THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

LLL - Q1 2016 L-3 Communications Holdings Inc Earnings Call

EVENT DATE/TIME: APRIL 27, 2016 / 6:00PM GMT

OVERVIEW:

Co. reported 1Q16 sales of $2.353b and EPS of $2.08. 2016 consolidated sales guidance remained at $10.050b at midpoint and increased 2016 EPS guidance at mid-point by $0.15 to $7.65. Expects 2Q16 sales to be $2.5-2.6b and diluted EPS to be $1.60-1.70.

THOMSON REUTERS

CORPORATE PARTICIPANTS

Mahmoud Siddig *L-3 Communications Holdings - IR*

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

Chris Kubasik *L-3 Communications Holdings Inc. - President & COO*

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

CONFERENCE CALL PARTICIPANTS

Ronald Epstein *BofA Merrill Lynch - Analyst*

Robert Spingarn *Credit Suisse - Analyst*

Cai von Rumohr *Cowen and Company - Analyst*

Myles Walton *Deutsche Bank - Analyst*

Carter Copeland *Barclays Capital - Analyst*

Seth Seifman *JPMorgan - Analyst*

Robert Stallard *RBC Capital Markets - Analyst*

Richard Safran *Buckingham Research - Analyst*

Howard Rubel *Jefferies LLC - Analyst*

George Shapiro *Shapiro Research - Analyst*

PRESENTATION

Operator

Good day, and welcome to the L3 Communications first quarter 2016 conference call. All participants will be in a listen-only mode.

(Operator Instructions)

Please note this event is being recorded. I would now like to turn the conference over to Mahmoud Siddig, please go ahead.

Mahmoud Siddig - *L-3 Communications Holdings - IR*

Thanks, Laurie. Good morning and thanks for joining us for L3's 2016 first quarter earnings conference call. With me today are Michael Strianese, Chairman and Chief Executive Officer; Christopher Kubasik, President and Chief Operating 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 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 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 & CEO*

Okay, thank you, and good afternoon, everyone. I'm pleased to report very solid first quarter results, demonstrating our continued progress and increasing margins and driving organic revenue growth as well as aligning our portfolio to our core businesses. I'll start out with an overview of our results and then we'll provide some color on the current environment, our strategic focus areas, and where we see opportunities for growth moving forward, then Chris will discuss our operational performance and Ralph will provide financial details before we take your questions.

For the first quarter, we reported net sales of $2.4 billion, a decrease of 5% over the same period last year. Excluding the impacts of divestitures and acquisitions, sales decreased by 2% organically. Our EPS was $2.08, which is a 50% increase over the first quarter of 2015.

We recorded net cash from operations of $112 million. Funded orders were $2.6 billion and our book-to-bill ratio was 1.1. Our segment margin performance was very strong in the quarter increasing 230 basis points to 10.7%.

This includes better than expected contract performance at Aerospace Systems, where margins increased to 10.5%. As we look at the overall environment, we've seen improvement in the US defense budget in 2016, and we're expecting that budget will continue to grow over the next several years. Our customer continues to focus on affordable solutions and L3 is well positioned to compete effectively.

We've mapped our strategy to address the DOD's spending priorities, which we feel are oriented towards weapon systems sustainment, space, the classified area, protected communications, as well as next generation products. The DOD remains L3's largest customer and we work hard to anticipate and adapt to its needs so that our capabilities and solutions align with their current budget. A major win for us in the quarter was the maintenance and sustainment work for the F-A18 A/B/C/D aircraft.

Building on our UK and Canadian F-A18 experience, this US Navy competitive win is strategic for us because it represents the first time we'll perform sustainment work on this platform at our Waco, Texas facility, and we expect additional follow on work in the years ahead. Similarly, in commercial aviation we're pursuing opportunities to increase market share and are encouraged by what we believe are very favorable long term fundamentals.

There's a particular demand for cockpit solutions -- I'm sorry, for checkpoint solutions, as airports around the globe upgrade their security infrastructure. In fact Singapore's airport is currently conducting a test of our advanced ProVision and ClearScan checkpoint solutions.

We also will be providing a variety of screening systems as part of the Bahrain International Airport modernization program. Also, airlines are continuing to modernize and upgrade their fleets with the latest technology.

We're well equipped to meet those needs with our market leading aviation products and next generation solutions. As you know, pilot training is another focus area for L3. There remains a shortage of trained pilots. In fact, it's estimated more than half a million pilots will be needed in the decade ahead.

L3 has the world's most advanced military and commercial total training solutions business. The combination of our recently acquired CTC Aviation business with our Link UK operation now offers certification training for a wide range of pilots using reconfigurable simulators that can address virtually any commercial air transport platform.

In the international area, there are longer lead times for new business awards and opportunities are driven by customer needs that are ever changing; however we continue to push our strong track record and reputation for quality and affordability. We're expanding our international marketing and sales infrastructure by opening new locations and hiring additional in-country resources in order to increase our visibility in important markets.

Our Far East operations has been helping to market L3 products in that region and last quarter, we received an order for our F-16 mission training system from Taiwan. We've had some other successes, which Chris will discuss in a moment. We continue to see international as an attractive high margin market and a long time growth driver for us.

Our results for the first quarter and our outlook for 2016 reflect the actions we've taken to transform L3 into a more focused and flexible Company with the goal of gaining market share in core areas and driving profitable growth. Our efforts to improve our market position have focused on strengthening our portfolio and targeted R&D investments.

In the first quarter we saw improvements in our margins, proof that we're on the right track in achieving our goals. We continue to have a disciplined and balanced approach to capital allocation, and to that end in Q1, we completed the sale of NSS, National Security Solutions, which was essential to our portfolio shaping efforts.

We believe that our business is strongly positioned and do not anticipate actions along the scale of NSS in the near term. That along with the MSI divestiture in 2015 has aligned L3 with the changing macro environment. We do have a few minor divestitures in process, but going forward our portfolio shaping efforts will be focused on acquisitions.

In January, we acquired Advanced Technical Materials Inc, or ATM, a small niche business serving the microwave marketplace. ATM will be integrated into our Narda-MITEQ business units. We will continue to evaluate potential acquisitions that will be accretive to earnings to complement our core businesses and expand our capabilities.

As always, we are strongly dedicated to generating shareholder value and we continue to return a significant portion of our cash in the form of dividends and share repurchases while also investing in the business. Ultimately, we believe our efficient capital structure provides us with ample flexibility to deliver value while allowing us to remain opportunistic to drive growth.

We're starting 2016 from a position of strength. I'm very pleased with our performance last quarter and I thank our employees for their continued focus on serving our valued customers. I'm confident that our business strategy positions us for even more success throughout the year, as evidenced by our increased full year EPS guidance today.

Now Chris will provide some operational details. Chris?

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Thank you, Mike and good afternoon, everyone. I will begin with a discussion of our portfolio, and then focus on operational initiatives and finally, summarize some additional new business wins from the quarter. As Mike mentioned, after completing the NSS divestiture, we believe our portfolio is now largely aligned with the needs of our customers and future market demands.

Accordingly, we are focusing our future portfolio shaping on acquisitions. Currently, we are evaluating several businesses targeting high margin, high growth companies that will further strengthen our portfolio to address new market opportunities in both defense and commercial.

Along with M&A, we are increasing our investment in R&D, as we seek to distinguish ourselves not only as leaders in quality and affordability, but also as innovators who develop cutting edge technology and next generation products. For example, I've been spending time with our Patriot Works organization, which is developing next generation products and subsystems that address the DOD's third offset strategy and other US government classified opportunities.

I've also been visiting our facilities to review our operations and to meet with business leaders and employees. I continue to be impressed with the talent we have in our divisions and the breadth of our solutions as a global security company.

Working closely with the divisions, and our proposal, quality and procurement teams, we are developing initiatives aimed at increasing efficiencies to drive organic growth and stronger margins. Also, we are identifying opportunities for collaboration to pursue new business. This will insure we stay focused on performance, as well as secure new business and win recompetes.

Our efforts have already begun to yield tangible results. In the first quarter, we saw outstanding performance on many of our existing contracts, particularly in Aerospace Systems, which helped drive our solid results. I'm very pleased with the progress we are making and we will continue to execute on our plan.

Now let's discuss some of the key contract wins for the quarter in defense, commercial aviation, and international. Starting with defense, we won several major new contracts. We will supply two key subsystems to the US Navy's combined EO/IR surveillance and response system, known as CESARS, which will provide unprecedented coverage for situational awareness and threat detection.

CESARS is an enhanced countermeasure system to protect surface warships against a wide range of threats, including optically guided anti-ship missiles, fast attack craft, and UAVs. In addition, we will provide our advanced DC power systems switch gear for the Ohio class submarine replacement. This award is significant because we have been improving functionality while reducing cost on this system, and we are pleased to have won this competition for this new growth platform.

We also received an award to continue our longstanding service life extension work for the LCAC program. Aerospace Systems received continued funding for our role as the prime on the EMARSS-M Army ISR program. Notably, we recently achieved a key program milestone with the inaugural flight for the EMARSS-M's prototype aircraft.

We received a variety of follow-on contracts and funding for logistics, life cycle maintenance and other projects on programs including the Army fleet support, the C-12, the [RC-135] (corrected by company after the call) and the T-45 training aircraft. Closing out our defense wins, we also received additional funding for many of our legacy communication programs in support of Hawklink, the P-8, and the B-2 aircraft.

Turning to commercial aviation, global events continue to generate increased interest in our aviation products and security systems. We received a new TSA order for examiner checked baggage screening equipment.

In aviation products, we received orders for approximately 400 flight recorders and TACAN systems from a variety of airlines. And in aircraft systems, we won a contract to modify a Boeing 747, which, when complete, will serve as an airborne launch pad for the Virgin Galactic Satellite Launch Service.

And finally, in international, we have several contract wins. As Mike mentioned, we've been expanding our in-country presence and leveraging our existing corporate offices to increase sales throughout the major regions. We received funding for communications and ISR integration work on South Korea's Global Hawk program.

Also this year we'll be starting ISR work for another -- ISR work for another foreign government. For decades, L3 has been the prime contractor on the RC-135 ISR aircraft. We recently expanded our support work on this program to include training, and in Q1 we booked our first RC-135 simulator from the UK Royal Air Force. This new system will feature our innovative Reality 7 full flight simulator.

Finally, we've received international orders for our sensor systems and night vision equipment from a number of countries, including Canada and Algeria. We made our largest direct sale of Fusion night vision goggles to Turkey, and we're also supplying MX-15 EO IR turrets to the Saudi Arabia National Guard.

Overall, our business mix remains at about 70% US defense and 30% international and commercial, but we will continue to forge new customer relationships in emerging markets that will increase our international commercial business in the long term. I will now turn it over to Ralph, who will give you more insight into last quarters results.

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

Thank you, Chris. I'll discuss in detail about the first quarter results and then review the update to our 2016 guidance. We had very solid financial performance for the first quarter, with diluted earnings per share, operating margin, free cash flow, and orders all above our first quarter outlook.

Earnings per share was $2.08 - more than $0.45 higher than our outlook for the first quarter and driven primarily by higher operating margin and secondarily, lower taxes. Sales were $2.353 billion and in line with our expectations.

Organically, sales declined 2%, but encouragingly our US government business, which is mostly the Department of Defense, grew 4% organically. This demonstrates the sales growth rate for our US government business is improving, which is significant as the US government market comprises about 72% of our business mix.

Consolidated operating margin was 10.7% for the first quarter, and about 150 basis points higher than we anticipated, with segment margin increasing 230 basis points, compared to the 2015 first quarter. The higher margin generated operating income above our plan for the first quarter by about $35 million, which added $0.32 to EPS in the first quarter and that was mostly in Aerospace Systems.

Aerospace Systems margin was 10.5%, and significantly higher than we expected for the 2016 first quarter. I want to elaborate on this point. Heading into 2016, we anticipated the favorable year-over-year comparisons on the Army C-12 contract and the Head of State jobs. What was unexpected was the profit resiliency at ISR Systems, and that was the main driver of the better margin for Aerospace Systems in the first quarter. ISR Systems improved its contract performance across several programs, including lower direct labor and higher productivity. Some of these improvements represented upside opportunities that we were targeting for this year and they converted early. Additionally, ISR Systems had a good outcome on negotiated price contract adjustment. Also, improved contract performance at Aircraft Systems contributed about $5 million of the higher operating income for the first quarter.

Communication Systems margin was 10.8%, and that included a planned $3 million gain on the sale of a parcel of land which added 60 basis points to the first quarter margin in that segment.

Electronic Systems operating margin was 10.8% for the first quarter, it was lower than we expected due to a $15 million charge to increase the product returns allowance for the EOtech holographic weapon sites. Otherwise, Electronic Systems margin was in line with our full year estimates.

First quarter income taxes were lower than expected, due to the early adoption of a recently announced new accounting rule, which reclassified $10 million of excess tax benefits on stock-based compensation from shareholders equity to the income statement. This tax benefit added $0.13 to EPS for the first quarter.

Free cash flow was $84 million, and it represented a good start for 2016, as the first quarter is our seasonally lowest cash flow quarter each year.

Moving on to the 2016 guidance update. We increased EPS at the mid point by $0.15 to $7.65 due to two items. One, the new tax accounting rule, which I just mentioned, adds $0.13 to EPS and it was all recognized in the first quarter. And two, a net increase in segment margin adds about $0.02. So our 2016 EPS guidance mid point is an 11% increase compared to last year.

Consolidated sales guidance remains at $10.050 billion at the mid point. We also maintained consolidated operating margin guidance at 9.8%, with margins expected to increase for the full year over 2015 in all three segments.

We made two changes to segment margin guidance. First, we raised Aerospace Systems' mid point margin by 50 basis points to 7.1%, and that was for the better contract performance in the first quarter at ISR Systems. This added $20 million to our full year estimate for operating income at the segment level. Secondly, we lowered Electronic Systems mid point margin by 40 basis points to 12.1%, and that was for the $15 million charge to increase the product returns allowance in the first quarter.

With respect to operating margins, we continue to work on improving program execution, increasing productivity, and contract profit rates while maintaining tight control over overhead cost. I'm working very closely with Chris and we're making progress with all these margin expansion levers.

Our free cash flow estimate stays at $825 million for the full year.

With respect to our 2016 capital allocation, it continues to include planned share repurchases of $750 million, of which we repurchased about $200 million during the first quarter. It also includes estimated cash dividends of $217 million, which reflects the $0.05 increase in our quarterly dividend per share that we approved in February, 2016, and a $300 million debt repayment which we announced on March 24, 2016. After these cash deployment actions, we estimate that we'll end this year with a cash balance of about $275 million and that assumes no additional acquisitions.

Our capital allocation and financing strategy continues to include our commitment to maintaining our investment grade credit ratings which is why we are repaying $300 million of debt this year. I want to underscore that if we achieve the operating income growth we're projecting for 2016 and next year, we will not be required to make additional debt repayments.

The last point for the full year 2016 guidance is that we still expect the book-to-bill ratio of 1.0 and possibly higher.

With respect to the second quarter outlook, we expect sales in the range of $2.5 billion to $2.6 billion, with operating margin of about 9% and diluted earnings per share between $1.60 and $1.70. Free cash flow should be in the $100 million to $150 million range, with the book-to-bill ratio of about 0.9.

So to conclude my financial review, the Company is clearly making progress and has positive momentum. We look forward to building upon our strong first quarter performance the rest of this year.

Thank you and we'll now begin the Q & A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from the line of Ronald Epstein of Bank of America.

Ronald Epstein - *BofA Merrill Lynch - Analyst*

Good morning guys -- or good afternoon now.

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

Hello, Ron.

Ronald Epstein - *BofA Merrill Lynch - Analyst*

Two questions for you, really. When we think about the international markets, international sales were down about 14% while domestic was up. What's going on there? Should we expect more growth internationally, or just a seasonal thing, or how should we think about that?

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

Okay, hi, Ron. So you'll recall that our guidance -- our sales guidance for this year assumed or contemplated about a 14% decline in our international sales. And that's organically, and what we talked about there was that we have three large ISR systems jobs in Aerospace Systems that are nearing completion this year, and they will decline $150 million or so, year-over-year. Then within the Communication Systems segment, we booked a large SATCOM terminal job last year for Australia, which we shipped most of it, it was about $80 million. So we have that negative comparison this year and we do expect follow-on orders for more terminals from Australia. We'll probably book those some time in the fourth quarter of this year, or early in 2017. So that's a solid customer. And even with respect to the declines on those three foreign ISR jobs, in ISR Systems, they each represent very good long term customers of L3, and they procure and modify their ISR aircraft on different cycles. There's peaks and valleys in those cycles, and we're entering a valley with those three jobs this year and some more next year. But those customers are certainly going to procure more aircraft in the future, and we have insight to their air procurement plans because we're very close to them. So by the time we get to the latter part of this decade, we expect to have new programs, each driving growth in our international end market for most customers.

Ronald Epstein - *BofA Merrill Lynch - Analyst*

Okay, great, perfect and then just as a follow on, when we think about what potential programs or wins or competitions are out there, say in the next six to 12 months, what should we keep an eye on? What's bigger than a bread box, or potential wins that -- outsiders trying to keep tabs on things?

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

Well I guess what we think is one of the attractive characteristics of L3, is that we don't have any singularly large programs or contract pursuits that we're going after that individually moves the needle. Instead we have numerous opportunities that we're going after, and the expectation is that we'll succeed on a more than a few of them. That said, there are some larger one-off opportunities, mostly in the logistics solutions area, that one or two will be decided this year. But we'll wait until that happens before we start talking about them. There's a lot of new business opportunities in the pipeline, and in the ISR space there's some opportunities that we're pursuing in the Middle East and Asia-Pac markets that should, or will, drive future growth in that area the next several years.

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Ron, this is Chris. I'll just chime in that when I went through my list of wins you'll notice there aren't a lot of large significant programs here at L3. There's literally thousands that contributed to our growth.

So the price of oil declining has caused some of the delays of the orders in the Mid East and we have some significant classified ISR opportunities, both domestically and internationally, that are moving along well. So those will be the things at least we're watching internally, and we'll keep you abreast as those proceed.

Ronald Epstein - *BofA Merrill Lynch - Analyst*

Great, thank you very much.

Operator

Your next question comes from the line of Robert Spingarn of Credit Suisse.

Robert Spingarn - *Credit Suisse - Analyst*

Well, good afternoon.

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

Hello, Rob.

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Hi.

Robert Spingarn - *Credit Suisse - Analyst*

So Mike, if I could start with you, and then I have one for Chris, as well, and one for you, Ralph.

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

Thank you.

Robert Spingarn - *Credit Suisse - Analyst*

So Mike - just high level question - once these international headwinds slow, when do we see organic growth overall for the Company inflect upward? Can you time that for us?

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

Well, I think that it's going to be weighted more towards the latter part of this year, but really it will pick up in 2017. As Ralph and Chris said on the last question, really we have this timing issue going on internationally where we have large programs concluding and have yet to be replaced by programs of a similar size. I mean there's a lot of smaller programs that are going on, but in terms of some of the major aircraft programs that we are delivering, those have not been filled to that level yet.

But we have pursuits that we're working on. That cycle is longer, as you know, and again, we're optimistic that the latter part of this year or early 2017 we'll be returning to more what I would say healthy growth rates internationally, and commercially for that matter.

Robert Spingarn - *Credit Suisse - Analyst*

Okay, and moving to you, Chris, first welcome to the call.

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Thank you.

Robert Spingarn - *Credit Suisse - Analyst*

Since you've been going through the business as somebody with, perhaps a fresh perspective -- we've talked a lot with Mike and Ralph about divestiture and portfolio shaping - sounds like you're largely through that. Could you highlight what you think are some of the crown jewels here at L3? The businesses that you're most excited about from a capability perspective and then from an upside perspective?

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Yes, I'll be happy to do that. I guess with the first six months, I have been spending most of the time on the road, as I mentioned, reviewing the strategies and the operation. What's unique about L3 is - and it's somewhat tied to Ron's question - is the products that we focus on, whether the sensors or the communications are really applicable to the new programs and then the upgrades of the existing programs.

These platforms will not be of any value to our customers without secured communication and world class sensors. And I think, when I look at what we're most proud of, I think on the communication front, the secured communication, the data links and such is something we're known for, a lot of the EO IR capabilities and then at Aerospace, the whole focus on ISR I think is a hot growth market.

We spent a lot of time looking at the various DOD initiatives, the focus of Secretary Carter, the communities of interest. And we're pretty well aligned with where the DOD government is focused, and that's where we've allocated our IRAD. Then I do not want to ignore the commercial aviation.

That's a long term growth business, and we believe, as Mike said,in those pilot shortages. We are one of the top pilot training providers in the world. And a lot of our products are focused on security, and I think that positions us well. So the upside will probably be - we're looking across-the-board in all three of our groups with long term growth potential.

Robert Spingarn - *Credit Suisse - Analyst*

You know you mentioned, in the discussion on M&A, targeting some commercial M&A, potentially. Do you and Mike have a target for commercial mix long term?

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

We don't have a specific numeric target. These things vary based on opportunities. We do like the fact that L3 is one of the few companies that has exposure both to defense, not only in the US but globally, along with the commercial aviation aerospace -- but a balanced portfolio.

We'll kind of go year by year and deal by deal but we're happy where it is. If it gets a little higher commercial and international, we won't object to it, based on the financial returns we expect to get from those markets.

Robert Spingarn - *Credit Suisse - Analyst*

Okay, and then Ralph, just going back to Aerospace and the margins, it sounds like what you saw in Q1 was essentially EAC driven, if I'm understanding that right? In other words, the run rate for the year resets back? But what is a normalized run rate now for this business?

Is it what's implied in the last three quarters, or is it ramping?

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

Well, we're clearly beginning to improve the margins in the segment. That's for certain. I would say the run rate for now is in the low end of the high single digit range. Which happens to be our guidance right now, and the updated guidance which is about 7% -- and certainly we're going try to do better than that. We do have additional upside opportunities, but it's early in the year and we still need to do some more good executing to realize those. Clearly, and positively, we're on the right path in terms of taking the margins higher in the segment.

Additionally, Chris mentioned that we're starting some new foreign government ISR work in his comments. And that's going to be a multi-year program for us, but the initial scope of work on the contract is mostly concerning aircraft and material procurement with some engineering. That work carries lower margins at the front end, but in the latter stages we should have much better margins there. So, that's an example of what's going on.

And then I talked about those declining other ISR foreign jobs this year, where we're going to have the declines. They will be more pronounced this year after the first quarter and that will also have some impact on the margins.

Robert Spingarn - *Credit Suisse - Analyst*

So net-net, are we static with the margin quarters two through four? I want to make sure I understand what you said.

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

I would say yes.

Robert Spingarn - *Credit Suisse - Analyst*

Okay, thank you all.

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

Thanks, Rob.

Operator

Your next question comes from the line of Cai von Rumohr of Cowen and Company.

Cai von Rumohr - *Cowen and Company - Analyst*

Yes, thank you and great first quarter. So Aerospace, you did 10.5% margins in the first quarter. To get to your number, you've got to do a smidgen over six in the last three.

How come the margins come down so much?

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

Okay, so I think that I just covered some of that, Cai, but I'll try to make it a little clearer. So we're going to have year-over-year quarterly comparisons with the work that's declining this year, namely those three international large aircraft ISR jobs. Additionally, the final run-off of the Afghanistan support of the US military, which is mostly small ISR aircraft, we have bigger declines later in the year and those will impact the margins.

I talked about that new program we're starting for another international customer. I also talked about the upside opportunities that we have. I think given what's happened at Aerospace the last couple of years, it's prudent to have some conservatism at this point in the year for that segment margin.

Cai von Rumohr - *Cowen and Company - Analyst*

Okay, but I mean it's a huge step up. It's like over 400 basis points. Were there any particularly robust margins in the first quarter, or particular one-time catch ups so that we get the big stair step down in the second?

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

In the earnings release, we talked about a favorable contract mod negotiation, or adjustment to a price which was about $10 million. So that was a one-off item, but the rest of it was strong contract performance across several contracts and mostly in the direct labor area I talked about in my comments.

Cai von Rumohr - *Cowen and Company - Analyst*

Terrific, and last one for you, Chris. You've talked of a little bit more about M&A. Are we talking still about things that are $50 million to $70 million?

Are we talking about bigger? Are we talking about a pipeline that you're seeing lots more opportunities? Maybe give us a little more color on that if you could please?

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Yes, be happy to. We do spend a fair amount of time looking at potential acquisitions, some for R&D, some for new products and some for new customers. On the low end I guess I could say $50 million to $200 million is kind of what's in the pipeline now.

I don't anticipate doing anything significantly different than that but we have pretty good visibility, and six or seven that are in the process of being reviewed and negotiated. One or two of those will probably hit and the others probably won't but we're kind of in that range, and if anything changes we'll be sure to give you guys a head up but that's where we're looking.

Cai von Rumohr - *Cowen and Company - Analyst*

Terrific, thank you very much.

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Thanks, Cai.

Operator

Your next question comes from the line of Myles Walton of Deutsche Bank.

Myles Walton - *Deutsche Bank - Analyst*

Thank you, good morning, or afternoon. Six of these in a row you forget what time it is. The question was on electronic systems, and obviously you had the EO tech charge there.

I'm just curious are you holding back a little bit to protect against any further creep there? Or do you feel like that's kind of buttoned down? Also in that segment, in terms of the margin opportunity it seemed like that business plus maybe the logistics business within Aero are your biggest source of upside to margins?

Is that -- would you agree with that statement? And how quick will you get the ES margins up into next year?

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Yes, why don't I take that. Relative to EOTech -- we were actually just up there a few weeks ago in Michigan redoing the operations and looking at the production. We believe they've made significant improvements to the products.

If you'll recall there were four issues dealing with weather distortion and moisture, thermal drift and parallax. Two of those are fixed, and two are within 30 days of being fixed so we're confident that we're going to have a product that we understand and properly disclose its specs. We think that we've made our best estimate of what needed to be reserved and we recorded that.

Again, it's a voluntary program which we all decided was something we wanted to do for our customers. We have a very loyal customer base, a great brand even in spite of this issue. We're actually developing new products that will be coming out later this year that are getting some very positive early reviews.

So we made our best estimate and next quarter we'll give you an update on that, but again I'll emphasize it's a voluntary program we've decided to do. We've already started to see a drop off in the return rate, so we'll see how that plays out. We look at this every month, Mike, Ralph and I decide what we want to do and we opted to keep it going at least for the foreseeable future. On your second question, you're right.

The margins' upside, I think on the logistics Vertex business has a lot of potential and even in the quarter we started to see some progress. I think once we made it clear we were going to keep this business, we had about half of the executive team changed over. And with a new GM and a new CFO, and just last week we were down in Mississippi and we were impressed with the progress they've made.

It was a long way to go but the team is clearly motivated, and as Ralph said, we're hoping to get some news in the next couple of weeks on some big potential wins that would really help boost us. We felt other than this EOTech reserve, we were on track for the year and we're confident that's one of our solid performing groups long term. We've talked about having 13% up to maybe 14% margins and we don't see any change to that in the years ahead.

Myles Walton - *Deutsche Bank - Analyst*

Ralph, you mentioned some upside to the book-to-bill. Is that, to Chris' point, out of some of the business maybe in platform and logistics coming out or is it out of some other segments?

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

There's certainly some logistics, some in the ISR systems, and then also in the other two segments in electronics and communication systems segments.

Myles Walton - *Deutsche Bank - Analyst*

Pretty spread around. Thanks.

Operator

Your next question comes from the line of Carter Copeland of Barclays.

Carter Copeland - *Barclays Capital - Analyst*

Good afternoon, gentlemen.

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

Hi, Carter.

Carter Copeland - *Barclays Capital - Analyst*

Just a couple, on the details. I wondered if you could give us some color on the power and propulsion moving pieces? I felt the expectation was $50 million to $75 million down there.

It looks like it's already down $25 million per the commentary in the release? On the margin mix down on aviation product security -- what was so dramatic in that driver? I think 160 basis points seemed like a big swing?

So any color on either of those?

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

Sure, I'll cover both of those, Carter. So in the power and propulsion sector, we have a couple of jobs that are ending, but we've also booked a couple of significant new jobs in the quarter including some switch gear power systems for the Ohio replacement program. That's going to be a growth driver for that sector.

We continue to have good opportunities with power systems, really, across the whole US Navy including all of the platforms that are growing like the Virginia class. That's just a timing item and the $15 million increase to the products allowance was also a reduction to the sales so that was part of the impact.

In the aviation product and security sector, there's a mix change going on there. Last year, we had some significant sales of our very high margin airborne collision warning systems that were tied to a mandate that has essentially expired. So we're having less of those sales this year, and they're mostly software-oriented, but again we expected that, so nothing unusual there. As Chris said, excepting the products return allowance, Electronic Systems is on track with respect to its margin performance for this year, including the improvement that we expect to have next year when the margin should get to the 13% to14% range for the whole sector - segment, rather.

Carter Copeland - *Barclays Capital - Analyst*

Great, and then just another one on the M&A commentary - the sort of general posture there as that being part of the value proposition? I think about valuation. Obviously, you compare your own stock to where valuations are across the market, and you think about putting control premiums on assets that are already trading at really high values -- is that a different story down in that $50 million to $200 million range where there's stuff you can still generate significant value?

Or is that a big hurdle?

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

We believe there's still value there. I think there's a lot of these privately owned companies, and I met with a founder and the CEO, a few weeks back, of a $100 million company and they like the L3 model. They like being able to somewhat maintain their identity and continue to be entrepreneurial and innovative.

Even though there's the usual governance and oversight that we provide, they like the ability to work amongst the other divisions of L3 and share the R&D and such. So we think we're in a unique position. We've been able to introduce them to other people we've acquired three, five years ago who have had great experiences.

There's also tax strategies that we're able to work with in obviously more reasonable multiples of that level so we don't see that being a problem. Long term, I would like to continue to grow this Company, both organically and inorganically. That's the strategy Mike's laid out and we're all going in the same direction there.

Carter Copeland - *Barclays Capital - Analyst*

Great thanks for the color Chris.

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Sure.

Operator

Your next question comes from the line of Seth Seifman of JP Morgan.

Seth Seifman - *JPMorgan - Analyst*

Great, thanks very much and good afternoon. You mentioned spending a little bit more on R&D and investment? I wonder if you could talk a little bit more about how much of that is a net increase versus how much is redirected?

And it's generally being in sort of the low 2% of sales range over the last several years. Some of the competitors are up closer to 3%, so were you thinking about additional dollars or redirecting it?

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Yes it's actually both. We've added about $30 million year-over-year in R&D and I mentioned the Patriot Works organization that we stood up a few years ago and they've been making a lot of progress in the classified world. We're looking at our R&D, and again I mentioned the DOD talked about their communities of interest, Secretary Carter has been pretty clear as well as several others in the DOD, and it's really optimizing that R&D.

We're looking at areas that we specialize in, whether it's autonomy or robotics or secured communications, and we're putting the money where the growth and need is -- took a few more bucks. We've even been somewhat unique and creative and teamed with a couple interesting innovative West Coast organizations - probably all we're allowed to say - and working collaboratively with them in a very unique and just a very unique collaborative manner so we're seeing some pretty good stuff there in a rapid development environment.

Seth Seifman - *JPMorgan - Analyst*

Maybe as a quick follow-up, the security products opportunity - you mentioned some specific opportunities at the beginning of the call - but just thinking broadly about the specific products where there are opportunities and the way that market's going to evolve? Or the way you see it evolving? Is that a place where you see significant growth, is there -- are there particular product replacement cycles coming?

THOMSON REUTERS

Are the products that you're offering additive, and needed to provide additional levels of security? How does what you're doing there now fit into your growth plans for that part of the business?

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

Well, there's a number of items. One, there is a life cycle replacement we would expect on the original EDS machines, or the automated bomb detection machines that were the first to go in the checked baggage line. Those are probably very close to end of life, or requiring major overhauls, so I'd expect to see some form of upgrade program in the not too distant future.

Last summer we introduced a new product for the checkpoint that was known as ClearScan and is designed to hopefully make it a little bit easier to get through the checkpoint by not requiring liquids, for example, to be removed from bags since the machine can interrogate what liquids are in the bag without removing it. There are new technologies that could be added as well to provide further screening capabilities. Such as the trace detection capability, which right now isn't done 100%, but you can imagine that technology could probably get built into the tunnels that are already processing bags rather than in the individual one-off examinations that are being conducted.

And then of course, you have some of the events - the horrible events that have happened in Europe involving airports that suggest that the checkpoint needs to start at the curb, if you will, or there's other needs for additional security outside the terminal perhaps. It's certainly a lot of questions being asked, and we're certainly thinking of a lot of ways we can help be part of the solution to those questions. It's an active area, both from an R&D standpoint, from a potential M&A standpoint, because there are technologies that are available in the marketplace for us to evaluate but as always we'll be mindful on price.

We do require acquisitions to have real economic returns for us, so we are very focused on what we're willing to pay. We always have the ability to develop things on our own too. Unfortunately, a lot of things of this market have been more event-driven than long term strategy.

We have been working with our customers to try to shift that model to more of a long term strategy, and be proactive rather than being reactive all the time. It's something we're very engaged in lately and I would expect some more activity in that area during the year. We'll be back to you on it.

Seth Seifman - *JPMorgan - Analyst*

Thank you very much.

Operator

Your next question comes from the line of Robert Stallard of Royal Bank of Canada.

Robert Stallard - *RBC Capital Markets - Analyst*

Thanks so much, good evening.

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

Hi, Rob.

Robert Stallard - *RBC Capital Markets - Analyst*

On the M&A front, I'm trying to square what you - Mike and Chris - said about your desire to do deals. Ralph had said about the balance sheet and your maintenance of the in vestment grade - so I was wondering if you could give us an idea of the Quantum of the fire power you have to do deals?

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Yes, what Ralph was talking about - year-end, assuming no M&A, we have $300 million on the balance sheet. We also guided about $750 million of share repos, so right there, there's almost $1 billion of cash in this calendar year. That, coupled with the ability to borrow some and maintain the investment grade are all there so I'd say we've got $1 billion at the high end.

I don't think we'll do $1 billion of acquisitions this calendar year. But if we do a handful at a $100 million or $200 a piece, I don't think any of us would be disappointed. Then we'll see what 2017 brings, but we think we have the cash available and those were the numbers we've laid out.

Robert Stallard - *RBC Capital Markets - Analyst*

Maybe on the security side, a few questions about that here. There's been some consolidation in this market as well. Would you be interested making acquisitions in that area as well?

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Yes, I think when we talked about growing organically or inorganically, it's applicable to both our commercial aviation and our defense business. So absolutely, if there's good returns, and it either adds a new product, a new capability, a new customer, we're pretty pleased with the technology in the investments we've made, but I wouldn't say we're against it. We would look at anything that becomes available and put it through the normal review process.

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

I'd add that market as you know is not brand new but relatively on market and is fragmented, there's a lot of players. There's a high hurdle for us in terms of what we look at as being acceptable. Because we believe our business performs probably the best out of any of them in this space in terms of technology, margins, product offerings, customer satisfaction, performance and the like.

So to expand our offering in the customer base is a goal. If there's a property out there that will help us achieve that goal faster at good economic terms, we're certainly interested. Again, we're very satisfied with the business that we have put together.

It's a completely organic business. Its been grown -- well let me take that back. There was an acquisition or two in there, but the base technology was developed at L3.

The automated threat detection technology and those algorithms were L3-designed systems. And we could grow it, either through further R&D internally or acquisition, depending on what generates the best returns for us, so it's something we're looking at pretty closely right now.

Robert Stallard - *RBC Capital Markets - Analyst*

Great thanks so much.

Operator

Your next question comes from the line of Richard Safran of Buckingham Research.

Richard Safran - *Buckingham Research - Analyst*

Hi, good afternoon.

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

Hello, Rich.

Richard Safran - *Buckingham Research - Analyst*

So do you know what? I had a question - a bit of a multi-part question on pricing. So you noted improved pricing on the C12 program to help you with the margin improvement there at logistics. You also noted an unplanned ISR systems price adjustment.

First part is, are there other contract opportunities coming up where you could see improved pricing? Michael, I'm getting the sense that since Investor Day your outlook on pricing is improved -- is that correct? The final part to the question is are you seeing, Chris, are you seeing improved pricing on the contract wins that you mentioned at the outset of the call?

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Yes, why don't I take that. I think on the C12 and ISR, when we were talking about pricing - and in these cases we're talking about modifying the contracts - we make commitments. And a lot of these are based on such items as flight costs per hour and other assumptions that are made.

In several instances, customers will either use the aircraft more or less than anticipated. It's hard to predict those things, and a lot of these are just truing up the contracts through normal negotiations based on actual - in this case I'll use flight hours as an example - compared to what we signed up, so that's what we see there. It remains to be a competitive market out there.

We're seeing more best value versus the LPTAs - low price technically acceptable. I think our customers appreciate the need to have products that work on time and protect those people that are flying them. I think with our track record and past performance, the best value competitions are helping us with new opportunities.

So our goal is to increase the margins and we're doing a lot of that through cost reductions. I would say we're getting better margins, but not necessarily increasing the prices, just having lower costs.

Richard Safran - *Buckingham Research - Analyst*

Okay, thanks for that.

Operator

Your next question comes-- (multiple speakers)

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

Go ahead, take the next question, please.

Operator

Your next question comes from the line of Howard Rubel of Jefferies.

Howard Rubel - *Jefferies LLC - Analyst*

Good afternoon. Thank you very much.

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

Hello Howard.

Howard Rubel - *Jefferies LLC - Analyst*

Just a couple of small items. Ralph, you've got the debt repayment but you've also got more current debt due. Are you thinking about using kind of the window of rates to extend some maturities?

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

The answer is yes. So we have $500 million of debt that's going to mature in November of this year, then another $350 million next May. So the $300 million that we're repaying and that we made a call on, on March 24, 2016, is $300 million of the $500 million that matures this November. We aren't taking away any flexibility we have with our debt maturities, and we certainly do intend to take advantage of favorable credit markets.

Howard Rubel - *Jefferies LLC - Analyst*

And will you take a charge because some of this will be at a premium or is this all kind of--

---

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

There's like a $2 million or $3 million charge that comes with it and it was factored into the original guidance so it's covered in the guidance for this year.

Howard Rubel - *Jefferies LLC - Analyst*

Thank you, and then just a follow-up, one with Mike or Chris. As you've had this new operating structure, this new triumvirate with the three of you, what have you done in terms of looking at the organizational structure and communicating performance metrics? And how are you seeing the organization respond?

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

Well, Howard, as we discussed last year, we were introducing margin improvement as an important metric to our business units and their teams and building it into their compensation models, if you will. I think they have embraced it and responded very nicely, we're very pleased with the first quarter and I think I'd expect to see more of that. We just went through a question about pricing, I think from Rich Safran.

A lot of that had to do with the margin improvement story we've been working on. A thorough analysis was done of many of the contracts in the logistics space as to why the margins were coming in low or coming in different than that which was originally bid. Some of the analysis showed there are probably opportunities for further dialogue with customers where the customer side of the equation was not meeting what the assumptions were in terms of flight hours or other metrics that didn't develop.

So there was room for further adjustment there and I think that its made our people a little smarter about how they bid jobs. Like some of these logistics jobs where you could have deviations from some of the original assumptions that could have negative impacts on the margins going out. So it certainly has gotten people to focus on everything they do whether it's how they manage their Supply Chain, how they manage their labor hours or how they manage the delivery side with the customer in terms of keeping their eye on the ball as it relates to margins.

We like to know if we aren't achieving what was bid, why? With a rational explanation. I think we are getting a good response from the team on it. But let me give Chris a chance to add his two cents on it because he's been very involved in this.

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Yes thanks, Mike. Howard, when I joined L3, Mike and I talked about me helping to optimize the organization and really accelerate a lot of initiatives and that's how the three of us have been working. We pride ourselves on being agile and responsive, and I think we've made a lot of positive changes and decisions in a relatively short period of time.

I think the con ops has been well received, and I'm sure you have lots of contacts within L3 you talk to anyway, Howard, but I think presidents and others have embraced - at least from my perspective - embraced from joining and it's a very collaborative organization. I've said that to anyone who asks, I've been most impressed with the collaborative nature of the team and the Company. Everybody wants to do well and we're all proud of the first quarter and we have a lot more work to do, but it's exciting to see good results and we're all aligned on the strategy and what our goals are.

So I would say - so far, so good.

Howard Rubel - *Jefferies LLC - Analyst*

I would agree. Thank you.

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Thank you.

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

Thank you, Howard.

Operator

We'll take our last question from George Shapiro of Shapiro Research.

George Shapiro - *Shapiro Research - Analyst*

Yes, good afternoon. I wanted to pursue a little bit more, this margin in Aerospace. If I looked at the fourth quarter, you had a 5.5% margin and you had negative contract adjustments.

Now we jump to over 10%, and we've got positive adjustments. And if we go forward - it would seem, Ralph - if this ISR program that created strong margins for you is declining, we would have a more of a sequential decline Q2 to Q4. Where you average 6% over the three quarters, as opposed to just each quarter being 6%. I just wonder if you'd comment a little further on that?

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

Sure. So I said that the margins - in response to Rob's question - would be similar for two to fourth quarters in Aerospace System segment. There are a lot of moving parts, if you will, in terms of pluses and minuses to the margins.

While these jobs' run-off in sales is more in the latter part of the year, in aircraft systems we're going to be doing less work on low or no margin contracts and they kind of tend to offset each other. And make no mistake about it, we're going to try to do better than that and hopefully we'll have more to tell you about in the next quarter conference call with respect to that, George.

George Shapiro - *Shapiro Research - Analyst*

And then just one follow-up as to the status of the Head of State program. You still got the two aircraft to deliver some time this year or ones next year?

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Yes, George, we were just down in Waco, and it's one this year and two next year. Plane looked great and working closely with the customer and everything seems to be on track.

George Shapiro - *Shapiro Research - Analyst*

So Chris, tell me, what do you look at from that program given the problems we've had to make a judgment? You think at this point the problems are pretty much behind you? Or we really got to wait until we start to make some of these deliveries?

Chris Kubasik - *L-3 Communications Holdings Inc. - President & COO*

Well, it's always good to make the deliveries. I mean it's three separate aircraft. The one is effectively done, and just waiting for its final flight acceptance test, and the other two are progressing.

I think the lessons have been learned, each one will be successively better than the next, relative to hours and the learning curve concept. I know its, for three aircraft, hard to have a learning curve, but each one is showing progress on that front. So there were no changes to the reserves and we look forward to keeping you updated and having happy customers fly their plane out.

George Shapiro - *Shapiro Research - Analyst*

Okay, thank you very much.

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

Okay thanks, George. And on that note, let me just make a few summary comments. First of all we're off to a solid start in 2016.

Our results reflect our focus on margin improvement, as well as driving organic revenue growth. In spite of the unprecedented volatility in the geopolitical environment, we're identifying growth opportunities across major markets and executing well throughout the organization. Additionally, with more clarity in the defense budget and positive signs for growth in military spending, we are well positioned to capitalize on emerging opportunities.

I'd add that, more now than I can remember in the past, there has been a very productive dialogue with the folks at the Pentagon. Particularly the AT& L organization under Secretary Kendall, with industry, in terms of what their needs are and things they would like us as industry to focus on because their desire of course is to get things to the warfighter quicker, cheaper, and things that work out of the box. You've heard Secretary Carter mention the five areas of concern - Russia, China, North Korea, Iran and the War on Terror - they are very focused on solving all those problems, they are all very challenging issues and they have many initiatives they are working on.

You heard the term third offset strategy, so there's a lot going on in that area. That dialogue is very important to keep industry focused on making the right investments in the right places, so that together we and the warfighters are developing the systems that they need to deal in the current threat environment. Our focus has never been sharper than it is right now on R&D and how we spend it.

We're leveraging our expertise and working with our key partners to invest in and develop those technologies that strengthen our competitive profile and meet customer needs. Our agility and strong customer relationships are also differentiators that enable us to adapt quickly to evolving customer needs. Bottom line -- we're very encouraged by the Company's performance and the overall industry environment.

We remain committed to delivering long term value to our stakeholders. Let me just thank everyone for joining us this afternoon for the call. I know it was a busy day, and we look forward to speaking with you in July, so thank you.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.
