

REFINITIV STREETEVENTS

EDITED TRANSCRIPT

LHX.N - Q3 2022 L3harris Technologies Inc Earnings Call

EVENT DATE/TIME: OCTOBER 28, 2022 / 12:30PM GMT

OVERVIEW:

Co. reported 3Q22 results.

CORPORATE PARTICIPANTS

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

Michelle Turner *L3Harris Technologies, Inc. - Senior VP & CFO*

Rajeev Lalwani *L3Harris Technologies, Inc. - VP, Investor Relations*

CONFERENCE CALL PARTICIPANTS

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

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*

Kenneth George Herbert *RBC Capital Markets, Research Division - 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*

Ronald Jay Epstein *BofA Securities, Research Division - MD in Equity Research & Industry Analyst*

Scott Deuschle *Crédit Suisse AG, Research Division - Research Analyst*

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

PRESENTATION

Operator

Greetings. Welcome to the L3Harris Technologies Third Quarter Calendar Year 2022 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 now begin.

Rajeev Lalwani - *L3Harris Technologies, Inc. - VP, Investor Relations*

Thank you, Rob. Good morning, and welcome to our third quarter 2022 earnings call. We published our investor letter after the market closed yesterday. Today's call will primarily be focused on answering your questions. Joining me for the call are Chris Kubasik, our CEO; and Michelle Turner, our CFO.

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 investor letter 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. Before going to questions, Chris will make some brief comments.

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

In the midst of quarterly results and financial outlooks, we can easily lose sight of the importance of the mission. Delivering the technologies to our war fighters who are never in a fair fight is imperative. Earlier this week, we lost a great American and pioneer in Defense. Dr. Ash Carter fostered collaboration between Silicon Valley, the defense industrial base and the Pentagon. He successfully changed the way we combat terrorists, and he opened combat roles to women. Many of us at L3Harris, including our Board of Directors, either knew or worked for Ash Carter. We all send our deepest condolences to his family and friends.

Before jumping into questions, as we normally do, I'd like to make a few comments. By now, you have read our investor letter, and much like you've heard from our peers, it's clear that we're operating in a dynamic environment.

Starting with the good news. My team's energy and excitement continues to build as our trusted disruptor strategy is yielding tangible results and is well aligned with the recently released National Defense strategy. We've carved out a leadership position as a nontraditional prime with a record quarter of over \$5 billion in funded orders and a book-to-bill of roughly 1.2. These were driven by notable prime position awards related to Armed Overwatch for SOCOM, responsive space with the SDA Tracking Tranche 1 and network systems for the U.S. Navy.

We also announced our first acquisition since the merger. We're acquiring ViaSat's Tactical Data Link business and gaining access to the ubiquitous Link 16 network. This product line fits nicely in our comms and networking-centric portfolio, enabling us to bring the DoD's JADC2 effort to life. Our momentum is building, and I'm optimistic about the value-creating opportunities ahead.

Conversely, on the not-so-good news, we rightsized our 2022 guidance based on current realities. We previously highlighted a steep ramp in the back half of the year. And while we're making progress, today's backdrop necessitates a more measured approach.

Let's start with the top line. We grew for the first time in 4 quarters at 3%, though fell short of our mid-single-digit expectations. This is because of 2 primary factors: First, we were previously selected for a Mideast aircraft missionization program that included a profitable sale to a key customer, but the formal signing of the contract has now been pushed out as the shifting geopolitical landscape continues to hamper the timing of certain international awards. This would have supported 2 points of growth for the full year, alongside profit and cash.

Second, supply chain headwinds continue, and although improved, the recovery was not aligned with our expectations. As a reminder, with our commercial business model, 25% of our revenue is tied to end unit deliveries. We need 100% of the parts to assemble our products, such as a radio, in order to make deliveries and recognize revenue. Thus, we are taking a more prudent approach in the fourth quarter as the availability of mainly electronic components remain volatile. So our expectations is for a 2% decline in 2022 versus the roughly 1% growth we pointed to previously. We ultimately view these as deferrals versus lost sales.

Next on segment margins. The approximately 16% in our previous guide is going to be closer to 15.5% and in the range of our year-to-date average. This is a result of net higher inflationary input costs offset by proactive cost actions focused on controlling what we can. As expected, the reduced revenue and margins are driving the guidance decline in EPS and free cash flow.

On 2023, I know there's a lot of focus here, and we'll properly guide with year-end results as we typically do in January. That being said, our expectation is for improving revenues and relatively steady margins while growing free cash flow and free cash flow per share year-over-year. This remains a work-in-process for the next couple of months. So a tough but necessary financial update. We remain focused on executing our strategy of being a trusted disruptor and controlling the controllables in today's dynamic environment. With that, Rob, let's open up the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Sheila Kahyaoglu with Jefferies.

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

Chris, thanks so much for your letter and kind words on Secretary Carter. I think there's no doubt that you're not only a trusted disruptor, but you add a human element to everything that you do, whether it's tapping to the DoD or the investor community, and you picked a partner in Michelle that does the same. So just wanted to mention that.

But in terms of my question, in the letter, you talked about analyzing the situation over the next few months prior to providing 2023 guidance. So how do you think about maybe the pinch points, whether it's on sales or margins and how you're thinking about the range of outcomes?

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

Okay. Well, Sheila, first of all, thanks for the kind comments. The whole team here is highly motivated to support the war fighter and our customers, as you know. Why don't I focus on the sales or revenue piece, and then I'll ask Michelle to talk about the margins as we planned for 2023?

I noted the book-to-bill strength and the strategy is working. We're winning a lot of business, including as a prime, I highlighted armed overwatch as an example. And just to show you the speed and agility with which we work, we'll be making our first delivery in 2023 as an example. We had previously won Tranche 0 and we have launches scheduled for March of '23. We won Tranche 1 for SDA Tracking for 14 satellites, and those are obviously doing well and scheduled for launch later in this decade. We haven't talked about HBTSS in a while. That launch is looking good for mid-2023.

So while we may not recognize revenue upon launch, I just want to highlight the cadence in the volume and the speed in which we're working. And just looking at the manifest the other day, we have about 40 spacecraft scheduled to be launched in the next 24 months. So that gives you an idea of how we're doing in the space world.

We talked historically about some of the airborne headwinds using that as kind of a proxy for F-35, which decreased in '22 compared to '21. I think like everybody else on the program, we're kind of seeing a leveling off. So we will not have that headwind. It won't provide a tailwind, but nonetheless, it will flatten out.

So the supply chain is really the focus and it is quite volatile, I can assure you. Relative to that, I may give more detail on a subsequent question if I get one. But look, CS grew 4% for the quarter. TCOM was double digit. Of course, that was a pretty easy compare to a year ago. So we're going to just look at the progress we're making as of November and December, and that run rate will give us insight. I think we all tend to talk about supply chain as a homogeneous entity. But as you know, it's much more fragmented. We see improvements in shipping and components and chemicals, but there's still a lot of turmoil, as you would expect with electronic components. So we'll take the last available data and then give guidance that we have confidence we'll be able to achieve for '23. Michelle?

Michelle Turner - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes. And I'll just add before jumping into the margins. When we look at our overall portfolio, just a reminder for those on the call, 25% is recognized in terms of revenue based on delivery. So that's a little bit different than others within the industry. So as you think about some of the supply chain constraints and the deferrals associated with it, it really is the entirety of the revenue being recognized versus over like a cost incurred type of revenue recognition. Also, this is our higher-margin business. It runs about 25% for us. So again, to Chris' point, this is more reflective of deferred revenue versus lost.

But just to give a little bit more color in terms of margins, how it's playing out in 2022 and how we're thinking about 2023. To Chris' opening comments, we did reduce our guide to 15.5% from an overall segment perspective, really driven by 2 things. One was around the volume mix in terms of our aircraft missionization along with the supply chain constraints, tend to be margin accretive for us across our portfolio.

But also just in recognition of the overall macro operating environment, you're hearing this consistent with our peers. Higher input costs, whether it be supply chain, labor, inflation, along with things like redesigning parts internally to ensure we can continue to meet our customers' critical missions, all of that is equating to about a \$250 million incremental cost headwind for us in 2022, of which we are doing what we can to control the controllables, and we've been able to successfully offset about 70% of that increased cost across the overall ecosystem. So as we think about 2023, we're taking all of these data points into effect, along with where do we land at the end of the year from a supply chain perspective. Given that 40% of our overall portfolio is short cycle in nature, that data point is going to be very relevant in terms of how do we set guidance, both from a top line and bottom line perspective for next year.

Operator

Thank you. Our next question comes from the line of Robert Stallard with Vertical Research.

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

I'd like to delve into the noncash charges that you booked this quarter. And what exactly drove the timing of those charges being taken here? And in particular, you mentioned that the demand for precision guidance seems to be weakened, but that would go against the grain given the broader defense environment we're seeing?

Michelle Turner - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes. So I'll take this, and Chris feel free to jump in, in terms of overall demand. But thanks, Rob, for highlighting this. I think it's creating some noise in terms of our overall reporting. So it's a good opportunity to talk about. This is really a continuation of what we've been amplifying across our portfolio. So just to put this into perspective, we have \$18 billion of goodwill on our balance sheet related to the L3Harris merger. We took a \$800 million charge within Q3. It's about 4%, 4.5% of the overall balance, really targeted at 2 of our legacy businesses that we've been talking about for a while in terms of being on the low end of our portfolio from a growth perspective.

And so as we went through our strategic plan over the last month, along with the updated DoD budgets, and really aligning with what we've been highlighting the areas of focus from a customer perspective to what we're seeing within our overall product portfolio, this is really just a continuation of 2 of our legacy businesses where we've highlighted risk associated with these businesses as we're investing in areas from a DoD perspective, like space and cyber. Similarly, we have parts of our portfolio that are going to be on the lower end of that growth spectrum. So not a surprise here. This is consistent with what we've been talking about across the overall portfolio.

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

And I think, Rob, to the timing question, I think most companies look at this at the end of the year per the requirements for goodwill accounting. But to the extent you become aware of an instance to do a check, you ought to do it. So when we looked at the rising interest rate environment, and as Michelle said, having just completed our preliminary plan, we went ahead and ran the numbers and took the charge here in Q3. So that's the timing.

Operator

The next question is from the line of Richard Safran with Seaport Research Partners.

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

Chris, I appreciate and I really like the commentary in your letter. But I was really surprised to see you categorize defense budget environment under ugly. So I have 2 things I want to ask you here. First, nobody thinks that CR is good, but they're generally short term. Do you think or is your thinking that the CR could go past December? And more importantly is if we just exclude the CR for a moment, given the bipartisan support for defense, do you hold a positive view of defense spending and see continued year-over-year increases above inflation and especially as it pertains to L3Harris programs?

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

Yes. Rich, thanks for that. We did lay out the good, the bad, the ugly. Clearly, the war is ugly. So there's no dispute in that regard. And for those of us that run a business, we like to have things done on time and on an annual basis. And to be honest, the CRs are getting old. I think this is the 15th CR in 20 years. So it almost becomes the norm. But I still hold out hope that we can have a budget in a timely manner. So to your point, specifically on the CR, we do have an election upcoming as we know, in November. So we'll see how that plays out. And I'm hopeful that we have a budget and the conference occurs in December.

But when you look at the total debt that's accumulating in our country, you look at the debt ceilings, many of us were around and remember sequestration and Budget Control Act and all those things that are looming out there, it does give me concern. The PBR was \$773 billion and we have the different markups from 777 to 819 and a couple of things in between.

So there has to be a conference. There has to be a process and -- until it's signed, it's hard to run the business. And I think when I talk to my industry peers, we all agree. We prefer to have a budget approved. And I think there is some potential that this thing could get extended past December and put the same pressures on our business that we experienced this year. So on the upside, when I look at all of our customers internationally, we're seeing budget increases aligned with the threats. So there is some good news there. The overall budget environment is growing. We just need to get it.

When I'm in the Pentagon in D.C., trust me, the customers have the same feeling. They probably hate a CR more than I do. So I decided to call it ugly until we have a budget.

Operator

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

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

I wanted to go back to the supply chain and communication systems. This has been -- you all highlighted this as an issue for some time. And what I'm trying to understand here is, at one point, it was about semiconductors and then it appeared to expand a little bit into some other components. And I guess, what I'm trying to understand is how confident you're on top of this now that -- are you seeing basically the same components as a problem? Has this expanded more?

And then if I can tag on to that, as you have delays in shipments, you talked about pent-up demand in the letter. Should we be expecting a surge at some point back in terms of deliveries, say, in late '23 or into '24?

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

All right, Doug, thanks. Let me take the first part on supply chain. I'll ask Michelle to comment on the surge. And it's a great question. And I'll say, I think we have control over the situation, but let me explain the complexities as we were reviewing this a week or so ago. And I'll just use TCOM as an example.

So in the quarter, we delivered about 12,000 radios. And you've heard me say and Michelle say, and we'll probably continue to say, we don't book the revenue, the profit until we make the delivery. So they were split between manpack radios, call it, 8,000 manpacks and 4,000 handheld radios. And when you go down into the details, and we looked at the schematics, talk to the team, I think Michelle was just up there a few weeks ago at an AIA event on supply chain that we hosted. There's about 10,000 parts in a manpack 5,000 in a handheld. I'll do the math for you. The bottom line is we needed 100 million parts to deliver those 12,000 radios.

So we monitor this on a daily basis. I would say, we get 97.5% of the parts in. But as said in my prepared comments, if you don't have all the parts, you can't deliver a radio. You can deliver an airplane with missing parts, you can deliver a ship with missing parts, and you deliver a lot of things with missing parts, but you can't deliver a radio or arguably night vision goggles or cameras. So I think that's what's unique.

And the question has got to be, do we know what the heck we're doing here, which is a fair question, you didn't ask that, but I'm sure that's on people's minds. So we looked at a key supplier as an example, where we ordered 18 months ago, 25,000 parts. We have a commitment, we pay the cash, all the good stuff you would expect. But the mid-September delivery, which would have allowed us to ramp up and maybe get closer to our prior guidance, only 5,000 parts arrived because there's an allocation process.

So these commitments and all of us, me personally talking to CEOs of major corporations, you get the commitment that passes through the system, they get an allocation and we come up short. So this happens on a regular basis. We're leveraging DPAS. Like I said, we have executive outreach. We have contacts. We look at this daily. But that's an example of maybe it's down in the weeds, but that's what we're tracking, 100 million parts for 1 entity for 1 quarter, and that's how we came up where we are.

And that's why, to Sheila's question, we'll kind of look and see how November and December -- we do track, I'll just stick with radios, but I can go through all the entities if you want. We have about 400 key suppliers. We had 30 that were on the watch list back in Q1. We're down to 10 that are on the watch list, meaning either poor quality or cutting the allocation. So that's kind of where we are. And that's why I can say we're making progress, but you almost have to be perfect in that regard. So I don't know, Michelle, if you want to supplement what I said or talk about the surge.

Michelle Turner - L3Harris Technologies, Inc. - Senior VP & CFO

Yes. So a couple of things I would highlight. I think on the positives, right, we continue to see sequential improvement quarter-on-quarter. So even with the guidance change, I think it's important to note that we assumed a significant ramp-up within the second half. So although we're disappointed that we're not getting to the ramp that we originally had anticipated, we are seeing improvement from where we started having this acute pain point in Q3 of last year versus where we're at today.

The other thing I would highlight is we continue to see really strong demand across communication systems, particularly within our TCOM business. Chris noted the record \$5 billion bookings that we had within the quarter that was led from Tactical Communications. And then if you look at our backlog, it continues to grow. We started the year at \$1.3 billion. We're ending Q3 at \$1.9 billion. So going into next year, we're certainly going to have a strong tailwind in terms of demand for the product.

To Chris' point, however, this is going to be muted a bit by this headwind from a supply chain perspective. We do anticipate that it will continue to be volatile through the end of next year. And our challenge is getting our arms around expectations for 2023 with the recognition that we continue to see volatility even within a quarter, particularly within our short-cycle businesses like communication systems.

One thing I do just want to highlight because I want to give huge -- Chris noted that I was up in Rochester at an AIA event a few weeks ago. I want to give props to the Rochester TCOM team. We talk a lot about the supply chain volatility and our ability to react. And again, we're disappointed with the results but just gaining an appreciation for what it takes to actually deliver on what we did deliver on in terms of that double-digit growth within the quarter.

But what we don't talk a lot about is the demand volatility that goes along with that. And so the team received an urgent request order for Ukraine at the end of Q3, we were able to book and turn that within a matter of 7 days. And so it just speaks to the agility from internally within the company. But it also speaks to how we're rising to the challenge from a mission perspective, ensuring even with all of these things that continue to disrupt and create volatility within our ecosystem, we're continuing to put the mission of our customers first.

Operator

Thank you. The next question comes from the line of Scott Deuschle with Credit Suisse.

Scott Deuschle - *Crédit Suisse AG, Research Division - Research Analyst*

Chris, this quarter reminds me of the old L3, to be honest, which was always pretty unpredictable and prone to surprises. I had thought with the switch to an operating company type approach that this would perhaps be less prone to happening since you'd have better visibility into the business. So maybe just help us understand why the switch to the operating company approach hasn't driven better predictability? Or would you just say that it has helped and it's just that the environment is simply too unpredictable?

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

Scott, thanks for the question. And what I like about your question is it kind of aligns with the culture that we're trying to build here at L3Harris. And that is just encouraging people to speak up and ask the tough questions. And I appreciate you asking it actually because, as you can imagine, I kind of had a similar thought across my mind having taken over L3 back in 2018. So this was the whole basis -- one of the key basis of the merger is how do we accelerate that transition from holding companies, which really doesn't work in this industry for a variety of reasons to an operating model.

So I think it has helped. I think if we go back and look, it's probably been at least 12 months for certain, and clearly, the last 6 months that Michelle and I in public forums and other venues have been pretty outspoken about the risks. I think it was in the second quarter, we talked -- I mean, I go back to January, right? And we were very transparent in my opinion. And we said, look, we're going to shrink in the first half and then we're going to go up the steep slope in the second half. And as you would expect, we honored our word and we shrunk in the first half. I wasn't happy about it, but that was the plan and we executed accordingly.

And we really needed to have a good ramp here in Q3. And we laid out there were 3 main components that were going to drive it. One occurred, which is just our normal focus on delivering quality products on time. We had an assumption on supply chain, which I think I've given enough examples on the 100 million parts and that one supplier is an example that came up short and then this Mideast International missionized aircraft which was just a matter of getting the contracts signed. So it was probably the 20th of September with 10 days to go where we figured this contract is going to be signed. And you get down to the 29th, and it's not signed. It's 2 points of revenue for the whole year.

So I would say, we have very good visibility. I personally, along with Michelle, participate in monthly financial reviews. I don't think there's a lot of companies who have their CEOs involved in a monthly review at the level and size of our company. So we have good visibility. We track the risks. We mitigate them where we can. Opportunities pop up like Ukraine. We capitalize on those. And we're trying to be transparent, measured and prudent in telling you what's happening. So I think that was a great question, and hopefully, that addressed it.

Michelle Turner - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes. The only thing I would add to it, Scott, just going back to our previous example, and I think what you're seeing within our portfolio that's different than maybe others within the industry is this revenue recognition for 25% of our portfolio being on delivery, right? And so you could be missing a part in a program-based scenario, but you're still going to recognize the revenue. Here, if we don't have every part, we're not going to recognize it. And to Chris' point, when you think about radio, we can book and turn those pretty quickly within a week.

And so I think you get the combination of the fact that we take revenue based on delivery, coupled with the short cycle nature, there can be and there has been and there will continue to be volatility within the quarter.

Operator

The next question is from the line of David Strauss with Barclays.

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

Chris, I just want to see, as we think about next year, does adjusted EPS grow given I think you're going to have a pretty meaningful pension headwind? And then I think you said that free cash flow is going to grow. But if you can give us some of the mechanics there because I think you're also going to have a pension cash headwind as well?

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

Yes. Thanks, David. So with the free cash flow, we have the tax, the R&D capitalization. That's still something we're watching assuming that there's no fix to that issue. The impact of that will be about \$150 million less. So if we can grow the top line, we'll keep the margin steady. We should have a little more cash from operations plus the \$150 million from taxes. So that gives me confidence in free cash flow growth and free cash flow per share growth.

The current outlook just on the pension on cash is 0. We're going to be funded in the mid- to high 90s. So there is no cash draw on pension. Relative to adjusted EPS, I'll ask Michelle to give you the details on the pension. But yes, there will be a pension headwind. We'll true up those final assumptions at the end of the year. She'll give you the impact. And I think we just got to see where the year ends up and what we give for next year. I think it could be flattish to maybe up or down a couple of points, depending on the final assumptions and where we end '22 as a takeoff point for ['23] (corrected by the company after the call). So Michelle?

Michelle Turner - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes. So to Chris' point, just to hit a couple of your questions, David, we don't anticipate having to do any incremental funding from a pension perspective but well-funded. When you think about the income line and EPS, 2 impacts there, very consistent with what you heard from our industry peers. On the FAS income line, we anticipate that it will be about \$150 million impact going into 2023. And then from a CAS recoverability perspective, consistent with what we've shared historically, we expect that to continue to dwindle over the next few years with it representing about a \$50 million impact in 2023. So in totality, about \$200 million.

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*

I was just wondering if you could elaborate on your comments about potentially stable margins next year. Obviously, the CS volatility, you've explained. But on the other 2 segments, do you think -- like can you maybe describe or quantify the headwinds you see as of now that you're going to need to offset? And maybe just talk about stable relative to what the full annual '22 levels of margin or kind of the exit rates out of the year?

Michelle Turner - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes. So just to give a little bit of color and context, and feel free, Chris, to jump in as well. Here is kind of how we're thinking about it. What's going to be key is how we close the year from a Q4 perspective, particularly within tactical communications given the margin impact across all of our product portfolio. Within that, there's also a mix component, right? So we've seen strong demand internationally. And so these are tailwinds as we think about going into next year.

From a headwind perspective, it's really around the macroeconomic environment, right? We're continuing to see higher input costs. I talked about that in terms of 2022 impact. But as we think about going into next year, what does that look like and we're assuming that it's going to continue to be volatile. There's going to continue to be rising costs and then the actions that we're taking internally to offset that. And I think a great example

of this is we announced the voluntary retirement program at the end of Q3. That's going to help us as we think about inflation next year, particularly on the labor side of the equation. And so how does all of that come together in terms of our guide, which we're triangulating around this relatively flat point based on what we know today.

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

And Gautam, it's so important to have a talented workforce in order to execute on everything we talk about. So a lot of our focus of the leadership team has been to keep the workforce engaged and motivated. And I think we can all admit over the last couple of years, we found new ways to do work. The attrition was hard hit for, I think, every company, but it seems this industry in particular, that seems to have stabilized a little bit.

But we're spending a lot of time focusing on the workforce, and there will be headwinds in 2023 compared to '22. We're going to have a larger merit increase pool. We're holding the medical dental vision co-pays flat year-over-year. Everybody is going through open enrollment as we speak, and we're getting great, great feedback on that decision. But these cost money, and it's a decision that I and the leadership team made that we're going to spend more money on the workforce, and that does provide a headwind to the margins, which we're going to try to find a way to absorb. But I'd rather make these investments now, keep the workforce engaged, motivated and focusing on the programs that they support.

Operator

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

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

Michelle, you mentioned the 40% kind of short-cycle exposure. Maybe you could just update us your thoughts on just your ability to kind of reprice or get pricing in to kind of help offset inflation, how we think that kind of flows through when we're thinking about '23? And then just, Chris, you've given us a lot of details on the supply chain. But just are your thoughts on any further like vertical integration to kind of help either redesign or help try to limit some of the disruptions that you've had?

Michelle Turner - *L3Harris Technologies, Inc. - Senior VP & CFO*

Thanks, Peter, for the question. So just a reminder for folks, about 25% of our overall portfolio is what we consider commercial and we have the ability to reprice in an environment like we're in today. And so teams are doing a good job in terms of as we're reacting to the higher input costs, ensuring that we're getting priced where the market will accept those price increases.

As I think about 2023, I think one of the benefits of our portfolio is that we do on our program side of the house, which is about 50% of what we do or 75%, including the cost side piece, it tends to be shorter in nature in terms of period of performance. And so our average period of performance is about 12 to 18 months.

And so if you think about this increased inflationary environment starting in the middle of this year, I anticipate that, by the end of next year, we've worked through that backlog that was priced in the pre-inflationary environment. And so I think that's one of the advantages that we have, given our shorter cycle nature, but it also plays into how are we thinking about guidance for next year and going back to that there's multiple variables that we're taking into consideration, that being one of them.

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

Yes. And to your supply chain question, I should have emphasized we're continuing to redesign our existing products. In the old days I think a lot of companies had a process that focused on design for cost, given the focus on affordability. There are new initiatives that have come about in the years past, we post-merger, really focused on design for manufacturing as a way to not have the engineers design something so complicated that

we can't actually build it in an efficient manner. And of late, we're rolling out and have been rolling out our design for supply chain. So you now have to consider all those factors when designing a new product, which we're doing and, in our case, redesigning our existing portfolio, if that makes sense.

Relative to the vertical integration, we were suggesting acquisitions, I'm generally against making acquisitions to acquire a sub or a supplier. But it does kind of bring up the point that everything is changing. And I think that's where our company is unique, the ability to adjust. And we're not going back to the old days. And in the old days, you had a single supplier and now we're going to probably have 2 or 3 sources of supply.

In the old days, you did just-in-time inventory, and that doesn't work anymore. Lead times, as I mentioned in that one example, are going out 18 months versus 18 days. So the company that can adjust and accept these new realities, which I think we have, will ultimately play off in the long term. So that's how I look at it. We're still continuing to work with lots of high-tech Silicon Valley and disruptive companies, smaller companies we've talked about through our venture capital and Shield as an example.

I think so far, we're up to 10 different investments, minority positions. But again, the key point there is to pool their technology into our portfolio. And I think that's starting to happen, and we're starting to see good receptivity from our customers because these companies can't get programs of record on their own. And I think we're the guys that are out there embracing and encouraging and working with them.

And I referenced, I think, early on the National Defense strategy and there's an interesting part in the NDS that talks about transforming the industrial base. And it really talks about the focus of the prior strategies not incentivizing companies like ours to design open systems that can be incorporated into cutting-edge technologies. And it goes on to say that they're going to reward those companies with rapid experimentation, acquisition and fielding.

So it was good to see the NDS come out because it's consistent with what we've been talking about as a trusted disruptor, and now we just have to operationalize their strategy and our strategy to align. But I like seeing the reference to open systems, and I like seeing the reference to speed because when you think of L3Harris, you should think of open systems and speed.

Operator

Our next question is from the line of Ken Herbert with RBC Capital Markets.

Kenneth George Herbert - RBC Capital Markets, Research Division - Analyst

Just starting off on the Tactical Datalink acquisition. I know obviously, it hasn't closed yet, but Chris, maybe you can provide a little bit more in terms of your thinking strategically how this supports the JADC2 opportunity and maybe how this just supports broader modification and upgrade opportunities? And could we see maybe an acceleration in the top line of that business once it's part of your portfolio? Because obviously, it's a relatively mature technology and a mature set of assets, but I think it could present some interesting opportunities.

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

Yes, Ken, thank you. I think you probably asked a great question and answered it at the same time. So let me see what I can supplement. I mean, well, first of all, as I've said before, we look at all of our acquisitions, this being the only one so far, strategically, operationally and financially. So strategically, I couldn't have asked for a better first acquisition. This was pretty straightforward and pretty easy, as you suggested. I mean, it fits perfectly into our portfolio, fill the gap that we had. It ties into JADC2, networks comms, everything we're known for.

And it gives us the footprint on 20,000 plus platforms, and real estate matters on these platforms, whether they're aircraft or ships or other platforms. So we'll be able to modernize and upgrade Link 16. We'll be able to work in other wave forms and focus on resiliency.

So my expectation, I think you said it well, is it's an accelerant not only for their business but for our JADC2 efforts. And on the tactical side, a little bit, we've been making the regulatory filings. Everything is tracking. We are still projecting a first half of 2023 close. And there has been some positive receptivity. We actually got a couple of calls from customers that were so excited, they wanted to meet. But of course, we have to wait until we close the deal. So we were excited to hear that already. Operationally, I think it will be pretty straight straightforward to integrate this business. And then financially, as I've said, it's accretive.

So it also gives us, again, a seat at the table and continues to move us up the food chain. I'll just say on the -- I mentioned this was the only one we did. We are active in the market. We did make a couple bids on other properties. And I just point out from a financial discipline perspective, we were outbid by like 50% or 60%. So we're not going to chase bad deals, we're not going to overpay, and we wish those lock that paid the prices they did. And maybe they were right and we were wrong, but you can't win them all.

Operator

Our final question comes from Ron Epstein of Bank of America.

Ronald Jay Epstein - BofA Securities, Research Division - MD in Equity Research & Industry Analyst

Yes. Just maybe a question and a follow-up. Forgive me if you already talked about this a little bit because I got on the call a little bit late due to a conflict. Anyway, why did you take the charges now? I mean, what was the impetus? And then Chris, I mean, were those legacy L3 businesses or legacy Harris businesses?

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

Well, let me go first, and then I'll throw it to Michelle. Yes, you have to go back 3 years to remember this, but it was a merger of equals. And for accounting, one company had to acquire the other based on a variety of rules. And I think the key rule is who had the larger shareholder base. So if my memory is right, I think it was 52-48, 52 Harris; 48 L3. So for accounting, Harris acquired L3. So all the goodwill went to the L3 property. Had it flipped, all the goodwill would have gone to the Harris property. Pretty sure we would have come up with the same answer regardless. But yes, all this goodwill is applied to the legacy L3 businesses, and those were the ones that took the charges. But go ahead, Michelle.

Michelle Turner - L3Harris Technologies, Inc. - Senior VP & CFO

Yes. And just timing-wise, Ron, to your question, this was as a result of going through our strategic plan process and aligning with the overall DoD priorities. I think it's important to note with these 2 businesses, we've been illuminating for a while that they're on the lower end of the portfolio from a growth perspective. So there's no surprises here. It's really just part of the annual assessment, if you will, in looking at where the priorities are from a budget perspective with our strategic plan and then the recognition that these businesses were already on the bubble to begin with.

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

All right. Well, thanks, Michelle. And thank you, everybody, for joining the call today. I want to thank our 47,000 team members across the globe. It seems like, each year, we continue to get new challenges, and I appreciate your hard work and agility as we move forward.

So before signing off, I'd like to acknowledge the progress the team has made on the ESG front with their dedicated effort over the last few years. And per Sustainalytics, we've become a leader in the global aerospace and defense industry, recently ranking in the top 5%. So our nontraditional strategy is paying off on many levels. I hope everybody has a great weekend. Thank you.

Operator

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

DISCLAIMER

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

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

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

©2022, Refinitiv. All Rights Reserved.