would grow. We'd love it to snap back in 2022, but that's unlikely, but we would expect that recovery to be in '23.

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, thanks for all the details on kind of the progress you're making on e3. But kind of just tying back to your comments that you've been operating in 7 quarters of the pandemic does feel like eternity. But did you set up the e3 program before the pandemic. Did you get any kind of opportunities that evolved during the last 7 quarters where you think there's significantly more upside that you can do from the kind of the $350 million target that you've put out there?

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

Yes. No, Peter, the $350 million target we threw out was the cost synergies from the merger, so we'll be kind of putting a bow on that here in the next few quarters, and we've overdriven the synergies that we laid out. Anything post the merger synergies, we'll just count towards the e3 program. I think we've learned a lot, as I've said, relative to the pandemic, how we do business. And I didn't really get to focus on international as an example. And it's still amazing to me that we're effectively double digit on international growth. And it's probably the worst time ever to do business internationally during the pandemic, but I think we learned a lot as to how to better use our time. I've been on all sorts of Zoom calls at strange hours of the day to connect with customers. And if you have those prior relationships, it's still going to be beneficial to get on an airplane and see people face to face. But I think we've been able to find a way to do business more effectively. We're going to have about 10% of the workforce working remotely permanently. We're going to have about 20% doing hybrid. So those are all new and different ways to do business. And we're excited about the future. Having less people in the facilities, we've been able to go ahead and make some of the changes I highlighted in the factory and go ahead with the -- some of the robots that we're using, some of these light guide tools. It's just easier to get those things done.

Jay mentioned the facility consolidation. We probably lost a little bit of time, as you would imagine, due to the pandemic, no one being vaccinated and the difficulty of getting labor. But now we're picking that pace back up again. So yes, we see this as really being a differentiator, something that's in our DNA and something that everybody is engaged with. So thank you for the question, Peter.

I guess with that, we'll just kind of wrap it up for the day. So obviously, I'd like to recognize the 47,000 employees who are focused on delivering value for our stakeholders, and they continue to overcome the unprecedented challenges presented by the pandemic. Their resilience, combined with the many opportunities ahead, keep me, Jay and the whole leadership team excited about the future of L3Harris. So I thank you for joining the call, and look forward to talking to you again in January. Have a great week. Thanks.

Operator

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

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