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# EDITED TRANSCRIPT

LLL.N - Q4 2017 L3 Technologies Inc Earnings Call

EVENT DATE/TIME: JANUARY 25, 2018 / 4:00PM GMT

## OVERVIEW:

Co. reported 4Q17 sales of \$2.6b and diluted EPS of \$3.34. Expects 2018 consolidated sales to be just under \$10b and EPS midpoint to be \$9.40. Expects 1Q18 sales to be approx. \$2.3b and diluted EPS to be \$1.85-1.95.



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## CORPORATE PARTICIPANTS

**Christopher E. Kubasik** *L3 Technologies, Inc. - CEO & President*

**Mahmoud Siddig** *Joele Frank, Wilkinson Brimmer Katcher - MD*

**Ralph G. D'Ambrosio** *L3 Technologies, Inc. - Senior VP & CFO*

## CONFERENCE CALL PARTICIPANTS

**Cai Von Rumohr** *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

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**Jonathan Phaff Raviv** *Citigroup Inc, Research Division - VP*

**Michael Frank Ciarmoli** *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

**Richard Tobie Safran** *The Buckingham Research Group Incorporated - Research Analyst*

**Robert Michael Spingarn** *Crédit Suisse AG, Research Division - Aerospace and Defense Analyst*

**Seth Michael Seifman** *JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst*

## PRESENTATION

### Operator

Good day, and welcome to the L3 Technologies Fourth Quarter 2017 and Full Year 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** - *Joele Frank, Wilkinson Brimmer Katcher - MD*

Thank you. Good morning, and thanks for joining us for L3 2017 Fourth Quarter and Full Year Earnings Conference Call. With me today are Christopher Kubasik, Chief Executive Officer and President; 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 Chris Kubasik. Chris, please go ahead.

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**Christopher E. Kubasik** - *L3 Technologies, Inc. - CEO & President*

Thank you, and good morning everyone.

We're beginning an exciting new turn in the history of L3. 2018 kicks off a new era as we transition to L3 3.0. As you may have seen, we hit the ground running in early January with new organizational announcements. We're adding well-respected outside leaders to help us intensify our drive for growth and bring a fresh perspective.



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Hopefully, you all know the number of new initiatives to further my 3 key themes for 2018: integration, collaboration and innovation. If we go back to our investor conference in December, we spoke about our focus in 2018 on better integrating the enterprise. This is a company with a lot of potential and a lot of work to be done. We are actively at work improving our processes; streamlining our procedures; deepening our L365 initiatives, which is our continuous improvement focus; and in some areas, moving and changing our people for improved growth and accountability.

We're positioning the company for higher margins this year, and at the same time, we're investing in new processes as well as getting more strategic on our technology road map. It's important to push open the aperture for more top line growth in the years ahead.

I believe and our segment presidents believe we can be doing better across the board, and we're raising expectations to achieve that. I'm a big believer in continuous improvement, and we have embarked on a number of internal initiatives.

Before we discuss our results, I want to touch quickly on the Defense budget. The recent vote to end the shutdown and fund the government for 3 weeks shows some progress, but it is still temporary. Like the rest of the industry, we are concerned about how the continuing resolution impacts the U.S. Military's ability to plan and execute its mission. We will leverage our strength of agility and adaptability to support our customers as they navigate in this uncertain budget environment. We are watching the matter closely, and our guidance assumes that we don't have a protracted CR.

In terms of our financials. We had a good quarter and ended the year with increased sales, improved margins and a double-digit increase in EPS. Our 2017 EPS and margins could have been higher, but we continue to make decisions to increase our efficiency and profitability by integrating and restructuring our businesses. As I've said before, we'll take a short-term onetime charge in exchange for recurring long-term profitable earnings growth. Ralph will explain some of the fourth quarter decisions in a few minutes.

We entered the year with a goal of growing sales for the first time since the turn of the decade, and we accomplished that goal. I will also add that with the new tax law, we had a onetime gain of almost \$80 million, and we will have a lower tax provision in the future. We're one of the few companies that recorded a gain from the tax reform due to our various tax planning strategies.

We also increased our strong cash position, giving us the ability to grow our business through acquisitions and various organic growth initiatives. This is and will always be a priority for L3.

Free cash flow and cash conversion are important metrics to me and the leadership team. It's a big part of how we evaluate our performance, and we'll be discussing it regularly in our conversations with you. At the same time, we are investing to drive more top line and earnings growth in the years ahead. We know where we're headed, and we're determined to become a nontraditional 6th Prime. We have the resources to execute this vision, and we will invest in new technologies that are vital to the warfighter and our commercial aviation customers.

As we began 2018, our leadership team is energized, and we're starting from a unique position. We stand apart in the industry as a high-tech innovative aerospace and defense company whose very structure is designed to enhance entrepreneurship. We have a lean corporate structure and minimal bureaucracy, which allows us to move quicker than our competition. To successfully execute our strategy, we're going to integrate and collaborate more to make effective use of our strength. And we're pushing agility, technology and rapid adaptability deeper into our markets. We believe, and the world around us shows, that the future belongs not to the biggest but to the fastest.

Operationally, we are integrating our businesses and internal systems to increase productivity and accelerate information flow. This will lead to more timely decisions and increased profitability. We are intensifying the focus on collaboration by bundling capabilities into total solutions as well as collaborating on technology development and strategic pursuits. In addition, we are investing in areas that are aligned with the new National Defense strategy.

Across L3, we are developing advanced technologies in important growth markets to enhance our leadership position, including ISR, protected communications, sensors, night vision and airport security. We also have affordable and innovative solutions in both commercial and military pilot training.



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As we execute on our vision for L3, it is clear that some capabilities are no longer a good fit and would be better in another company. We've begun the sale process for Vertex, and we've seen a significant amount of interest in the business. We expect to receive initial indications of interest before the end of February and remain on schedule to sell Vertex by the middle of this year. Divesting it will enable the Aerospace Systems' leadership team to redirect our focus into areas where it is best suited to grow. We continually evaluate the portfolio based on market trends and outlook.

Structurally, our business leaders have been working hard at sectorizing our divisions. By integrating and optimizing our sectors, we are creating businesses that have critical mass and are aligned with customer priorities.

We're also taking steps to improve how we market ourselves internationally. At the beginning of this year, we established 3 new boards in Australia, Canada and the U.K. These boards will help our focus on growing more international business, strengthen customer relationships and support the thousands of employees who are working every day to meet the needs of our customers in these regions. Looking ahead, we have prioritized a dozen or so countries, primarily in the Middle East and Asia, and we're tailoring strategies for doing more business in each.

Let's now turn to talent as I'm putting the right people in the right places. We've made some great additions to the management team. Sean Stackley has joined us as our Vice President of Strategic Advanced Programs and Technologies. Sean was a former Assistant Secretary of the Navy and was one of the most respected leaders in the Pentagon. We also brought on Pat O'Reilly as our Vice President of Corporate Engineering. Pat was the Director of the Missile Defense Agency and will help us expand our system engineering capabilities. John Feren recently joined us as the new Vice President of Business Development and Marketing. John is a well-recognized expert in commercial aviation and will help us better connect with customers in that market. Just last night, John was recognized as the face of aviation at the Dublin Airline Conference. So congratulations to John. And finally, we recently promoted Andy Ivers to lead our Communication Systems segment. Many of you got a chance to meet him at the investor conference, and he has done a great job running several businesses within Communication Systems and has consistently delivered strong operational and financial performance while maintaining a focus on our customers. And he succeeds John Mega, who has been with L3 since the beginning and was instrumental in growing that segment into a multibillion-dollar business. After 44 years in the industry, John will be retiring, and we wish him well.

Let me now talk about our cash deployment priorities. As I noted earlier, we are approaching R&D in a more strategic way by aligning it with our technology road map and investing in the most promising technology. We will continue to spend about 3% of our revenues on R&D.

Turning now to M&A. We are stepping up activity in attractive growth areas and strengthening areas of strategic significance for us. We invested over \$300 million in 8 acquisitions in 2017. Right now, we have about 20 companies of varying sizes in our pipeline. I think it is reasonable to say we can spend \$1 billion a year in M&A. Moving forward, we are deploying most of our cash to build the company through M&A, and we will buy back shares to offset share creep as a secondary use of our cash.

In closing, I want to acknowledge the hard work and professionalism of our employees. We have a terrific team at headquarters and across all segments that is executing on our strategy. We're embarking on a number of changes to the growth -- to grow the company over the long term, and we'll continue to improve our margins and deliver organic growth, quality earnings and strong free cash flow.

In addition, we're going to accomplish this by keeping our eye on the ball, being customer-centric and never being satisfied as we pursue excellence every day.

Ralph will now take you through the financial performance and outlook, and then we'll take some questions.

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**Ralph G. D'Ambrosio** - L3 Technologies, Inc. - Senior VP & CFO

Thanks, Chris.

I'll review some details about the fourth quarter and our 2018 guidance update. As a reminder, I will only discuss the company's continuing operations, which exclude the Vertex aerospace business, which we are selling and reclassified to discontinued operations.

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Reviewing the fourth quarter, our results were generally in line with our outlook with strong orders, plus higher free cash flow and favorable tax items, mostly due to the recently enacted U.S. tax reform. Admittedly, there are a few moving parts in our results, including the Vertex reclassification to discontinued operations, so we added a reconciliation of diluted earnings per share from continuing operations from our midpoint guidance to our actual fourth quarter results in our website financial charts.

So if you look at Page 5 of our web charts, you will see that our fourth quarter diluted earnings per share was \$3.34, and it exceeded the midpoint guidance of -- by \$1.12. The largest component of our higher EPS was a tax reform gain of \$0.99. We also had a tax benefit of \$0.38 from realigning our foreign legal entities. Partially offsetting these tax gains was charges of \$0.24, mostly for new business integration and restructuring actions, which we took to further improve our core structure.

Fourth quarter sales declined 3% to \$2.6 billion. Regarding the negative sales growth, you should recall that our accounting calendar added an extra week to our first quarter, which reversed in the fourth quarter. And everything else being equal, this lowered our growth rate by about 6 percentage points. Fourth quarter sales were on the high end of our outlook. Within the segments, DoD sales were solid, including the start of the new Compass Call Recap program in Aerospace Systems and higher classified contract and airborne data link sales at Communication Systems. Soft market conditions continue to weigh on aviation security at Electronic Systems and commercial SATCOM at Communication Systems.

Fourth quarter operating margin was 10.2%, declining 50 basis points compared to 2016 fourth quarter because of an increase in restructuring charges.

As we previously explained, we are decisively pursuing our integration strategy. Our fourth quarter results included business integration and restructuring charges of \$39 million, which lowered margin by 150 basis points. Almost \$30 million of those restructuring charges were not anticipated in our last guidance update. The components of the \$30 million are a \$12 million asset write-down on our property containing one of our IR detector foundries that we will consolidate; a \$4 million pension curtailment charge; a \$4 million of severance expenses to combine our 2 Canadian business in Aerospace; and approximately \$10 million for incremental costs on in-process restructuring activities, primarily the Traveling-Wave Tube business consolidation in Communication Systems.

The IR foundry consolidation is a new restructuring action in Sensor Systems, which we expect to generate annual cost savings of about \$9 million beginning toward the end of 2019.

Regarding the pension curtailment, at our investor conference, Chris and I commented that we were evaluating our pension plans. And since then, we've decided to freeze substantially all of our salary pension plans effective January 1, 2019 (corrected by company after the call) to no longer accrue annual service credit. We expect this action to reduce our pension expense by at least \$25 million in 2019.

Communication Systems margin was 7.8%. And excluding the \$15 million of restructuring expenses there, it would have been 10.3%, slightly below our 2017 margin estimate. Communication Systems margin was also affected by the softness in the commercial satellite market, which caused lower overhead absorption and inventory provisioning in the space & power sector.

Sensor Systems margin was 10.9%, and without the foundry consolidation charge, its margin would have been 13.6% for the fourth quarter.

Fourth quarter free cash flow was robust at \$347 million, and it benefited from higher receivable collections. Orders were also very healthy at \$2.7 billion, resulting in a book-to-bill ratio of 1.06 for the fourth quarter and 1.04 for the full year 2017.

Moving to our 2018 guidance update. We increased our EPS midpoint by \$0.67 to \$9.40. The EPS increase is due to lower estimated taxes with a tax rate now at 20% arising from the U.S. tax reform, which adds \$0.80 to EPS, partially offset by \$15 million of higher estimated pension expenses for 2018 based on the final December 31st pension assumptions, which subtracts \$0.13 from EPS. Adjusting to exclude the 2017 tax reform gain, we expect 2018 EPS to grow about 11% over 2017.



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Consolidated sales guidance remains just under \$10 billion with expected growth of 4% over 2017. We maintained all of our 2018 segment guidance ranges, and we now expect the growth over 2017 of 7% for Electronics, 2% for Communications, 12% for Sensors, and this growth is partially offset by a 4% decline at Aerospace.

Our updated operating margin guidance of 11.2% subtracts the higher pension expense, and we expect 2018 margin to increase 40 basis points versus 2017, with operating income growing 8%.

We also adjusted our 2018 margin guidance for 3 of our segments for the higher pension expense, and we now expect margins of 13.7% for Electronics, 7.9% for Aerospace, 11.1% for Communications. And we increased Sensor Systems margin by 30 basis points to 11.8% unrelated to the pension expense.

Regarding free cash flow, we increased our estimate by \$35 million to \$900 million due to lower taxes, partially offset by an expectation of fewer receivable collections.

Regarding capital allocation, after paying dividends, as Chris explained, we continue to favor acquisitions. During 2017, we invested \$317 million on acquisitions. We also repurchased \$89 million of our stock during the fourth quarter and \$180 million for the full year 2017. We ended with a cash balance of \$662 million and expected to increase to \$1.2 billion by the end of 2018 after paying our dividends and repurchasing \$300 million of our stock in 2018. So, we will have plenty of firepower to make acquisitions.

Taking a quick look at the 2018 first quarter, we expect sales of approximately \$2.3 billion with operating margin in low 10% range and diluted earnings per share between \$1.85 and \$1.95.

Finally, to conclude my financial review, we had a very solid 2017. Compared to 2016, we grew orders 5%, sales 4%, operating income 7%, EPS 20% and free cash flow 3%. We also increased margins 30 basis points to 10.7%. We remain focused on continuously improving our operational and financial performance. In 2018, we will grow order, sales and all the profit metrics, and we are also strategically executing our disciplined growth capital allocation plan and have ample liquidity to support those plans.

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

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Your first question comes from the line of Richard Safran of Buckingham Research.

### Richard Tobie Safran - The Buckingham Research Group Incorporated - Research Analyst

Chris, first, I'd like to ask you a question about some of your opening -- just kind of a philosophical question about management incentives for your comments regarding integration, collaboration and innovation. I wanted to know if you could -- you had a number of hires here, and I'm wondering what your incentives are that are going to be driving the cooperation that you're seeking and the coordination, et cetera. So I just wanted to know if you could discuss what changes you're making in the incentive structure that's getting management on the same page with your initiatives. And are these incentives going to be carried down to, like, rank and file, for example?

### Christopher E. Kubasik - L3 Technologies, Inc. - CEO & President

Okay. Excellent question. We have 2 forms of performance-based compensation. The first one is a little longer term, which is basically equity-based. And there's no significant changes there because there's only, as you know, one share of L3 stock, and we all share in its ultimate growth. But on

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the annual bonus program, we're making changes in 2018 on a couple of fronts. First of all, instead of being solely focused on the earnings and cash metric, we're adding a third metric, which I'll be proposing to our Compensation Committee and Board in a few weeks, and that is one of organic growth. So the team will all be compensated on earnings, cash and growth. And then secondarily, we're going to have a mixed bonus where you will be compensated not only for how your entity does but the entity above you, which will drive collaboration. And then I reserve the right to make discretionary adjustments for cross-segment collaboration. So I think excellent question. And you get what you measure, and you pay what you measure. So we made those adjustments. I'll be proposing them. I have no doubt the board we'll embrace them, and I think that's going to help assure our success.

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### **Richard Tobie Safran** - *The Buckingham Research Group Incorporated - Research Analyst*

Okay. Now, Ralph, I wanted to ask you about Electronics. And I thought I'd ask you about maybe the moving pieces here that is driving your outlook here for '18, specifically security detection, commercial aviation and defense and training. Maybe in broad terms, could you discuss how you see growth in margins trending in the 3 business areas? I'm trying to get -- just get a sense of which of the businesses are really going to be the major contributors and drivers of Electronics in '18?

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### **Ralph G. D'Ambrosio** - *L3 Technologies, Inc. - Senior VP & CFO*

So in 2018, the main point is that we expect to have essentially really all of the sectors within Electronic Systems contributing to sales growth and operating income growth. The main drivers among the sectors there are going to be Precision Engagement, where we've done pretty well, I would say very well in some recent classified pursuits that we see contributing to our growth, not only next year, but the next several years. And within Security & Detection Systems, or Aviation Security, we definitely had lower order flow in 2017, and we see the orders improving this year in 2018. So that's going to be a contributor to sales growth and operating income. And we see continued growth in the training and simulation businesses both on the military side and the commercial side. So generally, we expect good performance across that segment.

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### **Christopher E. Kubasik** - *L3 Technologies, Inc. - CEO & President*

I'll just chime in on the security and detection. At least here in the U.S., as you would expect, the TSA is our largest customer, which is part of the Department of Homeland Security. And here's an instance where you do see the impacts of the continuing resolution. However, recently, the administrator has been on record saying that there is definitely a need for more CT scanners. So not only will our security and detection team, but Todd Gautier, the President of Electronics and the rest of the team, be focused on trying to get those contracts signed up once the CR is behind us.

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### **Operator**

Your next question comes from the line of George Shapiro of Shapiro Research.

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### **George D. Shapiro** - *Shapiro Research - CEO and Managing Partner*

I was wondering, Chris or Ralph, if you had the time to think about what your longer-term margin goals are. I know, Ralph, you've talked about them in the past. If you could just update us. And if, Chris, you think there's any thinking as to changes that should be done.

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### **Christopher E. Kubasik** - *L3 Technologies, Inc. - CEO & President*

Yes. I mean, I'll just point out. I know we get a lot of questions on margins. But if I look back on what's been accomplished the last 2 years, if you recall in 2016, we had 10.4% margins. We just wrapped up at 10.7%, and we're guiding to 11.2%. So I think in the last couple of years, I like the trajectory that we have. I've said, and we've jointly said, that we want to get to 12% by 2020. So I'm happy with the progress that we're making. I



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don't think there's a lot of guys that are growing year-over-year the way we are, and I think we're tracking. The decision on the pension, the defined benefit pension freeze, which, just to be clear, is effective January of '19, so in 11 months, that will kick in. That will be contributing favorably to our 2019 and beyond earnings. There's a lot of calculations and assumptions in that, but it's going to be at least \$25 million based on what Ralph and I have seen for 2019. So that's going to obviously help us. And we're on a path to get to 12%. And as I continue to say and will continue to say, we're looking at long-term growth. We'll take restructuring charges. We'll take charges for layoffs. We'll take charges for selling facilities at a loss, and we will lower our earnings, as I told you in the October time frame, to increase R&D as we have in Sensor Systems for opportunity. So I like the trajectory we're on. I think we get everything we said we would, and we plan to continue with that. I don't know, Ralph, if there's anything further you want to add.

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**Ralph G. D'Ambrosio** - *L3 Technologies, Inc. - Senior VP & CFO*

I think you covered it all, Chris.

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**Operator**

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

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**Robert Michael Spingarn** - *Crédit Suisse AG, Research Division - Aerospace and Defense Analyst*

I wanted to ask 2 quick things. The first one for Ralph on Communication Systems, just the margin guidance. You explained some of this earlier, all the restructuring and so forth, but I think you said it would have been 10.3%. And so the move up to the low 11s, what gets you there? And then -- and maybe I'm not including the foundry and some of the other things you're talking about, but I just wanted to get a sense of the confidence in that. And then, Chris, for you a higher level question, going back to the 6th Prime discussion and so forth. When you break this up into the services and I think about some of the hires that you've made, you called out Sean Stackley, which we all know is an excellent hire. How do you think about L3 going forward from a service targeting perspective, especially with the loss of some of this Army work recently that we've all talked about. How -- is there a strategy here by service?

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**Ralph G. D'Ambrosio** - *L3 Technologies, Inc. - Senior VP & CFO*

Okay. So your first question, Rob. On the margins, IR foundry consolidation is a new action. That's an action in Sensor Systems. And with respect to Communication Systems, your question was, how do we get to our guidance for 2018, which is around 11% from where we were in 2017? And there's basically 3 drivers of that. One, we expect that we're going to begin to realize cost savings or profit improvement from the Traveling-Wave-Tube consolidation that we've been working on for the last 1.5 years. That's going to end in the first quarter of 2018, and we expect to generate about \$7 million of savings from that consolidation in 2018. Additionally, I talked about the softness in the commercial satellite or commercial SATCOM market that we've been enduring in 2017, which caused low overhead absorption as well as some inventory reserving. So I don't expect that, that's going to recur in 2018. And then lastly...

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**Robert Michael Spingarn** - *Crédit Suisse AG, Research Division - Aerospace and Defense Analyst*

Ralph, on that last one, does the market need to improve for that to be true?

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**Ralph G. D'Ambrosio** - *L3 Technologies, Inc. - Senior VP & CFO*

No, it does not. We've lowered expectations for any kind of rebound in the commercial SATCOM markets, so that's not factored in or assumed in our 2018 guidance. And then lastly, we're going to see continued growth in our U.S. military business, in Communication Systems, so that's going



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to drive some improvement in the margin as well because we are not increasing our overheads at the same rate as sales. So those are the 3 main drivers of the better margin performance in Comm Systems this year versus 2017.

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### **Christopher E. Kubasik** - L3 Technologies, Inc. - CEO & President

Okay, okay. And, Rob, I like your question because I've been using this phrase a lot, and we all have internally. There's really 2 parts to it. The -- which I don't want to downplay. The first part is the nontraditional part, which I think aligns very well with the National Security strategy and some of the initiatives that secretary, board and other have on acquisition form. And it's really, I think, one of our key differentiators when we're talking about agility and innovation and speed to market. So that's the nontraditional piece. The 6th prime, of course, is having us prime, more work or move up the food chain or bundle our different systems into subsystems, subsystems into products and such. So that's kind of what I've laid out, and that's what the team has embraced. But relative to service by service, what I've said internally and publicly, aligns with the strategy that our nation has on this aggregation. And as much as I'd love to have a multibillion-dollar bomber or multibillion-dollar submarine or a multibillion-dollar ship, we're not going to have that. What we're going to do is support those, and our unmanned vehicles are a good example. So when we look at the Navy, you know we have 3 acquisitions last year to really get into a new market of unmanned undersea vehicles. And by all accounts, that's off to a great start. It's still in development. The mediums we're having in D.C. are very favorable. And I think there are hundreds, if not thousands, of UUV potential in the years and decades to come. So that's an example on the Navy strategy. With the Army, there's a whole push on soldier as a system. As you know, there's a whole Army modernization uptick, and I think we're going to have some progress there that we can talk about in the months ahead. And of course, with the Air Force, while we're platform-agnostic because we don't have a platform, I think when you look at some of the things we're doing in Aero, there's some great opportunities, whether it's C-130-amp. There's some classified things we're doing. There's some things we're doing for the new presidential aircraft. But at the end of the day, we have, I think, the best ISR capabilities out there, and that's an area where we're going to continue to grow. And we do have some unmanned air vehicles, probably like everybody else that they can't talk about. But that's the vision. And of course, sticking with the Air Force, the pilot training is an important part, and we made an acquisition a year ago. And I think we're the only company that actually does live training for the Air Force to get the pilots into the queue. So that's how we've laid it out. It's one of the things that Heidi Wood is spending a lot of time on as our Chief Strategy Officer, and we do have very unique and specific strategies that we're developing and implementing.

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### **Operator**

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

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### **Cai Von Rumohr** - Cowen and Company, LLC, Research Division - MD and Senior Research Analyst

So, Ralph, you did a good job of explaining the tax rate. Could you just explain how much it added -- it's adding to cash flow in 2018?

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### **Ralph G. D'Ambrosio** - L3 Technologies, Inc. - Senior VP & CFO

Sure. So compared to our prior or our initial guidance for 2018, at that time, we were expecting a tax rate of about 26.5%. So we lowered it to 20% following tax reform. So that translates into about a \$60 million reduction in income taxes. Most of it should turn into lower cash taxes. There could be some timing items, and so that's an increase to our free cash flow. And then I talked about offsetting some of that higher cash flow, is the fact that we had very strong receivable collections in December of 2017. So we want to take a more conservative assumption with respect to the receivable collections in 2018. So those are the 2 moving parts, if you will, with respect to our free cash flow guidance for 2018.

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### **Cai Von Rumohr** - Cowen and Company, LLC, Research Division - MD and Senior Research Analyst

And then, Chris, you talked about focusing on areas of greater opportunity and maybe deemphasizing or possibly divesting things that don't really fit. Could you give us some color on -- when you think about things that don't fit beyond Vertex, how big is that potentially? What's -- give us a range maybe of how big that is in terms of your sales and profits.



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**Christopher E. Kubasik** - *L3 Technologies, Inc. - CEO & President*

Yes. I mean, Vertex is clearly the focus. We do an annual review. There's probably a couple \$100 million of revenue on the watch list, but my general goal is either to fix the businesses or increase the investments to try to align to where I think there's growth opportunity. But right now, I think it's all about Vertex. Got a couple of things I'm looking at, but nothing material. I do get a lot of inbound calls with people trying to buy certain parts of L3, so I find that to be kind of flattering that we have such a good portfolio. People want to buy it. And obviously, I turn down those offers given how I think we're doing and what the potential is. So nothing significant. It's all about Vertex and then trying to grow 2018 over '17. And when you look at those numbers, 4% on the top line, 8% on operating income and 11% of EPS, I think that's pretty ambitious and something we're all excited about and plan to deliver on.

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**Operator**

Your next question comes from Michael Ciarmoli of SunTrust.

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**Michael Frank Ciarmoli** - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Ralph, maybe just on sensors, the sensor systems, the revised margin outlook, moving that up. Can you just help us bridge that gap there? And is there any change to the level of R&D expense that was going to weigh on that segment in 2018?

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**Ralph G. D'Ambrosio** - *L3 Technologies, Inc. - Senior VP & CFO*

Michael, so number one, there's no change to the anticipated R&D spending. And if you recall, we talked about increasing the R&D in that segment by about \$30 million in 2018 versus last year, so that's still our current plan. The reason we increased the margins modestly for 2018 was that we had very strong order flow in Sensor Systems, really all year long in 2017, but especially in the fourth quarter. So we do see some improvements in our mix driving a better margin and also the continued focus on L365, which is our continuous improvement process or program, which is generating a lot of improvement, especially in Sensor Systems.

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**Christopher E. Kubasik** - *L3 Technologies, Inc. - CEO & President*

Okay. I'll just chime in. It was a year ago, Michael, that we all made the decision to split the then Electronics segment into 2 pieces. And you have to make decisions, and some people questioned it or wondered if it was risky you're adding cost. But when I step back and look, I have to say 2017 probably went better than I expected. And then more importantly, as we look forward, when you look at the guidance we've given in the midpoints and such, we're over 10% year-over-year growth in Sensors and 7% in Electronics. So the thought of splitting this into 2, getting more focused on the strategy, closer to your customer and integrating and collaborating is paying off, and you can see it in just 2 years. So I'm glad we did it, and we'll continue to look for other opportunities to realign for the benefit of the shareholders and the customers.

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**Michael Frank Ciarmoli** - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Got it. That's helpful. And then just one last one, Ralph. On the EPS guidance for 2018, can you just give us a sense of what sort of restructuring spending might be embedded in that guidance? I think you called out that you had some more that hit unanticipated in Q4. I mean, can you kind of give us some sort of range of what you think overall restructuring integration or cost-cutting spending might shake out to be in 2018?

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**Ralph G. D'Ambrosio** - *L3 Technologies, Inc. - Senior VP & CFO*

Sure. So presently, we're expecting that we'll incur integration, restructuring, severance costs, et cetera, of about \$30 million this year. And that's partially offset by some consolidation savings, which we are currently estimating to be about \$15 million. So it's a net severance, restructuring, cost savings of about \$15 million.

**Christopher E. Kubasik** - *L3 Technologies, Inc. - CEO & President*

Is there anybody else? Can anybody hear us? Ralph, I have a question or 2 for you, if you want to fill the dead space.

**Ralph G. D'Ambrosio** - *L3 Technologies, Inc. - Senior VP & CFO*

Sure. What do you have, Chris?

**Christopher E. Kubasik** - *L3 Technologies, Inc. - CEO & President*

Well, hopefully, people can listen. Can anybody confirm? Can anybody hear? Okay. They can hear us. We just don't have any more questions? All right. All right. I think Ralph and I will just kind of -- so Ralph, tell us more about the pensions. Is it January '19? And what was the thought process? And how many people are impacted? And what do you think the benefit will be?

**Ralph G. D'Ambrosio** - *L3 Technologies, Inc. - Senior VP & CFO*

Sure. So -- and thanks for correcting me. I misspoke. I said that we expect that -- from soft freezing the pension plan that we expect to generate at least a \$25 million savings on pretax pension expense beginning in 2019. And today, about 25% or so of our workforce have defined benefit pension plans, and it's something that we've been looking at for at least a year, and we decided that it was time to take this action to further improve our cost profile going forward. So that's what's happening there. And I guess I'll take the opportunity to ask Chris a question.

**Christopher E. Kubasik** - *L3 Technologies, Inc. - CEO & President*

Sure.

**Ralph G. D'Ambrosio** - *L3 Technologies, Inc. - Senior VP & CFO*

Maybe you can comment on what's happening in Aerospace as well as on the M&A front, Chris?

**Christopher E. Kubasik** - *L3 Technologies, Inc. - CEO & President*

Yes, I thought I'd get more questions on Aerospace. So thanks, Ralph. It's all going to be about growth. We're not happy, as I've said and Mike said even before I got here about where we are in Aero. It's a tough market. It's been shrinking, and it's a key year. The main focus is on Waco. We need to get more base in there, and we have a bid for the P-8 depot award. We expect 2 awards hopefully in the first quarter, maybe early second quarter, and our goal is to get one of those 2 awards. And as you would imagine, this would replace the P-3 work that finished a couple of years ago. So strategically, I'd keep an eye on P-8. It's a slow ramp, but it will give us the base that is so important in these capital-intensive facilities. The one I'm excited about is later in this year, is C-130-amp, and this is the avionics upgrade program for the C-130s. There's 3 or 4 competitors. You probably guessed who they are. And we've invested in some new avionic packages that are flying quite well on the C-130s, and it's a big cockpit upgrade. It's in our sweet spot, and the proposal is in. We'll know more in the fourth quarter, and I'm sure we'll go through the normal fee and process. And then we have a classified program that's pretty exciting. So I feel like we have opportunities in Waco. We have a couple of big proposals then, and that's something you guys and I and Mark Von Schwarz and others will be watching closely. Greenville is kind of the bread-and-butter of Aero, and



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they have a great tradition in ISR capability. And we had a big international award last year with the business jets. And there's 3 countries in the near term that we have discussions with, and those could be 2019 orders. And I think in the next 12 months, in addition to Mark and a few of us, I'll personally be visiting those 3 countries to let them know of our corporate commitment and the importance of that. And it's really about, I think, in the near term fleet expansion. These ISR capabilities are so, so good. There's high demand to give them the threats in the world, and there really is a fair amount of short supply. So it's going to be a key year and a transitional year. We did mention that we're doing work on the new presidential aircraft for the mission communications systems. So there's a whole lot out there. And then I'll just say on M&A. I mentioned we did 8. We got a pipeline here. Everybody's focused on it. Every one of our core groups, core segments, has something. And just like the last 2 years, they vary from niche bolt-on all the way up to what I'd like to say are more interesting acquisitions. But they're all under \$0.5 billion, and there's a couple of international and mainly defense-related things. We get a lot of pilot training and security detection the last couple of years. So that's where we are.

I guess if you want to email questions in, we seem to have some sort of technical difficulty, just email them to Heidi Wood. And someone is actually handing me a new iPhone 10 here that says, oh, from Carter Copeland. I guess I got to read this out loud to myself and answer.

Chris, here's a 2-part question. \$30 million of incremental restructuring, this all just in the month of December. Has been wondering specifically about the pace with which you and the rest of the team are identifying opportunities, whether they be on cost, talent, process improvement, M&A, you name it. Can you provide some insight on that perspective? And then secondly, the comment you made about widening the aperture of technology, can you elaborate on what that means for both of your existing business as well as things you may want to acquire? This was kind of cool, like I read myself a question from -- I'm going to have to get myself an iPhone 10. It's actually a nice large screen.

So the first question, I guess, is the pace. Well, if anything isn't obvious, I like to go fast. My team likes to go fast. And I can assure you, we are going very fast. Three of the 4 group presidents have been in the job less than a year. We were all together just 2 days this week going through our plans and strategies. And it's -- just quicker is kind of our theme here. So we're taking out cost on the structuring. We'll continue to do that. We have some big wins that we need to get. But if they don't play out, we will have layoffs. We will restructure. We will move facilities. Clearly, we're working with local state to get incentives where appropriate to help offset some of the cost, selling the building for the gain out in California. We have another property we're looking at that's got a lot of interest, so we might do something creative there on a sale-leaseback. Everything's on the table. On the M&A side, we're not adverse to joint ventures. Again, the National Security strategy talks a lot about partnerships around the globe, and I think we are in an incredibly unique position. We have great relationships in Europe and around the world, who are a trusted partner, and I think that's going to give us a strategic advantage, so we seem to be well aligned. So on the M&A front, we did 8 last year. I have no issue doing 8 this year if they made sense, and we're looking at them. We have a couple we'd -- may be able to close them in the next 60 days, and we'll keep you abreast on that. But we're all moving very, very quickly.

And then the second question. He just deleted that. Someone -- can you go back to the second question? It was about widening the aperture on the technology. Well, that comes in a couple of forms. We -- there are some things we're looking at where we have to do a better job, maybe tying in with commercial companies and taking their technologies to market. Some of these markets we're looking at and our customers want are literally hundreds of millions or billions of dollars of investment. So we're looking at how we can partner with some companies out in the West and bring them in to the Department of Defense. And we're also looking at different customers. It's the same old -- some of these ISR capabilities are world-class, and we tend to focus on 1 or 2 customers. But there's other services in the U.S., and there's international countries, so we're going to be much more aggressive on that front. So historically, our group president, maybe myself, have been focused on the internal operations and the financials, which will continue, but we're going to be traveling the globe. We're going to meet with customers. We're going to be meeting with members of Congress, and we're going to aggressively grow this company. Ralph?

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### **Ralph G. D'Ambrosio** - L3 Technologies, Inc. - Senior VP & CFO

Sure. So we also received a follow-up question from Cai at Cowen regarding the underlying assumptions for our pension expense for 2018. So I'll quickly review those. So we basically had a few items that resulted in us increasing our estimated pension expense by \$15 million for 2018. And even after that increase, we still anticipate that our year-over-year net pension expense, FAS expense less to CAS recoveries is going to decline by about \$13 million. So with respect to discount rate, our discount rate has declined by about 60 basis points from the end of 2016 through the end of 2017, so the assumption that we're using is 3.78%. And what happened there is, not only did we see a reduction in the treasury yields, but there's



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also been a tightening of credit spreads, especially across the investment grade bonds, and that's what's driving the reduction in discount rate. Fortunately, we have very good asset return in 2017, where the pension trust returned 15.5%, which is much better than our assumption, which is just under 8%. And we'll be assuming the same asset return-type assumption for 2018. So...

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**Christopher E. Kubasik** - *L3 Technologies, Inc. - CEO & President*

Okay. Well, good news. Apparently, the system is back on for asking questions. So we probably have time for maybe 2 more. So let's see who's in the queue and...

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**Operator**

Your next question comes from Jon Raviv of Citi.

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**Jonathan Phaff Raviv** - *Citigroup Inc, Research Division - VP*

Chris, can you offer us some perspective on the DoD strategy to accelerate growth to counter some of those high-end threats versus this persistent legislative impasse, really? How do you expect this to all kind of work out on the other end? And what is industry's role, you reckon, in this process?

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**Christopher E. Kubasik** - *L3 Technologies, Inc. - CEO & President*

Yes. Thanks, Jon. I mean, I think the industry, including myself, had been in D.C. Me, as recently, as last week. And the recurring question is what is the impact of the CR, and I've taken the approach, which I believe in is the biggest concern is the impact on our customers. And we all know the impact of the CR, the inability to have new start, the inability to ramp up. And clearly, there's a strategy that's requiring certain systems. And when you can't provide them to the warfighter, I think they're the ones most harmed. And something that doesn't get a lot of attention in my opinion are the second, third and fourth year subs. There's a lot of small companies that we all work with, especially L3, and we find our self maybe propping these guys up financially with cash. So the bread and butter of our country are these small innovative businesses. And I've told you I think we're the federation of entrepreneurs, but much larger than some of these companies, and I don't think people understand and appreciate the impact they're having. So we're focusing on the supply chain and customer. And then ultimately, everything I'm reading is there should be a budget in mid-February, maybe it slips a week or 2. And once that happens, it will be a matter of how quickly everyone can get the new contracts onto -- or the new orders on the contract. So 7 straight years, I think the industry has probably figured it out. It's the obvious stuff. We're not hiring people if we don't have business. We're trying to keep the R&D spend up. But it just puts a drag on the business. And we all know the situation around the world. The new strategy focuses more on near peers than the terrorist threat, and that has different ramifications. There's a lot of discussion about having a more agile military, and I like that because I believe we're an agile company. There's a lot of discussions about [neutrality] and partnerships. So that's the start with the strategy, and then it has to flow, just like a company, into the budget. And we'll be prepared to be with our customer and try to get the stuff under contract as quickly as possible. So hopefully, that answers your question, Jon. And I think we'll take our last question next.

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**Operator**

Your next question comes from the line of Seth Seifman of JPMorgan.

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**Seth Michael Seifman** - *JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst*

So Chris, when you look at your international efforts and you look at what the administration is trying to do now in terms of using more military attach?s and really the entire diplomatic corps to spur U.S. defense exports, is that something that you think has an opportunity to accelerate your international efforts? Or is it really something more about the long term?



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### **Christopher E. Kubasik** - L3 Technologies, Inc. - CEO & President

Yes. Thanks, Seth. I mean, we've laid out international as an area of focus. And I guess when we give our numbers, we're talking about direct international sales. So this is L3, right, either direct commercial or FMS. We do have a lot of business supporting primes and other partners on systems that may or may not be deployed internationally, so we don't throw that number in. But no, I think all the trends are good. There's been discussions about accelerating the licensing and the export approval process. And I think this is an area where we set up the board. I'm looking at adding more talents in these international area. Because when you look at our portfolio and you look at the affordability and the agility of our systems, notwithstanding ISR is a larger one, there's a lot of need, and a lot of these countries have tight budgets. I was recently in Singapore and Japan and Taiwan. We've got some Mid East trips coming up in a few months. And we can get under contract quickly, and we have capabilities that they need. So things always take longer abroad, but I like the fact that the administration is aligning with the industry and trying to get these things that are appropriate into our partners and allies' hands. So that will be a focus of ours for 2018 as it was in 2017. And I'm just talking the military stuff. The commercial side, clearly, the pilot shortage is a global issue. We have trained centers in Taiwan and U.K. and are looking to expand elsewhere. So I feel real good about what we can do on the pilot training side internationally. In security and detection, as I told some people, Europe is ahead of the U.S., which I think is unfortunate as an American to be lagging the rest of the world. So we're actually doing quite well in security and detection in Europe, and hopefully, our country catches up and get some new systems in.

So with that, apologize for the technical glitch. I thought we did all right filling the dead space, Ralph? But...

### **Ralph G. D'Ambrosio** - L3 Technologies, Inc. - Senior VP & CFO

I agree.

### **Christopher E. Kubasik** - L3 Technologies, Inc. - CEO & President

Probably not going to have our own cable network anytime soon. But nonetheless, we thank you guys for joining the call, and we'll speak to you again in April. Thanks.

### **Operator**

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

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