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# EDITED TRANSCRIPT

LLL - Q2 2015 L-3 Communications Holdings Inc Earnings Call

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## OVERVIEW:

LLL reported 2Q15 net sales of \$2.8b. Expects 2015 sales to be \$11.45-11.65b and adjusted EPS midpoint to be \$6.85.



## CORPORATE PARTICIPANTS

**Mahmoud Siddig** *Joele Frank - Managing Director*

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

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

## CONFERENCE CALL PARTICIPANTS

**Robert Spingarn** *Credit Suisse - Analyst*

**Cai von Rumohr** *Cowen and Company - Analyst*

**Myles Walton** *Deutsche Bank - Analyst*

**George Shapiro** *Shapiro Research - Analyst*

**Noah Poponak** *Goldman Sachs - Analyst*

**Robert Stallard** *RBC Capital Markets - Analyst*

**Richard Safran** *Buckingham Research - Analyst*

## PRESENTATION

### Operator

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

(Operator Instructions)

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

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### Mahmoud Siddig - Joele Frank - Managing Director

Thanks, Mike. Good morning. Thanks for joining us for L-3's second-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 the factors that may cause actual results to differ materially from those anticipated.

Please also note that this call is being simultaneously broadcast over the internet. I would now like to turn the call over to Michael Strianese. Mike, please go ahead.

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

Thank you, and good morning everyone. Thanks for joining us for our second-quarter conference call. I recognize that there are items that stand out in the quarter, and we'll discuss those in detail. We are disappointed with the second-quarter results, but we are actively working through them and we're confident that we have the right strategy in place to drive continued value. There are a number of bright spots as well. Our fundamental



growth drivers remain in place, as we ended the quarter with a book-to-bill ratio of 1.01, or \$2.8 billion in funded orders, supporting the improvement we expect to see in the second half of this year.

L-3 remains well positioned. We are transforming our business portfolio to sharpen our focus on the defense electronics, communications and ISR markets where we have market-leading positions. We are intensely focused on capturing new opportunities and executing on our programs. We will accomplish this by investing in areas of the market that we know well and leveraging our strong cash flow to support our growth initiatives, as well as returning capital to shareholders. We believe we have the right strategies in place to drive profitable growth and shareholder returns. We're also confident that we are near the end of the shrinking DoD budget environment and expect an inflection point starting next year. This will obviously support the growth of our business.

Before I turn to our results, let me touch on an important step we are taking in our portfolio-shaping strategy. This morning we announced that we are exploring strategic alternatives for our national security solutions business. Our strategy of building market-leading business positions in areas where we can generate higher margins and force the sales growth and returns for shareholders remains a central theme for us at L-3. While NSS has performed well for their customers in this challenging environment, we believe that the improving DoD budget presents better capital deployment alternatives for us. The strategic review of NSS is well underway, and we expect to make further announcements at the appropriate time.

Turning to our aerospace systems business, we continued to have challenges with our three Head of State aircraft programs, resulting additional cost growth of approximately \$84 million. As we stated last quarter, there is risk remaining on the contracts, and during the second quarter we experienced new challenges that impacted the schedule and increased our estimated cost to complete the work. We have addressed leadership and program management, and continue to work with our customers to deliver the aircraft. We've made a number of site visits to the facility and are dedicating significant attention and our best resources to these programs. Recently I had the opportunity to meet personally with one of our customers to assure them of our focus and update them on our work. Bottom line, this is a complex program. We have more to do, but we have our arms around the issues and are taking the necessary steps to address them. Ralph will discuss the second quarter charges relating to these issues in more detail later.

Turning to our second-quarter results, we had net sales of \$2.8 billion, a decrease of about 7% compared with the 2014 second quarter. During the quarter we generated net cash from operating activities of \$227 million. This is a decrease from the second quarter of 2014 when we generated \$277 million in net cash. Funded orders for the quarter were \$2.8 billion, which was about a 14% decrease year over year. And we ended the quarter with about \$10 billion of funded backlog. As I will discuss later, our mission integration division within aerospace systems continued building on its strong track record of excellent program performance. During the second quarter we delivered large complex ISR aircraft on budget and ahead of schedule for DoD and international customers. From a business generation standpoint, we secured key contracts across all of our segments, making continued progress repositioning our portfolio and achieving efficiencies at our business units.

As evidence of our disciplined portfolio-shaping strategy, we recently announced that we expanded our commercial aviation training solutions business through the acquisition of CTC Aviation Group. This acquisition, which is immediately accretive to our operating results, fits squarely within our strategy to expand our international and commercial presence in key markets by focusing on higher margin businesses with number one and number two positions, and with the strongest prospects for future growth. Though I can say for this particular acquisition, the margins are expected to be about double the margins of the entire electronic systems group. So we're very pleased with the prospects for CTC. And it's an excellent fit for us. In addition, our CTC acquisition extends our commercial aviation business and allows L-3 to offer enhanced worldwide capabilities through a broader portfolio of training devices and delivery systems, as well as scalable training solutions. This represents an important growth opportunity for us, given the well-recognized shortage of new commercial airline pilots around the globe. We also completed the divestiture of our MSI business during the quarter, which will result in improved margins and free up capital to be reinvested in higher growth, higher margin opportunities. As we move into the second half of the year, we will continue to actively pursue additional acquisition and portfolio-shaping opportunities. As always, our goal is to complement L-3's existing businesses with new acquisitions that expand our market share, broaden our offerings and bring us new customers. We are actively looking at businesses that will meet these criteria.

We're also continuing to invest in our core businesses, as well as developing promising technology that fit our customers' evolving requirements and enable L-3 to penetrate new markets and upgrade our product offerings. By doing so, we will leverage our strong cash flow, including returning

more capital to our shareholders. We are increasing our strategic investments in defense electronics, simulators and training, as well as solutions to carry the ever-increasing anti-access area denial threats from near-peer adversaries. We are focusing resources to be consistent with the third offset strategy and Secretary Kendall's long range R&D planning program. We expect that IRAD will represent close to 2.5% of our 2015 revenue, reflecting our commitment to investment in areas related to our core businesses. Importantly, we are yielding innovative results, particularly in the area of classified programs where we are delivering new capabilities and products to our customers and pursuing new business opportunities. Along those lines, L-3 has been partnering and collaborating with other innovative private sector technology companies in order to provide the war fighter with the latest technology systems that could be trusted and are effective in a wide range of operational contexts with the ability to respond to changing conditions. Given the global threaten environment, what we're seeing is reconfigurable systems win the day. And that's where we are focusing.

I'd now like to make some brief comments on each of our business segments and touch on some important awards and milestones. In electronics systems, our largest segment, we made progress in securing new business and continue to gain international and commercial market share. A great win for us in this space was the competitive award for the delivery of three A320 simulators and one 787 simulator for Hainan Airlines in China. We also received a five-year contract to deliver Block 4 low-profile photonic mass for Virginia Class subs. This key win helps L-3 maintain its position as the supplier of this critical technology and creates additional opportunities to work with allied navies. Additionally, we had a strategic win to supply a ship set and circuit breaker for a naval customer in the Republic of Korea. We were also awarded a contract to provide integrated platform management systems to the frigates in the Taiwanese Navy. Lastly, sales of west cam turrets remain robust, with new orders for the MX10 units from the US Army, Airbus and the Royal Saudi Air Force. Overall, we're pleased with the performance of this segment and continue to make progress improving our margin profile.

In the aerospace systems segment, I have high confidence in our team and expect we will see improving performance and execution in this segment going forward. In fact, I'm pleased to report that we recently received a contract extension from the US Army on the C12 program. This extension becomes effective August 1 and has new terms that are profitable for L-3. We also received additional funding for a number of programs, including the Gorgon [Stamp] program, the Spider program in Saudi Arabia and the C27J program in Australia. We will remain focused on improving performance in this segment, delivering for our customers and increasing market share in core margins across the business.

In our communications systems segment, we had a strong quarter and are continuing to work on both margin improvement and technology development. We have a solid domestic military business and received continued funding for legacy DoD programs including Hawk Link, Win T, Rover and Global Hawk. And we also received a new contract on a cyber program for the Army Intelligence Center of Excellence.

In the space domain we secured a contract to supply the traveling wave tubes on the M-RAM CECA through 2018. As we have noted in the past, L-3 is one of only two global suppliers capable of performing this work. We also received an award to develop a new sat com modem for the E4B aircraft. This will be another critical piece of L-3's offering in the senior leader continuity of government communications suite for the DoD. And our international business is expanding in this segment, with Australia as a key market. We're doing advanced communications work on two key naval programs that creates the opportunity for L-3 to become the maritime integrated communications systems provider of choice for this customer. The recent expansion of our sat com business in Australia establishes L-3 as the leading supplier of man-pack through 2.4-meter size sat com terminals for the Ministry of Defense's wide-band global sat com, or WGS communication system. In Canada we made initial penetration into a large potential maritime market to provide communications for six arctic offshore patrol ships for the Royal Canadian Navy.

Within the national security solutions segment, results were primarily impacted by the continued delay of some international contract awards. That said, NSS has a well established reputation for performance through decades of serving customers successfully. We had some notable contract wins in NSS during the quarter, including the Royal Saudi Air Force air operation center training contract. This contract represents a foreign military sales IDIQ opportunity, under which L-3 will provide air operation center training to personnel in Saudi Arabia for a five-year performance period. We also won an international biometric contract. Finally, we received notice that a protest of the JIOC task program was resolved in our favor.

Shifting gears, let me update you on our outlook for the remainder of 2015. As I mentioned earlier, we expect to see increasing momentum in the second half of the year. We continue to operate in a challenging macro environment related to budget uncertainties which impacts our business; however, we're seeing clear signs that the downturn is approaching bottom and the DoD budget is either stabilizing or on an upswing. In fact, we anticipate an acceleration in the contracting environment as the government fiscal year closes. Regardless of the industry dynamics, we are



committed to delivering value to shareholders and to deploying capital in ways that contribute to that goal. Share repurchases and dividends continue to be a key component of our capital allocation strategy. And during the quarter we returned almost \$300 million to our shareholders. \$246 of it was in the form of common stock repurchases with the balance in dividends.

As always, we continue to evaluate M&A opportunities. We're looking for ways to expand our international and commercial footprint as well as our DoD business to capitalize on the expected uptick in the defense budget. Taken together, this will provide even better value to our customers by offering a broader range of innovative products. This improving environment is creating opportunities to redeploy capital into higher valued areas. The sale of MSI along with the acquisition of CTC are an example of the strategy. Likewise, our evaluation of strategic alternatives for MSS is another effort. This will further strengthen our core business, improve our margin and sales growth profiles and generate strong cash flow for the Company.

We will make further announcements regarding the NSS process at the appropriate time. With that, I'll turn the call over to Ralph to review the financial data in more detail. And then we'll be happy to take your questions. Go ahead, Ralph.

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

Thank you, Mike. I'll discuss some details about the second-quarter results, including unusual charges, and then review our 2015 guidance update. However, before I review those items we had several positives in the second quarter and I want to quickly cover a few of them. First, we had another solid quarterly book-to-bill ratio, setting us up for the second half to return to profitable organic top-line growth. Secondly, we had improving top-line and healthy core margin performance in electronic systems, communication systems, and the ISR system sector in aerospace systems segment which comprise the businesses where we want to -- where we intend to perspective focus the portfolio. And third, we generated robust cash flow of \$183 million in the second quarter.

That said, adjusted earnings per share was \$1.41 with the operating margin of 5.9% for the second quarter. And second-quarter sales, operating income margin and EPS were below what we expected because of the \$103 million of charges at the Platform Integration division in aerospace systems segment, which lowered EPS by \$0.77. Income tax gains totaling \$0.43 of EPS partially offset those charges. These items together caused a net reduction of \$0.34 to EPS and 350 basis points to operating margin.

The contract charges of platform integration division primarily relate to the additional losses of \$84 million on the Head of State aircraft modification contracts. When we reported our first-quarter results we were expecting to deliver one aircraft at the end of June and the next by the end of December. And at that time we explained that until we delivered those aircraft we had lingering inherent risks. During the second quarter we completed certain ground and flight tests, customer inspections on the first two aircraft, which revealed significant additional and more extensive rework. And on the third aircraft we completed a series of design reviews. Consequently, the delivery dates for each aircraft has slipped an average of 10 months and the estimated cost to complete those three contracts have increased by \$84 million in the aggregate. To be clear, we're really disappointed by the size of the additional cost growth charges on the Head of State contracts. However, the Head of State contract performance problems are transitory. We will eventually complete the interior modifications and deliver those aircraft, and they will be high quality aircraft. More importantly, while the second quarter charges are very painful, they will not continue to disrupt the Company's financial performance because Head of State aircraft modifications comprised a very small sporadic part of our business base. To provide you some more context, the Head of State modifications contracts usually have sale prices of about \$150 million per contract with periods of performance of about four years. It is not steady, recurring annual business. Procurement cycles are usually 10 years or longer. Thus, Head of State modifications comprise less than 1% of our annual consolidated sales.

Moving onto second quarter segment results. Sales and operating margin for electronic systems and communication systems were ahead of our expectations, and aerospace systems would have also exceeded our expectations if it were not for the platform integration division charges. The NSS segment performance continued to lag our estimates for the second quarter.

At electronic systems organic sales growth was minus 1% with solid operating margin of 11.5%. Favorable sales mix, due mostly to more commercial aviation product sales, largely offset our unusual charges of \$14 million in that segment. We incurred an incremental charge of \$8 million in anticipation of a settlement for a product specifications matter with the US government pertaining to our EOTech holographic weapon sites. And

at the end of June we received an adverse arbitration ruling of \$6 million stemming from a dispute with a non-performing supplier that we terminated back in 2011.

For aerospace systems segment, excluding the \$103 million of contract cost growth charges at platform integration, operating margin would have been about 8% driven by continued strong program performance at ISR systems sector where the margins exceed 10%.

At communication system segment, top-line pressures began to abate during the second quarter, with sales only declining about 4% and operating margin was a very healthy 10.4%, tracking higher than our full-year estimates. We had better margin performance in both broadband communications and advanced communications.

And at NSS sales and margins were again lower than what we expected due to continued delays and booking of select high margin international commercial work, which had similarly impacted the first-quarter results. Encouragingly, we booked some of those new contracts in late June and in July, but these awards were not soon enough to benefit the second quarter. To this point NSS had another strong book-to-bill ratio of 1.21 for the second quarter, supporting the sequential sales growth that we expect to realize there in the second half of this year.

With respect to the guidance update for 2015, substantially all the changes relate to the second-quarter contract cost growth charges at platform integration, mostly in the Head of State contracts and the unrelated tax gains in the quarter. We lowered our 2015 adjusted earnings per share guidance by \$0.65 -- or 9% to a new midpoint of \$6.85. And with respect to sales, we maintained the guidance range of \$11.45 billion to \$11.65 billion which now includes an increase of \$50 million at electronic systems for the CTC Aviation Group acquisition that we completed on May 27. And it also includes a \$50 million sales decrease at aerospace systems due mostly to the Head of State contract adjustments. If you pro forma the MSI divestiture, our full year consolidated sales are expected to decline about 2%, and adjusting for all acquisitions and divestitures, we expect organic sales to decline about 3% versus 2014.

In terms of our segment guidance update, other than the aerospace systems adjustments there are no other major changes or items that require explanation. So I'll leave those for the Q&A to the extent that you have any questions on those. But I will say that regarding NSS segment guidance, we still expect sales and margin to increase in the second half of the year, and there is risk there related to some of that high margin international commercial orders which we expect to add about \$60 million to sales and 170 basis points to operating margin for the year in the segment. The remaining increases in the second half of this year versus the first half at NSS pertain to sales volumes of about \$80 million on new program ramp-ups for which the contracts are in backlog, and higher award fees, each of which will add about 40 basis points to full-year NSS margin.

With respect to free cash flow, we lowered our estimate for the year by \$75 million to \$850 million, primarily due to the Head of State contract issues. In addition to estimated cash outlays of about \$40 million for the cost growth charges that will incur in the second half of this year on those programs, we had about \$50 million of cash collections that were tied to delivering the first two aircraft this year, and those collections have slipped to 2016 and 2017. We expect our free cash flow to return to over \$900 million in 2016.

With respect to our capital allocation, we are still assuming \$800 million of share repurchases for the year. During the first half we repurchased \$346 million, leaving about \$450 million for the second half of this year. We are now planning to repay about \$300 million of debt in the fourth quarter, and that is because we are committed to preserving our investment-grade credit ratings. We still expect the full year book-to-bill ratio to be approximately 1.0.

So I'd like to conclude my financial comments by summarizing with the fact that the DoD budget is stabilizing and will likely increase beginning in FY16 which begins in a few months from now. Although our first-half results were disappointing, order flow was solid and encouraging. And we have several bright spots in our key business areas. We expect our financial performance to improve significantly in the second half of this year, and we'll continue to generate robust cash flow and effectively 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 we have comes from Robert Spingarn of Credit Suisse. Please go ahead.

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### Robert Spingarn - Credit Suisse - Analyst

Good morning, Mike and Ralph.

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

Good morning.

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### Robert Spingarn - Credit Suisse - Analyst

Mike, a high level question. And I don't mean to put you on the spot. But at the same time it sounds like there is some better context would be helpful here. You've always had strong performance. This Company has had a very strong track record. This year's gone a little bit awry. And I'm just wondering, when you look at the Company's performance, particularly to shares over the past year, there's really a bit of a difference relative to peers. In thinking about what's happened at aerospace systems and NSS, is this a bunch of blocking and tackling on small things, or are there some larger strategic fixes that you can apply?

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

Well Rob, there's a central theme. L-3 is a great Company. We're a strong Company, well positioned to succeed. I appreciate your comment.

It is certainly very unlike L-3 to have cost growth or execution issue on a program like we're seeing. But I can assure you, we're very focused on it. Where necessary, we've changed the management. We, in general and me in particular who have been at this business unit several times over the last month or so, have our arms around the issues and we're addressing them head on.

I spent last week doing a lot of travel and visiting the customer in person, just to make sure that we are communicating clearly as to how we're proceeding. And resolving this is going to be a bit of a matter of time but we will resolve it. And there's a lot of great things happening around the Company, and I don't want everybody to lose sight of that, including some very proactive portfolio shaping. At the end of the day we expect to have a leaner, more profitable L-3 with a much better growth profile when we're done with the portfolio shaping. And we'll continue to be a market leader in our businesses that will be focused on defense electronics, our communication systems, as well as ISR. So I think we have the right plan and we will execute it.

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### Robert Spingarn - Credit Suisse - Analyst

Just looking specifically at aerospace systems, really a question for both you and Ralph. First, when you talk about new management, are you referring to what you did back a year ago or are you talking about incremental changes now? Are there -- are we talking about a single customer here with this particular contract? It sounds like this all started in the March quarter. And then for Ralph, what are the normalized margins for this business going forward? Thank you.



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

All right. Well let me address the management issue first with you, Rob. Yes, we did have changes last year. However, in the, say, I guess it was early second quarter we did appoint a new group executives -- executive in aerospace systems. And then as a result of addressing the issues that are focused on this particular, or these particular programs, we changed program management and a bunch of functional leads in that area. So we've made every change we thought was appropriate and necessary, and brought stronger resources to the table, if you will. Your question regarding the customer is, this is two customers. And that's kind of all I can tell you on that at this point.

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**Robert Spingarn** - *Credit Suisse - Analyst*

Then on just on the -- Ralph how do we --

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

Ralph you want to address -- thank you.

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

So, hi, Rob.

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**Robert Spingarn** - *Credit Suisse - Analyst*

Good morning.

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

So aerospace systems, if you look at our guidance update for the year, it's a little more than \$4 billion a year of sales this year with the margins that are now down to 5%. So you asked, the question was what are the normalized margins. So they are about 9%. And I want to parse the segment for you because I made some comments about a couple of the sectors.

So a little more than one-half of aerospace systems is ISR systems, which is our strongest business in that segment. In fact, a very strong business in general. The margins there are very healthy, and I said that they exceed 10%.

Logistics solutions is about \$1.2 billion in sales this year. And that is a business that we're still in the process of rebuilding and strengthening, if you will. And Mike talked about the new Army C12 contract that begins in a couple of days from now. That will become a profitable -- will be a profitable job compared to the previous Army C12 work that we've done the last several years. So that's a big step towards improving logistics solutions. But logistics solutions margins on a normalized basis are in the 4% to 5% range.

And then lastly platform systems, which we now call aircraft systems, which includes the platform integration business. That's the remaining sector in the segment, which is about \$800 million of sales. And the margins there on a normalized basis should be in the high single digit range. There nowhere near that right now because of the problems that we've had on Head of State. But that's where they are going to head back towards.

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**Robert Spingarn** - *Credit Suisse - Analyst*

Okay, and then just we talked about in the past on logistics solutions. Is there anything strategic there, given the margin level?

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

Rob, as I had been saying, we are evaluating the entire portfolio. I mean, the question we would regularly getting as related to NSS, and NSS and logistics, but as you know from what we've announced, we've gone beyond that with the marine systems business and a couple of others. So the answer is yes, we're doing a very wholesome review of the entire portfolio with an eye towards bringing L-3 to a place where it's a much more focused Company on our high quality defense electronics, communications systems and ISR businesses.

What's common there is that if you look at virtually everything we do across those businesses and in the sectors of those businesses whether it's night vision or EOIR, we are the number one and number two player in each of those spaces. And we've built tremendous franchises that have created a lot of value. And we do much better when we're leading the market and defining things. And we've always attempted to look across the entire portfolio and make smart decisions. And we do have a good track record of doing things right. This is a speed bump, if you will, in the road and we'll get beyond it. We have the right resources in place, but that's where we are.

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**Robert Spingarn** - *Credit Suisse - Analyst*

Thank you both.

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**Operator**

Next we have Cai von Rumohr of Cowen and Company.

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**Cai von Rumohr** - *Cowen and Company - Analyst*

Yes. Thank you very much. So Ralph, could you give us a little bit more granularity on the Head of State aircraft, specifically when did the new guy come in and really start to evaluate the program? Maybe give us the delivery dates of the three remaining aircraft, together with the key milestones you have to hit to make sure we don't have another glitch here. Thanks.

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

Okay. So, Cai, the management changes that we talked about that we made at the platform integration division, including the President and many of the senior leadership positions, as well as program management on all three of the Head of State contracts. Those changes were made in the middle of April, around April 20. And those folks are, together with us, have been assessing these contract EACs since then. And as Mike said, we also changed the aerospace system segment President early in June, and we did a press release on that on June 3.

So the second question you asked was, what's happening with the delivery dates on the three contracts. And in my prepared comments I explained that on average the delivery dates are slipping by about 10 months for each of the three contracts. Aside from that, I don't want to get into the particular dates for each of the three contracts. But I will tell you that we're not going to be delivering any of those aircraft this year and the deliveries will be made in 2016 and 2017. And in terms of key performance milestones that need to occur between now and then, there are a series of them and they pertain to items, including a variety of flight test with and without the customers present, obtaining FAA certifications for each of the aircraft, and then going through some customer training periods on each of the three aircrafts. But those performance milestones are staggered over the next year or two, and they happen at appropriate times on each of the three contracts.

So clearly, we're very close on the first aircraft. I'd say about halfway there on the second one. And you may recall that in the third aircraft I explained that we're going to receive that aircraft next month. So that's clearly mostly in front of us right now. We did some very detailed reviews during the quarter, which we do in every quarter for that matter. And we factored in the experiences that we had in the second quarter on those contracts when we developed the estimates. And on the first aircraft we've experienced and incurred a lot of rework issues. And we've taken that experience

and we've made changes to make sure we don't repeat that on the second two aircraft. So we believe we have our arms around all three contracts. Did I answer all your questions, Cai?

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**Cai von Rumohr** - *Cowen and Company - Analyst*

Pretty much. One more. What kind of platforms are they? Specifically, like are they common platforms so that if you get the first one, you're more likely to get the next one?

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

They are large twin-aisle commercial platforms. Everyone knows what I'm talking about. There aren't many that fit that description. I'd like to leave it at that.

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

Cai, (inaudible) while that's true, these are common platforms. It's a very complex program, as you might appreciate. But we are able to do very complex things. And as I said, we do have our arms around it and we'll work through it.

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**Cai von Rumohr** - *Cowen and Company - Analyst*

Great. And a last second one. For NSS, maybe refresh our memory in terms of where its tax basis is. And also for the platform systems and logistics, where their tax bases are, just in terms of if you were to divest them, what kind of [net proceeds] we might be able to think about?

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

Well. I don't want to go into a lot of detail, but when we did the Engility transaction, after that NSS has a high tax basis. And with respect to the platform business, if you look at the individual businesses that comprise platform systems and you trace it back through our acquisition history, you'll find that a lot of it pertains to the early acquisitions that we made at L-3 or organic growth in those businesses over the last decade or so. That would tell you there's low tax basis there.

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**Cai von Rumohr** - *Cowen and Company - Analyst*

Okay, great. And just the last one. You gave us the guide for the Q3. What are you looking for for book-to-bill?

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

The Q3 book-to-bill, which has seasonally our lowest book-to-bill quarter for the last two or three years, we expect it to be somewhere between 0.8 and 0.9 in the third quarter.

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**Cai von Rumohr** - *Cowen and Company - Analyst*

Thank you very much.

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

You're welcome.

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**Operator**

Next we have Myles Walton of Deutsche Bank.

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**Myles Walton** - *Deutsche Bank - Analyst*

Thanks, good morning. Maybe Mike, I guess the thing I'm trying to understand is each quarter, it seemed like we're getting things, new things, and they seem like they are derisked but then something else pops up. So in particular, the C130, \$19 million charge also embedded. How contained is that? Where did this one pop up from? And, I mean, it's bigger than the Head of State charge you took last quarter.

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

I believe that the one you're referring to was an international program where we have, I would characterize it as a subcontractor issue as it relates to software. And it's being addressed, either by a claim against the subcontractor. We're in discussions with the customer, who could probably pursue a warranty claim on it. But this is relatively new news that was a post-delivery item that came up. So we're addressing it real-time, if you will. And I'm sure we'll be able to work our way through it.

I mean it was a bit of a surprise to all of us that we did not expect to have this type of an issue on something that I would have viewed as more of a straightforward upgrade program. We've done a lot of work on 130s and not have this kind of an issue. But it's a unique issue to this particular customer. (Multiple speakers) that we're working through it with the customer.

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**Myles Walton** - *Deutsche Bank - Analyst*

Just seems like in that sector in particular there's been a lot of eyeballs on the portfolio of program since the accounting issues last year. I would have thought some of these things would have crept up a little quicker. And I'm wondering, are we at the bottom of the pond yet? Or should we feel comfortable that we're at the bottom of the pond?

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

Yes, I certainly do and I can share your concern on the heels of last year where we had a rather extensive review with many different parties looking at the group and all the programs. What it indicated to me, since I've gone through a lot of angst over this after we've just been through an extensive review, why we're hearing about this. And some of these problems were not as apparent as one might think.

And an example on the Head of States, that there was some in-flight checkouts this May and June where a lot of the problems appeared after those flights, which would be when you would normally expect to start seeing program issues of that nature. However, with the new management in place who's very experienced on these types of programs, I believe that they and we have our arms around all of the issues. And we'll be able to drive the business forward.

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**Myles Walton** - *Deutsche Bank - Analyst*

Okay. Ralph, just a clarification on NSS. Should we think about the cash contribution in line with the earnings contribution, or is it liquidating receivables and a better cash producer than it looks?

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

This year they are, given the sales decline, they're liquidating some working capital, but not much. So you should think about it in line with their profits.

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**Myles Walton** - *Deutsche Bank - Analyst*

Okay, thanks.

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

Adjusting for taxes accordingly.

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**Myles Walton** - *Deutsche Bank - Analyst*

Okay.

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**Operator**

Next we have George Shapiro with Shapiro Research.

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**George Shapiro** - *Shapiro Research - Analyst*

Good morning. I don't want to beat a dead horse, but Mike, if you look back at the second quarter of last year, it strikes me that some of these programs are the same. Now maybe, not reading it correctly. But I did go back and scan last year's review. And if they are similar, than what's happened that it wasn't all caught last year, that we keep seeing this recur?

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

Well George, as I mentioned on the Head of State, there were test flights, if you will, on May 12 and June 11. And many -- of this year that had not occurred last year. And subsequent to those flights there was an expensive customer inspection that's part of our delivery process with the customer. And that's when these particular problems became identified. These are the types of items that you wouldn't necessarily see looking at paper. You literally need to go over an aircraft with a magnifying glass and a flashlight to find some of them. So it were not the most obvious things that ones one would think about. But the 130 program, that was a post-delivery issue that came up and last year we hadn't delivered. So it wouldn't have come up, just by the very nature of the time in which it occurred.

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**George Shapiro** - *Shapiro Research - Analyst*

Okay, I guess that's explainable. It just seemed like last year, the second quarter Q was delayed for almost two or three months. And I would have thought that maybe you would have done a little more scrubbing of the whole thing. But maybe it wasn't possible to do that, that's all. And Ralph, if I look at the cash flow that you're projecting at the end of the year, only \$160 million. And I guess you're kind of caught. You don't want to issue new debt out there because of the concerns from the credit side. But is that, I mean that's a lower level of cash. But I guess you're okay operating with that level of cash?

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

The answer is yes, George. The cash, I mean, our businesses generate cash every quarter, except for sometimes we have a use in the first quarter. So we have a \$1 billion revolver, which also gives us ample liquidity. And the cash balance that we're projecting at the end of this year doesn't factor in any other portfolio-shaping activities that are underway right now. So we're very comfortable -- I'm very comfortable with where it is right now, George.

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**George Shapiro** - *Shapiro Research - Analyst*

Okay, and then one last quick one for you, Ralph. The share count that you have averaging for the year at 81.9, that's a pretty sizeable drop yet from kind of the 83 that you've had in through the first half here. Did you buy back a bunch of stock at the end of the second quarter so we aren't seeing that effect yet until the second half of the year? Or are you still that comfortable that you can buy enough to reduce the shares that much more in the next six months?

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

The purchases that we made in the second quarter were pro rata over the quarter, I would say, as opposed to being back-end loaded. And the projection that we have for diluted shares outstanding factors in the remaining share repurchases that we'll do, what happens with the dilution in our various stock-based compensation programs. So we're comfortable that we're going to come close to that number by the end of the year. Obviously it's impacted by change in the stock price that impacts dilutions on the options outstanding, et cetera.

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**George Shapiro** - *Shapiro Research - Analyst*

Okay, very good. Thanks very much.

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

Thanks, George.

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**Operator**

Next we have Noah Paponak of Goldman Sachs.

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**Noah PoPONAK** - *Goldman Sachs - Analyst*

Hi, good morning.

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

Morning, Noah.

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**Noah PoPONAK** - *Goldman Sachs - Analyst*

Is it safe to assume that after the delivery of these three Head of State aircraft that you're unlikely to perform that business again?

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

Well, I don't want to get ahead of ourselves. I would say that's a safe statement, though.

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**Noah Poponak** - *Goldman Sachs - Analyst*

Okay. Ralph, could you go back through the bridge from the old free cash outlook to the new? It sounded like the pieces added up to a larger number than what the change was. I don't know if there was a positive offset or I just missed it.

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

So I explained that the -- we reduced the free cash flow by \$75 million and I talked about a \$90 million reduction pertaining to the contract cost growth in aerospace systems segment. Additionally, we are probably going to incur about a \$5 million debt retirement charge for that debt repayment we'll do in the fourth quarter. And offsetting it will be other working capital improvements, including the pension funding. We had a range in our previous guidance that we would fund about \$130 million into the pension trust. So based upon where our year-to-date actuarial returns are and what we see happening in the interest rate markets, we're probably going to fund a little less than that \$130 million. So it's probably closer to \$100 million or so. And that's how we -- that's how you reconcile the free cash flow estimate change.

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**Noah Poponak** - *Goldman Sachs - Analyst*

Okay. And then is it possible to give a similar bridge to the going back above \$900 million next year comment that you made?

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

Sure. So first of all, we don't expect to have over \$100 million of charges on contracts at platform systems. So that itself is going to improve the cash flow next year by \$60 million to \$75 million, I'd say. And then -- and that's really the main driver. The pension funding is probably going to be about the same, in the \$100 million to \$125 million range for next year. So nothing else really to explain it, I guess.

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**Noah Poponak** - *Goldman Sachs - Analyst*

So it sounds like it's sort of assuming flattish segment revenues and EBIT, exclusive of charges in the base business? Because I would have thought you'd have a little bit of margin expansion in pretty much every segment, especially ES. But perhaps it's too early to --

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

We are expecting margin expansion, but we expect next year our top line to improve next year. So in that regard we'll be putting more money into working capital.

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**Noah Poponak** - *Goldman Sachs - Analyst*

Okay. Just lastly, what's going on in international and commercial that has that seemingly pretty far off what the original full year was -- plans to be?

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

So there's a couple items. One is the divestiture of MSI and all the sales declines there fall into the international and commercial bucket or category. So international and commercial sales declined by 11% for the second quarter. On an organic basis, if you strip away all the M&A and divestiture activity, they declined by 6%. And all that 6% decline is due to the true-ups on the sales in terms of percentage of completion on the Head of State contracts for the most part, plus some FX-related reductions. But if you take away the FX and the Head of State, the international sales in the second quarter grew about 5%. But obviously you've got to peel the onion a lot to see that. And we provided those details in the earnings release when we explain the change in those sales.

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**Noah Poponak** - *Goldman Sachs - Analyst*

I see. Okay. Thanks very much.

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**Operator**

Next we have Robert Stallard, Royal Bank of Canada.

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**Robert Stallard** - *RBC Capital Markets - Analyst*

Thanks so much. Good morning.

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

Good morning, Rob.

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**Robert Stallard** - *RBC Capital Markets - Analyst*

Mike, on your plans to do some of this NSS, I'm a little concerned about the timing of this, given that it looks like Lockheed Martin and BAE Systems could be pursuing similar sales and that collectively you guys could be swamping the market with assets.

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

Yes. So my thought on that, Rob, is that I believe we will be way out ahead of both of them. And I could just leave that there. And in terms of the timing for us is I'm happy with the timing because if I look at the period from the Engility spin until now, we've generated between cash that we pulled out of the business and overhead absorption almost \$400 million. So whatever our value creation through the exit transaction, just add \$400 million more to it. So I'm very pleased with where we are. And again, I think that the comments may suggest that it's a little further off than I believe reality is, but that we are well underway in the process. And I am not concerned with swamping the market, as you said. So I'm highly confident we'll be in a good place here.

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**Robert Stallard** - *RBC Capital Markets - Analyst*

A quick follow-up for Ralph. You mentioned about working capital building with a return to growth. Would you also expect to see a pick-up in internal R&D as well?



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

Well the last time we talked about R&D we said that we're increasing it this year, and that we expected that we'd also increased our investment for the next couple years. So the answer is yes. We talked specifically about putting more R&D into the US government classified areas where we see a lot of growth and a lot of good opportunities for us to capitalize and win new business. So that's a long answer, but the answer is yes.

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

I'd also -- I'd add, Rob, that I think in the environment that we are in, we are very mindful of the things we are investing in. But in discussions with our US DoD customers, I believe that those companies that are willing to lean forward at this time are the ones that are going to be the most successful. And that's why we are pursuing that strategy.

**Robert Stallard** - *RBC Capital Markets - Analyst*

Thanks, Mike.

**Operator**

Our last question will come from Richard Safran of the Buckingham Group.

**Richard Safran** - *Buckingham Research - Analyst*

Hi. Good morning. Thanks for getting me in. Just a couple of real quick ones here. Michael, I was interested your opening remarks about the budget. Do your expectations factor in a CR at the end of the year? And if so, do they factor in a fairly rapid resolution to that? I just thought maybe you'd discuss a bit about how you're thinking about your key end markets if we do have a continuing resolution.

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

The answer is yes and yes. The risk of a CR has certainly been considered, as has been a rapid resolution, too. So right now I think there's a high risk or likelihood that we could be in CR territory. But I think it's something that would likely get wrapped up rather quickly. And I don't necessarily believe it will be that painful to go through, given the size of our backlog and how we should be going into the latter part of the year.

**Richard Safran** - *Buckingham Research - Analyst*

Lastly and quickly, project Liberty and Spider Aircraft, you thought that was going to be a pretty meaningful growth area. I just want to know if you could maybe discuss the opportunity set from here and how you think about that?

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

Well, the program or the platform has gotten a lot of international interest, especially given the environment, especially in the Middle East. We are getting continuous requests to bring aircraft over and let customers test fly them. We have several under contract and more to go.

I'm not going to get in front of Ralph with putting numbers out yet, because I -- international sales have a very long incubation period. But I am confident, or optimistic enough, given the amount of proposal activity and demonstration activity and it's price point, that this is platform that is starting to get a lot of interest. Also given its performance for price, that we will start to get more traction as we go forward. I don't know if you want to add some color there, Ralph?



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

The only thing I would add is that we're also seeing good increasing demand from our US government customers. And that's something you'll probably be hearing us talk about in the future. So it's a very versatile, affordable and highly capable aircraft. And there are some good opportunities emerging. And like I said, we're going to be talking more about that in the future at the appropriate time.

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

I mean, although Spider was designed to be an export product, it does have differences from the performance parameters that Project Liberty that renewed the interest in the US government on it, on the platform, and particularly the potential to augment what they already have. Again, it will be driven by requirements and things, but it's a highly capable, highly versatile aircraft. And as I said during my presentation, reconfigurable seems to rule the day in today's world. If you're operating in very different theatres with very different requirements, you're looking for different types of signals, you're dealing with different terrain. We make these aircraft highly reconfigurable in the field so you don't need a fleet of different aircraft to do different missions. They're very, very versatile. And that has gotten a lot of attention. And I think the US government interest on it is something beyond what we thought about when we initially invested in this platform, because it was really an export product. So we're happy to sell it domestically.

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**Richard Safran** - *Buckingham Research - Analyst*

Thanks very much.

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

Okay. Well, thank you. In conclusion, I'd like to spend a moment or two talking about L-3 strategy and why I believe we're well positioned to grow our global footprint, expand our market share and enhance our long-term shareholder value. At its core, our strategy is very straightforward. We're focused on performance and capturing new opportunities. We are transforming the business portfolio to sharpen our focus on the markets where we do best and have leading positions.

Lastly, we are focused on leveraging our strong cash flow generation to invest in areas critical to the future of our business. Most important, we'll continue to return capital to shareholders. In the second quarter we returned approximately \$300 million between the repurchases and dividends. And we will continue to utilize that strategy to drive value. Again, the performance at aerospace was a big disappointment. But we will get beyond it and turn the corner. And I'm confident we have the right people on the job and that we have a lot of good things to look forward to at L-3, including the portfolio sharpening that's well under way.

So with that, thank you for joining us. I hope everyone has a nice remainder of the summer. And we will look forward to speaking with you again in the Fall in October. So thank you.

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**Operator**

We thank you, sir, and the rest of the management team for your time also today. The conference call is now concluded. At this time you may disconnect the lines. Again, we thank you all for attending today's presentation. Take care, and have a great day.

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