OVERVIEW:
Co. reported full-year 2014 net sales of $12.1b and diluted EPS of $7.56. 4Q14 net sales were $3.2b, operating income was $303m and diluted EPS was $2.36. Expects 2015 consolidated sales to decline about 2% to midpoint of $11.850b vs. last year and diluted EPS to be $7.35-7.65. Expects 1Q15 sales to be $2.7-2.8b and EPS to be about $1.50.
Good day, and welcome to the L-3 Communications Holdings Incorporated fourth-quarter and full-year 2014 conference call. All participants will be in listen-only mode.

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

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

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

Operationally, we continued to execute well on our programs, increase our international and commercial business, and create value for shareholders through some disciplined capital allocation, and our dividend strategy. Amid persistent challenging conditions, we continued to manage our business effectively, exceeding our 2014 financial plans for orders.
Our balance sheet is strong, and we continue our robust cash generation. Our net sales for the quarter were $3.2 billion, a 1% decrease from the fourth quarter of 2013. Net sales for the full year were $12.1 billion.

Declining US government sales were partially offset by an increase in net sales to international and commercial customers of 2%, to $1 billion, in the fourth quarter, compared to $980 million year over year. This increase puts us at 31% international and commercial sales for the quarter, which would be about 28% pro forma, excluding the MSI divestiture, which we expect to close during the second quarter of 2015 and I'll talk about that in more detail in a few minutes.

We continue to pursue a number of international and commercial opportunities across the Company. Diluted earnings per share for the quarter increased by 16% year over year, to $2.36, compared with $2.04. Diluted EPS for the year was $7.56.

Funded orders were $3.4 billion, a 14% increase year over year. Funded orders for the year were $12.1 billion. Our book-to-bill ratio was 1.05 times in the quarter, and it was 1 times for 2014, reflecting the continued strength of our market positions and exceeding our expectations for 2014.

Operating income for the fourth quarter declined by 1%, or $3 million, compared to last year, to $303 million. Operating margin decreased by 10 basis points to 9.4%, compared to 9.5% in the fourth quarter of 2013. Our free cash flow for the quarter was approximately $452 million, bringing our full year of 2014 cash flow to a very robust $946 million.

While there are clear signs that the US defense industry downturn is approaching the bottom, our strategy remains unchanged. We are focused on providing value through innovative and affordable solutions for all of our customers. An important part of that strategy is continually reshaping our portfolio to reflect our customer's priorities, and bring new efficiencies to our core businesses.

During the fourth quarter, we announced a definitive agreement to sell our marine systems international, or MSI, business. The sale of MSI will sharpen our focus on our core businesses, and also improve our margins on a consolidated basis. Also, our recently completed acquisition of MITEQ reflects a key element of our continuing portfolio shaping strategy to enhance and augment our business capabilities with niche acquisitions that create long-term value for our shareholders.

Now, some brief comments about the performance of our business segments, including significant awards and milestones, starting with Electronic Systems. At Electronic Systems, net sales for the fourth quarter increased by 80 million, or 6%, on a year-over-year basis. Operating income was up 6%, from $145 million to $154 million.

Overall, within Electronic Systems, we are well positioned to increase market share across a variety of business areas, and we remain focused on driving margin expansion in the near-term. We have excellent performance, and continuous improvement will help us achieve this goal.

Here are some highlights for the quarter. We continue to receive strong orders from our Wescam -- for our Wescam sensors from the US military and key international customers, including the Royal Saudi Air Force, the UAE, the People's Democratic Republic of Algeria, and AFRICOM. And we continue to make on-time deliveries to our global customer base, including a recent successful delivery to Egypt.

We are steadily gaining market share in aviation products. We received a contract for avionics in support of the US Army's UH60 program, where we will be providing standby instrument systems.

Also, L-3 entered into a reseller agreement to supply avionics for Boeing 737 and 767 aircraft, which includes component repair and maintenance support. Related to this, we also entered into an agreement for the distribution of L-3 aviation products here in the US.

We also received the first purchase order for our new links -- multi-link surveillance system. This single box 80-SB solution is a new product line for the general aviation marketplace, which will be rolled out and marketed in the first quarter of 2015. We recorded a strategic win for specialized directive energy products for the space and missile command, and in order for our HELRAS antisubmarine warfare system for Indonesia.

Under a five-year program, we were awarded a nine ship set order for switchgear and circuit breakers for the Virginia class submarine. In our security and detection systems business, we've been selected to provide a new networked radiation detection capability for Dutch customs. Additionally, in Saudi Arabia, we are providing mobile scanning machines for customs use.
At Warrior systems, we saw continued orders for our night vision equipment from both commercial and military customers, including SOCOM. We continued on-time deliveries for shipments through the fourth quarter, and received orders for thermal systems from the US Army. And our link business was selected to provide contract training and simulation services for the E3 program.

Moving on to Aerospace Systems, net sales in the segment increased $13 million, or about 1%, compared to the 2013 fourth quarter. Operating income was up 2% year over year.

Platform and logistic solutions accounted for $8 million of the sales increase, and the remaining 5 million came from ISR systems. Our performance on legacy programs, especially at ISR systems, has been outstanding and this fuels our business, along with our tactical ISR and international modernization work.

Going forward, we see a strong pipeline of opportunities to increase our business base in this area. Key wins in the quarter included a five-year program to support special mission aircraft operating out of [Bantz] Air Force Base. We were selected to upgrade Communication Systems on the C-32 and C-40 aircraft for the DoD, and to support a datalink upgrade initiative for the C-37 aircraft.

Internationally, we received continued funding for our work upgrading Argentina's C-130 fleet, and our work on the UK Air Seeker program continues to proceed very well. We are expecting to deliver our second of three aircraft ahead of schedule, and on budget.

Our tactical ISR work continues to advance and deliver solid performance metrics. We have received funding for our ISR integration work in Yemen.

Our SPYDR platform continues to operate at more than 300 hours per month for its DoD customers, with an overall mission availability rate of 98.8%, and we are meeting our milestones with our Middle East customers. Additionally, we are at work on a new variant of SPYDR to address future Army and SOCOM sensor requirements.

We've also been awarded a contract in support of a basic trainer and light lift aircraft initiative in Afghanistan. Performance-wise, we delivered 33 aircraft on time or ahead of schedule, to a wide range of customers.

Communications systems. Sales in our communications systems segment declined by $73 million, or about 14% year over year. We are working to improve Communication Systems operating performance, building off our unique capabilities and strong market position.

Ralph will go through some of the reasons for the decline in a little while. But some other highlights in the quarter are, we continue to see strong domestic and international demand for SATCOM. We also had continued orders and funding for SATCOM terminals, including the SPN Light program and our Hawkeye equipment, as well as an expansion of our work in Australia.

We received continued funding for a variety of legacy programs, including orders for over six and vortex for both domestic and international customers, and additional funding for the Grey Eagle program, as well as the U2 and F-35 programs. On the Global Hawk program, we received follow-on funding, which also includes a key international opportunity with the Republic of Korea.

In addition, we received continued funding for our work on the WIN-T program, as well as orders for a life cycle upgrade. On the Navy side, we saw continued funding for a variety of programs, including the offshore patrol program in Canada, and the rigid hull inflatable boat program for the Royal Australian Navy.

We are continuing our communications upgrade work on Australia's Collins Class submarines. Our customer reports they are extremely pleased with our progress.

From the Israeli MOD, we received two sets of orders for our traveling wave tube equipment, and we have continued our work on the Gorgon Stare program, which is now a program of record. L-3's communications work on increments one and two of this program have been excellent, with 99% mission effectiveness since 2011. We are working with the prime on the next-generation hardware for the potential increment three program.

Moving on to National Security Solutions, net sales for the fourth quarter at the NSS segment were 15% lower, or about $46 million, compared to the fourth quarter of 2013. This was mainly due to reduced demand and contract completions, as well as delayed contract awards for international contracts and protests on US government contracts where we were the winner. These decreases were partially offset by our acquisition of the data tactics business.

Despite the challenges in this business area, we are successfully penetrating emerging markets, and gaining new customers and market share in the US government intelligence community. The National Security Agency awarded L-3 the enterprise program management contract, or EPM, to provide systems engineering, acquisition planning, program management and financial management for two of NSA's major mission areas. This was our largest contract re-compete for 2014.
We received a major win in the form of a task order to support the US Army's medical communications for combat casualty care program, providing engineering and logistic support. We were selected as one of three awardees for the US Navy's cyber warfare development group vehicle, which is a strategic three-year program to provide cyberspace support, cryptologic and electronic warfare operational capabilities.

And we recorded our first-ever prime contract win with the National Geospatial Intelligence Agency, as part of the ITEMS program. We have also received follow-on funding from the Defense Threat Reduction Agency and nuclear test personnel review. This is an eight-year program.

Now a little bit about capital allocation and acquisitions. Following our longstanding strategy of maximizing shareholder value through dividends and share repurchases, we returned $460 million in the fourth quarter, compared to $444 million in the fourth quarter of 2013. For the year ended December 31, we returned over $1 billion.

In the fourth quarter, we repurchased $410 million, compared to $396 million year over year. This brought the total common stock repurchase for the year into December 31 to $823 million, up from $800 million in the prior year. We will continue to implement our cash allocation strategy, which includes a prudent combination of returning cash to shareholders and common stock repurchases, while still investing in the business through R&D, acquisitions et cetera.

While our M&A activity was limited in 2014, we continue to look closely at opportunities for acquisitions that meet our criteria of adding to market share, enhancing synergies and collaboration across our business segments, and delivering new and more innovative solutions to our customers.

As part of this strategy, last week, we announced that we have acquired the assets of MITEQ, which will be combined with Narda Microwave East business.

L-3 Narda MITEQ will employ about 700 people, and provide products for the US military, government agencies, prime contractors, and commercial customers, as well. The acquisition is expected to generate approximately $55 million in sales in 2015. This deal adds key RF, Microwave and low-power SATCOM products and capabilities, and creates cross-selling opportunities that will expand our customer base.

As I mentioned earlier, we continue to shape our portfolio to reflect our customer's priorities and help us achieve operational efficiencies. The sale of our marine systems international business is further evidence of this strategy.

The MSI transaction is anticipated to be completed in the second quarter of 2015 and, of course, is subject to customary closing conditions and regulatory approvals. While these transactions are relatively small, they do demonstrate our commitment to finding opportunities to tailor our product mix to our customers' needs and achieve efficiencies that will help us expand. Across L-3, we are committed to finding opportunities to tailor our product mix to achieve efficiencies.

Regarding the budget, the US government market remains a challenging environment, with ongoing budget uncertainty, but I do believe we've reached the bottom of the downturn, and things will soon begin to grow. What we need are security-driven budgets that reflect the geopolitical issues the US is facing.

The defense sector contributes to our national security, in close partnership with our men and women in uniform. It is essential that our personnel have equipment readiness to fulfill their duties in this ever-dangerous environment.

Stopping sequestration has been a difficult process within government. However, with positive signs like the 2015 budget authorization and the OCO budget, we remain optimistic that our DoD customer will receive some continued sequester relief for FY16 and beyond. Overall budget stability and growth will help with our planning process and increase the visibility of our business.

We need to continue working with Congress to end sequestration and appropriately fund R&D programs that will drive innovation and maintain IR&D investments. For L-3, we are continuing to work with the DoD to strategically invest in new technologies that support DoD requirements and priority areas. In this regard, we are also increasing our R&D by about $20 million in 2015.

Our focus areas include electronic warfare, sensor development, ISR systems, space work, cyber and big data, and the classified arena, which is a growing budget area. Overall, this will help improve our productivity and increase market share in the DoD business.

L-3 has a diverse base, including content, on nearly every DoD platform. At the same time, we continue to expand our international and commercial business to offset the challenges to our DoD business.

With that, let me turn it over to Ralph, who take us through the financial data in more detail.
Thank you, Mike. I'll discuss some details about the fourth-quarter results, and then review our 2015 initial guidance. Overall, our fourth-quarter results generally exceeded our expectations, driven by strong orders, sales, earnings per share and free cash flow, and a lower tax rate.

Fourth-quarter sales were $3.2 billion, only declining 1% versus the 2013 fourth quarter, and that was the high end of our most recent sales guidance range. Fourth-quarter diluted earnings per share was $2.36, and it benefited from a lower tax rate, primarily due to Congress re-enacting the research and experimentation, or R&E credit, in December, which lowered taxes by $22 million and added $0.26 to EPS.

Our fourth-quarter EPS was also negatively impacted by and $18 million charge in the Electronic Systems segment, related to a product specifications matter with the US government, which subtracted $0.17 from EPS. The R&E credit and the Electronic Systems charge were not assumed or expected in our most recent 2014 guidance.

At the segment level, fourth-quarter sales and margin were ahead of our most recent guidance at communications systems and Electronic Systems, excluding that charge for the product specifications matter, but below our guidance at Aerospace Systems and National Security Solutions. At Electronic Systems and communications systems, margins benefited from better sales volume, cost take-out actions, improved contract -- and improved contract performance. Communication Systems also booked and shipped some high-margin SATCOM terminals sooner than we had expected. Conversely, at Aerospace Systems, margin was negatively impacted by additional scheduled slips and cost growth on two international aircraft modification contracts, and reduced pricing and a revised incentive fee structure on the new T-45 training aircraft support contract, which began in October 1.

NSS margins were lower, due to higher-margin international sales sliding to 2015, as well as increased spending on business development and marketing and selling expenses.

Lastly, fourth-quarter free cash flow was very good, totaling $452 million, resulting in full-year free cash flow of almost $950 million, with an earnings for cash flow conversion of 142%, and free cash flow per share of $10.77.

Moving on to this year, today, we provided our initial guidance for 2015. It is consistent with the preliminary outlook that we provided three months ago, with some pluses and minuses that offset each other.

Our 2015 diluted earnings per share range is $7.35 to $7.65. Included in the EPS guidance is higher pension expense versus 2014, and no federal R&E tax credit in the tax rate. Pension expense will increase versus 2014 by $59 million, primarily due to a lower discount rate, and that is reducing EPS by $0.45.

We expect consolidated sales to decline about 2%, to a midpoint of $11.850 billion for 2015, versus last year. The Afghanistan draw-down is expected to reduce sales by approximately $250 million year over year. And we expect our US government business, including the DoD, to decline by about 7%, and our international commercial business to offset that decline, growing also at about 7%. Our recently announced MITEQ acquisition adds about $55 million to sales in 2015.

For operating margin, we continue to expect 2015 consolidated margin to be about 9.3% after higher pension expense, which will reduce margin by 50 basis points. Excluding the higher pension expense, we expect margins to increase in every segment, with most of the increase in Aerospace Systems and NSS, which have the easier comparisons versus 2014.

We have a few offsetting changes in our initial 2015 margin guidance compared to our 2015 preliminary outlook. First, the pension expense increase will be $14 million less than we previously estimated. And that's due to a variety of changes and assumptions unrelated to the discount [rate]. And that is being offset it -- that's being offset by higher medical expenses of about $10 million across the company, and about $5 million that will incur to integrate MITEQ with Narda Microwave.

The good news, with respect to the MITEQ and Narda Microwave integration and consolidation is that, beginning in 2016, we expect those combined companies to generate annual operating income synergies of about $5 million, which will increase 2016 operating income year over year in Comm Systems by about $10 million, when you factor in the $5 million that will incur in 2015 for the integration. Additionally, for 2015, we're increasing our investment in R&D by about $20 million, aimed at US government classified markets, mostly in Electronic Systems and that is to drive future sales growth, and that increased investment in R&D is being offset by cost improvements elsewhere in the business and the segments.

The 2015 tax rate is going to increase, because we have no R&E credit. If the R&E credit is re-enacted, it will lower the tax rate by about 220 basis points, and increase EPS for 2015 by about 0.24. We ultimately expect that there will be an R&E credit for 2015; it's only a matter of when Congress enacts it.
We expect to generate free cash flow next year -- or this year, rather, of about $925 million and that's going to -- that will be cash flow per share of about $11. With respect to the capital allocation, we are still planning for initial share repurchases of $500 million.

We ended 2014 with a cash balance of approximately $500 million, that's including $61 million related to MSI, which is classified as an asset held for sale, which we will collect when the MSI sale is completed later on this year. So after dividends and the share buyback of $500 million, we will have excess cash to deploy in 2015 of up to $900 million, including the MSI sales proceeds and that excludes cash overseas, which will only be about $125 million by the time we get to the end of 2015.

We expect to have a book-to-bill ratio for the full year of approximately 1. With respect to the first-quarter outlook, we expect sales to be in the $2.7 billion to $2.8 billion range, margin in the low 8% range, EPS of about $1.50. Our free cash flow will be negative in the first quarter by about $100 million, similar to what it was in 2014 and the first-quarter book-to-bill ratio looks like it's going to be about 0.95.

I'd like to make a couple of points about the MSI divestiture, because it is not reflected in our guidance that we provided today. We will include that in the guidance when the transaction closes. But I wanted to let you know what the impact would be ahead of that time. So once it closes, it will become a discontinued operation and that will lower income from continuing operations -- or results from continuing operations at the sales line by about $500 million. It will increase consolidated margin by 10 to 15 basis points, and have about a neutral or no impact to our EPS and free cash flow guidance that we gave today for the year.

So to conclude my financial review, while the DoD environment will again be challenging for this year, future budget levels are set to improve, with the budget likely up-turning in FY16, which begins October 1. We're effectively managing through the DoD down-cycle. The Company is resilient and healthy, we're generating robust cash flow, and will continue to allocate our capital and our cash flow to increase shareholder value.

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

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**Question and Answer**

Operator

(Operator Instructions)

Cai von Rumohr, Cowen and Company.

Cai von Rumohr - Cowen and Company - Analyst

Yes, thanks so much. So Ralph, on the MSI divestiture, if you treat it as a DisCo, what is the current operating margin? Because obviously, you are going to lose $500 million in sales, and a full amount of (multiple speakers).

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

It's about 6%, Cai.

Cai von Rumohr - Cowen and Company - Analyst

But then you got to buy back stock, or else it's dilutive, correct? And you plan to buy back the stock as soon as possible? Or how should we think about that?

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

It will probably be spread over the year. We'll try to do more of it earlier in the mid-year timeframe. We gave a wide enough EPS guidance range, which would accommodate what you're talking about.
Cai von Rumohr - Cowen and Company - Analyst

Great, thanks. And then just a last one. When I look at your cash deployment for this year, including the MITEQ, but obviously the MSI isn't in this, it looks like it's 81% of your cash flow. And you've been averaging more like 100% or more

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

Yes, that is correct, Cai. And -- which is why -- what I explained in my comments was that, after we pay our dividends, which will be about $200 million this year, and make the $500 million of share repurchases -- and that's before doing anything with the proceeds from the MSI divestiture. I said that we expect to have up to $900 million of additional cash to deploy in 2015. So we have a lot of opportunity to either do more acquisitions or buy back more of our common stock.

Cai von Rumohr - Cowen and Company - Analyst

Okay. You more recently -- it looks like you've been doing some more acquisitions. Most of last year, you were focused on repo. How should we think about the priority, or the likelihood, of doing some more in M&A versus stock repurchase?

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

M&A continues to be a key element of our growth strategy. But as you know, M&A, for us, has always been one, opportunistic, in that the targets or the candidates have to be available to acquire. And then there has to be fit with L-3. And lastly, and most importantly, good economic returns on the investment. So clearly, we'd like to do more acquisitions. But it is going to be subject to those three factors that I just talked about. Opportunity, fit and economic returns.

Cai von Rumohr - Cowen and Company - Analyst

Okay, terrific. Thank you so much.

Operator

Myles Walton, Deutsche Bank.

Myles Walton - Deutsche Bank - Analyst

Morning. Thanks. First, a clarification. Ralph, I think you said $20 million higher -- and I think Mike did, as well -- on R&D. And I just wasn't clear if that was already in your preliminary outlook, or if that's (multiple speakers).

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

No, it was not.

Myles Walton - Deutsche Bank - Analyst

Okay, so that's being offset by cost savings and --

Ralph D'Ambrosio - L-3 Communications Holdings Inc - SVP and CFO
I was trying to explain what changed in our margin preliminary outlook versus the initial guidance. It didn't change in total. I said there were some offsetting items, and that was one of them.

Myles Walton - Deutsche Bank - Analyst

Okay, great. And the NSS segment, in particular, Mike, put up 3% margin. I realize this 200 basis point of headwind that are probably more one-off than not. But still, obviously, the trend line of reducing the margin profile every quarter, over the last four quarters, then you get to the end of the year. And you're pointing a little bit up for next year, but still below where you thought you were going to start this year. So just that business, as it sits today, is it still the same business that you thought it was going to be? Is it still a business that is the place it should be?

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

This whole segment of the budget services, namely, has come under heavy pressure on the margins, due to in part to the better buying power strategy, and more competitions, more players willing to buy business. Just our overall competitive environment, Myles. So we would rather not see it that way. And candidly, if there's not in improvement over the next year or two, this one may be one that we would choose to part with. But right now, we don't think that makes sense. Because we think prices are probably lower than we'd like to see for it to make sense for us.

And we still see strong growth in the cyber area. And we've won a bunch of new contracts in that area. The new business has been robust, to say the least. We've been (inaudible) the disappointment is, it's at margins that we are not interested in. We're not interested in 5% businesses; we are interested in 10% and better. And there will become a point in time we're going to lose interest in pursuing it any further. So we have our eye on it, and we're doing everything we can do to try to keep the cost as low as possible, and get the margins up. But when that becomes absolutely pointless, I'm sure you'll see a change in strategy here.

Myles Walton - Deutsche Bank - Analyst

Okay, that's it for me. Thanks

Operator

Joe Nadol, JPMorgan.

Joe Nadol - JPMorgan - Analyst

Thanks, good morning. Just on NSS again. The issues you face in the quarter, can you give us just any more color or clarity around why you think you'll -- that they'll pass by, and they are over? And that margins will pop back up in 2015?

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

Sure, Joe. It's Ralph. So what we explained in the discussion in the earnings release was that there were some high-margin international sales that slid out of the fourth quarter into the first half of 2015. So there's two contracts in particular. One, we've already been selected. It's an FMS contract, and there's been delays in getting it contracted through the US Air Force. But we expect to book that order in the next month or two. And then there's another contract, which we expect to be sole source on. And that is -- likely will be booked in the second quarter. So we still expect those high-margin orders and sales to occur. They just have -- they are going to be happening later than we expected, at the time of our last guidance update for 2014.

Joe Nadol - JPMorgan - Analyst

Okay.

Ralph D'Ambrosio - L-3 Communications Holdings Inc - SVP and CFO
But no doubt, the margins guidance that we gave for 2015 in NSS is contingent upon booking and converting those orders into sales that I just talked about.

Joe Nadol - JPMorgan - Analyst

And does that mean that the margins should be back end-loaded for the year?

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

Correct. Yes.

Joe Nadol - JPMorgan - Analyst

Okay. And then just on the strategic level, back to Myles' question. Mike, there's been some consolidation recently in services. There's been a lot of talk that there's sub-scale players, that your business isn't that big, compared to other service companies. There's been talk of maybe a $4 billion or $5 billion threshold as being where you need to be in services to be able to compete. How do you feel about that? Is this just -- is it just not going after badly priced business? Or is it just that you're not big enough?

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

The comment you just made about needing to be $4 billion to $5 billion to compete, I don't buy. Because we have won a pretty healthy book of business this year, beating many larger players. So I think it's really -- your performance is what -- past performance and your capabilities are what it takes to win. I think that the margins adjust the current state of play in this segment of the business with the government. I don't see, really, many players earning double-digit margins in this area.

So I don't know that that's a scale issue, versus more a function of better buying power, and the customer just not being in a position to want to pay much more. Everything is going low price, and it's not an area where past performance is really doing a lot for us, I think. Where it goes to low price, we're not willing to bid much lower on anything. So I think, in terms of cost cutting, I -- we have a pretty lean operation to begin with. So unless we're able to win business that offers higher margins, I don't see a lot of opportunity to grow the margins here much much more than where they are.

Joe Nadol - JPMorgan - Analyst

Okay. And then just one more, just high level. I thought you said, Ralph, that in your plan for the year, defense sales, domestically, you expect to be down 7%. And that to be partially -- or largely offset by 7% growth in the international and commercial realm. And so on the domestic defense down 7%, I think that's a little bit lower than some of the other companies we cover, and what we are looking for out of the budget outlays. Is there a way to characterize where you think you're falling under what the industry is doing more broadly? And then, is that what you're attacking with your R&D? Or how are you planning to compensate?

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

Okay. So I did say that we expect our DoD sales to decline by about 7% this year versus 2014. And what I would call the base DoD business, which doesn't include the Afghanistan work, and the draw-down impacts that we're going to encounter this year. The DoD base business is declining about 4%. So it goes from minus 4% to minus 7%, because of the $250 million of sales that are going to decline related to the draw-down from Afghanistan.

Joe Nadol - JPMorgan - Analyst

Okay.

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

Okay.
Additionally, within that 4% reduction, which is roughly about $300 million at the 4% level, about 100 million of it is due to some legacy DoD platforms ending or being curtailed, in terms of fleet size, within the Platform Solutions sector in our Aerospace Systems segment. And I talked about this on the last conference call, and it's a few programs. In particular, it's the US Navy P3 modification business, which is declining, as that work transitions to the new platform, P8. The DoD is planning to reduce the size of the Compass Call fleet, probably halving it, if sequester remains in effect. And hopefully, that won't happen. But that's something we're seeing in 2015. And then lastly, we still have a little sales leakage or decline in 2015 that comes from the decision to retire the JCA fleet a couple years ago, at the beginning of all these budget cuts, and the DoD downturn. So those are the anomalies there. So if you take away the draw-down, and then take away those legacy programs that are ending, our DoD business is only declining about 2.5% or so, year over year. So hopefully, that helps you.

Joe Nadol - JPMorgan - Analyst

Okay, that's very helpful. Yes, very much so. Could you just tell us what sector, or which of your businesses, that extra $20 million of R&D is going into?

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

It's mostly going to go into Electronic Systems. I'd say $14 million or $15 million of it in that segment. And then the rest of it is split between Aerospace and Communication Systems.

Joe Nadol - JPMorgan - Analyst

Okay, very good. Thank you

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

The point is that we're stepping up the investment because we see very good medium-term and long-term growth opportunities in the classified markets with the US government. And we're putting our money where those opportunities are. And hopefully, that will lead to a good sales growth a couple years out.

Joe Nadol - JPMorgan - Analyst

Okay, thanks.

Operator

Robert Spingarn, Credit Suisse.

Robert Spingarn - Credit Suisse - Analyst

Good morning. Just a follow-up to Joe's question, Ralph, which you were just talking about. So if -- in a -- what has been a flattish defense budget environment, let's say, the last year, maybe two, your defense -- your core defense, base budget type sales would go down 4% in 2015. At what point might you benefit, if we see the 2016 budget rise, when all is said and done? How much of a lag would there be until L-3 would start to benefit from that?

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

Most recently, I said that, looking to 2016, I said I expected our total sales to be flat or up about 1%. So we're going to start seeing some improvement next year, and more so the year after. (multiple speakers)

Robert Spingarn - Credit Suisse - Analyst
But Ralph -- is that based on the cap numbers? Or on what is expected with some sequester relief?

**Ralph D’Ambrosio - L-3 Communications Holdings Inc - SVP and CFO**

It's the cap numbers plus some sequester relief, not what's going to be requested, or expected to be requested, for 2016 next week.

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

Right. I think we can all assume that the final answer on that will be something between the request and the sequester number, so let's say halfway, once we get a budget.

**Ralph D’Ambrosio - L-3 Communications Holdings Inc - SVP and CFO**

And the other thing, too, here, is if you look at what has been happening to -- we are all aware of the lag between the budget authority and the outlays. So while the budgets are bottomed, if you look at the total reduction in the budget authority since the downturn began in FY10, the outlays are still -- haven't declined as much as the budget authority. There's probably another 4 or 5 percentage points to go, in terms of outlays. And that's -- I think that's mostly because of what you're seeing across most industry this year, in 2015. But continued our decline in DoD sales, despite the fact that the budget stabilized.

**Robert Spingarn - Credit Suisse - Analyst**

Right, okay. And then just a quick one on your free cash flow. Your working capital usage comes down significantly from last year, although it's kind of in line with the prior year. What's happening there? And how comfortable are you with that number?

**Ralph D’Ambrosio - L-3 Communications Holdings Inc - SVP and CFO**

What's -- how comfortable are we with the free cash flow for [2015]?

**Robert Spingarn - Credit Suisse - Analyst**

I'm talking about the working capital as just a smaller use, if I remember.

**Ralph D’Ambrosio - L-3 Communications Holdings Inc - SVP and CFO**

So if you look at our working capital, the end of 2014 versus 2013, our days sales outstanding, with respect to receivables, was about unchanged, at 71 days. But we did have improvements in reducing our investment in inventories, and that led to an overall working capital improvement in 2014. In 2015 and 2016, I still expect that we are going to reduce working capital, in total, by what I would call modest amounts. Let's say $50 million to $100 million per year. And a lot of it is going to come out of Communication Systems, where, for a variety of reasons, the last several years, we've tied up a lot of working capital. And we began to liquidate that again in 2014. And I think we will continue to reduce that working capital investment this year or next year.

**Robert Spingarn - Credit Suisse - Analyst**

Okay, I just noticed it -- because it mostly offsets the reduction in the benefit from deferred taxes.

**Ralph D’Ambrosio - L-3 Communications Holdings Inc - SVP and CFO**

Yes.
Robert Spingarn  -  Credit Suisse - Analyst

Okay. All right, thank you

Operator

Noah Poponak, Goldman Sachs.

Noah Poponak - Goldman Sachs - Analyst

Hi, good morning, everyone

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

Good morning

Noah Poponak - Goldman Sachs - Analyst

I was wondering, back to the government services discussion, and the competitive landscape there, is the business that L-3 spun out specifically causing some meaningful percentage of the problem you're having there? Given the very low cost, across-the-board model they've gone with? And does the acquisition, that's basically a merger of equals, that they've announced, does that make that likely to get worse?

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

No, it was a different business in a completely different area. So the answer is no. It was -- the reason why the cyber -- this business didn't go with it is, it was a distinctively different business, with different customer. So no. The answer I would say is, no.

Noah Poponak - Goldman Sachs - Analyst

Okay.

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

Of course, et cetera.

Noah Poponak - Goldman Sachs - Analyst

And so, I guess maybe you've already answered this, but just to be sure. When -- Mike, when you talked, over the last few months, about reevaluating the portfolio, it did not necessarily mean just one or two MSI-like things. You are still reevaluating a number of things of different sizes after MSI, it sounds like?

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

Correct. Listen, if the goal is to improve our consolidated margins, there's a number of ways to do. You can bid higher margins, you can cut costs, and you can prune those operations you own whose margins are below the average. And this is part of the latter. Those that cannot perform above the [clip] level we're looking for, by eliminating those businesses from the portfolio, will bring the average higher, right?
Noah Poponak - Goldman Sachs - Analyst

Yes.

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

So it's just another thing to look at. But generally, we see this trend across any of the businesses that are in -- that are non-product businesses, that -- where the margin seems to be much softer, for a variety of reasons.

Noah Poponak - Goldman Sachs - Analyst

And then Ralph, just on the ES margin. Will any of this new R&D carry into 2016? And can you maybe just update us on -- I know you've been looking for, potentially, some nice margin improvement in that segment, as the mix reverts back in your favor. Is that still the case, once you're through 2015?

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

Yes. To answer your questions, yes, that is still the case. And we probably will spend more in R&D in 2016, as well. But the way I would characterize our margin guidance for both Electronic Systems and Communication Systems that we provide today, I would say that they are conservative, given that we are at the beginning of the year.

We still expect that those are going to drive core margin expansion for the entire company. And if you recall, last year at Electronic Systems, for example, we started the year with 11.1% margin guidance. And we ultimately did 12%, if you take away that charge for the product specifications matter, which is a nonrecurring item. So (multiple speakers) should have similar upside to margins in those segments for 2015, as well.

Noah Poponak - Goldman Sachs - Analyst

Okay. Great. Thanks a lot.

Operator

George Shapiro, Shapiro Research.

George Shapiro - Shapiro Research - Analyst

Yes. This is part Mike and part Ralph. If I look at the different sectors here, we had the product specification matter in ES. You had an unfavorable contract performance on the Head of State aircraft. In aerospace, you had unfavorable contract performance on a fixed-price development contract in communications. So for Mike, is there something here that we ought to worry about, given, obviously, what happened last summer, from a management perspective? And then for Ralph, if you could lay out additional risk that might be associated with these charges, as it goes -- as they go forward? Thanks.

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

George, I think that periodically, over time, businesses occasionally run into a problem program here and there. And I wouldn't read any more into this than the normal cycle of events. It's unfortunate, but they happen from time to time. I think our management is strongly focused on delivering top-shelf performance to their customers, and will continue to do so. I would say that one characteristic, when you get into heavily competitive times, is a little more risk is taken.
I wouldn't say that's a trend that we are seeing across the businesses, where people have stretched too thinly on taking too much risk on some of the programs. But we watch that all the time. We spend a lot of time looking at businesses before they go out, to make sure that's not occurring. We don't believe that it is. And I think all these items will be remedied, and our people will learn from them, and they won't be repeated. Go ahead, Ralph.

George Shapiro - Shapiro Research - Analyst

Okay. And then, maybe Ralph, if you just give it what kind of further risk there might be, given that a couple of these are development -- are fixed-price contracts?

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

Okay, so most of the negative contract performance in the fourth quarter that I talked about on those two international aircraft modifications contracts pertain to modification work we're doing on a couple of 747-8's. One of those contracts is -- presents most of the problems. And we've had some issues, and we're behind schedule. But we expect to make the delivery of that aircraft in the second quarter of this year. And so we don't expect it to be a continuing problem, in terms of adverse impacts to our P&L in the Aerospace Systems segment.

And to give you a little more detail, about $5 million of the charge pertains to liquidated damages that the contract provides for being late on schedule. And we are going to try to negotiate away some of those damages. Because there's been some impacts that have caused this degradation that don't emanate from the Company. So if we can do that, we will have some opportunity there. And then, with respect to the T-45 program, I think that we've adequately calibrated it in our guidance for 2015. So I think we're sufficiently providing for any additional risk on any of those items.

George Shapiro - Shapiro Research - Analyst

Okay. Thanks very much.

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

You're welcome, George.

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

Okay, great. Thanks. Once again, I'd like to acknowledge the strong, consistent performance of our employees. They've done an outstanding job of executing and delivering value to customers and shareholders. Our strategy of increasing market share and growing the business internationally and commercially is working. It's yielding key wins and market share gains. Our international commercial percentage of sales went from just 18% to over 30% in just three years, and we are all well positioned to take advantage of emerging opportunities that result from portfolio adjustments across the industry.

We believe that the bottom of the downturn is within sight, and have taken strategic steps to take advantage of opportunities that the upturn is certain to bring. Events unfolding around the world show that a strong US commitment is needed, which will continue to drive the demand for L-3's market-leading products in ISR communications, electronics and security. Our strong funded backlog of projects underscore solid growth prospects. Our agility and innovation continue to differentiate L-3 with the ability to move quickly and to deliver targeted and affordable solutions in a dynamic environment. So with that, we look forward to speaking with you again at our next call in April. Thanks.

Operator

And we thank you, sir, and to the rest of the management team, for your time today. The conference call is now concluded. At this time, you may disconnect your lines. Thank you, and have a great day, everyone.