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LLL - Q3 2014 L-3 Communications Holdings Inc Earnings Call

EVENT DATE/TIME: OCTOBER 30, 2014 / 3:00PM GMT

OVERVIEW:

Co. reported 3Q14 net sales of $2.9b and diluted EPS of $1.78.

CORPORATE PARTICIPANTS

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

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

CONFERENCE CALL PARTICIPANTS

Robert Spingarn *Credit Suisse - Analyst*

Joe Nadol *JPMorgan - Analyst*

Ron Epstein *BofA Merrill Lynch - Analyst*

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PRESENTATION

Operator

Good morning, and welcome to the L-3 Communications Holdings Third-Quarter 2014 Earnings conference call.

(Operator Instructions)

Please note this event is being recorded. I would now like to turn the conference over to Jennifer Beugelmans with Joele Frank. Please go ahead.

Jennifer Beugelmans - *Joele Frank - IR*

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

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

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

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

Thank you, and good morning, everyone. Thanks for joining us for our third-quarter conference call.

As you know, the environment continues to be challenging given the ongoing budget uncertainties and the aftermath of the Iraq and Afghanistan drawdowns. While we were disappointed by the performance at Aerospace Systems, the rest of our business segments performed well. The Company continued to generate strong cash flow, and increase our international and commercial sales.

Since 2011, we have expanded our international sales by 35%, which has helped us offset the declines in the DoD area. Our net sales for the quarter were $2.9 billion, a 2% decrease year-over-year. Sales to the US government, including the DoD, declined by 4% and included $23 million of net sales from acquired businesses in both our Electronic Systems and National Security Solutions segments.

Reflecting our focus on expanding beyond domestic and traditional markets, net sales to international and commercial customers increased by 3% for the quarter or $26 million to $842 million for the quarter versus $816 million for the same time last year. Net commercial and international sales as a percentage of our consolidated net sales increased to 29% for the quarter, as compared to 27% last year's quarter. Diluted earnings-per-share were $1.78, that was a decrease of 19% from the $2.19 reported in last year's third quarter.

Funded orders of $2.4 billion were down 10% year-over-year. Our funded backlog decreased 2% to $10.1 billion at September 26, 2014, compared to $10.4 billion at the quarter end for 2013.

Our book-to-bill ratio was 0.83 due to those lower orders within the Aerospace Systems segment. We also made adjustments to our 2014 guidance, and we are providing our initial outlook for 2015. Which Ralph will cover in more detail shortly.

Operationally, we continue to integrate our businesses to achieve operational efficiencies and collaborative gains, as we compete for opportunities across our global markets. We are maintaining our focus on innovation to gain market share, as we move into new business areas.

For example, we're gaining stature in classified markets through performance and cost-effectiveness, where we offer efficient subsystem solutions directly to the government and other primes. Our strong net cash flow and stable funded backlog underscore our solid position.

I have some brief comments on our segments for the quarter, which will cover some significant awards and other milestones. So starting with Electronic Systems, net sales for the third quarter decreased slightly by about $5 million or about 0.5%, compared to the 2013 third quarter. In the segment where we're well-known for our diverse discriminating products, and we're focusing on growing our market share and driving margin expansion through cost reductions.

Our Precision Engagement and Training business is performing well. In addition to winning a contract to provide Hawk Oman training systems for the Hawk MK 166 advanced jet trainer aircraft, as a key sub contractor to BAe Systems, we are seeing growth in both our military and civil simulation businesses. To meet local demand for pilot training, L-3 Link UK is expanding our Asian aviation training center facility in Bangkok, Thailand, with the installation of a second Airbus A320 Reality 7 full-flight simulator.

Sichuan Airlines also selected L-3 to supply an A320 simulator valued at $11 million. This is the fourth simulator we have supplied to this customer, and the contract was a strategic and competitive win. In addition, Interjet signed an agreement for one full flight simulator for the new Sukhoi Superjet 100 valued at $10 million.

Our Security and Detection business has seen new orders on both the domestic and international sides during the third quarter. In support of Korea's Incheon International Airport, we received a contract for 14 baggage screeners valued at over $25 million during the next 12 months. Commercial Aerospace is still a robust market for us.

Our Aviation Products organization secured new work from Boeing to provide a variety of avionics products to the TX program.

Warrior Systems also remained solid. Last year, we were awarded a major new contract to supply our Scarab laser designator system to the Republic of Korea. Our performance on this program has been very good, with production and customer deliveries now underway and this creates new opportunities for L-3 in this area with this customer.

Internationally, we received orders for 8,000 laser aiming devices for the Swedish and New Zealand governments. Bottom line, these key business wins combined with our internal collaborative and efficiency projects and technology updates position Electronics Systems well going forward.

For Aerospace Systems, we had net sales of just over $1 billion, which was a 5% decrease from the $1.09 billion year-over-year. In a challenging quarter, given the circumstances, sales declines at Platform Systems were partially offset by an increase in sales of $26 million in the ISR Systems area.

We reached a key milestone with our first international sale of the SPYDR ISR platform through an FMS contract in the Middle East. The customer has purchased 2 SPYDR aircraft, and we see the potential for at least 2 more aircraft in 2015, and between 8 and 12 additional aircraft over the next three years. We continue to see strong regional interest for this platform.

We were also awarded the highly strategic Argentina C-130 upgrade program for $30 million to L-3 during the third quarter. This positions us for new work in Argentina, as well of all South America, and for other international C-130 pursuits around the globe including Sweden, France, and Saudi Arabia.

We've been awarded a two-year extension for our work in Canada supporting the CC-150 Aurora program. And this award affirms our unique capabilities in supporting head-of-state customers.

In Communication Systems, net sales increased during the third quarter by 3%. This was due primarily to increased deliveries of power devices, the commercial satellites, and for advanced communications systems. Overall, we have solid long-term positions in this segment, and are seeing growth in both international and commercial areas.

Our SATCOM business continues to perform well, and we've secured orders internationally. Including in Australia and Iraq, where we've booked a multi-year contract for 25 advanced Hawkeye systems over the next five years.

Our Common Data Link business remains strong, where we received a $25 million award for the development of a covert anti-jam next-generation communication waveform capability to allow fifth-to-fifth generation fighters to communicate with each other. Based upon this initial award, additional funding is anticipated to continue the development of this crucial capability. This work also positions us well for future work in support of both the F-22 and F-35 programs.

We were also competitively awarded a $31.2 million contract for the AFRICOM 2014 program by the Air Force Life Cycle Management Center. L-3 was awarded this contract as the prime contractor and communication systems integrator, based upon our exceptional program performance with this customer on previous contracts. We will lead its team in production, modification and integration of intelligence surveillance and reconnaissance capabilities onto three aircraft.

L-3 received its first contract with a US Navy customer in the cyber SIGINT domain as part of Navy Engineering Technical Services, or NETS program.

A joint L-3 team also won a contract for 33 K-band traveling wave tubes. The value of this program is $27 million, and deliveries will be made during 2014. This is a strategic win in the space arena, and we are only one of two suppliers in the world that do this high-end fabrication work.

Additionally, this segment is providing products and capabilities to our National Security Solutions business to capture new contract award opportunities. This collaboration is yielding upside results, and expanding our work on programs like WIN-T.

For NSS, net sales for the third quarter decreased by about 5% compared to the 2013 third quarter. The business continues to win contracts; however, NSS is gaining market share, stabilizing margins, and making a targeted expansion into global and commercial markets.

We won a contract to provide IT distributed commuting support to special operations command, or US SOCOM, and continue to provide IT infrastructure support to governmental authorities. NSS was awarded a $30 million 12-month extension through March 31, 2016 for the SITEC distributed contract for US SOCOM and for prize wide IT support.

We also won CASCADE, a single award competition for the NRO. This contract provides NRO with a mechanism for quick reaction capability initiatives and studies. It's valued at approximately $51 million over the next three years. We're also very pleased to win the NGA IT Enterprise Managed Services, or ITEMS contract, valued at $215 million over the next five years.

In terms of capital allocation and mergers and acquisitions, we are committed to continuing our strategy of returning cash to our shareholders. Year-to-date, we returned $571 million compared to $550 million year-to-date at the end of third quarter of 2013.

Also on a year-to-date basis, our percentage of free cash flow returned to shareholders was 116% which matches last year's figure. Through the end of the third quarter, we repurchased $413 million of our common stock compared to $404 million year-to-date at the end of the third quarter of 2013.

This strategy is particularly appropriate at this time, because of the absence of significant M&A opportunities, although that may change going forward. For now, we don't see many if any what we would call tier 1 or tier 2 type companies for sale.

However, there are M&A opportunities for smaller strategic acquisitions for L-3, and we're working on several of those at this time. We're also in the process of divesting a few non-core businesses and product lines.

In terms of budget, we believe we're getting to the bottom of the US DoD budget downturn and are watching the geopolitical environment closely. In the near-term, we expect a more stable funding environment with no major changes in sight.

However, there are potential wildcards that will challenge DoD's current strategy. They include: the global Jihadist resurgence increasing cyber threats around the globe, and activities in Russia and China. As always, L-3 has a variety of products and services to support a wide range of national security initiatives.

We're focusing on the DoD's growth areas such as SOCOM, ISR, electronic warfare, and cyber, to name a few. We continue to monitor the budget and legislative environment, and we believe we're well-positioned with products and services to support key government priorities.

Before I turn it over to Ralph, I just wanted to make a few brief comments about the recently completed internal review. First off, the conduct that caused the review was isolated and does not reflect the standards by which we operate. I think everybody knows that.

I am profoundly disappointed with some of our people, but they are no longer L-3 people. However, I am proud of the way the Company handled this matter. A lot of people made heroic efforts during the summer to bring this to closure in a relatively short period of time. We've redoubled our commitment to excellence and our bolstering our policies and procedures at Aerospace Systems to ensure that these types of problems never recur.

And with that, I'd like to turn it over to Ralph for the financial data. And then we'd be happy to take your questions.

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

Okay, thank you, Mike. I'll cover some details about the third quarter, update our 2014 guidance, and I'll also provide our initial or a preliminary outlook for the next year.

But first, I want to briefly discuss the internal review of Aerospace Systems segment. Early in October, we completed our internal review of the Aerospace Systems segment, and on October 10th we filed our June 2014 10-Q. We also filed amendments to our 2013 Form 10-K and to our March 2014 10-Q to revise our previously reported financial statements to record the internal review adjustments in the periods that they affected.

The final internal review adjustments increased by $85 million to $169 million in total from the preliminary charges of $84 million that we announced when we first reported this matter on July 31st. The internal review adjustments affected the Logistic Solutions and Platform Systems sectors. There were no adjustments for ISR Systems. Pages 10 and 11 of our third-quarter 2014 financial data charts, which are on the Company's website, reconcile and explain the increase in the internal review charges including the periods that they affected.

And with that, I would like to cover some comments about the third quarter. Excluding the Aerospace Systems segment, our third-quarter results were generally in line with our expectations.

Diluted earnings-per-share was $1.78, and our third-quarter EPS was negatively impacted by weaker than expected sales and margin for Aerospace Systems, as well as $9 million of additional expenses incurred to perform the internal review at Aerospace Systems, which together, lowered EPS by about $0.23 compared to our preliminary third-quarter outlook that we provided on July 31st.

This lower than expected performance at Aerospace Systems was partially offset by a lower tax rate. And our free cash flow was a very robust $344 million.

Our third-quarter consolidated book-to-bill ratio was about as we expected at 0.83, but significantly lower for Aerospace Systems, which was only 0.49. And that was due to a variety of award and order delays and reductions, especially for international and commercial business. And those lower orders for Aerospace Systems impacted the third-quarter sales by about $80 million.

This softness in the Aerospace Systems orders will continue into the fourth quarter. And it is the primary cause that we are lowering our 2014 guidance for Aerospace Systems, and such reductions are unrelated to the internal review.

Next, I will review the 2014 guidance update compared to the preliminary guidance that we provided on July 31st. Which, I'll remind you, was preliminary because the internal review at that time was still ongoing.

We reduced our estimated 2014 earnings-per-share by $0.60 at the midpoint to $7.40. $0.55 of the reduction pertained to completing the internal review and finalizing the first half charges, as well as lower second-half profits at Aerospace Systems' Logistic Solutions and Platform Systems sectors, and the additional expenses that I just talked about to perform and finish the internal review.

We also reduced 2014 EPS by another $0.20 for the lower second-half Aerospace Systems' sales and margins that I just talked about. That pertained to the order and award delays that we began to experience in the third quarter, and again, those are unrelated to the internal review.

We also had a $0.03 reduction to EPS for higher pension expense, caused by the recently enacted Highway and Transportation Funding Act. Partially offsetting these EPS reductions was an $0.18 increase for higher sales in the other segments, as well is a lower tax rate for the year.

We lowered consolidated 2014 sales guidance by $50 million, which was comprised of a reduction of $150 million for Aerospace Systems, partially offset with estimated sales increases of $50 million each for Electronic Systems and Communications Systems.

With respect to the capital allocation, we increased our share repurchases estimate for this year by $125 million to $825 million for the full-year. Year-to-date share repurchases, as Mike just commented on, were a little more than $400 million. Which means that over the next couple of months, we will repurchase more than $400 million of our common stock. After these share repurchases and the dividends that we've paid all year long, we expect to end 2014 with a cash balance of about $500 million.

Moving on to our preliminary outlook for 2015. Since we last discussed this topic, there have been two major changes.

The first one concerns pension expense, which is increasing significantly versus 2014 by approximately $73 million, due to a lower discount rate, the impacts from that Highway and Transportation Act, and actuarial assumption changes, primarily mortality rates.

The second major change for the outlook for 2015 is that Aerospace Systems' sales and margins will be lower than we previously expected. The other three segments, Electronic Systems, Communication Systems and NSS are in line with our prior expectations for 2015 sales and core margin, including that they will each have core margin expansion, that on a combined basis would increase consolidated margin by 30 basis points before you factor in the reductions at Aerospace Systems.

We expect next year's sales to decline by about 2% to $11.8 billion versus our 2014 guidance midpoint. The Afghanistan drawdown is going to cause most of that decline, which is about $250 million, as the US military completes the drawdown in Afghanistan next year.

With respect to Aerospace Systems, we now expect sales for next year to be about $4.150 billion which is about $200 million below our initial 2015 forecast. It includes a $75 million reduction for the Army C-12 contract ending on July 31st of next year. A $75 million decline in the legacy US military programs at Platform Systems, due to DoD budget reductions and shortfalls, as well as $50 million related to slower international SPYDR sales partially due to the award and order delays that I just talked about.

For operating margin, we expect consolidated margin to be about 9.9% next year. And that's before the higher pension expense of $73 million, which will reduce consolidated margin by about 60 basis points.

At the segment level, we expect core margins to increase versus 2014 at Electronic Systems to the low 12% range. At Communications Systems to the mid-10% range, at NSS, margins will be close to 7%, and for Aerospace Systems we expect margins to be in the mid-8% range.

The Aerospace Systems margins will be lower than we previously expected for 2015 because of a few items. One, we have lower volumes on our legacy US military programs, including Liberty. Two, there are lower margins on follow-on ISR production for the US Air Force, which are being caused by better buying power pressures. Three, sales growth on new international and commercial business will initially generate lower margins, but we expect those margins to improve after 2015. And lastly, we have lower profits for Logistic Solutions. The Logistic Solutions' sector margins have reset to about 4.5% from what we thought they were going to be, which was about 7.5% at the beginning of this year. And what's happened there is that there's been intensified price competition as DoD budgets tighten, and contract award selection criteria have increasingly shifted to lowest price. The margins, however, at ISR Systems and Platform Systems on a combined basis will be somewhere between 10% and 10.5%.

So our current assessment for diluted EPS for next year, after you factor in all those changes that I just talked about, equates to about $7.50. Which again, is negatively impacted by $0.56 for a higher pension expense versus 2014, and approximately $0.70 for the lower Aerospace Systems sales and margins for next year that I just described.

We expect the tax rate next year to be 32.0%. And that continues to assume that we have no federal R&E tax credit. If the R&E any tax credit is reenacted for 2015, it would generate an annual benefit of approximately $0.19 of earnings-per-share.

We expect to generate strong cash flow next year of about $925 million, and that works out to about free cash flow per share just above $11. Next year, we're starting with an assumption for share repurchases of $0.5 billion, we'll and have the ability to buy back a lot more than $500 million next year, based upon our cash balance, and the free cash flow that we expect to generate.

So to conclude my financial review, while we're pleased with the progress that we're making at Electronic Systems, Communications Systems, and NSS we are very disappointed by the performance of the Logistic Solutions and Platform Systems' sectors at Aerospace Systems segment.

We're taking actions to improve it, and will continue to effectively manage the Company. L-3 continues to generate robust cash flow, and we're deploying that cash flow to increase shareholder value.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Robert Spingarn at Credit Suisse.

Robert Spingarn - *Credit Suisse - Analyst*

Good morning, Mike, Ralph.

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

Morning, Rob.

Robert Spingarn - *Credit Suisse - Analyst*

Mike, I want to ask you a question. And I don't mean to put you on the spot here, but it's a high-level question. And Ralph just told us about $11 in free cash flow next year, which puts you at roughly a 10% free cash yield which is a sizable discount to your larger peers, as you're well aware.

And I'm just wondering, given how reliable how you're free cash is and this discount, is it impossible that your higher percentages of services work might be the basis? And I say this in the context of what happened at Aerospace Systems, and with NSS.

And the fact that when you look at your results, your hardware business has consistently exceeded expectations, but not always on the services side. Does this perhaps invite some strategic look perhaps portfolio shaping on the services side?

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

Yes, absolutely, Rob. I cannot speculate how the financial community values the Company in terms of multiples of cash flow, earnings, a mix between services and products. It would be pure speculation on my part.

But having said that, a couple things to point out. The service part of the business has been the part that has been most impacted by spending priorities that were forced by the sequestration resulting from the Budget Control Act. And the better buying power, and the drawdowns in Iraq and Afghanistan.

So they've gotten hit three times. And it's been challenging, to say the least to make up for some of these shortfalls.

In fact, if you want to get a sense for the environment, there's actually an article on A2 in today's Wall Street Journal about some of -- not our programs. But it's about the impact the budget is having on keeping the frontline aircraft flying in terms of lack of maintenance, lack of qualified people, et cetera. Well you can only imagine when you think about our Logistics business, the pressure that the support aircraft are under.

So, yes, we're aware of the environment. I can assure you that we are well focused on portfolio shaping, and that should be an encouraging comment in terms of what's possible for us in the future, and potential upside opportunities that we see from portfolio shaping.

Robert Spingarn - *Credit Suisse - Analyst*

Okay. Thank you. That was it.

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

Okay.

Operator

Joe Nadol at JPMorgan.

Joe Nadol - *JPMorgan - Analyst*

Thanks, good morning. I had a couple, a few. I'll try to keep it brief.

On the aerospace or on the guidance for next year, Ralph. On slide 18, you have Aerospace Systems providing a 40 basis point headwind to consolidated margin, but excluding pension.

And I'm trying to square that with what you said about 8.5% versus the 7% that you're now expecting this year. So I just don't quite understand what the expectations for Aerospace going into next year, and why that's [providing] incremental pressure.

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

Okay. So 8.5% margin for Aerospace Systems for next year is core margin. It's before the reduction for the higher pension expense. And that higher pension expense will take the Aerospace Systems segment margin from 8.5% to about 7.6% or 7.7%.

Joe Nadol - *JPMorgan - Analyst*

Right. But you have that below the line on slide 18. You have Aerospace providing a 40 basis point headwind to get to the 9.9%, and then you have a 60 basis point headwind from pension expense after that.

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

Okay, I understand. So I was first trying to explain what the margins look like at Aerospace Systems before and after the higher pension expense. So the next part of your question was what exactly, Joe? What's driving the margin reduction in the Aerospace Systems' segment?

Joe Nadol - *JPMorgan - Analyst*

Yes. I'm trying to get my arms around the outlook, because I see Aerospace Systems at 7% this year. And then I hear you saying it's going up next year, but then on slide -- on that slide I see it providing a headwind.

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

There are two elements on the chart 18 that you have to look at together. So there's a separate line that adds back $100 million for the internal review charges in the first half of this year, and the $25 million of expenses to perform the review that we're incurring mostly in the third quarter, which increases Aerospace Systems margins on that chart on a consolidated basis by 80 bps. And then you have the 40 basis point reduction, which gets to what's happening in the core margins, excluding the internal review charges. So you have to look at those together, Joe.

Joe Nadol - *JPMorgan - Analyst*

Okay. I guess I understand.

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

So essentially, to put in dollars terms for operating income. There's an add back for the internal review charges and expenses of $100 million, and then there's a subtraction for the margin erosion that I talked about of about $50 million. And that is partially also related to sales reductions.

Joe Nadol - *JPMorgan - Analyst*

Okay. That makes sense. Can you size, when we look at that 8.5% next year, and you mentioned in your remarks on each of the sectors that there's some upside beyond next year. How do we think about the long run margin opportunity in Aerospace?

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

I said that the core margins for the combined ISR Systems and Platforms Systems sectors would be somewhere between 10% and 10.5% for next year. And we expect to modestly improve those margins beyond 2015, but it's not going to be easy because we're going to continue to deal with pricing pressures, especially here in the United States. But as we bring some of the new products online, particularly items like international SPYDR, that's going to help our margins.

So Logistics Solutions is probably going to be more difficult to enhance the margins. There are some things that we're going to do in terms of streamlining those operations that will provide some benefit. But those margins are going to continue to be lower than the composite for the segment, for sure, into the future.

Joe Nadol - *JPMorgan - Analyst*

Okay. And then just one more quick one for you, Ralph. Pension contribution next year from a cash standpoint? What's baked into your guidance?

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

It's very similar to what it is this year. So this year, we're contributing just under $100 million. It's going to be about the same for next year.

Joe Nadol - *JPMorgan - Analyst*

Okay. And then just one more. Mike, you talked about you're looking at several strategic opportunities on the M&A side, and also some divestitures of product lines. Are these small? Can you just help size, or is there anything that's more -- that's larger that's in there?

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

Joe, right now, they're all small. And small being, I would say the sub $50 million neighborhood. So things that are in process at this moment. This did not count forward-looking activities we may undertake on a larger scale, as I said to Rob, regarding portfolio shaping and the like.

Joe Nadol - *JPMorgan - Analyst*

Understood. Okay. Thank you.

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

Thanks.

Operator

Ron Epstein at Bank of America Merrill Lynch.

Ron Epstein - *BofA Merrill Lynch - Analyst*

Hey, good morning. So just a couple questions for you guys, if I may. The first one for Mike.

In the wake of what happened in Aerospace Systems, in terms of how you think about the Company and how you run the Company, but yet that the history of the Company is a lot of smaller businesses. Have you changed how you think about the controls of the Company and that sort of thing?

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

Yes, Ron. During my tenure, which is rolling into its eighth or ninth year I forget, time is gone so fast. But when I took over back in 2006 I guess, we had 11 groups and 11 group Presidents. We now have four.

We did a lot of consolidation. And with that one of the factors was bringing more oversight and control through a more organized streamlined structure. More back office consolidation, and the like.

This is a situation that I think is unprecedented, not only at L-3, but in my entire career which included ten years as an auditor. Where you had three individuals at three different levels, colluding to evade the Company's controls. And no control system would withstand that kind of collusion.

So I don't want to be defensive or make and excuses for it. On the other hand, I don't think that the likelihood of a recurrence in my lifetime is possible. And if you look at the filings, there are remediation efforts that are underway. They have all been put in place, all of them.

Some immediately, the day we learned of the problem regarding with the personal changes. So we are always striving to improve our control environment, just as any Company should.

Ron Epstein - *BofA Merrill Lynch - Analyst*

Okay, great. And then for -- I think another strategic picture. So far, we've been talking in the M&A environment about divestitures. One place where I think you've mentioned in the past where you might have interest to grow a bit, and I was wondering if you could speak to this.

Is in the commercial world. Now that you've got the UK Link business. Are there other areas in commercial where you might think you want to get bigger?

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

We continue to look at opportunities to expand our Avionics business. We are -- we really look at it two ways, Ron. One, we're looking at acquiring businesses like the Link business that operate in both the military and the commercial domain, although it could be all commercial as long as it's technology we understand and are comfortable with managing.

We're also approaching adjacent markets. So a good example of that are taking our aerostructure businesses both the Crestview business in Florida, and the MAS business in Canada. Which have been exclusive to the military markets, and having them address the commercial aerostructures business.

So that is taking internal investment. And that also would be an area that we would be looking at. Commercial communications in terms of some of the gear that we're putting on communication satellites and the like, the traveling wave tubes.

Again, without getting too far outside of the box, it's prudent for us to take our existing technologies and capabilities broaden our aperture. And like many defense companies are doing now, and either moving into adjacent commercial spaces or for the most part addressing the international marketplace as well.

That provides a broader audience for our products and systems, but also higher margins. So we're doing all of those things.

Ron Epstein - *BofA Merrill Lynch - Analyst*

That's great. And then one for Ralph. Ralph, you mentioned in your remarks a couple -- good morning.

So you mentioned in your prepared remarks a couple times about the pressures you're seeing from better buying power. I was just wondering if you could give more color on that. Like how you're seeing it, how that's impacting the businesses just to better understand from your perspective how it's playing out.

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

So I commented on that in two areas. One was, the Logistics Solutions sector, where we're seeing the customer when it comes to maintenance work just default to a low price when they make their award selections. And it almost seems like they're willing to take the risk on the performance side in order to get the better or lower price. And I think that's a function of the continuing pressure that you see within the defense budget. Even though the overall budget is stabilizing, there's still internal pressures among the different categories, particularly when it comes to those types of services.

And then I also talked about it with respect to Aerospace Systems within the ISR Systems area. Where we have had healthy margins, and we're going to continue to have healthy margins. But even in those instances, our customers are doing what they can to stretch their budget situation. And a lot of that work that we do with the US Air Force, it's priced on an annual basis. So we're constantly having to negotiate this year's contract price based upon the costs that we just incurred, and all the labor productivity improvements that we had embedded in that cost that we just incurred. And a lot of that ends up being negotiated with the customer, and that puts pressure on the margin. So that's what's happening with respect to the pricing pressure that I talked about. Hopefully, that explains it a bit.

Ron Epstein - *BofA Merrill Lynch - Analyst*

Yes it does. Thank you very much.

Operator

Cai von Rumohr at Cowen and Company.

Cai von Rumohr - *Cowen and Company - Analyst*

Yes, thanks so much. Ralph, could you tell us the $73 million swing in pension? Basically, how does that sort out by the three businesses? I know that there is nothing at NSS.

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

So the $73 million spreads across the segment as follows. It's $35 million for Aerospace Systems, $18 million for Electronic Systems, $19 million for Com Systems, and $1 million for NSS.

And I'm sure you already understand this, that's based upon where we think the discount rates are going to end at December 31st of this year. And we did it based upon the prevailing interest rates that we see today, and so we used a 4.17% discount rate in that assumption.

So that's down significantly from the discount rate that we started the year with, which was 5.03%. And the impact now from every 25 basis points and the discount rate is roughly $14 million of pretax expense. That's where we see it as of today, and it likely will change between now and the end of this year.

We didn't comment on our asset return in the earnings release, or in the data charts on the website. The asset return that we're assuming for 2014 is about 8%, and our year-to-date return is about 7%. So we're tracking very closely on the asset return front.

Cai von Rumohr - *Cowen and Company - Analyst*

Terrific. And you told us about the expected $250 million decline in OCO. OCO has been running a little bit stronger I think than you'd expected this year.

So, is that a conservative number? And also, maybe give us some color on the expected trend by market commercial, forum, and DoD ex-OCO. Thanks.

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

The Afghanistan OCO sales we presently expect to be about $700 million for 2014. So our previous assumption for 2014 was $650 million, so it's $50 million higher than we previously expected.

And we said that next year, we expect it to decline by $250 million. Which will put it at around $450 million for 2015, and most of that decline is in ISR Systems, for less small ISR activity, small ISR aircraft activity, mainly Project Liberty. That's $230 million of that $250 million reduction we see for next year.

So with respect to the end customer markets, embedded within our 2% reduction in sales for next year. That assumes a 5% reduction in our US government and DoD business, including that $250 million for the lower OCO sales. The DoD sales would decline in total by about $500 million. So the OCO drawdown is about half of it. And offsetting part of those US government and DoD declines is expected growth of about 5% in our international and commercial end markets.

Cai von Rumohr - *Cowen and Company - Analyst*

Got it.

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

And that would place those sales at about 31% of sales for 2015 International and commercial.

Cai von Rumohr - *Cowen and Company - Analyst*

Great. And then the last one. So I think on one of the last calls you'd mentioned that the C-12 contract that you had goes until January. And now you're telling us it goes until July. How come?

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

You're correct. So the way the contract was structured, there was a base period with a number of option years. The last option year expires on January 31st of next year. However, within the contract, there was a six-month unilateral extension that the Army has that it can exercise if it needs to while it sorts out what it's next procurement strategy is going to be.

And we don't know for certain that that's going to happen. But here we are, it's the end of October. We still haven't seen RFP, so it's probably a good assumption that the Army is going to avail themselves of that extra six months, which would take us to July 31st of next year.

Cai von Rumohr - *Cowen and Company - Analyst*

And that contract is basically under water, correct? (multiple speakers)

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

So the extra six months generates about $10 million of losses at the operating income level. I think that's where you're going with it.

Cai von Rumohr - *Cowen and Company - Analyst*

And that's embedded in the 4.5% Logistics margin?

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

Correct.

Cai von Rumohr - *Cowen and Company - Analyst*

So really, if you get rid of C-12, it's not as ugly.

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

That's true. But you have to also consider that C-12 is a large contract in terms of sales volumes, so it absorbs overhead. So the loss would go away, but then we'd have to find ways to reduce those overhead costs that are no longer being absorbed by Army C-12. So it's not binary in that respect, Cai.

Cai von Rumohr - *Cowen and Company - Analyst*

Terrific. Thank you very much, Ralph.

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

Cai, I just wanted to add. Then, even if the customer were to extend, we are still evaluating recovery of some of this overrun. And there is the possibility of some dialogue around the cost of this program.

What the actuals are running, versus what the expectations were when it was bid. It's very complex in terms of logistics and readiness, which are important. So I would personally expect to be having a dialogue at some point.

Cai von Rumohr - *Cowen and Company - Analyst*

Terrific. Thank you very much.

Operator

Myles Walton at Deutsche Bank.

Myles Walton - *Deutsche Bank - Analyst*

Good morning. Thanks for taking the question. Maybe to follow-up on that line for a second. Ralph, can you size how big Logistics Solutions is in 2015? Both with and without C-12?

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

Okay, so next year, it's just under $1.2 billion of sales. And that includes a little more than $100 million for Army C-12. About $115 million or so.

Myles Walton - *Deutsche Bank - Analyst*

Great. And then on the pension side, it looks like if I map everything through the unfunded liability re-expands to maybe $1.05 billion something on that order magnitude. And I'm curious, does that than have any governor to your ability to spend on repurchase versus any type of trimming you have to do on debt to maintain that's return leverage?

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

Well, your math is pretty good, actually.

Myles Walton - *Deutsche Bank - Analyst*

Yes, sometimes.

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

Myles some of the rating agencies include unfunded pension liability in their leverage metric. So, to the extent that they do, it does increase the leverage ratios. But at this point, given our cash flow and the cash balances that we have, we don't really expect that to have an impact on our abilities to continue to buy back a lot of our common stock.

Myles Walton - *Deutsche Bank - Analyst*

Okay. But it may have -- to lead the question a little bit. If you did divest something, it might cause you to not be able to use all the proceeds for non-debt repurchase opportunities like you might have otherwise? If the pension funded status had been better?

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

That's certainly a possibility.

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

I would characterize that as possible, but not likely.

Myles Walton - *Deutsche Bank - Analyst*

Okay. Then the last one. In terms of the overseas engagements that are being started with respect to Isis. Obviously, it's starting small. But curious if you're seeing any early pull.

And also curious, Mike, maybe in terms of the OCO budget, numbers being thrown around in terms of where the increase could go, versus the current request. And I'm curious what your thinking is on that front for the FY15 OCO budget? Thanks.

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

Your use of the word throwing around is pretty accurate. Numbers are being thrown all over the place, and it's very hard to predict at this point, and especially pre-election. Obviously, a big, big pivotal point would be whether in fact boots in the ground are used or not.

What that means to us and in a large way is right now, one of the downdrafts we're having in Aerospace Systems is it relates to the Project Liberty program. Which will be rotating out of Afghanistan, or is in process of it, and it's creating a hole next year. Now, should we end up in a situation where there are indeed boots on the ground, you would see Liberty finding a home pretty fast.

Right now, we are assuming they don't find a home. So it does create a hole in the plan.

So in terms of making that call, my guess is as good as yours in terms of how that plays out. There obviously has to be funding put in place though, because right now there's a big hole. And the immediate impact to the forces is readiness, and it's going to have increasingly bad effects for the men and women in uniform, especially those that have to be put in harm's way.

So I expect to see more political pressure behind this, no matter what happens next week with the midterms. So it would be hard for me to say -- it's hard to make this call to say that there's only one direction up, but really there has to be additional funding given the geopolitical environment right now. I don't know what bucket it's going to come out of, but it has to go in place.

Myles Walton - *Deutsche Bank - Analyst*

Okay. All right. Thanks guys.

Operator

George Shapiro at Shapiro Research.

George Shapiro - *Shapiro Research - Analyst*

Yes, good morning.

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

Hello, George.

George Shapiro - *Shapiro Research - Analyst*

Ralph, in terms of the cash flow for next year, I assume that you're going to continue the $130 million or so benefit from deferred taxes. I'm sure the 401K match continues.

How long does that deferred benefit go on at this point? Because you haven't been making a lot of acquisitions lately.

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

So within the total deferred tax benefit for 2014, about $90 million pertains to the deductions from the prior business acquisitions where we can deduct the intangibles straight-line over 15 years. So, assuming that we make no other acquisitions, that $90 million over the next five years trends down to about $65 million, almost pro rata.

And then it continues to decline thereafter. But that, again, assumes that we don't make any additional acquisitions. Which is a poor assumption, and most of the acquisitions that we've made recently, the last few years, are the ones that we've been able to structure in that tax advantageous manner. So, I don't expect it to go down to $65 million over the next five years from $90 million in 2014, George.

George Shapiro - *Shapiro Research - Analyst*

Okay, thanks. And then in Aerospace, you mentioned that you had these delays in orders that's knocking revenues down this year $150 million, and you still got it down more next year. Are you assuming that these delayed contracts are in next year's guidance, or that they're just continually delayed?

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

We're assuming that they're in there, but at factored reduced levels. So there's some conservatism around both situations.

George Shapiro - *Shapiro Research - Analyst*

Okay. And one last thing, based on your guidance, the implied margin for Aero in Q4 is about 9.2%. I assume if I took out the pension adjustment of 80 basis points or so, that that's how you're coming up with around 8.5% for next year. So a continuation of what we see in the fourth quarter?

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

Yes.

George Shapiro - *Shapiro Research - Analyst*

Okay. Those are my questions.

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

It works out that way coincidentally George.

George Shapiro - *Shapiro Research - Analyst*

Okay.

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

Thanks, George.

So in closing, we will continue to deliver on our commitments to our customers, and continue to operate well in this challenging environment. We're looking closely at the Aerospace Systems segment and the Logistics Solutions sector, which is most impacted by sequestration, better buying power, increased competition and the drawdowns, as I mentioned.

So as you know, we continuously review the portfolio and will take portfolio shaping actions when we consider the conditions to be optimal. At the same time, we're in the process of reviewing several attractive acquisition candidates that fit well with L-3, although as I said, they are of a modest size. We expect to continue to generate strong free cash flow, and we'll focus on deploying that cash in a manner that is accretive, and we'll continue to increase shareholder value, and we'll also continue with our dividend policy.

The defense down cycle is near its end, and we are well-positioned to capitalize on emerging opportunities, and there will be emerging opportunities. I think one common denominator, no matter what geopolitical environment you look at, is the need for the persistent ISR capability. Of which L-3 is a world leader, not only in the integration of airborne platforms, but also in the delivery of all the hardware that makes those systems operate, and the aftermarket support that keeps them running.

I have every confidence that we'll continue to perform with excellence in leveraging our position as the number one or two supplier in each of our markets. And we look forward to speaking with you again at our next call in January. Thanks for joining us this morning, and have a great day.

Operator

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