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# EDITED TRANSCRIPT

LLL - Q2 2016 L-3 Communications Holdings Inc Earnings Call

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**OVERVIEW:**

Co. reported 2Q16 net sales of $2.7b and diluted EPS of $1.88. Increased 2016 consolidated sales guidance by $150m to $10.2b at mid-point and 2016 EPS guidance at mid-point by $0.10 to $7.75. Expects 3Q16 sales guidance to be $2.5-2.6b.





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## CORPORATE PARTICIPANTS

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

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

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

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

## CONFERENCE CALL PARTICIPANTS

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

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

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

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

**Carter Copeland** *Barclays Capital - Analyst*

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**Howard Rubel** *Jefferies LLC - Analyst*

## PRESENTATION

**Operator**

Good day and welcome to the L-3 Communications second quarter 2016 conference call.

(Operator Instructions)

Please note this event is being recorded.

I would now like to turn the conference over to Mahmoud Siddig. Please go ahead.

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

Thank you. Good morning and thanks for joining us for L-3's 2016 second-quarter earnings conference call.

With me 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 that during this call, management will reiterate forward-looking statements that were made in the press release issued this morning. Please refer to this press release as well as the company's SEC filings for a more detailed description of factors that may cause actual results to differ materially from those anticipated. Please also note that this call is simultaneously broadcast over the internet.

I would now like to turn the call over to Michael Strianese. Mike, please go ahead.

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

Okay, thank you and good morning, everyone. I'm pleased to report that L-3 continues its positive momentum, demonstrating solid results and marked progress on our key strategic initiatives. Our employees and business leaders did excellent work in the quarter and we're proud of their performance, so I'd like to thank everyone for their dedication. As a result of their hard work we had organic growth, margin expansion, and cash generation in the quarter.

I'd like to begin with an overview of the quarter and discuss our business with respect to industry trends and the steps we are taking to continue delivering value to the customers and shareholders. Chris will then discuss some of the details regarding our operational performance, followed by Ralph's review of the financials.

Over the past year we've pursued a disciplined growth strategy that concentrates on areas where we believe we can consistently win due to strong product offerings and past performance. For the second quarter we reported net sales of $2.7 billion, an increase of 5% over the same period last year, and improved margins. We recorded net cash from operations of $257 million for the quarter and funded orders were $2.1 billion, while the book to bill ratio was 0.8, driven mainly by award timings and delays. And we expect that we will have a book to bill ratio over 1 for our defense business this year.

We continue to have success across L-3 in our new business pursuits. Chris will discuss these in more detail, but I'd like to mention a few. We received several significant logistic support contracts, including significant wins on almost $2 billion for the KC-10 program and over $300 million for the US Navy C-12 program. We are also successfully performing on the Navy's F/A-18 depot upgrade program we recently won. We also have some key international wins which Chris will take you through.

As we pursue opportunities, we remain committed to leading the industry as an innovator, and developing and delivering solutions that meet our customers' needs. Prioritizing growth and remaining an agile company have enabled us to capitalize on expansion opportunities, invest strategically in R&D, and improve our market positions.

We remain focused on areas where we have leading positions and the strongest potential for growth. This includes training and simulation, aviation products and our legacy work supporting a wide range of ISR platforms, unmanned systems equipment, and secure communications such as rover and communication systems for the Virginia class submarines.

The US DoD remains our largest end customer constituting roughly 70% of our total sales. Following a decline over the past five years, the US defense budget is beginning to trend upward, which is important to the growth of our business. We anticipate the DoD budget as a whole is heading towards low single-digit growth at a minimum. Given that both candidates in the upcoming election have expressed a strong commitment to national security, this is clearly a positive development for L-3, the industry, and the nation.

As I mentioned, we expect that we'll have a positive book to bill ratio for our defense business this year, meaning above one. As you are aware, commercial aviation remains a growth market, revenue from global traffic continues to outpace GDP, as the mature markets of North America and Europe recapitalize their fleets, while many parts of the world like Asia and the Middle East continue to grow steadily.

This continued robust demand for commercial airplanes is resulting in new regulations, demand for more pilots, and technical upgrade requirements, all areas where all three products and technologies come into play, like airport security and baggage detection, pilot training, and avionics.

International sales remain a focus for us and as events in recent weeks have shown, the global threat level remains very high. International business including military and commercial represented 24% of our sales last year, and while the total addressable market appears flat for the remainder of 2016, we do see significant potential in emerging sectors to expand market share and increase our global footprint over the long term. There are opportunities to make headway with our competitively-priced offerings, including our commercial training solutions, EO/IR sensors and night vision equipment, security and detection systems, and our communications systems.

Turning next to capital allocation, we remain committed to delivering value to shareholders and intelligently deploying capital when and where it supports the overall business strategy. Share repurchases and dividends are ongoing components of the strategy. We continue to maintain a healthy and efficient capital structure which provides us with the flexibility to invest in our business while at the same time returning capital to shareholders. We're also evaluating potential acquisitions that expand our market share, broaden our offerings, and bring us new customers. We've heightened our focus on transactions that will strengthen our portfolio.

As you've read in June, we welcomed Heidi Wood to our newly-created position of Vice President and Chief Analytics Officer, and many of you know Heidi, I'm sure. Heidi brings to L-3 a wealth of industry and financial expertise, and she's supporting both myself, Chris, and Ralph and the rest of our leadership team as we execute on our M&A and investor relations strategies, and evaluate our portfolio as we continue improving the efficiency of our operations. We will continue to bolster our strong management team with talented people who have the expertise to help us take advantage of emerging opportunities within our industry.

We're also prioritizing our R&D investments. This is an important part of our long-term strategy to ensure we remain competitive in the dynamic, ever-changing, and highly-regulated industries in which we operate. In fact, we're investing more than 2.5% of our revenue in R&D this year. We also have several exciting products and new capabilities that are already in early development, such as a smaller form factor SIGINT system, low-cost next-generation infrared search and track systems, and our mission simulator which will enable us to deliver scenario training at the mission level.

Overall, we're pleased with our performance during the quarter. I'm confident that we're on the right track to achieve our goals, and with that let me turn it over to Chris to give you some additional operational details. Go ahead, Chris.

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

Okay, thank you, Mike, and good morning. First let me echo Mike's comments. We made great progress during the first half of this year and we have the momentum to continue delivering results as we enter the second half.

I've been here nine months now, and one of the things I've been most impressed by is the extent to which the L-3 culture is truly entrepreneurial, highly responsive, and ready to take on change. We are collectively working well together and getting a better handle on areas requiring operational improvement, as well as supporting new initiatives and increasing our focus on acquisitions.

I'd like to give you an update on what we've been doing recently to improve margins, refine our portfolio and enhance the focus on operational excellence. In Q2 we continued to challenge our existing structure as we look for opportunities to drive value for our customers and shareholders. We are realigning a number of facilities, downsizing the work force, and consolidating business units to enhance our competitive profile and position L-3 for future growth.

With respect to portfolio shaping, we are in the final innings. We are divesting a few very small businesses, but have largely completed our previously-announced portfolio-shaping phase. We are now focused on the next phase of our history which is disciplined growth. In May we announced the closure of our electron devices facility in San Carlos, California, and we'll be transitioning those manufacturing operations to our facilities in Los Angeles and Pennsylvania. These actions will help reduce costs over the long run.

In order to expand strategically into emerging markets as a prime system integrator and a subsystem provider, we are aligning unmanned systems, space and navigation, and Mustang technologies into a single business. This consolidation will also yield cost reductions through shared management and back office resources, while optimizing our R&D.

But we are investing for growth where it makes sense. So in May we announced the plans to open a facility in Ottawa, Ontario that will accommodate a team of highly specialized engineers and a state-of-the-art lab. This will allow us to better develop and demonstrate future maritime communications for the Royal Canadian navy submarine, and surface fleets.

With our M&A strategy, we have kicked up the intensity a notch and are assessing the landscape to identify opportunities that would be a good strategic fit for L-3. As we've been saying, we are looking at about a dozen or so properties across all the markets we currently serve, and we like the pipeline that we're seeing.

We are sharpening our vision and looking for ways we can add new and proprietary capabilities to our portfolio. We continually evaluate prior deals and seek ways to maximize their value to the enterprise. Our last four acquisitions of MITEQ, CTC Aviation, ForceX, and ATM have all enhanced our growth prospects and are performing at or above our business cases.

Let me now turn to some of our new business wins. Let's start with defense. Although the book to bill ratio is low, we have several noteworthy wins across our defense businesses that reflect our strategy of growth through excellent program performance.

For the US Air Force, we won a key recompete for its war fighter readiness and training programs. This is a seven-year contract to provide a wide range of advanced technologies to improve training effectiveness. We will also provide the Air Force and the special operations command with a life cycle product support and spares for our panoramic night vision goggles, our ultra-light range finders, and our fusion goggle system.

For the US Navy, we received a follow-on contract for engineering services for the flight test instrumentation systems in support of the Trident program, and we were selected to supply next generation towed-arrays for submarines. Our systems will provide an increased ASW capability and reliability suitable for an increasingly challenged undersea environment.

Additionally, L-3 was one of nine firms that earned a spot on the $1.7 billion ID/IQ contract to provide training services, systems, and related support to the Navy, the Marines, and FMS customers. And for the US Coast guard, we won a recompete to provide the integrated C4ISR system for the Sentinel-class fast response cutter. We've been performing work on this platform since 2009.

In our commercial aviation products business, we received a contract to provide T3CAS surveillance system to easyJet for its A-320 aircraft fleet. We continue to receive solid orders for our NXT line of transponders for multiple US airlines as they equip their fleets to meet the FAA's 2020 mandate. And we received additional follow-on funding from the TSA for our leading airport security products, which include passenger screeners as well as carry-on and checked baggage scanners.

Demand is strong for our commercial training solutions business. Since quarter end, we have already received approximately $150 million in commitments for our aircraft full flight simulators. We expect these will be contracted for in the third quarter, including an A-320 simulator for ANA in Japan.

During Q2 we marked a few operational milestones that are worth noting. At our Waco facilities, we inducted the first US coast guard C-130J aircraft for a mission systems upgrade. We also made key aircraft deliveries, including a fourth small cargo aircraft for Australia and T-130s with upgraded avionics for the Air Force and an international customer under a foreign military sale.

Finally, turning to international. Last week Ralph and I visited our WESCAM business in Canada which produces market leading stabilizing cameras and imaging systems for the military and public safety customers. WESCAM recently received multiple orders for our MX electro-optical and infrared systems for the international military customers. This latest order reaffirms the market interest in our MX line which provides full motion intelligence for a range of high altitude and ultra-long-range missions.

Lastly, we've been selected to deliver night vision goggles and capabilities to a NATO member state's special operations force. With this contract, there are now five NATO countries that have purchased L-3's fusion goggles.

As we move into the third quarter, we will continue to respond quickly to market opportunities and capitalize on a steady demand environment. With a commitment to operational excellence and program performance, we look forward to continued progress in the months ahead. Now I'll turn the call over to Ralph.

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

Thank you, Chris. I'll discuss some details about the second quarter results and then review the update to our 2016 guidance.

We had another constructive quarter. Our second quarter results were better than we expected, primarily because of higher sales. Free cash flow was also very solid, and while orders were lower than we estimated, that was primarily due to award timing, some delays, and the fact that our quarter ended on June 24.

Diluted earnings per share was $1.88, increasing 38% compared to adjusted diluted earnings per share of $1.36 for the 2015 second quarter. Second quarter sales were almost $2.7 billion and grew 7% organically. Our US government sales, which are mostly to the Department of Defense, totaled $1.9 billion and grew 6%. And our international commercial sales grew 11% to almost $800 million.

Our second quarter sales growth rate was unusually high due to some timing items, including the procurement and delivery of two aircraft on a foreign ISR systems contract which added about $90 million of sales to the second quarter. We expect a lower sales growth rate in the second half because that is when most of the sales headwinds that we have this year versus 2015 happen.

We previously discussed these negative year-over-year sales comparisons. They include an aerospace systems, the final runoff of our sales declines related to the Afghanistan drawdown, and the three large international ISR systems contracts which are nearing completion. And in communications systems, they include the Australian MoD SATCOMM terminals and the declining TWT power devices for commercial satellites. However, the key takeaway is that our sales growth outlook is improving, and that's evidenced by our $150 million increase to our 2016 sales guidance which I'll cover in a few minutes. Consolidated operating margin was 9.3% for the second quarter. Margins increased in all three segments, raising consolidated margin by 330 basis points compared to last year's second quarter. The main reason for the large increase in margin was the $84 million of losses that we recorded in aerospace systems in the second quarter of 2015 on the head of state aircraft modification contracts.

Electronics system's operating margin was 12.2% for the second quarter, and communications system's margin was 10.5%. Aerospace system's margin was 6.1%, in line with the 6% margin for the second, third, and fourth quarters of the year which we discussed on our first quarter earnings conference call. Free cash flow generation was also robust for the second quarter at $221 million.

Moving on to our full year guidance update, we increased earnings per share at the midpoint by $0.10 to $7.75. This increase is driven by higher sales and a slightly lower tax rate, partially offset by more diluted shares outstanding. The diluted EPS guidance midpoint is a 12% increase compared to 2015's adjusted diluted EPS of $6.91.

We increased consolidated sales guidance by $150 million to $10.2 billion at the midpoint, and that calculates to an organic sales decline of about 1%. We expect our US government sales to now grow 1% organically versus 2015. This compares favorably to our prior guidance, which estimated a 2% decline for our US government sales. Our updated sales guidance also projects commercial to now grow at about 3%, and international sales to decline 13% versus 2015.

At the segment level, we increased aerospace systems sales by $150 million, and communications systems sales by $50 million, with both of these increases due to a stronger US Department of Defense market.

We lowered electronics systems sales by $50 million due to softer sales in two niche commercial markets. These are one, our holographic weapons sights that we sell into the sporting and recreation market; and two, a new transponder that we introduced last year for the general aviation market where the sales are developing at a slower rate than we planned.

Our updated aerospace systems guidance does not add any sales for the US Air Force KC-10 tanker sustainment contract, the Vertex Aerospace won in early June, because our award has been protested by a competitor. Moreover, our KC-10 work would not begin in earnest until January of 2017 even before considering the delay caused by the protest. We expect that this contract will have annual sales of about $200 million, and that's obviously conditioned on our award being upheld.

We maintained consolidated operating margin guidance at 9.8% and segment margin guidance was also unchanged. I'd like to elaborate on a couple of points about our margin guidance update. First, in electronics systems there's upside in the second half to our 2016 margin guidance and operating income, but that could be offset by downside risk that remains on the holographic weapons sights. Second, while communications systems margin was not changed, we now expect higher margin for both broadband communications systems and advanced communications, driven by better contract performance and labor productivity.

These improvements are being offset by an initial $6 million of severance and restructuring costs, related to the consolidation of our traveling wave tube or TWT power device businesses in California that Chris talked about. That business consolidation is a complex multi-year project. We expect







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that we will incur additional larger restructuring costs in 2017, and by 2018 we will complete the consolidation, and at that time we expect to begin to generate annual pretax savings of about $9 million from the consolidation.

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

With respect to the book to bill ratio, second quarter orders were about $250 million below our estimate. This was primarily due to timing. For example, as Chris mentioned a few minutes ago during his comments, last week we received orders for several new simulation and training devices worth about $150 million. I'll add that it's common and normal to have orders timing volatility among the quarters. Secondarily, our international ISR systems orders are trailing what we planned with several pursuits sliding to 2017 or not materializing. That said, with increases that we currently see in electronics systems and communications systems, we remain on track to achieve our full year consolidated book to bill ratio of at least 1.0, and that's even after raising our sales guidance by $150 million.

Regarding capital allocation for this year, while it's the same as our prior guidance, we have deliberately slowed the pace of share repurchases because we expect to shift some cash deployment to acquisitions in the second half of this year. We still expect to end this year with a cash balance of about $300 million.

Looking at the third quarter outlook, we presently expect sales in the range $2.5 billion to $2.6 billion, which will calculate to organic growth that's about flat. Margin should be in the low 9% range, with diluted earnings per share between $1.75 and $1.85. Free cash flow should be in the $100 million to $200 million range, with a book to bill ratio of about 1.0.

A couple of other things regarding the third quarter. I want to remind you that we presently expect our 2016 third quarter operating margin and EPS to decline compared to 2015's third quarter. In 2015 our highest quarterly margin occurred in the third quarter at 10.7% and that was due to abnormally high margin in aerospace systems. And if you recall, what happened there was that we had significant risk retirements on three large international ISR contracts that are nearing completion and in fact declining this year, and we've talked about that. Also, in last year's third quarter we had an $8 million REA profit recovery on our previous Army C-12 contract.

So to conclude my financial review, the company continues to make progress, contract performance is solid, we're increasing margins, and our orders and sales trends are improving.

Thank you. We'll now begin the Q&A.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions)

Noah Poponak, Goldman Sachs.

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

I wondered if you guys could speak to this KC-10 win and how it fits into the overall strategy of the business, because with what you guys have done with assets and the margin improvement plan you have, it sounds like the strategy of the company is to move into higher margin, higher return on capital businesses, and while this is a nice win size-wise, it sounds potentially pretty low margin. So how do we -- one, is that right? And then two, how do we pair those two things?

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

Yes, your assumptions are correct. However, looking forward and as you could have heard from the testimony of some of the service chiefs on readiness, readiness has become a critically important area for our customers, and it's an area where they're used to having L-3 as a player, as a good player in that space, and that is evidenced by some of the substantial wins in the quarter. And the fact that the print on what the margin might be is lower than we would like, it does provide operating leverage for that entire business because of the absorption in that group as well as for all of L-3.

Those customer relationships are invaluable, and in terms of operating leverage for pulling our products through, it does present us with opportunities where we might be able to cross-sell avionics or heavy maintenance, whether it's engine work or whatever in our Waco facility and the like. So I mean having more business is a good thing.

We are working with our customers to change some of the dynamics of the margin model where we can, and I had expressed some serious concerns with customers about where margins are and our ability to continue in this space, and I was assured that customers were willing to listen and help us address that.

So I know Chris has spent some time on this too. This is a debate we have regularly, but we're all on the same page. So Chris, why don't you add your thoughts on this.

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

Yes, I will definitely, Mike, and thanks for the question, Noah. Clearly we made a strategic decision, as Mike said, to keep Vertex and to fix it. And when you look at what we've done in the first quarter with these new wins, I think we're off to a pretty good start. I mean a couple of these are being protested. We'll go through that process, but with over $2 billion of awards, you have to be booked and finalized, we feel pretty good.

The customer dynamics are changing. We've talked about the shift from the LPTA to the best value model. I think that's going to give us some opportunities. Margins are important and we've talked about our need to increase those, but we also like to look at the ROIC and many of these programs do not have a lot of capital intensity. So when we balance the return on invested capital with the margins, we think we're creating value for the corporation.

So there's still work to be done in Vertex. We're not done fixing it. But this win, and given our large aircraft capabilities such as KC-135, we're comfortable with our ability to satisfactorily perform on KC-10. Then I'm sure we'll talk more about things like Fort Rucker and Army C-12 and Salsa, three large opportunities that will be coming up late 2017, 2018. We like our positioning. Ralph, did you have anything else to add, or --

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

Just to underscore what both Mike and Chris just explained, the two key ingredients or drivers to improving the margins at Vertex Aerospace are going to be one, to grow the business base. We think we need to take those sales from where they are presently, about $1.2 billion per year in sales, to at least $1.5 billion. The KC-10 win gets us, clearly, going in the right direction. We also need to win the two recompetes that we have coming up over the next year, which Chris talked about, Fort Rucker and Army C-12.

And then, the second main item is that we need to see an increase in flight training hours. Based upon what's being discussed about the 2017 DoD budget and all of the discussion in that conversation about increasing readiness support, we think that should lead to increased flight hours. And given that most of our contracts have terms that are based upon flight hours, that should also help us improve not only our top line, but the margins in the business as well.

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

Okay. Great. That's helpful.

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

Let me give you -- from a historical perspective, also know -- about eight years ago our top line was being driven by the services business, which we spun off, namely Engility, because of the occasion work needed in theater.

Now, it's a different cycle right now, but readiness has become a critical issue for customers. We have a great asset in that space, and it's a space that I don't think we should be ignoring. We definitely want to do better with the margins on it. But I think we've demonstrated in the quarter that we're well thought of by the customer community, and we're winning sizeable long-term work on significant platforms with significant units that are fielded. So this is an area that has the potential to be a good driver of top line in our business base going forward. And, believe me, the margins are something that we're focusing on.

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

Okay. Yes. No. It's helpful. When you see it, it sort of seemed to maybe diverge, but that's helpful. That scale matters and it's sort of recurring revenue and there's cross selling opportunities. That's helpful. Who's protesting KC-10?

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

I don't know if we know that. Someone who we beat, obviously.

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

Yes, (laughter). Okay. That's okay. Ralph, just since you brought it up on the two recompetes there, can you just update us on size and the time line?

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

Sure. The first one is the Fort Rucker maintenance support contract, and that happens to be our largest contract in terms of annual sales at about $450 million per year. Our contract is scheduled to end on September 30 of 2017. We'll be recompeting that over the next year or so, and I wouldn't be surprised to see our contract extended six to nine months, which is becoming more and more common on these recompetitions. It's likely to be a late 2017, early 2018 item. We're performing well in that contract and we like our chances in that recompetition.

The second one is the Army C-12 contract, which is presently doing about $180 million to $190 million in sales per year. That's also within our Vortex Aerospace business. The new contract should start in the fourth quarter of 2017. Aside from those two recompetitions, we don't have any large single-contract recompetitions across the entire company for the next several years. But that's where those two stand, Noah.

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

Great.

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

One thing we've -- this is Chris -- just added a slight change to our process on these larger opportunities is Mike is heading up regular quarterly reviews of these key win opportunities. That gives us a six-, nine-, 12-month visibility so we can all agree on what teammates we align with. We look at the draft proposals and challenge terms and conditions, to the extent that's appropriate, and we develop an outreach program to make sure that we're touching the appropriate stakeholders. In fact, we have one of our top executives earlier this week down in Fort Rucker spending a few days just to independently talk to our customer and see how we're doing and getting some favorable reports out of that. So I think given the significance and then maybe a little more focus at the executive level earlier in the process is going to improve our chance of winning.

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

To chime in on that. There were also recompetes going on in that space where we are not the incumbent, where we will be pursuing the recompetitions to go after additional market share, so that should provide some cushion just in case. But I think our past performance, especially on Fort Rucker, gives me a comfort level that we are in good shape there. That's become a very critical capability for our customer, and we should have about five years under our belt of excellent performance. So it's one that we're looking forward to being successful winning.

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

Terrific. Thanks a lot. I'll jump back in the queue.

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**Operator**

Richard Safran, Buckingham Research.

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

I wanted to ask about your targets, how you're thinking about them now after 2Q results? The margin targets of communications, aerospace and electronics, just wanted to get your -- are we moving towards the higher end of the range here? Just want to know how you're thinking about it.

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

Sure, Rich. I'll take that question. I'm probably starting to sound like a broken record when it comes to our margin targets for 2017 because we've been saying the same thing now for at least a year and a half. So I'll go through it again.

Within electronics systems, we expect margins to be somewhere between 13% and 14% for 2017. Obviously, I'm more comfortable with the lower end, and that is a nice increase to this year's margin guidance which stands at 12.1%. Within communications systems, the margin targets that we articulated for next year are between 10% and 11%. Our midpoint guidance for 2016 is 10.4%, so I think we're going to be closer to the high end of that range for 2017.

Lastly, within commercial -- within aerospace systems, we said that the target range for margins is in the high single-digit area, which is 7%, 8% or 9%. What we explained was, the way we get to the high end of that range for aerospace systems is more international ISR, and other international work, to grow in the business base and improving the margins of logistics, or Vertex, and we covered that in the first question. So, clearly we're still working on those items. And as of now, I'm more comfortable with the low end of that range for 2017.

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

I've got to chime in. We've talked about this before. Ultimately, we're all trying to get more operating income and more cash. We're going to do that through top-line growth, we're going to do it through M&A and we're definitely going to do it through margin expansion. But the ultimate goal here is to generate more cash, and I think that creates more value for everybody involved.

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

Okay. Just quickly, on your comments on the holographic weapons sight that, Ralph, that you mentioned additional risk. Could you go into that in just a little more detail. When those issues get settled, how much additional risk really remains here? Is this something that could linger beyond this year, or do you think it ends this year?

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

Sure, Rich. There's primarily two risk items. The first one concerns our voluntary return program, which we instituted in the fourth quarter of last year. As you know, it stands at $35 million in terms of total estimated returns, and that's following the $15 million increase that we recorded to it in the first quarter of this year. The good news with respect to the returns are, one, it's voluntary, so we could discontinue it at our discretion. Two, it takes care of our customers. Three, the return experience is trending in the right direction, declining. And we now have seven plus months of experience with that voluntary return program. We have a very robust, detailed statistical analysis, and our estimate is holding and proving to be accurate. Like anything else, it's subject to change, if the return rate were to change for some reason. But right now it's heading in the right direction.

The second item is that we're involved in class action lawsuit litigation on the holographic weapons sights. We have valid defenses and we're vigorously defending ourselves. And we're presently scheduled to go to mediation in August to try and settle that litigation. Obviously, litigation is inherently risky, and we're not sure -- we can't predict if we're going to be able to settle those items and what the ultimate outcome will be. Those are the items on the holographic weapons sights, Rich.

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

Appreciate that color. Thanks.

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**Operator**

Myles Walton, Deutsche Bank.

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

I was hoping you could touch -- maybe first, Ralph, on the repurchase. You said you're scaling back away from the guidance to incorporate or contemplate acquisitions in the back half of the year. I guess you have $475 million left to go on the $750 million placeholder. What's the new placeholder for repo for the year?

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

The placeholder is still $750 million. But as we talked about, we're looking at several acquisition targets and opportunities. We should be able to at least complete a couple of transactions, and when and if those occur, we'll shift some of that remaining $475 million in share repurchases to M&A. So, handicap that now in the $200 million, $300 million range. We'll see what happens.

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

Okay. Makes sense. You just mentioned the margin targets. How much of a swing factor, if you match up discount rates, would pension have to the margins, 20, 30 basis points next year?

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

Actually, I'm glad you asked that question, Myles, because the targets that I just discussed for 2017 do not factor in any pension expense assumption changes. So we're not going to set the assumptions for next year's pension expense until we get to December 31, because that's our measurement date. The way things are trending in the interest rate markets year to date, we're looking at a meaningful reduction in the discount rate for the pension expense assumptions, somewhere in the 90 basis point range. That 90 basis point breaks down to between a nearly 70 basis point reduction in the 10-year Treasury yield, since the end of last year, and another 20 basis point reduction due to the overall tightening of credit spreads in the investment-grade market. So that 90 basis points reduction, if it holds, would translate into about a $45 million increase to pension expense for 2017 versus this year on a pretax basis.

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

Any contribution impact?

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

This year we're funding the pension plan at $100 million, which is twice what the minimum requirement is. And I expect that we would fund another $100 million for next year. I don't see any other requirements beyond that, even given what's happening when interest rates. Our asset returns for the year are doing well and tracking nicely to our full-year estimate of 8%.

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

Great. Thanks.

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**Operator**

Robert Spingarn, Credit Suisse.

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

You mentioned your bid process and teammates, and I was going to ask you about a couple programs where you're teaming with Northrop, so there's the trainer, there's JSTARS. Do you have any update there how big these could be, or when you think we're going to hear more on those? And if you should be fortunate and win, when those could begin to contribute?

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

I'll just say, relative to the teammates, we work with pretty much everybody in the industry. We try to align with what we think our customer wants from a platform perspective, and then we select and work closely with that OEM. I think in the -- and the trainer has been talked about, it seems, like for half a decade here. And I think given the budget and such, it's probably a 2018 time frame. Training, unfortunately, is one of those things that's easy to push off. I guess JSTARS is probably in the next six to nine months. We'll be working jointly on putting together proposals, is my expectation.

We have a great relationship, I think not only with Northrop, but a lot of the other companies. When Mike and I were over at the air show, we spent a lot of time reconnecting with our partners, both internationally and domestically. We're satisfied with that process.

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

Chris, are there any opportunities out there, maybe -- not on the logistics side, but more on the platform side where you'd like to be a prime?

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

There absolutely are. We're working some things in the classified world, which probably is an easy answer since I can't tell you much more than that, but we're looking at all aspects. We have opportunities in space, we have opportunities at sea, under sea and some airborne assets. It's early to say, but I think we're in pretty good shape.

All the ISR aircraft are going to be up for recapitalization and some of them are shifting more to business jets from the larger platforms for performance and endurance and cost savings, so we're adjusting our strategies and our offerings accordingly. But there's a lot out there, and I think we're kind of moving up the food chain a little bit, Mike, and starting to bid some of these as primes that we might not have done previously.

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

Part of that has to do with how the customer is pursuing the program, meaning if they want an airframe OEM to be the prime, we're not going to become an airframe OEM, obviously, but we can be a significant subcontractor on a missions system. There are times where the mission system becomes the driver of who primes a contract.

We try to stay as flexible as we can and get ourselves on the best team or get the best members on our team where we have the best probability of a win. We're very fortunate in the space occupy where we bring to the table not only state-of-the-art sensors and communications gear and data links, but we also have a very strong capability, as you know, in systems integration in the Greenville facility where I believe -- I would call it a national asset in terms of being able to integrate sensors and coms on virtually any platform. We're very platform agnostic, which gives us the ability to partner and team anywhere we see a good opportunity on a global basis. There certainly is a lot of activity, I was going to say, with platform OEMs looking for partners to help missionize airplanes, and we're always at the top of that list

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

Okay. Just on the M&A side, you said you kicked that up a notch. Are there particular areas -- I think you've talked about $1 billion plus in potential M&A. Are there specific areas you're targeting?

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

There's a couple of areas where a modest acquisition would give us the ability to be a prime on a smaller scale, if you will, in some of the areas that Chris mentioned. So let me turn it over to Chris for the M&A, because he's really been tracking that carefully. But it seems to be a very broad spectrum of companies that are on the market at this point, whether it's in avionics space or whether it's in the ISR space, et cetera. But go ahead, Chris.

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

Actually, all the markets, we have at least one opportunity in each of these. We even have a couple internationally, but those would be in countries where we already have a footprint and understand the political and governmental situation. We have some in commercial aviation, the pilot training, security and detection in defense.





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We're really looking for one of three things. We're either looking for some new technologies, as a way to jump start an area of interest to our customers as compared to spending the R&D. Or we're looking for some new products that can enhance our existing business, and then there's occasions where we actually get access to new customers.

So it's a pretty obvious process. We refocus first and foremost on the strategic bit. Just last week Mike and Ralph and I were going through the list, and like I said, about a dozen of these passed the strategic hurdle, and now we're going into the next phase of making offers and starting due diligence and working the finance side.

As Ralph said, we would love to do a couple in the second half of the year. We're not going to do a bad deal just to say we did one. I kind of like our position and some of these, given our reputation of doing over 100 acquisitions, a lot of people come to us on a proprietary basis because they like the model. They like the culture and they like the opportunity to be part of a bigger company. So I'm very pleased and excited about the potential on the M&A front.

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

Thanks for the color.

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**Operator**

Carter Copeland, Barclays.

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**Carter Copeland** - *Barclays Capital - Analyst*

Wondered if, Ralph, you could clarify the revision in commercial, if that was just EOTech in general aviation, and if so what it was in general aviation that changed?

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

Okay. It was those two items. In general aviation, what I said during my comments was that last year we introduced a new product. It's a multi-link transponder, which we call LYNX. It's for the general aviation market, and that is geared toward responding to a new mandate that's presently in effect. The sales on that new product, even though the mandate are in effect have been slow to materialize and they're lagging what we planned. That's probably $20 million of the $50 million sales reduction in electronics systems guidance and the other $30 million is due to softer demand for the weapons sights at EOTech.

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**Carter Copeland** - *Barclays Capital - Analyst*

Okay. Great. Thanks. Just to keep track of everything that's going on in all these BUs, just if we keep score on what you've done year to date, it sounds like you've divested $50 million to $100 million in revenues. You've, I think, outlined now two consolidation efforts in aviation products, and then the one you mentioned today with Mustang and something else. You've closed a facility, is there anything else that's -- or you're planning on closing a facility. Is there anything else that I missed in that list?

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

No. I think that's a good list, but we're continuing to work with the business leaders and see what makes sense. Some of these consolidations are actual movements of facilities, and some are organizational, trying to optimize the management in the backroom operations. We haven't actually divested anything in 2016 other than NSS, which closed in January, as you know.

The ones we're working are so small, I was almost reluctant to even mention them. But we're going to do something -- I think that's a lot in one year, and we're going to continue to look where it makes sense. And part of these acquisitions are going to fold into the strategy as to how we organize and structure depending on the size and location of them.

We'll keep you abreast of these things as we go through them. But these aren't easy to do, and I think we've got our hand full with the ones we've announced.

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**Carter Copeland** - *Barclays Capital - Analyst*

I think people appreciate that. I just want to make sure we're keeping track of all that's being done. Thanks, guys. I'll let somebody else ask.

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**Operator**

Seth Seifman, JPMorgan.

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**Seth Seifman** - *JPMorgan - Analyst*

Just to follow up maybe a little bit on Carter's question, does the consolidation efforts you've launched thus far and maybe future ones that you might launch, are those all sort of contemplated in the margin targets for next year?

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

We have some savings from those consolidations that are contemplated in those margin targets, Seth, so --

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**Seth Seifman** - *JPMorgan - Analyst*

Okay. So partially.

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

We hope to do better.

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**Seth Seifman** - *JPMorgan - Analyst*

Right, of course. Okay. Thanks. As a quick follow up, there's talk of maybe keeping a larger contingent in Afghanistan now, does that have any impact on your sales?

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

To the extent that it results in additional ISR assets being deployed, that would clearly bring an uptick for us, also in the comms -- the communications area as well. But as of right now, the -- I talked about this earlier, the reduction in sales this year coming from the final run-off of the Afghanistan drawdown, which is presently at about $160 million, $165 million, is where it stands. So the improvement that we're seeing in our DoD business in sales for this year, which is about $200 million, is not coming from that area, Seth.

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**Seth Seifman** - *JPMorgan - Analyst*

Right. Okay. Great. Thanks very much.

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**Operator**

Howard Rubel, Jefferies.

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**Howard Rubel** - *Jefferies LLC - Analyst*

One of the other things you're doing besides consolidating is you're also pushing innovation. Mike, maybe you could talk for a minute about some of the things that you're doing to give some of the business units opportunities for more innovation. One thing, that sort of stands out might very well be applications for what's going on with the TSA solutions.

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

Howard, we attempt to be a thought leader in this area, and one of the things that I think we've done to get ahead of the pack, if you will, is to sign a teaming arrangement with a technology-driven company on the West Coast. I'm not going to name them, I've mentioned this in the past, that is on retainer with us in bringing some of those commercial technologies to the table and marrying them up with some of our defense technologies in terms of user interfaces, weight, power, size. All things that are very important to the war fighter, especially if they're carrying something around. In addition, just the type of technology that would traditionally be nurtured in the commercial environment.

As you've read, the DoD has done something in the Silicon Valley, now they've moved to open an office up here in the Northeast, near MIT. So they are very, very focused on accelerating innovation, if you will. And we have certainly not missed that, and we are attempting to stay ahead of the pack.

As I said during my comments, we're working on smaller form factors for our SIGINT Systems, some low-cost next-generation infrared search and tracking systems as well as our mission simulator, which will enable us to bring the war fighter training at the mission level. Now, a lot of this technology is dependent on video graphics and things like that as well as the expertise we bring, and we've really found a great partner to help us in this area. It's a mutual relationship, of course, but it's working very well.

And we've made this as a resource available across the Company for our group presidents where they can tap into it and bring it into their R&D programs as needed. I see it really bearing fruit in the future for us, where it's really differentiating the things that L-3 is doing. I think we're one of -- I haven't heard anybody else taking this kind of a step other than maybe on one other occasion. And we're looking at more opportunities like that to reach out of the box, if you will, and bring some thought leadership, commercial technologies to the table to stitch into our own product offerings where we can make a big differentiator between what we're offering versus the competition.

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

I'll just chime in. We've talked a little bit about the agility of L-3, and Mike and I have had several customer meetings on this topic. The focus is on the third offset, and we have some offerings and some investments to provide some capabilities that are needed. It's our rapid development methodology, and working with this partner that Mike mentioned, I think we're bringing some things to the forefront quicker than a lot of other guys. I think that's going to pay off.

So we did a mid-year correction on where we're spending our R&D to try to address some of these challenges. Again, I think we're one of the few companies that's increased our R&D spend year over year as a percentage of revenue, or however you want to mention it, and I think that's the long-term approach we're taking to growing the Company. And I think we're going to see some benefits in the years ahead.

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

Certainly as you've seen, as we see almost every week now, the global threat environment continues to get worse and worse. Different threat scenarios are occurring, whether it's an airport situation or other soft targets. Being a thought leader in this area and how we could adapt technologies to help keep citizens safe, if you will, and help identify threats, whether it's through systems we have or things that need to get developed, we're certainly on the case right now.

**Howard Rubel** - *Jefferies LLC - Analyst*

Thank you, gentlemen, very much.

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

Thank you, Howard.

With that, thanks very much for joining us this morning. We had, what I would characterize as another strong quarter, and we continue -- we intend to continue to build on this progress. As we've discussed, we are pursuing a three-pronged approach to drive growth and enhance profitability.

First, we want to achieve more organic growth and are working closely with our business development organization to better leverage our investments in R&D, as well as approaching proposals, teaming agreements and making sure that we engage in the best win strategies that we can think of. Second, we're active in scouting out potential acquisitions to broaden our customer offerings and enhance our long-term strategic positioning. We'll continue to take a disciplined approach, as you've seen us do in the past, but we liked having a healthy pipeline of candidates to look at and we're seeing that now.

Third, with respect to cost control, we are tightening operations, as you've heard. We're consolidating where it makes sense, and we are engaging in other cost reduction activities to help with the margin story. Our program execution remains strong and consistent, and we're focused on opportunities in our commercial training solutions business, ELIR, and in additional markets which will be part of our growth story going forward.

The steps we've taken are showing positive results. Overall, we are well positioned to achieve future growth and deliver long-term value to our customers and shareholders. So once again, thanks for joining us. Everybody enjoy the rest of the summer, and we look forward to speaking with you again in October. Thank you.

**Operator**

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