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LLL.N - Q2 2018 L3 Technologies Inc Earnings Call

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OVERVIEW:

Co. reported 2Q18 sales of $2.6b and adjusted diluted EPS from continuing operations of $2.47. Expects 3Q18 sales to be at least $2.5b and adjusted diluted EPS to be approx. $2.40 and expects 2018 EPS to be $9.90 at midpoint.

CORPORATE PARTICIPANTS

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Ralph G. D'Ambrosio *L3 Technologies, Inc. - Senior Vice President and CFO*

John H. Kim *L3 Technologies, Inc. - Vice President of Investor Relations and Analytics*

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PRESENTATION

Operator

Good morning, and welcome to the L3 Technologies Second Quarter Conference Call. (Operator Instructions) Please note, this event is being recorded.

I would now like to turn the conference over to John Kim, Vice President of Investor Relations. Please go ahead.

John H. Kim *- L3 Technologies, Inc. - Vice President of Investor Relations and Analytics*

Thank you, and good morning. I'd like to welcome everyone to our second quarter 2018 earnings conference call. With me today are Chris Kubasik, our Chairman, CEO and President; and Ralph D'Ambrosio, our Senior Vice President and CFO. After their formal remarks, management will be available to take your questions.

Please note that during the 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.

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

Okay. Thank you, John, and good morning, everyone.

As you saw this morning, we reported solid quarterly results. Consistent with our integration and growth theme, we delivered 8% year-over-year growth in both operating income and sales. Second quarter organic growth of 7% is the highest rate we've achieved in about a decade and speaks to both the improving execution on our growth initiative in addition to being well positioned in growing markets, including defense, security and commercial pilot training.

Our book-to-bill was 1.1, which includes only $15 million of the initial funding for the $391 million ENVG-B night vision goggles program. Funded orders were up 32% in the quarter led by strength in Aerospace. And based on our year-to-date performance and a continued positive outlook for the rest of the year, we are raising our guidance for sales, adjusted EPS and free cash flow.

I returned last week from the Farnborough Airshow with my team where we had our most productive show ever. We had 1,000 guests to our chalet and pavilion conducted over 200 meetings with customers, partners and global government leaders. We showcased our technology as a nontraditional sixth prime and also announced the recent hire of Steve O'Bryan, our new Senior Vice President and Chief Global Business Development Officer. I've been focusing on strengthening our leadership talent, and Steve is the latest addition who is an experienced and respected industry leader.

At our Annual Meeting in May, two of our directors chose not to stand for reelection, and Rita Lane was unanimously appointed to be our newest member of the board. Rita is a distinguished graduate of the U.S. Air Force Academy and spent her career in operations at 3 Fortune 100 companies, including Apple. Her high-tech and operations expertise is certain to help us, and she brings a refreshing and vital Silicon Valley perspective to our company.

We kicked off the year with a theme of integration, collaboration and innovation, and I want to report back to you on the progress now that we're midway through the year. When I took over, I saw an important need for the enterprise to work more efficiently, be more collaborative and increase our effectiveness at helping our customers solve their most complex and pressing problems.

We're making progress to get better integrated and are evaluating plans for realignment. First, along every functional area, we are developing plans on standardizing and streamlining processes, systems and policies.

For example, in the area of IT, our CIO will have company-wide responsibility for integrating our IT systems, and we will realize improved efficiencies, better security and lower costs. In HR, we're streamlining many legacy policies. And based on feedback from a company-wide employee survey, we're developing leadership and training programs to invigorate our workforce.

As a high-tech growth company, our engineering workforce and their development are part of the lifeblood of this company, responsible for driving innovation that ultimately fuels our growth.

If you will recall, I hired a new leader of engineering earlier this year, and he's been coordinating the efforts to elevate and promote the role of engineering in building our advantage for the future. We're taking steps to connect our engineering community to enhance collaboration, standardization and upgrade in our engineering tools and capabilities as well as investing in training and professional development.

We are continuing to sectorize our 70-plus divisions and consolidate select operating facilities to drive greater efficiency. The Electronic Systems segment is leading this effort with the goal of reducing its division by half. This is a multiyear effort, which we expect to complete by 2021.

Consistent with our strategy of becoming a nontraditional sixth prime, we've been evaluating the alignment of our capabilities and core competencies across the reporting segments. In order to move up the food chain and deliver more integrated solutions, we need to be better coordinated in developing technology and agile in addressing customer needs. Therefore, we're reviewing plans to consolidate from 4 segments to 3 segments. We'll be finalizing this plan in August, and we'll provide additional detail at that time.

Change is never easy with a large company, and there are many steps in a sequence to coordinate the gearing, so the engine of the corporation runs better. Many customers are underserved relative to their needs for fast innovative low-cost solutions, and we intend to fill that need as a nontraditional sixth prime. I'm encouraged by discussions with the Department of Defense and many international customers.

Our teams are starting to think more creatively about harnessing the power of L3's technologies to move up the value chain. This shift in how we go to market will take time, but I want you as shareholders to know what we're working towards as the company and what I'm expecting of my team.

Let's now turn to the quarter's results. In terms of sales, all segments grew sales in the quarter led by Sensor Systems, which was up 22%. Our renewed focus on driving growth and targeted business development activities are bearing fruit with first half book-to-bill of 1.1.

Turning to our segments. Aerospace Systems had a good quarter, improving both financially and operationally. We converted several of our long-term pursuits in the quarter, our aircraft recapitalization and fleet expansion. Moreover, we continue to pursue U.S. and international opportunities, and we expect the growth to continue into the second half of the year.

Communication Systems continues to be a challenge. While we are seeing a pickup in military demand for traveling wave tubes, the commercial satellite market continues to face headwinds. However, the Communication's segment long-term growth prospects are bright with ongoing development work in Free Space Optics and electronic warfare that will yield production work in the years ahead. We won several initial awards in targeted areas such as classified space, Maritime C4ISR and electronic warfare that open up opportunities for much larger awards.

Electronic Systems continues to deliver solid results across a broad array of programs. On the commercial side, our Security & Detection Systems had a strong sales and orders driven by explosive trace detection and workflow solutions. On the defense side, we booked strong orders from precision engagement and power and propulsion.

Sensor Systems was again our fastest growth segment. As planned, our operating margins were down year-over-year due to increased R&D investment. Order growth was particularly strong in WESCAM and Maritime. We're also investing in several next-generation technologies, such as directed energy and Unmanned Undersea Vehicles that will drive future growth for L3.

One highlight for sensors was a 3-year $391 million next-generation night vision goggle award for 13,000 units; 10,000 for the Army and 3,000 for the Marines. Consistent with our customers' desire to move rapidly, the Army and L3 used an Alpha Contracting process to negotiate and complete the deal in about 60 days. This 10,000 unit initial orders positions us to compete for the Army's planned purchase of 100,000 night vision goggles in the years ahead. This is a case in point of bringing a disruptive and innovative technology fast to market at an affordable price.

Turning to capital deployment. We acquired 2 small companies in June for $69 million and entered into an agreement to acquire 2 more companies in July for approximately $200 million. Applied Defense Solutions, which we acquired last month, is an important addition to our space portfolio. It is a business we know well, and we expect it to have an immediate impact on our new business pursuits.

The 2 related companies we announced in July are leaders in computer network operations and vulnerability research. We acquired these businesses at an attractive 9x estimated 2018 EBITDA multiple and 7x estimated 2019 EBITDA. This business enhances our capability and the convergence of electronic warfare and cybersecurity, enabling us to expand and enhance our C6ISR offerings globally.

In addition to acquisitions, we frontloaded our share repurchase for the year. We purchased $168 million worth of our stock in the second quarter, atop $119 million in Q1 for first a half total of $287 million. In addition, we repurchased $34 million in July for a year-to-date total of $321 million.

In closing, we are moving fast and have accomplished a lot in the first 6 months of this year, and we're just getting started. Transforming L3 into a truly world-class company will require time, hard work and dedication from everyone at L3. Our employees and leadership have firmly embraced this challenge and change.

I want to thank the entire L3 team for taking us on this journey.

Now I will turn it over to Ralph to go over our financial performance and outlook.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

Thank you, Chris. I'll review some details about the second quarter and our 2018 guidance update.

Reviewing the second quarter, we had solid operating results and/or outlook, with strong growth in orders, sales, segment operating income and adjusted earnings per share.

Segment operating margin, excluding a property gain in the second quarter of last year, was unchanged at 10.6%. As Chris said, we also increased our R&D spending, and that was by $19 million quarter-over-quarter to fuel future growth, and that higher R&D lowered second quarter margin by 70 basis points.

Adjusted diluted earnings per share from continuing operations was $2.47, and it increased 20% excluding the $42 million property gain in the 2017 second quarter. Adjusted EPS excludes the debt retirement charges of $0.45 and a gain of $0.31 on the sale of the Crestview and TCS businesses, which we sold with Vertex. These 2 items were not contemplated in our prior year 2018 guidance.

Second quarter sales increased 8% to $2.6 billion, with strong organic growth of 7.5%, driven by 10% growth in our U.S. Department of Defense business. Sales growth was strong at Sensors, Aerospace, Electronics, with each growing 22%, 9% and 6%, respectively.

At Communications, sales were about flat. Second quarter operating margin was 10.6% and lower than the 11% we expected because Communication Systems margin lagged again at 8.1%. I'll explain the softer Communication Systems margin when I review the 2018 guidance update in a few moments. And I'll tell you that we -- despite those softer margins, we have maintained our 2018 consolidated margin guidance of 11.2%.

Segment margins for Electronics, Aerospace and Sensors were in line or better than our full year estimates. Sensor Systems margin declined 180 basis points to 11.3% as expected primarily due to higher R&D spending, which we planned for, and that was $17 million. In fact, we accelerated R&D spending in the second quarter to take advantage of certain new business opportunities in that segment. Free cash flow was $165 million for the second quarter.

And now moving to our 2018 guidance update. We increased adjusted EPS by $0.40 or 4% at the midpoint to $9.90 due to higher sales and operating income, as well as, lower interest expense and taxes. Excluding the 2017 tax reform onetime gain of $0.99, EPS will grow 17% compared to last year.

We increased our sales guidance midpoint by $150 million to $10.1 billion, and we expect sales to grow 6% over 2017.

We continue to expect total segment operating margin of 11.2% for 2018, and that will expand 40 basis points over 2017. And combined with our sales growth, we expect segment operating income to increase 10% year-over-year.

We revised our 2018 segment margin guidance midpoints to 14% for Electronics, which is up 30 basis points, 12.5% for Sensors, up 70 basis points, 8% for Aerospace, which is up 10 basis points, and 10% for Communications, which is down 100 basis points.

We reduced margin guidance for Communication Systems for 2 items. First, production orders for broadband communications have remained sluggish, causing us to lower those sales for 2018. Second, at the traveling wave tube businesses in space and power sector, while we completed the consolidation of those businesses in April, their return to normal manufacturing productivity and yields is happening at a slower pace than we planned.

Below the operating income line, we lowered interest expense for the savings from our recent debt refinancing, and we also lowered the estimated tax rate. We increased estimated free cash flow for the year to $915 million.

Regarding capital allocation, Chris covered the recent acquisitions and share repurchase activity. So I'll add that with respect to share repurchases, since our year-to-date July repurchases are $321 million, which is above our previous plan of $300 million, we. could repurchase up to $400 million for this year, depending on acquisition activity, and there are a few other deals that we're presently looking at.

Additionally, we completed the sale of the Vertex businesses on June 29th, and the final net proceeds after paying taxes on the gain on that sale should be about $430 million.

Also, with respect to our recent debt refinancings, they'll reduce our annual interest expense by $15 million. We incurred $69 million of debt retirement charges totaling $0.66 per share. And since the debt retirements straddled June and July, $48 million of those charges were recorded at the second quarter, and the remaining $21 million will be recorded in the third quarter.

Taking a quick look at our third quarter. We expect sales of at least $2.5 billion, operating margin of about 11% and adjusted diluted earnings per share of approximately $2.40, which excludes the third quarter debt retirement charge of $0.20.

Finally, to conclude my financial review, we had very solid orders, sales and EPS growth in the second quarter. We're investing more in R&D. We raised guidance for the full year. We are allocating capital to grow and increase shareholder value, and we have ample resources and liquidity to support our growth strategy.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from Ronald Epstein of Bank of America Merrill Lynch.

Ronald Jay Epstein - *BofA Merrill Lynch, Research Division - Industry Analyst*

So Chris, just want to ask a question maybe on the commercial side of the house. If you could walk through a little bit how that's going for you? And in particular, in the training business this past year, you've had some good success selling flight training equipment. And there has been a lot of press lately about the pilot shortage and so on and so forth. So kind of what's your outlook for that business? And where could you take the commercial business?

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

Yes. Thanks, Ron. As you know, I'm pretty excited about our commercial pilot training program. We've made a couple of acquisitions in the last few years to really provide, I think, the only company with a full solution set. We have the cadet training program where we bring in 1,600 cadets a year for about an 18-month program where they come in having never flown an airplane and leaving flying for a commercial airline. We have the simulators that we sell, but we're seeing more and more with the airline, the desire for them to outsource and use our school houses, if you will. And I announced at the Farnborough Airshow our $100 million investment in Gatwick, where we're going to have the ability to run 24/7 8 full flight simulators, adjoined to the property where we'll be able to also build simulators. So we're quite optimistic. There's clearly a shortage, at least 30,000 pilots per year by all forecasts. And that's driven both from retirements and then the increase in aircraft. So I'll turn it over to Ralph to give you some numbers that we're looking at. But we're very excited about what we've done, and we also have consolidated all those aviation capabilities as a one-stop shop. Ralph...

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

Sure. I'll just add that our commercial training solution business is performing very well. It's growing. And this year, we expect that its sales will be about $425 million, and that's with organic growth of about 13%. So, we continue to expect CTS to be a fast-growing business for the company.

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

And somewhat related to that business which I guess you could call commercial is our Security & Detection business, for airport security. And of course, we're seeing more airport security threats and more desires for better capabilities. So, the acquisitions we've made in the last couple of years, whether it was Implant or Mac H, again being integrated, we're seeing growth there and the demand is high. So very excited about the commercial business. And I think one of the few A&D companies that have the mix of the defense with security and the commercial pilot in one-stop shopping.

Ronald Jay Epstein - *BofA Merrill Lynch, Research Division - Industry Analyst*

Yes. If I could follow up on that. Are you considering -- Boeing has talked about trying to grow more in pilot training, that sort of thing. Would you guys consider teaming up with one of the big OEs? And then finally, just a market share question. When you think about the big players in the market today, it's both CAE and FlightSafety, what do you think about how much market share you could actually be? And what's the market share goal, I suppose?

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

Yes. We're open to all sorts of business relationships. Sometimes we prime, sometimes we sub, sometimes we're in joint ventures. I'd say everything is on the table. CAE is #1. We compete with them. Although a few weeks ago, Marc Parent and I had a call, and we agreed to team on an opportunity. So it may be somewhat unusual, but we are going to go after a commercial airline together because our combined capabilities are what the customer needed. I think that FlightSafety is more general aviation and not really in the same market as we are, although maybe we compete on the military side. So, there's more than enough players. I think there's 7 or 8 that are somewhat well recognized. Our goal is to be #1 or 2 in every market that we serve, and we're going to aggressively grow organically, make acquisitions, partnering and teaming. And I think a lot of the airlines that we've had discussions with may be interested in just unloading their assets, their simulators and the responsibilities to a company like L3, and we may be in position to take those over. So we're going to be very aggressive. And highly confident we'll be quite successful.

Operator

Our next question will come from Carter Copeland of Melius Research.

Carter Copeland - *Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense*

I wanted to ask you, you've got a lot of simultaneous efforts going on across the company. You talked about a couple more this morning. Just wondering, you're seeing that bear fruit at the margin line in some places, but not in others. Clearly, Comm Systems, the market is not, I think, participating the same way. But as you think about your efforts to date and then what you sort of laid out for the remainder of the year, the realignment and whatnot, as we roll forward to next year, what do you think that means in terms of translation to the margin line? I mean, how should we think about this impacting the level of profitability?

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

Yes. Great question. We do definitely have a lot going on simultaneously. And just to refresh everyone's memory, we're working on the integration to be more lean, and that will ultimately result in, I believe, reduced costs and increased margins. We're growing organically, as you've seen. And of course, we're primarily deploying our capital for acquisition. So, I'm highly confident that the team and myself were up to the challenge to do all 3. We'll be bringing on a Chief Transformation Officer just to make sure that we do this in a coordinated manner. There's a lot of things that are working well at L3. And clearly, you don't want to break things that are working well, but you want to make everything better. But to answer your question, I think Ralph has historically said that our target was 12% margin in 2020. And after looking through things over the last few weeks and some of the great progress we've made, I'm willing to say that we are going to get the 12% margins in 2019 on a consolidated basis, 1 year earlier, but I'll ask my CFO if he is going to back me up on that one. Ralph?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

I agree. And you can be certain that Chris and I spent a lot of time reviewing and discussing this to make sure that we're on the same page.

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

Good answer.

Carter Copeland - *Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense*

I don't think you had another choice, Ralph.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

Well, if you recall, what we said that once we get the margin to 12%, we're going to try and do better than that, and we'll talk about what we can do after that. So, I think a key takeaway is that we're seeing 12% for 2019 and that we're going to do better than that in 2020. And Chris talked about the primary levers as to how to we get to 12% next year.

Carter Copeland - *Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense*

And Chris, just as a follow-up. When you think about the balance between growth and margin and pulling forward that 12% by a year, does that come at the expense of growth in any way? Or does that still give you the full ability to go tackle all the stuff you want to go get?

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

Absolutely. We are not going to sacrifice growth for the sake of margin. And I think I've been pretty clear starting last year really focusing on the integration story and the progress we've made. And then with the defense budget improving, I did add the growth side. And that's why our theme is integration and growth, I get it, it's 2 things at once. I think a perfect example, this quarter with Sensors in particular but the corporation in total, accelerated our R&D, and I think it was about $17 million in Sensors. Again, they grew 22%. And I'll say what I've said every quarter, I have absolutely no problem spending money in the near term, whether it's R&D, whether it's severance, whether it's restructuring, taking charges, spending the money for the long-term growth of this company. I understand the complications of doing that. I think we balanced it pretty well. And the more you grow, the more volume you have, in theory the higher your margins get to absorb a lot of your fixed costs. So, we've got a pretty sophisticated model we look at. We're highly confident in the 12% in '19, and we plan to grow organically and inorganically. And that's only going to make it easier and a lot more fun.

Operator

Our next question will come from Rob Spingarn of Credit Suisse.

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

A question for each of you. I'll start with Ralph. Ralph, on the seasonality of the business from a free cash flow perspective, you're back-end weighted, maybe a little bit more so than usual. So was wondering if you could walk through some of the moving pieces there, working capital or what have you. And then, Chris, on the Army -- I thought we'd go to the Army for little bit. There's a nice increase in ground combat vehicle procurement funding, it's up to $6 billion a year. I wanted to ask you what your positioning is on things such as Abrams, Bradley, AMPV and how you think about growth to the extent that you've got some decent chipsets there.

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

Okay. Go ahead, Ralph.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

Sure. So, regarding the seasonality of our free cash flow, historically the second half has been higher in terms of free cash flow, particularly the fourth quarter. And that is going to continue -- or it's happening again this year. And I'll also add that when you look at the businesses that we divested over the last couple of years, which are all service-oriented, their cash flow cadence is more even or straight line, whereas the seasonality is more pronounced in the hardware businesses, and those are the ones that remain at L3. With respect to the second quarter itself, we did have some rather meaningful sales happen toward the end of June. For example, in Aerospace Systems, we had taken a conservative position with the EC 37B or Compass Call Recap, and we ended up booking the second aircraft procurement and taking it to sales toward the end of that month. So, there's about $40 million that's sitting in receivables just from that item. And then we've also had some very large shipments of night vision equipment into the Middle East toward the end of June, and that accounts for another $15 million to $20 million of building working capital that's going to liquidate, or be collected in the second half of this year.

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

And Rob, relative to the Army, rather exciting -- I don't want to go back on the night vision goggles, but I think an interesting question that we get a lot is the new leadership in the Pentagon is talking about the rapid acquisition and moving quickly. And again, I think some early meetings in the Pentagon and commitments by the Army and us to move quickly on the night vision goggles and get things under contract is rather exciting. We've had similar meetings with the leadership of the other services. So, I think L3 is uniquely positioned to try to keep up and move quickly with our customers, and they're actually doing what they're saying, which I think is quite promising. On the ground combat vehicles within our Electronics segment, we do have combat propulsion systems up in Michigan. They do a lot with the engines here in the U.S. and internationally, and that business has been growing. So, I think we have a play there that we're working on. And of course, the sensors on various vehicles we're working with and looking for opportunities to have our sensors, including some of the WESCAM balls which have historically been on airborne platforms. We've invested some R&D to have those, not only be maritime ready but ground vehicle as well. So, it's an opportunity we're looking at and seeing how we can get more of the pie.

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

Chris, is there a way to ballpark what a shipset value looks like across ground combat vehicles?

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

Yes. Probably not at this time. We have a strategic review coming up in September where we're going to look, again, at all the capability, not dissimilar to what we did on the Canadian Surface Combatant and the Sea1180 and Sea5000 in Australia, taking these capabilities coming up with a single offering and moving them forward. But we should have an answer in October and get you better intel on that. But it's clearly a growth opportunity where I think we could do more.

Operator

Our next question will come from David Strauss of Barclays.

David Egon Strauss - *Barclays Bank PLC, Research Division - Research Analyst*

Chris, since you were willing to talk about 2019 margins, I thought I would ask top line. So last call, you were willing to endorse the idea that growth would accelerate in '19 from a top line perspective. Obviously, you've got a higher base now in '18 at growing 6% or so. Do you still think as you look at '19 today that the growth rate accelerates off of what you're seeing in '18?

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

Yes. Sounds like I'm slowly going to be giving 2019 guidance 6 months before I had planned, but we definitely see top line organic growth for '19 consistent with what we said previously. We're going through our planning process and have to fold in the acquisitions that we've made, but I think we said mid-single-digit growth last time or something like 5. I'm willing to maintain that. And Ralph, we're still a month or 2 away for rolling everything up. I don't know if you want to supplement or add to that, but I think we'll stick with what we said.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

I think you covered it all, Chris.

David Egon Strauss - *Barclays Bank PLC, Research Division - Research Analyst*

Okay. And then on the margin side, restructuring this year, what does that look like in terms of the spend there? I know you had talked potentially about taking additional restructuring, specifically at Aerospace, and now you're talking about maybe consolidating from 4 to 3 businesses. What are you thinking in terms of, I guess, growth in net restructuring this year and then how does that look in '19?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

So, the gross restructuring and integration spending for this year is -- will be somewhere between $30 million and $35 million. And I previously commented that we expect that we will get about $15 million in savings this year from those activities. They're still on track, although it's more second half loaded, especially in Communication Systems segment. And we do expect that from the current restructuring and integration activity, there will be incremental savings that we'll realize next year, and I previously said that, that would be about $15 million. So, I'll say that again, repeat that $15 million number. And we will definitely have -- also have more restructuring expenses next year because we're in the midst of a multiyear process to fully integrate the businesses. That said, the gross restructuring spending next year should be less than what it is this year. And with respect to the realignment evaluation that Chris talked about going from 4 to 3 segments, we'll talk more about that and what it entails with respect to restructuring on the next earnings conference call after we announce it and finalize it.

David Egon Strauss - *Barclays Bank PLC, Research Division - Research Analyst*

Okay. And that restructuring spend, Ralph, is incorporated into the 12% margins next year?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

Yes.

Operator

Our next question will come from Noah Poponak of Goldman Sachs.

Noah Poponak - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Ralph, I wanted to try to better understand the moving pieces in CS, where I think last quarter with the unmanned systems for broadband, I think you had called that out last quarter. And I thought I remembered you saying that you expected to have orders in the back half of '18, that became revenue in '19. So, a little surprised to see a not insignificant revenue forecast reduction because it didn't sound like you're really expecting that to pick up. So, if you could walk me through that, and I don't know if it's possible to size that business so we could sort of understand where it's gone this year versus last. And then in the margin in that segment, I mean, obviously, the margin in the back half needs to pick up significantly to get into the range for the year, if you can sort of walk me through how that happens.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

Sure. So, with respect to top line, as I explained, we lowered the estimated sales by $100 million for the year, and that is in the broadband communications sector. On the last earnings conference call, when I talked about where sales were trending by segment, I did explain that we were trending to the low end of sales for Communication Systems segment. I also had explained that the pickup in sales that we were anticipating was contingent on booking certain orders later on in the year. So, I said today that the production order volume has remained sluggish. And as Chris explained, we are seeing some nice wins, which is mostly development work for next-gen communication type work. So, the business in broadband communications is transitioning to more development, cost-type work versus fixed price production work, and that definitely weighs on the operating margins.

So, with respect to the reduction in the Comm Systems margins of 100 basis points this year, I said that the main item or the first item was that lower sales volume in broadband communication systems, that's probably two-thirds of the reduction in operating income and margin in that segment guidance, and that's a business that will be about $1.2 billion sales this year. So those sales have been declining about 8% year-over-year. The other item impacting the margins is the traveling wave tube or TWT businesses. And you recall that those are 2 businesses that we consolidated over the last year and a half plus. We completed the consolidation in April, and I said, that we're not yet experiencing what we would consider to be normal manufacturing yields or productivity on those traveling wave tubes. We're going to get there beginning in the second half of this year, and we started to see some improvement in June. I'll also tell you that in terms of manufacturing complexity, Traveling Wave Tubes is among the most complex type of manufacturing that we do, it entails a lot of calibration and tuning activity. And those skill sets we had to rebuild with new employees and train those new employees, so it's taken us a little longer than we thought to get there on the operating margins.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

That's what's happening with the sales and the margins.

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

I'll just chime in. Again, you know my passion for leadership and talent, and we have a new leader in the Comm segment. Andy took over in January. But when I look at the larger entities under there, we have a new leader and new President of Comms West and a new President at Comms East, both outside hires with great experience. Also, we had an internal promotion of Lori Eckles, one of our top stars out of Salt Lake City. So, 4 new leaders with fresh ideas and willing to make changes, I think, is going to make a huge difference and challenge the status quo and take us to the next level. So, I'm pretty pleased with that. And also, we'll be at the next level consolidating from 3 sectors to 2 within the Communications segment. So, all these things will contribute to more efficiency, a better focus and, hopefully, better financial results.

David Egon Strauss - *Barclays Bank PLC, Research Division - Research Analyst*

Appreciate that. If I could then just ask about cash and its deployment. Ralph, is there -- with the sale of Vertex, is it the case that the proceeds going to investing where the -- where any tax payment goes in the cash from ops, if you could walk me through that. And then in terms of deployment, I guess I'm a little surprised to hear the discussion of share repurchase moving to only 400 million from 300 million, just if I plug that in with your free cash and the other pieces of cash. It looks like you built a decent amount of cash. I guess M&A is maybe the plug in that, but any other moving pieces I'm missing on cash flow statement there?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

No. On your first question, with respect to the net proceeds from divesting Vertex. So, the gross proceeds, if you will, which is the proceeds before taxes, those get classified on the cash flow statement as an investing activity. Whereas the income tax payments on that gain, most of it will go through cash flow from discontinued operations. The larger part of the gain was on the Vertex element versus Crestview, TCS. And those are 2 businesses that go through continuing operations this year.

David Egon Strauss - *Barclays Bank PLC, Research Division - Research Analyst*

So that's not in cash from ops?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

Correct.

David Egon Strauss - *Barclays Bank PLC, Research Division - Research Analyst*

Okay. And then on the buyback?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

Well, on the buyback, I said that we already -- year-to-date, we've already exceeded our previous plan of $300 million of share repurchases, and that -- we could go to $400 million depending on the M&A activity. Clearly, we have the ability to deploy a lot more capital and cash flow. And even after we pay for the recently announced acquisition of Trenchant, that's the renamed business, that's going to close sometime in the second half, we expect that we're going to end the year with over $1 billion of cash on the balance sheet after paying our dividend and after doing our share repurchases. So, we have plenty of resources, plenty of cash.

David Egon Strauss - *Barclays Bank PLC, Research Division - Research Analyst*

I guess why would you build a cash balance at the current leverage level versus buying the stock?

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

I think hopefully we've proven in the last year or so that we try to be opportunistic. I had to decide between frontloading or backloading the share repo. The stock was weak, in my opinion, earlier in the year, so we frontloaded the repos. We -- I answered lots of questions as to why we didn't make an acquisition for the first 5 months because there were no good deals that made sense. And then in 30 days, we get 4. So, I didn't want to say that we said 300, we met 300 we're done, threw another 100 on the table and kind of go month-to-month. I can assure you the team meets regularly and evaluates the market and the opportunities. And I think we have another acquisition hopefully in the next 30 days that we'll announce.

And we've got lots going on, and we monitor it. I'd be surprised if we end the year with a $1 billion cash balance, but -- and at this point, this is what we're willing to say.

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

Also, I was just explaining what the cash balance could be. I didn't say that's what it's going to be. Historically, L3 has never stockpiled cash because it's not a good use of cash and it's going to be subject to the deal flow as to how we deploy that cash flow.

Operator

Our next question will come from Seth Seifman of JPMorgan.

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

Chris, I was wondering if you could talk a little bit about just the changes you're looking to make at the company, it seems like will require a bigger corporate structure to kind of manage what has been historically a very decentralized company. And just sort of how far along the way you are in terms of having the pieces in place that you need to do that?

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

Okay. Great question. I'm not really looking to build a large corporate staff. I look at everything in totality. So, we may have had 10 people in IT at corporate and 700 people in the field, I just look at it in total, L3 has 710 people and can we get better systems, better processes, better security and have less than 710 people in that hypothetical example. And I really don't get caught up as to whether they're in a shared service cost pool or corporate pool or 70 different divisional pools. The goal is to optimize the business, make us even more agile, more lean and more responsive to our customers. And the geography of where the people reside and where they're charged, I think the entire gets it that it really doesn't matter. So other than maybe bringing on our Chief Transformation Officer to coordinate and orchestrate all these moving parts, we keep what's working and budget the costs of these initiatives, their recovery, the business case over a 2- to 3-year period that it's going to take is the goal. So, I would not anticipate a significant change in headcount at corporate, but I'm looking at things in totality for all of L3. And I could envision another 400, 500 layoffs by the end of the calendar year as we continue to optimize the business in the months ahead.

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

Okay. And maybe as a follow-up, what are the things that -- or is there -- are there things at this point, the things that you're seeing and that you're looking for to get the sense that the DoD or your main customer is kind of doing things differently and following through on some of the rhetoric that we're hearing about trying to buy things quicker and in a more cost-effective way?

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

Yes. I think that night vision goggle example is a perfect case. I mean, that again, $391 million for 10,000. The opportunity for 100,000, you can do the math. Those need to be competed over the next years, 3 phases or whatever the Army wants to do. You can get some pretty big numbers with billions on them. I've personally been in the building as well as our executive leaders, and we're responsive, we're committed. I think these guys are doing a great job, and they need people like us they can align and prove that these types of things could be done. So, it's applying in the international market as well. We'll have things hopefully in the months ahead. And I think there's just good, good synergy and good relations. And like I said in my opening comments, I believe the customers are underserved when it comes to having companies that can be quick and agile and affordable, and that's been our theme from day 1. It takes time, and I think it's gaining some momentum, so that's what we're doing.

Operator

Our next question will come from Jon Raviv of Citi.

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

I was wondering if you can talk a little bit about the longevity of the investment plans at Sensor Systems and to what extent could you see [plans at] sensors or other plans and what plans of other segments pick up, just in light of the fact that sensor growth is clearly benefiting. That would be great.

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

Yes. That's a great question. I mean, the desire for at least the military customers to have situational awareness and -- is critical to the national defense strategy. So, it's not surprising that these capabilities are in high demand. We've been investing on several fronts to move these products forward, both with less power, less weight and better capability. At L3, I understand it's hard to think about us having 1 franchise program that we could put on the cover of our annual report, but I think our ISR capabilities are the best in the world. And when I look at the capabilities we have at Aerospace and the enabling technologies within Sensors and Communications, it's how do we put these better together to go to market. So, we just met earlier this week to review the R&D plan for Sensors and the corporation, and I expect it to maintain the current pace. And when we can get these type of quick results, it's a no-brainer. I think in Electronics, we're doing a fair amount in the classified arena. And also on the Commercial side, we're going to try to grow or double the commercial aviation business that we set up, which includes the avionics and the training. We've been investing in new simulators, as you know. And in Security & Detection, one of my favorite products, the ClearScan detector is starting to get traction in Europe. Hopefully, it will get traction in the U.S. And as we all travel to airports, hopefully you'll see more L3 systems in these airports to get you to your flights quicker and safer than before.

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

And just a quick follow-up on M&A. Are you thinking about accretion on your M&A strategy? Sounds like you've got some attractive multiples on the ones you disclosed just now. And similarly also bite-sized, we've seen you get into more of the bolt-on thus far. Any updated perspective on what's affordable or doable from a size perspective?

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

Yes. Thanks for that, Jon. I mean, we do monitor these acquisitions. A couple of weeks ago, we were looking at the 2016 acquisitions, and they are effectively a little over 9x EBITDA multiple this year relative to what we paid for them '16. The '17 stuff is still too early to evaluate. We did get some good interesting acquisitions this quarter. And again, a lot of these are built on relationships. I think at least 3 to 4, we've known the companies and the owners for years, and we've worked with them, supported them. And at the right time, we enter these deals. So, we try not to get into auctions and bidding wars. I mean, obviously, we work with the bankers on an as-needed basis. But a lot of these, as we talked about, want to be part of L3. We have success stories, they come in, they meet other entrepreneurs that we've acquired that are still with us. And it's that same theme that we have talked about for years is that it's the balance of maintaining that entrepreneurial spirit with the scale of a major corporation. And that's our secret sauce. I think we're doing that well. Consolidation as a division in no way impacts that. And we said we can easily -- we could do up to $1 billion a year in M&A and still keep our investment credit ratings. So there's no walking back from that, and there's really no limitation on the sizes. We take what's available. I said before, I'd rather do $200 million and $500 million. But if they're not out there, we'll continue to do the $69 million ones, the $200 million ones and whatever's available. So, we've got a great process, a good pipeline. And like I said, I think we'll announce another one probably within a month maybe in the $100 million range, and we've got a couple others we're looking at. And some will close and some won't. But clearly, accretive deals is our preference unless it's a technology buy that accelerates our R&D effort for the long term. So, I hope that helps, Jon.

Operator

Our next question will come from Cai Von Rumohr of Cowen and Company.

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

Chris, now that you're in the process of becoming Silicon Valley East, maybe update us on your R&D spending, specifically new initiatives like this night vision program. Looks like that's a pretty major opportunity you'd like to spend some dough. So where are you spending the dough, and how much? And what are the key things we should look for?

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

Yes, that's a great question. Maybe a little early to declare ourselves the Silicon Valley of the East here in Manhattan. But I like it. We'll work that into our branding and marketing. We are all sitting around in jeans and T-shirts today, so maybe we are making progress after all. We historically had 3% of our revenue in R&D. I think we've taken it up a notch. Again, we're doing a better job aligning with where our customers are spending their money. They've laid out a national security and a national defense strategy, which is helpful. And again, the situational awareness, whether it's on the ISR front and the movement to business jets where we invested in miniaturizing some of our capabilities. It's all about lethality, speed to market, interconnectivity. The Comms segment, which we talked about a little bit, none of us are happy where we are, but one of the top priorities around the world is connectivity. These fourth gen and fifth gen aircraft, and like I said before, they need to be able to communicate data in a contested environment. It's well documented that, that is lagging, and we'll continue to invest in those capabilities. And I'm excited about the opportunity to get those requirements into the procurement process. So, we are doing a couple of things differently. We have innovation sprints. I think last I looked, we were up to 35 so far this year, where we have a week, we put people together and try to solve a problem in a week. And we're getting more bang for the buck, spending less R&D by setting these targets and goals. And you can learn a lot in a week if you get 5, 7, 10 men and women in a room with a set problem, a set budget and it's been pretty exciting. So, autonomy is big. Secured comm is big. What we've been doing in UUVs, UAVs, supporting small SATT payloads, those types of things is where we're spending our money.

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

Terrific. One last one. So you have a number of changes in your revenues for this year. Could you just give us some preliminary color on which of your businesses are expected to grow fastest next year, just sort of rough color.

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

Yes. I'll let Ralph look and see. The expectations at my level is that we're #1 or 2 in every business that we're in. We will have a realignment coming up, and we've been doing some consolidations, but maybe at a segment or sector level, Ralph, do you have any favorites you want to highlight?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

Yes, sure. We expect that all of our segments will grow next year, and that Sensors will likely continue to have the fastest growth rate. Another positive item is that we're going to be growing again in Aerospace Systems, which is a welcomed organic growth this year. And across the sectors, generally speaking, they're all going to continue to grow. And Chris commented earlier in response to a question on some of the commercial businesses. So, generally speaking, all the businesses are performing well and should grow next year.

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

Okay. We have probably time for one last question.

Operator

Our next question will come from Sheila Kahyaoglu of Jefferies.

Sheila Karin Kahyaoglu - *Jefferies LLC, Research Division - Equity Analyst*

Chris, I guess one follow-up to Cai's last question or your comments. Can you talk about what the right structure for the business is in terms of scale? Is it a $500 million business unit within the subsegments? And then separately, if you can comment on upcoming awards and what we should be paying attention to for the rest of the year.

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

Okay. Well, thanks, Sheila. Good seeing you at the airshow. I hope you had a good time there.

Sheila Karin Kahyaoglu - *Jefferies LLC, Research Division - Equity Analyst*

I was one of the 1,000 people that went through the chalet, so you can count me in that number.

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

Absolutely, thanks for visiting us. On the scale, it is a great question. We have about $10 billion revenue top line company right now. Aspirationally, we want to get larger. But historically, a few years ago, we thought the minimum was closer to 200, but that was really as we looked at how to start combining the divisions. Clearly, in this industry, a little larger is better. So, the 500 number doesn't strike me as being unreasonable. You get the scale to optimize the systems. But again, as we're looking more top-down than a bottoms-up perspective, it's really the production, the manufacturing, the innovation that needs to reside in the divisions and sector. I think 500 is a good number. As far as upcoming awards, Ralph, trying to think which ones we highlight. C-130 AMP is a big one, but that's probably late fourth quarter, early '19. I mean, we literally have hundreds of programs. I'm not sure if there's anything that's going to move the needle up or down significantly. F-16 trainer recompete. We have some international opportunities. As you know, I've been traveling a lot. I think Singapore has a couple of significant awards they hope to be announcing that we're participating in and a couple over in the UAE. Is there anything you want to throw in there?

Ralph G. D'Ambrosio - *L3 Technologies, Inc. - Senior Vice President and CFO*

Just to underscore the diversity that we have in the portfolio, in terms of a large number of not individually meaningful programs. So good diversity in the sales and orders.

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

Yes. We just put in a CRM system a few months ago that I occasionally like to look at, and the numbers are -- I know it's just a pipeline, but there are some pretty big numbers and lots and lots of opportunities. But they probably average $50 million to $100 million each and go on and on. So, we're optimistic about the book-to-bill going forward and the growth rate, but probably, the few we mentioned would be the big needle movers you might see. Any other follow-ups, Sheila?

Sheila Karin Kahyaoglu - *Jefferies LLC, Research Division - Equity Analyst*

No, all good.

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

Okay. Well, thank you all for joining the call. And we look forward to speaking to you again in October. And hopefully, everybody has a nice summer and enjoys some time off. Thank you very much.

Operator

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