REFINITIV STREETEVENTS

# EDITED TRANSCRIPT

LHX.N - Q3 2023 L3Harris Technologies Inc Earnings Call

EVENT DATE/TIME: OCTOBER 27, 2023 / 12:30PM GMT

**OVERVIEW:**

Company Summary

## CORPORATE PARTICIPANTS

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

**Mark Kratz** *L3Harris Technologies, Inc. - VP Investor Relations*

**Michelle Turner** *L3Harris Technologies, Inc. - SRVP & CFO*

## CONFERENCE CALL PARTICIPANTS

**Gautam J. Khanna** *TD Cowen, Research Division - MD & Senior Analyst*

**Jason Michael Gursky** *Citi Group Inc., Research Division - MD & Lead Analyst*

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

**Kristine Liwag** *Morgan Stanley, Research Division - Executive Director, Head of Aerospace & Defense Equity Research and Equity Analyst*

**Matthew Carl Akers** *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

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

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

**Scott Deuschle** *Deutsche Bank AG, Research Division - Research Analyst*

**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 2023 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Mark Kratz, Vice President, Investor Relations. Thank you, you may now.

---

**Mark Kratz** - *L3Harris Technologies, Inc. - VP Investor Relations*

Thanks, Rob. Good morning, and thank you, everyone, for joining us to discuss third quarter results. Joining me are Chris Kubasik, our CEO; and Michelle Turner, our CFO. Yesterday, we published our investor letter detailing our results, guidance and key company updates. So this morning's call will be focused on answering questions.

As always, we may discuss certain matters that constitute forward-looking statements. These statements involve risks, assumptions and uncertainties that could cause results to differ materially. For more information, please reference our provisions found in our investor letter and our SEC filings. We will also discuss non-GAAP financial measures, which are reconciled to GAAP measures in the investor letter.

I would now like to turn it over to Chris for some brief remarks.

---

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

Okay. Thank you, Mark, and good morning, everyone. I know you've all had a busy week, and we appreciate you joining us this morning. The current events in the Middle East remind us that what we do at L3Harris matters and the industry in which we operate is more critical than ever before. As a national security technology-focused company, we remain committed to supporting the U.S. and its allies to deter aggression and foster stability around the world. As we embark on our fifth year since the merger of L3 and Harris, I'm proud of our achievements. We've built a diverse and seasoned team that is integrating our company.

L3Harris is viewed as a disruptive competitor that is reshaping the U.S. defense industrial base. Meanwhile, underpinning our strategy is a focus on operational excellence, delivering quality products on time, driving cost out of our system and focusing our portfolio as a national security company. This ultimately benefits our customers and creates long-term value for our shareholders.

While the macro environment has been challenging, we are making considerable progress. The business is on solid footing, and we are building operational momentum. In the third quarter, we reported 16% top line growth, a second consecutive quarter of sequential margin improvement and strong cash generation, resulting in more than 100% free cash flow conversion. This extends our trend of generating positive free cash flow in each of the quarters since the merger. The team and I look forward to providing more details on our strategy and our 2024 outlook at our Investor Day in December.

And with that, Rob, let's open the line for questions.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Our first question is from Kristine Liwag with Morgan Stanley.

**Kristine Liwag** - *Morgan Stanley, Research Division - Executive Director, Head of Aerospace & Defense Equity Research and Equity Analyst*

Chris, Michelle, after owning Aerojet Rocketdyne now for a few months, are there any surprises to the positive or negative that you've seen?

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

Okay. Well, I expected an Aerojet question. So let me take this one and try to answer your question and maybe give a little more insight on Aerojet Rocketdyne. But just to refresh everyone's memory, we signed and announced the deal back in December, and we're able to close it in 7.5 months, which I think is pretty impressive in this environment. So either there was support or probably no objections obviously, from industry and the Department of Defense to allow the acquisition to go through.

So probably closed a little quicker than we expected. I think when we announced it, we said it could take up to 12 months. But we did hit the ground running on day 1, deployed the L3Harris leadership team to run the business, which I thought was critical to the success that we're going to realize. I'll say, from an integration perspective, all is going well. We're clearly on track to get to $40 million to $50 million of cost savings that we talked about previously. We've shut down the Aerojet Rocketdyne headquarters in California. We're ready for January 1 to transition all the employees to L3Harris payroll system, benefits and such.

The IT team is already a networked -- connected all the network. So the communication and such is working well, and we obviously have a little longer-term IT strategy to optimize the business from that perspective. I will say the workforce, we actually did a survey of the workforce about a month ago and the results were actually off the charts. I was more than pleased to see the enthusiasm of the workforce, the confidence that they have and being part of L3Harris, the alignment of being part of a larger company that's focused on defense and national security and space. So that's encouraging to get those types of results.

So we've been clear at least internally and hopefully externally that our #1 priority is to increase the deliveries, specifically in the rocket motor sector. So everything we're doing is focused on increased deliveries. We developed a plan, myself and the leadership team has reviewed it and we're off executing on it. It includes having centers of excellence for energetics and inerts separately. And I think that's going to help with production and flow and deliveries. We've supplemented the existing leadership teams at some of the key locations in Alabama, Arkansas and Virginia with resources and experience that I think is going to start showing immediate results.

And then we've deployed resources to our sub-tier suppliers. And that really is the challenge in the munitions and rocket motor business is a couple of levels down. And we only have, in some cases, 1 or 2 certified suppliers of cases and igniters and sometimes nozzles. So that is ultimately a choke point that we need to focus on as an industry and as a country. The DPA, you've heard us talk about the Defense Production Act, the over $200 million that was awarded earlier this year, that's focused on 3 main products. We have a plan and we're starting to execute upon that. In fact, we just leased a building in Alabama, so that we can modify and order the equipment to increase capacity at that facility.

So we'll use that as a framework. We're going to revitalize the business, and we'll use that for the other products that weren't necessarily covered by the DPA money. So all of this will contribute to 2024 starting to see a ramp-up in the output, and I would expect to have noticeable improvements by the end of 2024 and then continuing into 2025. We've had discussions -- I've had discussions with our end customers, different military services, and they are very excited to have L3Harris own this asset. Obviously, they see us as the answer to the challenges and problems that they and the industry has had relative to rocket motors and we have their full support which I expected, but is also encouraging.

We don't talk too much, but we should about the Space Engine business. And that's maybe about 1/3 of Aerojet Rocketdyne, that business is operating well. The RL10 engine, which is the upper stage is performing flawlessly. I think the run of successes goes back decades without a failure. And not even sure it ever has failed. So that's great news. We're excited to be on the United Launch Alliance, ULA first Vulcan launch and subsequent launches. So there's 2 RL10s per launch. And as of today, we have over 150 in backlog. So that gives us pretty good visibility and stability to the space side. So that's kind of operationally where we are relative to Aerojet Rocketdyne, Kristine.

But I also want to step back on the strategic rationale for the acquisition. It hasn't quite been a year, but I know people are still asking questions. But at L3Harris, we, as I said, are building a defense-focused, technology-focused company. We're taking a portfolio approach. We're looking to acquire businesses that are aligning with our nation's defense strategy and in growing markets. And then we're divesting those businesses that don't necessarily align with our strategy, but are still good businesses but not part of our focus. So Aerojet Rocketdyne is growing faster than the legacy L3Harris business.

I think when we look at everything that has happened since we signed the deal in December, there should be no dispute to demand for these products as they flow through the primes in most cases, is up significantly in the U.S. and in the world, which is why we need to focus on the increase in output. And I already mentioned the DPA money of $200 million, which will help us on these 3 particular lines; increased capacity, move production lines and digitize the engineering. So the tailwinds are there as well. So feel better about the acquisition today than I did in December to be honest with you.

And I think it's highlighting my last point, some of the challenges in the industry going back to the '80s and the peace time dividend, the industry contracted, our capacity contracted. We're on kind of a peace time mindset for the last several decades, and I believe, as a country, we need to ramp up to more of a wartime footing. And like I said, I think money and focus needs to go to the sub-tier suppliers that feed into not only us, but other industry partners, generally through primes and then to the end users. So maybe a longer answer than you wanted, Kristine, but I tried to hit a lot of different topics as it surrounds Aerojet Rocketdyne. So I think I'll just end on that.

---

**Operator**

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

---

**Gautam J. Khanna** - *TD Cowen, Research Division - MD & Senior Analyst*

I actually wanted to switch subjects and ask about Tactical RF. Maybe if you could talk about book-to-bill in the quarter where backlog stands and give us some pipeline color, both domestically and internationally? And also if you can answer the supply chain questions, how that's evolved in that business line?

**Michelle Turner** - *L3Harris Technologies, Inc. - SRVP & CFO*

Yes. So thanks for the question. From an overall Comms perspective, we continue to be on track to deliver to our guidance, which was double-digit growth across the business, which includes to your point, (inaudible)the abating supply chain challenges which we continue to see along with the acquisition of our Tactical Data Links business. Specific to radios and comms from an overall DoD budgetary perspective, we continue to see support. We're about 40% of the way through that modernization program. And we continue to see strong demand internationally as well. And so overall, I'd say, we're feeling like we're in a good place from a Comms perspective.

And then just from looking at supply chain specifically, we continue to see hiccups like you're hearing across the industry, but significant complements to our supply chain, our Tactical Communication business, Sam Mehta, Chris Aebli. The efforts that they've put in over the last 18 to 24 months in truly building a resilient supply chain that allows us to pivot when we continue to experience these hiccups is enabling us to continue to deliver for our customers and for our shareholders. And the other thing I would note for this quarter is that our overall deliveries are actually up from Q2. And so we continue to see the results of the efforts and the diligence that the team has put in over the last 18 to 24 months.

**Operator**

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

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

Chris, so you've alluded to the competing inputs for national security spending. I guess when you think about what's evolving geopolitically versus what's evolving with the deficit battle in the U.S., maybe some of the short-term items as well, I guess, what do you -- how are you thinking about what your medium-term end market growth rate is? And your latest thinking on the L3Harris spread versus that growth rate?

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

Yes. No, thanks. Noah, I appreciate the question. Step back a moment, I think kind of implied in there is the budget and what's going to happen in -- with the supplemental. So as we all know, we finally have the speaker of the house, so that's step 1. I do believe and I've been pretty outspoken on this, it feels like it's an even more dangerous world than it ever has been. You look at what's going on in the Mid East, Ukraine, South China Sea, national security has to be a top priority. And I'm concerned that a government shutdown would clearly weaken our national security as does a continuing resolution. So I think I speak for the entire industry and probably our customers, we hope that we get a budget here in the next couple of weeks, so we can start having the money flow to the industrial base.

There's been a lot of talk about the supplemental over $100 billion, split between state and DoD and Ukraine and Israel and Taiwan and the south border, I think we feel confident there will be a supplemental, I don't know if it will be 1 or 2 or somehow be partitioned, but I look at the supplemental as kind of playing into the near term. And I think when I look at our portfolio of products, literally products, not necessarily systems or platforms, we've been well positioned, specifically in Ukraine with a quick turn on the radios, night vision goggles, sites, sensors, cameras. So I look at the supplemental to kind of help us in the near term. The midterm, I think, is relying more on a continued budget growth, the need to invest in technologies, advanced technologies for a peer or near-peer threats. And we keep talking about that as part of our national defense strategy, but we keep getting distracted by these other conflicts.

So I think that's probably where I feel good about how we've shaped our portfolio specifically in the space arena, a lot of the missions that were normally conducted in the air domain, not all of them, but some of them have been moving to space. And I know people get tired of me saying it. I think this is the best example of our trusted disruptor strategy working. And at the date of the merger, L3Harris had 0 satellites in orbit as a prime. And as I look at our manifest in our backlog, we could very likely have 50, 5-0, 50, L3Harris Prime satellites in orbit in the next 3 to 5 years. So I think we're well positioned there. They tend to be more LEO satellites, 3- to 4-year useful lives, large constellations. So you can kind of see that as a potential ongoing annuity. In fact, we're building state-of-the-art factory for the satellite integration. So clearly, I see upside there.

Aerojet Rocketdyne, we talked about the munitions. We are in the rocket motor, solid rocket motor business supporting great primes who ultimately integrate the missile. So I feel comfortable with our position there. Michelle talked about the radios. We made an acquisition earlier this year on Tactical Data Links from ViaSat. And we keep talking about the connectivity of this network, and it is happening and it is going to happen. It's hard to find the budgetary numbers, but these different domains, space, air, land, sea, they have to be able to connect cross services, multi-domain, all those buzzwords we hear, but it's critical and it's happening and someone was asking me best to try to explain with waveforms and all these different things that we're doing with Link 16. And I think the simplest way I could come up with is just categorizing it as stealth communications. I think that's kind of a simple way to look at it.

And we have the footprint on these 20,000 platforms. So we're upgrading, if you will, an existing network of connectivity and I'll just say, making it stealth. So I think depending on the budget world events, you got to feel like mid-single-digit growth is not an unreasonable aspiration over the midterm. And that's what we're striving for. And as I mentioned to Kristine, I still think as a nation, we have to find a way to invest in the infrastructure to build the capacity of this industrial base given the surge of certain key products and areas. So that's how I see it, Noah.

---

**Operator**

Our next question is from the line of Scott Deuschle with Deutsche Bank.

---

**Scott Deuschle** - *Deutsche Bank AG, Research Division - Research Analyst*

I have 2 quick questions, both for Michelle. The first is on what's driving the difference between the $56 million of M&A expense add-backs on the P&L and the $250 million -- $215 million of add-backs for M&A on adjusted free cash flow? So that's my first question. And then my second question is what would drive CS margins to the 26% range in the fourth quarter, which is I think what's implied in the guide?

---

**Michelle Turner** - *L3Harris Technologies, Inc. - SRVP & CFO*

Thanks for that, Scott. And I'm going to start with the margin question and kind of take a step back and address it starting with the enterprise margins because we really think about this as managing our portfolio. So we're encouraged with the overall margin results within the quarter. This is our second consecutive quarter of sequential improving margins at 15% and this includes 2 months of Aerojet as part of our portfolio. And so we're most pleased because we're starting to see the efforts of our actions related to our Performance First initiative, which you may remember, is really grounded in meeting the commitments of our customers and shareholders, and it's starting to pay dividends now in terms of margin improvement.

So I'll walk through each of the segments because I think there's a lot of good work that's happening across the organization, plus it gives you a little bit of flavor as to how you should think about your models go forward. So I'll start with our Space and Airborne Systems business. It delivered a record profit in Q3 and 12.5% margins. And Ed Zoiss and the SAS team have really been early adopters on our LHX NeXt initiative in terms of really leaning into maniacally managing cost and spend, but also looking at organizational construct to ensure that we are most effectively running our business. The SAS business also benefited from a couple of accretive contract mods that they were successful and being able to deliver on within the quarter.

And so when you look at Q4, there is a step-down as a result of those onetime accretive actions that occurred within Q3.

From an Integrated Mission Systems business perspective, this business along with John Rambo's leadership and the IMS leadership team, saw sequential margin improvement of 180 basis points from Q2. And so you may remember this is where we've had the most acute EAC programmatic challenges in the first half of the year. And a lot of the work that John and his team are doing are starting to pay dividends now where we sit here in Q3. Now this will continue to be a bit of a lumpy part of our portfolio. But we expect that the worst is behind us in terms of overall programmatic challenges within IMS.

Within our CS business, I'm getting specifically to your question, Scott, CS delivered consistent with our expectations within the quarter along with consistent with Q1. And so we anticipated Q3 to be lower margins aligned with a heavier DoD shipment mix from a tactical radio perspective. And as I noted earlier, we actually delivered more radios this quarter. So this really speaks to the efforts that we're really putting around driving a resilient supply chain. A lot of work has gone into this from the teams to make this happen.

And then finally, from an Aerojet perspective, 2 months, a little over 90 days as part of our portfolio, roughly 12% margins within the quarter. You will note though there is a step-down within Q4. Q3 did benefit from about $8 million of purchase price accounting adjustments within the quarter. So we expect in the year consistent with the guide that we have updated for.

And then, Scott, to your question about the difference between the expense and the cash impact. This is really driven by the Aerojet acquisition, cash that flowed out closure from what was originally booked on the books of Aerojet from an expense perspective, we actually paid that cash post closing.

---

**Operator**

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

---

**Jason Michael Gursky** - *Citi Group Inc., Research Division - MD & Lead Analyst*

I just wanted to go back to the Space business for a minute, if you don't mind. Little contracting things going on here in the industry this quarter, you guys had a positive EAC in one of your customers -- one of your competitors out there in the world at a very large part this quarter in their space business. So I wonder if you could just help us or maybe walk around the space portfolio and tell us a little bit about what you have in that portfolio from a fixed price versus cost plus kind of mix and help us understand what the risks are and what the opportunities are as it relates to both revenue in the future. But I think most importantly, given what we're seeing across the industry, kind of what the risks might be on execution in EACs and just kind of help us better understand the overall health of that business?

---

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

Okay. Well, let me take that one, Jason. Great question. And yes, I mean to give the answer on the cost plus fixed price, it's about 50-50 between the two. And that's a big change over the last decade or so. I mean, people generally would have thought of space being predominantly cost plus if you go back 10 or 20 years. And as you know, that trend has changed, bring in more risk to everyone.

What we've -- I think a lot of this goes back, I don't know, specifically who you're referring to. But I think a lot of the challenges that the industry is having stems from the supply chain, which I'm sure is getting old hearing that. But if you go back a few years, we were talking about our portfolio, having a combination of short-cycle quick-turn products, that were reliant on microelectronic parts. So I felt like L3Harris was kind of at the pointy end of the spear and leading the industry and the supply chain adverse impacts given the fact we couldn't get those parts to deliver our products and recognize the revenue and profit.

And then I think the longer cycle business is -- which I would kind of throw space in there, is also having supply chain issues. But the challenge there, I believe, is more on inflation and then workmanship that everybody is dealing with those quality challenges. So while there's still supply chain challenges, I think they've shifted. And I think they're hitting the longer-cycle businesses now. So what we've done is really double down on our bidding discipline, some of the longer-cycle things going back 5 years, probably are making less margin than I would like. But on the new bids, we're clearly factoring in the appropriate risks, taking the most current estimates, and we're not going to bid to lose money and do the best we can, whether it's terms and conditions, contract reopenings, escalation clauses to protect ourselves.

So I feel like we're doing a pretty good job on the bidding discipline. We have regular independent reviews of our key programs, and that helps, again, identify risk early to the extent we have any and then work on mitigation or workaround. So you see how we're doing relative to the others on margins in the space, and we're pretty solid compared to our peers, and we haven't had, fortunately, any major write-offs. We continue to not bid fixed-price development programs that simultaneously ask for development and production, as I've said before. It's hard enough to estimate the development, let alone commit to production for 1, 2 or 3 lots in '26, '27 and 2028. So we will continue to no-bid those.

And ultimately, the customer has to use the right contracting vehicle, I believe. And I think at some point in time, everyone in the industry will stop bidding and will get the right vehicle, and will fight it out for the best solution. More than happy to sacrifice top line growth for profitability, cash and margin. And I've said before, the best way to get your margins up is stop writing off money on programs, and that moves the needle, and that's what we're trying to do.

I think it's some real tangible evidence. We had some fixed price contracts for missile tracking, we have one for the Missile Defense Agency, we refer to as HBTSS, and we have 4 for the SDA, call it Space Force now, Tranche 0 for tracking. And those satellites are done and waiting to be launched. So I can't wait to get those things in orbit. And I think that's pretty good evidence that we're able to meet our commitments relative to cost and schedule notwithstanding all the challenges from the supply chain inflation, attrition and such. Feel pretty good about our space business, and we've been able to attract new talent, which helps as well. So hopefully, that answers your question there, Jason.

---

**Michelle Turner** - *L3Harris Technologies, Inc. - SRVP & CFO*

I would just add to complement that along with the SDA and NDA work that Chris just referred to. We also have a very steady, stable business that we've been in for decades from a civil weather perspective. And so that -- there's also a growth cycle that's happening there, and we've booked about $1.5 billion associated with that business. So it's a good complement to the other work that's really growing from a DoD perspective.

---

**Operator**

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

---

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

Chris, I heard your remarks about 2024 in the Investor Day, but I thought you might be willing to discuss and maybe give a qualitative assessment of which segments have the most room to grow in '24? Any color you could provide there, I thought would be helpful.

---

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

Are you going to come visit us in December at our Investor Day, Rich?

---

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

I'm already signed up.

---

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

Well, there you go, there you go. I mean, this is like the coming attraction here. This is -- after Taylor Swift, it's the second hottest ticket in Florida apparently. So yes, we're in the process of going through our 2024 plan actually next month and -- so I'm not going to actually give you an answer that will be satisfying. I will tell you, based on what I see right now, it looks like all 4 of our segments will be growing. So we'll reveal which ones are growing faster in December. But in all seriousness, we kind of want to get through the next month or 2 and see what's going to happen. We can't have a government shutdown for any period of time. We can't have a continuing resolution. We all know the impact that has on our business. We all say, it really doesn't impact 2023 because the year is 3 quarters over. It's more or less true.

But 2024, 1-year CR, which I'm not at all suggesting will happen. But the one thing we can all agree on is we have no idea what's going to happen in D.C. And I kind of want to get through November and get some of those things behind us, including world events. But right now, it looks like we're going to experience growth -- top line growth in all segments. And on a consolidated basis, which we'll be talking about in December, I expect cash and OI and EPS notwithstanding pension headwinds and revenue to all grow. So that's encouraging, but details to come.

---

**Operator**

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

---

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

Chris, maybe just following up with Michelle on that comment and some of the comments on AJRD in the opening remarks, beyond some of the Defense Production Act opportunities, can you just talk about how you're viewing CapEx across sort of legacy L3Harris and then more importantly, sort of AJRD as we think about 2024 and off of this year? And are you seeing a need to specifically sort of accelerate CapEx in AJRD to address some of the issues you outlined? And maybe how should we think about that as it relates to the growth in free cash next year?

---

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

Yes. I'll start it off and then I'll ask Michelle to fill in. I mean, we're going to continue to prioritize our R&D and our CapEx based on business cases and based on needs. I think Aerojet Rocketdyne always had $50 million, $60 million of CapEx in their plan, so that -- I don't see any scenario where that would change or come down significantly. But we'll look at it compared to all the other investments that we have. I think I've already said, it's a pretty high-growth market and we're trying to accelerate. So between the DPA money, which is over $200 million, the $50 million to $60 million annual CapEx, any other supplemental sources of funding we get sometimes from states and local municipalities, I think it all fits within our overall CapEx target.

And to the extent we need more, it will be at the expense of something else in the legacy portfolio that we don't view as having the near-term need or the ROI. So that's kind of how I see it. There could be new markets down the road once we kind of catch up on this acceleration. And those will be case by case, but there's a lot of exciting new technologies within Aerojet Rocketdyne, but the team is really focused on the backlog and the core business for now.

---

**Michelle Turner** - *L3Harris Technologies, Inc. - SRVP & CFO*

Yes. So I would just add in terms of your question, Ken, around free cash flow for next year. So to Chris' comments, we do expect income to grow. So we think that, that will be a tailwind from an overall cash perspective. We expect some kind of nominal improvement in working capital. And then offsetting that, just as a reminder for everybody, our initial deal model on Aerojet assumed free cash flow accretion in year 2. So we expect there'll be some kind of marginal impact just in totality of where they're at in the program cycle. And then on overall CapEx, we typically run around 2%. We're not expecting any fundamental change in that level of investment as we go into next year.

---

**Operator**

Our next question is from the line of Matt Akers with Wells Fargo.

---

**Matthew Carl Akers** - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

I wanted to ask if you could touch on LHX NeXt a little bit. And specifically, just curious of the $500 million benefit that you called out, how much do you get to keep? Does any of that flow back to your customer or any other offsets we should think about?

**Michelle Turner** - *L3Harris Technologies, Inc. - SRVP & CFO*

Yes. Thanks for this question. I'm glad we're getting to talk about it a little bit more. And so this is the next phase of our L3 and Harris merger evolution, if you will. And so if you think about the initial integration savings that we did as a company, several hundred million along with some offsets, this is the next phase of this, kind of the harder parts, if you will. And it's really focused on leveraging our scale to drive efficiencies and also functional organization to ensure that we're optimized for value creation. And so to your point specifically around the overall bottom line impact, we do anticipate that there's more investment that goes along with this phase of the journey, Matt. So you'll see in our investor letter, we laid out about $400 million of investment.

And so you should think of this more as a nominal tailwind from a margin perspective and not flow it all to the bottom line. But I do want to highlight a couple of tangible examples that the teams have already driven as we're in the early stages of this, just so you can start to characterize what are we talking about and we're talking high level about LHX NeXt.

And one of our recent wins, I'll complement our HR team and Melanie Rakita, they've done a fantastic job in renegotiating our employee benefit package, again, leveraging the scale of the new L3Harris portfolio to not only increase our benefits and also save on costs, but we're also going to be holding our employee benefit cost flat to our employees. So this is really creating a win-win opportunity, both from a shareholder perspective and our employees in terms of better benefits while maintaining the cost that they have to flow back to their families.

And then on the organizational side of the equation, our comms team led by Tania Hanna has redesigned how we serve the company from a comms perspective and really focusing on the things that matter, right? And so when you think about comms and how we send out external communications or internal communications, what are the things that are really going to move the needle from a value creation perspective in terms of our shareholders. And so they focused on streamlining our overall workflows, and we've actually reduced double-digits the number of communications that we're distributing as a result.

So that gives you a little bit of color as to the things we're looking at. But the biggest buckets I would highlight here are really around the material opportunities, both on the direct side and the indirect side of the equation. And so again, going back to -- we're in our fifth year as a company and truly leveraging the scale of L3Harris as a $35 billion market cap and what we can bring to the table in negotiating with our suppliers has a real opportunity to drive value for our shareholders.

**Operator**

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

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

Michelle, maybe another question for you. If you could talk about the path to the delevering and just kind of how much cash you need to have on the balance sheet. I think there's probably some more debt coming up, then -- the company will have an ability to repay. So how do you think about what to term out versus what to repay now?

**Michelle Turner** - *L3Harris Technologies, Inc. - SRVP & CFO*

Yes. Thanks for this question. We want every opportunity we can to highlight that we are focused on debt repayment. And so what are we going to focus on first? We're going to focus on the commercial paper, the higher interest rates, the variable rates, if you will. Where we sit today, post acquisition, we're at $13.5 billion, and our target by the end of the year is to get to about $13 billion of debt. And so from a leverage ratio perspective, we're looking to be at 3.5. And our expectation is that we get below 3 over the next couple of years.

**Operator**

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

---

**Mark Kratz** - *L3Harris Technologies, Inc. - VP Investor Relations*

Rob, this will be our last question this morning.

---

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

Just stepping back, big picture, your margins are 15% today. How do we think about expansion from here? Is it possible? And then to that extent, maybe specifically on communication systems, can you talk about the puts and takes there? Can you shake off some of these supply chain issues? And how do you think about the improvement progress and just the core margin of that business and run away from here?

---

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

Okay. I think I'll take this one since it's our last question, Sheila, and I guess you snuck in right under the wire here. So good morning. Yes, thanks for acknowledging the 15%, which I think are industry-leading margins, which we are quite proud of. And even though they are industry leading, we are committed to find ways to continue to grow those margins.

So on the CS side, we do have the commercial model -- commercial business model, which has played well for us. And that goes beyond just the tactical radios we also have at WESCAM with our turrets and some of our sensors. So I think that's just an area that we need to leverage. We've been increasing our prices to cover the dilutive effect of the cost increase. And I think that's something that this industry doesn't naturally do. I think we all see in our day-to-day lives, prices are going up all over the place. So we tend to try to want to hold pricing flat. But the new reality is it costs you more to buy components and labor.

And Michelle mentioned holding the employee benefit costs flat for 2 years in a row. Those are going to be priced into our products, plain and simple, and that's going to help keep the profitability where it is, if not maybe even increase it. And again, we'll try to leverage the supply chain, the power of the enterprise. We recently had some successful negotiations by working across all the segments and sectors, getting all the buy together and negotiating at a corporate-wide basis for actually direct material, and everybody does that for indirect, but direct is a lot harder, and we were able to pull that off. So I think that's a key part of it.

We haven't talked about e3. That is just in the DNA. It's something we do every day, and that will continue to offset some of the headwinds and contribute to our bottom line. LHX NeXt, as Michelle gave a great description, I think, is really a key differentiator for us. It's the continuation, like you said, of what we started with the merger. I think we did the easy stuff first, and this is the harder piece and the ultimate goal is to simplify the business and change the way we do business. Everyone wants to just take an arbitrary cut to lower their G&A or overhead, but we are looking at everything and seeing if we can eliminate it, do it differently. And she gave some good early examples, but I think there's a heck of a lot more we can do, and that will contribute to lowering our cost base, which will make us more competitive and/or contribute to the bottom line.

And I said it earlier, and I think it's the truth, if you just look at the programs which you don't have all the visibility to, I appreciate. But if you don't debook profit and you don't have losses, the margins will just naturally grow. So that comes back to the discipline and I will trade off revenue growth every day of the week for profitable programs. And it's easy to say and sometimes it's harder to do, but if we can get to the point where we're not writing off money on programs for whatever reason, there's only overhead material and labor, sounds simple, but you have to get the right contracting vehicle, the right contracting terms, push back on the customer and negotiate a fair deal for all, and that's something we are absolutely going to do.

Relative to the mix, I think what you're getting out there is, we do have a portfolio and we're always going to have cost-plus jobs and fixed price and the cost-plus jobs, generally our development and on the front end of a potential long-term franchise or annuity of programs. So we will bid, and we will win cost-plus programs. And we all know those margins are dilutive. But I look at it on an ROIC basis, it's effectively infinite. So if we can get 9%, 10%, 11%, 12% cost-plus jobs that lead to low rate production, that lead to full rate production, that lead to exporting, that is the grand slam of new business, we will bid it each and every time. And it's a portfolio, as Michelle said, we run the company as a portfolio, we look at our financial results as a portfolio. Some segments have a good quarter, some don't. We put it all together, I could not be more proud of the team and what we were able to accomplish in the third quarter, the exceeded expectations on revenue, EPS and cash and it's something we're quite proud of.

So I think with that, I'll just thank everybody for joining the call this morning and another shout out to the employees for really coming through and delivering a great third quarter. I know we're all working hard on Q4, and I can't wait to see everybody in early December for our Investor Day down here in Florida. So with that, we will sign off, and thank you again.

**Operator**

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