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LLL - Q1 2015 L-3 Communications Holdings Inc Earnings Call

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OVERVIEW:

LLL reported 1Q15 sales of \$2.713b and adjusted diluted EPS of \$1.43. Co. expects 2015 sales to be \$11.45-11.65b and adjusted EPS to be \$7.35-7.65. 2Q15 sales are expected to be \$2.8-2.9b and EPS is expected to be \$1.60-1.70.



CORPORATE PARTICIPANTS

Mahmoud Siddig *Joele Frank - IR*

Michael Strianese *L-3 Communications Holdings Inc - Chairman, President & CEO*

Ralph D'Ambrosio *L-3 Communications Holdings Inc - SVP & CFO*

CONFERENCE CALL PARTICIPANTS

Cai von Rumohr *Cowen and Company - Analyst*

Robert Spingarn *Credit Suisse - Analyst*

Myles Walton *Deutsche Bank - Analyst*

Richard Safran *Buckingham Research - Analyst*

Robert Stallard *RBC Capital Markets - Analyst*

Carter Copeland *Barclays Capital - Analyst*

PRESENTATION

Operator

Good day and welcome to the L-3 Communications first-quarter 2015 earnings conference call.

(Operator Instructions)

Please note this event is being recorded. I would now like to turn the call over to Mr. Mahmoud Siddig from Joele Frank. Mr. Siddig, the floor is yours, sir.

Mahmoud Siddig - Joele Frank - IR

Thank you. Good morning and thanks for joining us for L-3's first-quarter earnings conference call. With me are Michael Strianese, Chairman, President, and Chief Executive Officer, and Ralph D'Ambrosio, Senior Vice President and Chief Financial Officer. After their formal remarks, Management will be available to take your questions.

Please note that during this call, Management will reiterate forward-looking statements that were made in the press release issued this morning. Please refer to this press release, as well as the Company's SEC filings for a more detailed description of factors that may cause actual results to differ materially from those anticipated. Please also note that this call is simultaneously broadcast over the Internet. I would now like to turn the call over to Michael Strianese. Mike, please go ahead.

Michael Strianese - L-3 Communications Holdings Inc - Chairman, President & CEO

Great. Good morning and thanks for joining us for L-3's first-quarter 2015 conference call. This quarter we had solid funded orders and positive cash flow. Our book-to-bill ratio of 1.06 for the quarter reinforces our growth strategy and outlook for the full year, where we expect our 2015 book-to-bill ratio to be approximately 1.

We continued to execute and deliver operational performance on the majority of our programs. However, we experienced additional cost growth on international head-of-state aircraft modification contracts due to supplier issues causing schedule slip and substantial rework. We also had continued delayed contract awards in our NSS segment, both of which impacted our first-quarter performance.



We have recently integrated our Platform Systems business into our ISR Systems sector to strengthen management and enhance multiple skill sets to improve program performance at Platform Systems. There were a number of key competitive wins that would not be possible without the efforts of our employees and our Management team, and as always, I thank them for their consistent hard work, especially in focusing on our strategy of expanding our international and commercial footprint.

The fundamental growth drivers of our business remained strong during the first quarter. We had net sales of \$2.7 billion for the quarter, a decrease of just over 8% compared with the 2014 first quarter. Net sales to international and commercial customers, as a percentage of consolidated net sales, increased slightly from 29% to 30% year-over-year. Adjusted diluted earnings per share were \$1.43, down from \$1.90 in the first quarter of 2014; this excludes an \$0.18 charge related to the sale of our Marine Systems International business.

During the quarter we generated net cash from operating activities of \$87 million. This is an improvement over the first quarter of 2014 when we used \$62 million in net cash. Funded orders for the quarter were \$2.9 billion, a 4% decrease year-over-year. Funded backlog increased about 1% to \$10.3 billion compared to \$10.2 billion at year-end 2014.

Investment in our business remains a priority and we have increased our focus on technology and investment. We will continue this with the expectation that IRAD will constitute close to 2.5% of 2015 revenues. Importantly, we are yielding innovative results, particularly in the area of classified programs, where we are delivering new capabilities and product to our customers.

Across L-3's business, we continue to focus on pay loads, not platforms, as an approach to upgrade and enhance our customer offerings and to provide the best technology available. This keeps us well-aligned with DOD initiatives like Better Buying Power 3.0. Several of our key wins in the quarter, including our Photonics Mast work on Virginia-class sub marines and advanced displays selected for the US Army's Black Hawk helicopters are examples of this approach.

In keeping with our strategy, we are taking the appropriate actions to enhance our ability to anticipate and effectively address customer priorities and to promote growth. As we remain focused on our core businesses, we continuously bolster our profitability through better integration and collaboration across the Company to both reduce costs, as well as increase productivity.

The integration of Narda and the recently acquired MITEQ business into our communications systems business is proceeding on pace and is a good addition to that segment. And the sale of our Marine Systems International business has received the necessary regulatory approvals and is now on track to be completed in the second quarter.

We recently sold our broadcast sports business to a private equity firm. Though small, this disposition is consistent with our strategy to continuously evaluate our portfolio and divest non-core businesses to strengthen our core businesses and better position to us capture growth opportunities. These divestitures demonstrate our focus on building our core business, improving margins, and enhancing our future growth profile. Each of these transactions is evidence of our disciplined business portfolio strategy.

On the acquisition front, overall M&A activity levels in our markets are increasing. We fully expect to continue to add to our portfolio with a view towards expanding our business base and delivering value that addresses our customer priorities. We are attuned to the industry and market conditions; we have a proven strategy in place with a focus on increasing market share and staying agile to take advantage of growth opportunities.

Now I will make some brief comments on our business segment performance and touch on significant awards and milestones. First off, in Electronic Systems, which is our largest segment, we continue to seek out new opportunities to gain market share. We've been focused on increasing margins in this area as well.

Nearly one-half of this business is international and commercial, and it is growing. We received ongoing orders and funding in the quarter for a wide range of project, including the Ship-to-Shore Connector, Hercules engines, and our security and detection systems products. This includes an order for our ProVision 2 screening systems for the TSA.



Link UK continues to increase its customer base with an award to provide Boeing 787 training devices to Virgin Atlantic Airways. We were recently awarded a contract for our unique Photonic Mast. This is a significant win for L-3 and provides the US Navy with new stealth technology for submarines.

In support of the Navy's ship modernization program, we were selected to provide a variety of services aimed at increasing readiness and reducing maintenance and work load requirements. This also positions L-3 for a range of similar international pursuits. We were awarded a contract by US SOCOM for binocular night vision devices and we are seeing ongoing strong orders for our ENVG equipment, weapon sights, and illuminator equipment for our Italian military customer.

We have been selected to provide the multi-function display for a digital cockpit upgrade for the US Army's UH-60L to the UH-60V configuration Black Hawk helicopters. We will provide our newest generation 10.4-inch digital electronic instrument displays for the UH-60V cockpit, replacing the older analog gauges.

We have a variety of products tailored to the law enforcement marketplace and recently introduced our body vision camera to complement our line of in-car recording and data management systems. Notably, we're responding to increased customer interest from police departments across the country. We were selected to provide dynamic unit hybrid replacement units to the US Army's Paladin and Paladin Integrated Management programs.

Our WESCAM business serves a global base of military, government, and public safety customers and orders remain strong. This quarter we were first to market with a 10-inch stabilized turret, complete with new electro-optic capabilities and daylight spotter cameras. This new innovation is targeted for law enforcement and public safety customers.

In our Aviation product sector, we are expanding our international footprint and advancing our investment with a new MRO facility in India. For Aerospace Systems, we're focused on an agile, low-cost provider and first to market with innovative technology. While this business has faced the Afghanistan draw down and sequestration, it is well equipped to address the US DOD need for low-cost, quick-reaction fleet upgrades.

In a significant international win for the quarter, we were selected to provide mission data management systems for two maritime surveillance aircraft for the Japanese Coast Guard. We received upgraded funding to support the Army fixed-wing ISR aircraft as part of the Constant Hawk program and received continued funding for our P-3 work and a variety of legacy ISR programs, including Project Liberty. We also received funding for wideband SATCOM and mission communication systems for National Command assets, using our Airborne Information Management System.

For Communication System, where we have a solid legacy of performance across those businesses, we had a number of long-term wins in this area. We're investing in A2/AD and communication-focused initiatives and are concentrating on margin improvement and manufacturing efficiencies.

During the quarter, we received an order for network communications and data storage products in support of the B-52 upgrade program. We received funding for a variety of legacy programs including Rover, WIN-T, and the Advanced Hawkeye program called Gray Eagle. We also received orders for our Traveling-Wave Tubes for both satellite and missile programs.

Australia remains a strong market for Communication Systems. We support several Royal Australian Navy programs, and very recently, we were selected to supply high-performance wide-band global SATCOM-based SATCOM terminals to the Australian Defence Force.

L-3 GCS is leading this program, and as part of a collaborative effort, we are also providing our Network Centric Waveform modem, which will enable the Australian forces to capitalize on the special features and benefits of the WGS satellite for the first time. We're pursuing additional key new business opportunities internationally, including one in South Korea, for Unattended Ground Sensors.

Next is NSS. In the context of this environment, NSS secured several strategic competitive awards during the quarter. As noted in the earnings release, NSS sales have been affected by completed contracts and work scope and budget reductions impacting programs across that business. The draw down in Afghanistan and delayed contract awards were also factors in the quarter.



Margins continue to be a challenge here, especially on new business due to a very competitive marketplace. We won an important recompetes for support of the US Air Force's Network Operations and Security Center. We also won another recompetes for intelligence analysis, language proficiency, and area studies as part of the [CLARET] program.

We received a delivery order for the Special Operations Joint Task Force with deployed communication support and IT work. And we were reawarded a task order under the DIA SIA II vehicle to provide the CENTCOM Joint Intelligence Operations Center with intelligence support, including CI, HUMINT, analytical training, knowledge management, translation, and ISR analytics and architecture as part of a five-year program.

With regards to capital allocation and acquisitions, share repurchases and dividends are a central element of our capital deployment strategy and reflect our ongoing commitment to deliver value to our shareholders. During the quarter, we returned \$158 million to our shareholders, \$100 million in common stock repurchases, and \$58 million in dividends. Also during the quarter, our Board of Directors approved our 11th consecutive annual dividend increase, raising it 8% to \$0.65 a share.

As I mentioned earlier, our acquisition strategy continues to support intelligent and disciplined growth. L-3 exercises a strict set of criteria in evaluating M&A candidates, focusing on companies that enhance our market share, expand our international and commercial opportunities, and provide a good fit with our collaborative culture. Ending sequestration will enable our industry to plan more prudently, especially regarding IRAD, that drives innovation and contributes to our ability to compete. Now Ralph will review the financial data in more detail and then we'll take your questions.

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Thank you, Mike. I'll discuss some details about the first-quarter results, in particular the unusual items and the variances from our outlook. Then I'll review our update to the guidance for 2015, including explaining how our results will improve the rest of this year from the first quarter to our full-year estimates.

Our first-quarter operating income margin and earnings per share were below our expectations primarily because of two items which Mike touched upon and are covered in the earnings release. First, we incurred a non-operating and non-recurring impairment charge due to the decline in the euro of \$0.18 on the net assets for the Marine Systems International business that we're divesting. Secondly, we incurred additional charges on international head-of-state aircraft modification contracts within the Aerospace Systems segment, which reduced EPS by \$0.13. We're especially disappointed by the head-of-state contract losses.

Except for these two items, the first quarter was generally in line or better than our outlook we provided on January 29. Pro-forma operating margin and EPS would have exceeded our first-quarter outlook. Sales of \$2.713 billion were on the low end of our range, primarily due to softer MSI sales caused by the FX changes and the head-of-state contract loss adjustments' impact on sales. Encouragingly, orders were higher than we expected resulting in a book-to-bill ratio of 1.06. Also, cash collections were better than we anticipated, resulting in positive free cash flow for the first quarter.

Our adjusted EPS of \$1.43 for the first quarter excludes the MSI divestiture impairment loss. MSI is not going to be classified as a discontinued operation in our results because the GAAP accounting rules for business dispositions recently changed, but MSI is clearly no longer an element of our ongoing operations, which is why we removed the impairment charge to calculate adjusted EPS.

Regarding the head-of-state aircraft modification charges, they relate to cost growth and schedule slips on two separate contracts with foreign customers, stemming largely from continued custom interior supplier delays, quality problems, and required rework. We expect to deliver one of those aircraft towards the end of June and the other at the end of this year in December. Until we deliver those two aircraft, we'll have lingering risks. We're addressing these contract performance issues at Platform Systems by realigning it with ISR Systems to strengthen leadership and management and to also add stronger program management, engineering, subcontractor management, and operations skill sets.

At the segment level, first-quarter sales and margin for Electronic Systems and Communication Systems were in line with our expectations. At Electronic Systems, sales mix changes, mostly more commercial aviation product sales, offset lower volumes to hold core margin unchanged, and core margin excludes the higher pension expense that we're having this year.

At Communications Systems segment, you may recall that when we reported our 2014 fourth-quarter results, I had explained that we had booked and shipped some high-margin SATCOM terminals sooner than we expected in December of last year. Those earlier shipments lowered the segment's 2015 first-quarter results at Comm Systems. This is only a quarterly timing issue, which lowered the first-quarter segment margin by 90 basis points at Communication Systems. It doesn't impact the full-year estimates or guidance there.

For Aerospace Systems, the weaker first-quarter results summarized to the \$17 million of cost growth charges on those two head-of-state aircraft modification contracts.

And at NSS, sales and margins were lower due to continued delays in booking some high-margin international orders and slowed starts and transitions on several recent new contracts, some caused by competitor protests. These items lowered first-quarter sales and also absorption of overhead and G&A expenses at NSS. On a positive note, NSS had a strong book-to-bill ratio of 1.25 supporting the sequential quarterly sales growth that we expect there the rest of this year.

Lastly, the first-quarter free cash flow of \$47 million was good start for the year, as the first quarter is always our seasonally lowest cash flow quarter.

Moving on to the guidance update for 2015, essentially all the changes that we made to our consolidated and also segment guidance pertain to the divestiture of MSI, which is scheduled to be completed on May 29. So we removed MSI from our estimates for the last seven months of this year. Adjusting for the MSI divestiture impairment loss, which I talked about, our 2015 earnings per share is unchanged with a range of \$7.35 to \$7.65. The additional share repurchases that we'll make using the MSI sales proceeds largely will offset the income removed from divesting MSI.

With respect to consolidated sales guidance, we lowered sales by \$300 million to a range of \$11.45 billion to \$11.65 billion, and that's due to the MSI divestiture. We also raised our consolidated operating margin by 10 basis points to 9.4%, also due to removing MSI. If MSI is excluded entirely from the full-year sales and operating margin, sales would decline only by 2%, and our operating margin for 2015 would be 9.5%.

In terms of our segment guidance update, other than adjusting Electronic Systems for the MSI divestiture, which lowers its sales by \$300 million and raises the operating margin in Electronic Systems by 30 basis points, there are no other changes or items requiring explanation in the updated Electronic Systems guidance. Guidance for the other segments remains the same.

At Aerospace Systems, we held guidance unchanged despite the first-quarter head-of-state aircraft modification losses because we had deliberately planned 2015 with conservatism for Aerospace Systems, and we entered the year with some solid upside opportunities there. We commented on a few of these opportunities over the last few months, and they will happen, and they're enabling Aerospace Systems to maintain its guidance for the full year. These upsides pertain to additional work on the Liberty small ISR aircraft, a profitable contract extension which we expect to receive on the Army's C-12 contract, and generally better contract performance on international ISR Systems contracts.

At Communication Systems, we booked a large international SATCOM terminal contract two weeks ago, and that, with second half ramps up on WIN-T, a variety of Data Links and the Rover terminals will increase sales and margin in the Comm Systems segment the rest of this year. These items are not changes to the guidance, as we had contemplated them in our initial 2015 guidance for Communication Systems.

Finally, regarding our segment guidance, I want to explain how and why we expect NSS sales and margins to increase from the first quarter through the rest of this year. NSS sequential sales volumes will increase by about \$30 million per quarter with the recent new start in contract award that I talked about in my first-quarter comments. And NSS sales are also expected to increase another \$75 million after the first quarter from those higher-margin international and commercial sales orders.

On the margin at NSS, we expect three drivers to increase margin from 4.5% in the first quarter to our full-year guidance midpoint of 6.7%. First, the higher-margin international commercial sales adds about 120 basis points. Secondly, the increased sales volumes that I talked about will add another 60 basis points. And finally, higher award fees that we expect in the second half of this year adds the remaining 40 basis points to margins, and on the award fees, as you may know, we record them when they're earned; we don't accrue them on a quarterly basis.

The tax rate for 2015 remains unchanged at 32%, and it continues to assume no federal R&E tax credit. That's an important credit for L-3. If it gets reenacted, which we expect will happen at some point -- it may not happen in 2015, but we expect to have an R&E credit in the future -- in any event, if it does get reenacted, it lowers our tax rate by about 220 basis points and would increase our EPS by about \$0.24. We continue to expect to generate free cash flow of about \$925 million, and that's despite the MSI divestiture, so our free cash flow per share will exceed \$11 per share in 2015, and that will provide a cash flow yield north of 9%.

With respect to our capital allocation, we are increasing our estimated share repurchases by \$300 million to \$800 million, as I talked about for the MSI divestiture proceeds. After we make those share repurchases, and also pay our dividend, we expect that we'll end this year with about \$750 million of cash, so we'll have flexibility for more capital deployment. For the full year, we still expect a book-to-bill ratio of approximately 1.

With respect to our second-quarter outlook, we expect sales to be in the range of \$2.8 billion to \$2.9 billion, margin in the high 8% range, EPS between \$1.60 and \$1.70, free cash flow approximately between \$100 million and \$200 million, and a book-to-bill ratio of 1. So to conclude my financial review, the DOD budget is stabilizing and will likely increase beginning in FY16.

Although our first quarter was a slow start for the year, our order flow is improving and we expect our financial performance to improve sequentially, especially in the second half of this year. We continue to generate robust cash flow and we'll continue to allocate capital to increase shareholder value. Thank you. We'll now begin the Q&A.

QUESTIONS AND ANSWERS

Operator

Thank you, sir.

(Operator Instructions)

The first question comes from Cai Von Rumohr of Cowen and Company. Please go ahead.

Cai von Rumohr - Cowen and Company - Analyst

Yes, thank you, Ralph. Could you give us a little more color on the international head-of-state? You mentioned you are going to deliver the last two vehicles June and December and that there's still some risk. What is the risk? Is the risk that you're not getting the equipment at the correct time from the supplier? Is it a quality issue? What's the problem, and maybe define the risk a little bit more?

Ralph D'Ambrosio - L-3 Communications Holdings Inc - SVP & CFO

Okay, so those are, as I said, two separate contracts, and as I explained, they both realized schedule slip in the first quarter. On the first aircraft, the schedule slipped by about 1.5 months and on the second one, by about three months. The risk that I talked about is, it's an inherent risk, simply for the fact that we've experienced cost growth on these contracts along with the schedule slip for the reasons I talked about.

Therefore, until we actually deliver these aircraft, I can say that there's a risk. I think we're managing that risk accordingly. We've bound it and provided for it appropriately in our contract estimates, but there's inherent risk there that doesn't go away until we deliver the aircraft, Cai, so that's what I meant by that comment.

Cai von Rumohr - *Cowen and Company - Analyst*

Okay, thank you. And then a second one. Even though you expect to end the year with \$750 million in cash, you didn't take down your debt and you talked about more M&A potential. What are you seeing? Are you seeing more good deals? Could we get big ones? Give us some color there?

Michael Strianese - *L-3 Communications Holdings Inc - Chairman, President & CEO*

Cai, we're seeing more volume of deal flow. And for us, the things that are attractive are typically in our Electronic Systems area that augment businesses we are already in, and will add either capability, technology, additional customers, the things we know well. They're modest size, in the \$100 million to \$200 million neighborhood I would say, but there's just a number of them we're working through. It's different than it has been the last couple of years in terms of the quantity of things we're seeing.

Cai von Rumohr - *Cowen and Company - Analyst*

Okay, great. Thank you very much. you're welcome.

Operator

Next we have Robert Spingarn of Credit Suisse.

Robert Spingarn - *Credit Suisse - Analyst*

Good morning. Mike, on that last one, with regard to portfolio shaping, especially in light of some of the things that have been happening lately and some of the pressure at NSS. I understand Ralph said the bookings -- book-to-bill is positive, but where are you on portfolio shaping? How has that evolved?

Michael Strianese - *L-3 Communications Holdings Inc - Chairman, President & CEO*

We've had two divestitures so far, the Marine Systems International, as well as the smaller broadcast sports.

Robert Spingarn - *Credit Suisse - Analyst*

Right.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman, President & CEO*

And we work our way through it every year, methodically, looking at the prospects for the business. I gather your question is towards looking at NSS.

Robert Spingarn - *Credit Suisse - Analyst*

NSS and logistics?



Michael Strianese - *L-3 Communications Holdings Inc - Chairman, President & CEO*

Logistics, we've had some new contract activity with our C-12 customer that we need to get settled before we do anything there if, we're going to look to transact that business. I'm not saying we are at this point, but we have a renewal at a much better rate, and we have the potential to settle some claims from the prior contract that gave us all the trouble last year so we need to get that behind us before we even start to think about that.

NSS has been slow because of the lag in some of these international contracts starting, which would have provided additional volume and higher margin. Whether or not to portfolio shape NSS is going to be driven by what kind of a price we could get, and that's going to be driven by whether there's growth in that business and what the margins are going to be, which are dependent on some of these new orders. So they're both in play a little bit, but this is something that's going to be looked at as the year develops and not tomorrow.

Robert Spingarn - *Credit Suisse - Analyst*

Okay. And then just to follow on with that for Ralph, on NSS, you talked about \$30 million in sequential revenue growth, which would be all added together about \$180 million over the last three quarters to get to the guidance. You got \$60 million of that with the high book-to-bill on the quarter. Where do you bet the other \$120 million? Do you expect continued book-to-bill to be strong here over the next -- is it continuing to be positive in April?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

We expect the book-to-bill for the year NSS to be above 1, probably about 1.05. And the second quarter, depending on how -- the timing of some of these order flows, we could be close to 1. What I talked about was that in the second half of last year, we won a number of new contracts in the intelligence community space, and not unexpectedly, most of those contract wins were protested by losing competitors.

That had the impact of not only slowing down the actual awards, but also slowing down when we start and begin to transition on these contracts. So those protests were all resolved in our favor, either just before the end of last year or in the first quarter. So now we're transitioning on those contracts, and there's ramp-up on them until you get to full run rates and so that's where the additional sales comes in each of the quarters that I talked about.

Robert Spingarn - *Credit Suisse - Analyst*

Okay. Just a clarification, Ralph, separate. In Aerospace have you eaten all of your cushion now, that you had built in there, given what happened in Waco? Meaning, any incremental trouble in Waco is downside?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

If we have some incremental trouble there, we have other opportunities elsewhere in the segment to offset it. That \$17 million of additional charges in the first quarter definitely ate into or consumed a lot of the upside that we were managing for. That's how I would characterize it.

Robert Spingarn - *Credit Suisse - Analyst*

Okay, thanks.

Operator

Myles Walton, Deutsche Bank.



Myles Walton - *Deutsche Bank - Analyst*

Question for you on the C-12. You described it as running through July and I know you talked about the favorable resolution to the amended contract. Is that all done and good so that it kicks over in August to this new profit booking contract and we have full clarity on that?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Given that it's the end of April, we're talking to the Army about it. We haven't received the extension yet, but we will receive an extension. It's a very important contract for the Army, so it's not a kind of thing that you can stop working on it when you get to the end of our existing contract on July 31.

So the extension, we anticipate, will start immediately on April 1 and go through at least the end of this year, August 1st, that is, go through the end of this year for at least six months, and probably longer. So based upon our latest performance evaluations in the contract, we're doing really well, and the Army is very pleased with our performance.

Myles Walton - *Deutsche Bank - Analyst*

The risk I'm curious on is what about the pricing dynamic. Can they extend it on the current pricing terms, or have you already--?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

No. It will be a new contract with new terms and conditions, including pricing. It cannot be extended on the existing contract terms, which are the ones that have been producing losses for us, and still are, for that matter.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman, President & CEO*

It will represent more reasonable normalized margins for that type of work in this segment, Myles. When I made the comment that it is going to be extended, it's going to be extended on terms that we would consider favorable.

Myles Walton - *Deutsche Bank - Analyst*

Okay. Then the other question I had for you was on the -- you said the two separate questions, one that you would finish in June, the other at the end of the year. Was one more of the attribute of the charge? Was three-month slip proportionally twice as big as the 1.5 month slip?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

The one with the larger slip had more of the cost growth, so obviously the contract where we expect to deliver it toward the end of June was the earlier contract that we've been work on for a longer period of time. We actually booked that contract at the end of 2010, inducted the aircraft in November of 2012, and that's when the bulk of the work starts to happen, after we get the aircraft and we start to work on it.

The second contract, we didn't book until early in 2012, and we inducted the aircraft there in July of 2013. So there's more work to be done, but what we're doing is we're factoring in some of the recent experience that we've had on the first one, on the second one, and that's what's driving more of our conservatism and cost increases on the second one.



Myles Walton - *Deutsche Bank - Analyst*

Okay Last one, still on the same topic. The new Management looks at the existing book of business and I imagine takes a finer comb-over of whatever your current backlog of these aircraft modernization programs are. Is there a risk that, using that finer comb, that they actually go through a bigger deep dive of the existing backlog, or is there further backlog?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

We expect there to be a finer comb used. I wouldn't call it a risk. It's prudent. That's something that's happening as we speak, but like I said, we calibrated it appropriately. It doesn't mean we can't have more cost growth there. But in terms of other similar contracts, there's only one other one in backlog, which is a newer contract on a different aircraft platform that we're not going to induct until late in August of this year.

So with the new Management team that we're putting in this line of business, plus the leadership changes that I talked about, and the recent experience that we've had on these two contracts, we're going to bring that all to bear on this newer contract, and we expect that we're going to have a better outcome for sure on that third contract. We don't deliver that contract until the end of 2016 or early 2017. But we've also taken a very conservative position on how we're going to accrue those sales and profits, which makes sense, given the recent experience.

Myles Walton - *Deutsche Bank - Analyst*

Yes. Okay. Thanks.

Operator

Next, Richard Safran of Buckingham Research.

Richard Safran - *Buckingham Research - Analyst*

Good morning.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman, President & CEO*

Good morning, Rich.

Richard Safran - *Buckingham Research - Analyst*

I just add real quick question here. I wanted to ask you about share buybacks and M&A, but as it relates to S&P's recently revised outlook here. I wanted to know if you could tell us about any of the discussions you're having here with S&P regarding their outlook, and more importantly, I want to know if you could tell us how this is shaping your thinking about debt reduction, buybacks, M&A, if at all, and how important is this to what you're doing?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

The process that we go through and other companies go through with respect to credit rating agencies are, that you meet with them on a periodic basis, usually annually, and based upon those meetings and the way a company's results have been trending, I'm talking about the credit ratios and credit metrics in this instance here, and they look at what we've been doing. Clearly, we have employed a lot of debt in our capital structure, which for our investment-grade credit ratings are near or above the limit in terms of what the rating agencies like to see, and that's what's being reflected in their outlook changes from stable to negative.

In both instances, the end of February and just yesterday, S&P, end of February was Moody's, they both reaffirmed our ratings, and they're essentially telling us they don't want to see any further deterioration in the credit metrics, and in some cases, some improvement. We're mindful of that. We think we have adequate cash flow and cash to continue to do what we're doing with the capital allocation in terms of the dividends and the share buybacks, and also manage the credit ratings effectively.

The way you do that is, if we make some acquisitions, and to the extent that we did, they would be profitable businesses, which would improve our EBITDA and lower the leverage. That's one way to improve the credit metrics. The second way is that we expect that we're going to have natural organic improvement in our business the next year or so, as we come out of the downturn, particularly with the DOD budgets. And lastly, we could also repay some debt. So we have the ability to use any of those items in order to manage the credit ratings, and that's how we're considering it.

Richard Safran - *Buckingham Research - Analyst*

That's terrific. Thank you.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman, President & CEO*

Thanks, Rich.

Operator

Robert Stallard, The Royal Bank of Canada.

Robert Stallard - *RBC Capital Markets - Analyst*

Thanks so much. Good morning.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman, President & CEO*

Hello, Rob.

Robert Stallard - *RBC Capital Markets - Analyst*

Hi, Mike. You mentioned the improving outlook for the DOD budget. What's the timeline for how this is going to flow through to your various businesses over this year and next year?

Michael Strianese - *L-3 Communications Holdings Inc - Chairman, President & CEO*

I think you said it. It's going to [go through] this year and next year, but pretty much, I would say, the latter part of this year rolling into next year. A lot of the -- the wild card there is to what goes into the OCO account, which is being driven by some of the geopolitical events that you see every day. There is continued demand for ISR assets, whether they're aircraft, the Data Links or cameras that go on them, and as well as support on the ground, whether it be SOCOM or our Night Vision products and the like.

Certainly communication products, very strong demand. So we have the event-driven growth. We have the fact that the budget request is an improvement from where we've been, and the fact that we see real growth starting in 2016; even with sequestration there, there's growth. The trends are changing as we look out. I don't think it will happen overnight, but it should gradually improve over the next 18 months, is our view.



Robert Stallard - RBC Capital Markets - Analyst

Okay. And then as a follow-up on NSS, you mentioned some challenging markets of pricing and margins. Would you say your overall market share has been doing there?

Michael Strianese - L-3 Communications Holdings Inc - Chairman, President & CEO

I'm sorry? Our overall market share?

Robert Stallard - RBC Capital Markets - Analyst

In NSS?

Michael Strianese - L-3 Communications Holdings Inc - Chairman, President & CEO

They're in a lot of different spaces so I don't think there's one composite number that can answer that question, whether it's cyber, intel support, IT support. I don't know that we can give you a very clean, discrete number there that makes a lot of sense.

Ralph D'Ambrosio - L-3 Communications Holdings Inc - SVP & CFO

But Rob, clearly the federal government technical services market is several billions of dollars each year.

Michael Strianese - L-3 Communications Holdings Inc - Chairman, President & CEO

Multiple billion.

Ralph D'Ambrosio - L-3 Communications Holdings Inc - SVP & CFO

Multiple billion dollars. So we have a small market share, which is the case for most companies, even the ones that are a lot larger than NSS. There's no dominant player in federal services that we can discern. I'm not sure if we're answering your question or where exactly you're going with the question, but is that what you're asking?

Robert Stallard - RBC Capital Markets - Analyst

It was really to get an idea of whether you're walking away from work, given how competitive the pricing and the (multiple speakers)--?

Michael Strianese - L-3 Communications Holdings Inc - Chairman, President & CEO

No, we're not necessarily walking away from work. In fact, last year, we won virtually every re-compete that we participated in, and they've done a very good job in the proposal process in winning business against bigger players that are bigger players, period. The performance or the contract execution has been very good. Their CPARS or their ratings have been outstanding.

The hesitancy on this side, which I'm sure you read, is that in the world that we're in, where there seems to be a cyber element in everything, whether it's a communication systems contract or, of course, anything in the IT domain, in many of the places [for the] diversified defense company wouldn't prudent to not after cyber element within the Company. So that's something that we are paying a lot of attention to. Since we do have some



significant capability in that space, you just look at some of the recent wins that we've had with the NSA and other customers, they're well thought of and they do have a unique offering with a very dedicated, skilled workforce. So they do well.

I've thought about in terms of Management, can we take more costs out? We really are running a lean operation, and I attribute it more to the space that they're in and the dynamics in that space, more recompetitions, breaking contracts into smaller pieces, and the fact that there are just a lot of players there that are all scrapping for some top-line growth, and they're willing to bid lower and lower numbers. And better buying power encourages that and the like, so it's a question of the space they're in right now.

You could look at this as a cycle also that this, too, will turn, because I don't know that going to the lowest priced bidder will save the day every time on the customer side. It will probably be the most qualified bidder. And we've been trying to gradually move to higher-margin work, and when you say walk away, yes, we would walk away from work at 3% or 4%, 2% or 3%, if we had to, but we'd like to still get in the DOD focused area of best value, which means putting out best proposal, if you will, or the best quality at the best price.

There's still time to be played out here in terms of whether this trend will change and we could see some improvement in the margins, but having a flat top line or a shrinking top line and shrinking margins at the same time is not a type of business that we would like to participate in. So if that continues, you could assume what our answer is going to be.

Robert Stallard - *RBC Capital Markets - Analyst*

Absolutely. Thanks very much, Mike.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman, President & CEO*

Okay, Rob, thank you.

Operator

At this time, we have time for one more question today, and it will come from Carter Copeland of Barclays. Please go ahead.

Carter Copeland - *Barclays Capital - Analyst*

Hey, good morning, Mike and Ralph.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman, President & CEO*

Hi, Carter.

Carter Copeland - *Barclays Capital - Analyst*

Just a couple of quick ones here. The first, Ralph, with respect to the AS cushion that you used to offset the performance adjustment in the quarter, just to clarify a little bit on that international ISR piece, is that all margin, or is some of that revenue oriented that pushed you up toward the high end of the prior guidance range? And then secondly, just on the award fees you mentioned in NSS and the timing, is there a particular quarter we should expect to see those that you are planning on? Thanks.



Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Okay. The better contract performance that I noted in ISR Systems international is mostly better margin from doing well on the contract performance on a handful of different contracts. But there still are some other opportunities that we're presently pursuing with our SPYDER aircraft, for example, that I still put in the opportunity category, as opposed to we're now assuming it in the guidance, so there are some other opportunities there.

Carter Copeland - *Barclays Capital - Analyst*

With respect to Afghanistan, I know you had sized the potential upside there as maybe \$50 million, \$75 million over the course of the year. That still exists?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

I talked about the additional sales on Liberty, that's about \$50 million.

Carter Copeland - *Barclays Capital - Analyst*

Okay.

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

So we have \$50 million there that I put in the realized category, and now in the guidance update.

Carter Copeland - *Barclays Capital - Analyst*

Okay, great. How about the award fees?

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

And your question of the timing of award fees at NSS, we're going to have our biggest award fee quarters in the third and fourth quarter, and on average, there's about \$3 million more of profit in each of those quarters compared to Q1 and Q2.

Carter Copeland - *Barclays Capital - Analyst*

Great. Thanks, Ralph.

Ralph D'Ambrosio - *L-3 Communications Holdings Inc - SVP & CFO*

Okay.

Michael Strianese - *L-3 Communications Holdings Inc - Chairman, President & CEO*

Okay. To wrap up, we are confident that, as the DOD budget stabilizes, we are well-positioned to take advantage of the growth opportunities that will present. Our strategy of expanding our international and commercial businesses will continue to dampen the effect of the DOD budget uncertainties. Our operational agility and commitment of delivering value are the backbone of our performance.



We will continue to offer affordable and innovative solutions to address customer priorities. We are making strategic investments that promote growth, while optimizing efficiencies, and we believe our business model is stable and well aligned with the current environment. With that, we look forward to speaking with you again in July. Thank you.

Operator

And we thank you, sir, and to the rest of the Management team for your time today. The conference call is now concluded. At this time, you may disconnect your lines. Thank you, and have a great day, everyone.

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