THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

LLL - L-3 Communications Holdings Inc at Goldman Sachs Industrials Conference

EVENT DATE/TIME: NOVEMBER 03, 2016 / 2:00PM GMT

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

CORPORATE PARTICIPANTS

Ralph D'Ambrosio *L-3 Communications - SVP, CFO*

CONFERENCE CALL PARTICIPANTS

Noah Poponak *Goldman Sachs - Analyst*

PRESENTATION

Noah Poponak - *Goldman Sachs - Analyst*

We'll get started with our next presentation out of aerospace and defense which is going to be from L-3 Communications and with us from the company is the CFO Ralph D'Ambrosio.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Good morning, Noah.

Noah Poponak - *Goldman Sachs - Analyst*

Thanks so much for being here.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Thanks for having me.

Noah Poponak - *Goldman Sachs - Analyst*

So I thought we'd start bigger picture top down on the budget and then move into your business specifically. So how long do you think continuing resolution will last and what kind of growth or lack of it is in the 2017 investment accounts once we actually get a bill?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Sure. So the continuing resolution extends until I think December 9th.

Noah Poponak - *Goldman Sachs - Analyst*

Yes.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

And our expectation is that we'll have a budget appropriated shortly thereafter. So we're not anticipating any type of extended delay. In terms of its impact, since the budgets for FY 2017 and FY 2016 were set in connection with the Bipartisan Budget Act at the end of 2015, there really isn't much impact from it anyway because the budgets are pretty much flat year over year 2017 versus 2016. There was meaningful growth in 2016, and then the growth resumes again in FY 2018 based upon what's been requested or projected by the administration. So --

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

Noah Poponak - *Goldman Sachs - Analyst*

Okay.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

So we're not expecting, at least in terms of L-3, any type of meaningful impact in 2017 from the CR.

Noah Poponak - *Goldman Sachs - Analyst*

Is there any -- any discussion in the industry yet about whether or not there could be another one or two-year deal that would take -- that would be struck in 2017 with regard to 2018 and 2019 or any discussion of it's not that long now until we get the 2018 request. In -- any discussion that is going on in the industry around the Hill about those items?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Not really. I think the expectation is that we'll likely have another two-year deal for FY 2018 and 2019 like we've had for the past several years, and that, of course, will be resolved by the next administration and the next Congress. So - but that seems to be the norm now.

Noah Poponak - *Goldman Sachs - Analyst*

Yes.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Do two years at a time.

Noah Poponak - *Goldman Sachs - Analyst*

Yes. Is it possible that the next two-year deal looks similar to the last two-year deal or the first of the two years has a pretty substantial growth rate and the second year is flat from that or is it just way too early to tell?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

I think it's too early to tell. We do believe and expect that there will be continued relief from the full BCA sequestration cuts by Congress just like they've done for the first four years of the sequestration cuts. And I think that relief has been somewhere around $15 billion to 20 billion per year compared to the $50 billion cuts that were supposed to occur per year under the BCA legislation. So we're expecting something similar to that.

Noah Poponak - *Goldman Sachs - Analyst*

So when you put it all together, what do you think your end market grows through the end of the decade?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

We think that the US defense budget in total grows on average about 2% at a minimum through the end of the decade

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Noah Poponak - *Goldman Sachs - Analyst*

So 2016 investment was up from 2014, 2017's is flat if you got a 2018/2019 deal that looked anything like 2016/2017 it would be pretty hard to get to 2%, right?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

I'm talking about the entire budget, which is more than just the investment account.

Noah Poponak - *Goldman Sachs - Analyst*

Okay.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

So I'm talking about everything, including operations and maintenance and the military personnel account. So --

Noah Poponak - *Goldman Sachs - Analyst*

Okay.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

I think on average it's going to work out to a low single digit growth, at a minimum. And then we'll see what happens with the next administration, new Congress and, of course, what transpires geopolitically around the globe. Certainly it looks like there's a geopolitical situation everywhere that supports continued spending on the military, and if not increased spending on the military.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. Can you speak to L-3's ability to outpace whatever that end market growth is on average over the next five years?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Sure. So what we've been discussing recently about the -- the growth in the US defense budget which I said we think is low single digit and we believe that we're going to grow all our US military business at least at the same rate as the overall budget and try to do better. And that's going to be contingent upon our ability to continue to win new business in the DOD space and that's something that we've been doing. We have a couple of programs that are still in the decline phase and that's impacting the growth rate this year, next year in our US military business. But at a minimum we want to do as good as the overall budget and then try to exceed that.

Noah Poponak - *Goldman Sachs - Analyst*

Can you speak to the items that are holding that back a little bit in 2017?

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Sure. So we -- we gave our -- provided our preliminary outlook for 2017 last Thursday when we reported our third quarter results, which is what we typically do each year, and I have a couple of charts here that we used last week. So I'm going to put them up on the screen.

So on this chart, we have our consolidated outlook for next year, and it expects or projects growth in sales of 1% to 2%, which is also organic. And then on the next chart, we provide the outlook by segment, and you can see that we expect two of our segments electronic systems and communications systems to each grow about 4% organically next year, and that is being partially offset by a decline of 1% to 2% in aerospace systems, and that's where we have some headwinds in terms of some legacy programs continuing to decline.

There's some in the military, US military area and also some internationally. But in the US military, we do work on the US Navy P-3s. That work has been declining as the P-3s transition to the P-8s. So that's an impact next year. We also expect slightly lower sales on Compass Call as well as the cabin assemblies that we do for the CH-47 and UH-1Y helicopters and so those are the US military headwinds we have in our program headwinds for 2017.

Noah Poponak - *Goldman Sachs - Analyst*

And so the guidance for U.S. government -- or the initial sort of look in 2017 for U.S. government growth I think was 2%.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Yes.

Noah Poponak - *Goldman Sachs - Analyst*

And that's with the headwinds you just described. So it would seem like beyond 2017 with the better budget authority flowing into better budget outlays, plus the absence of those headwinds, you'd be able to accelerate faster than the two beyond 2017. Is that fair?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

That is fair. Clearly, since we believe we're in a growing DOD budget situation or environment, to the extent things change, they should change positively with respect to our sales to that end market. And I think you saw that -- you definitely see that in 2016 where we -- our initial guidance that we provided a year ago for 2016 contemplated that our US military sales would be flat organically versus 2015, and in our most recent update that we provided last week, we expect our DOD sales to grow almost 3% organically. That's the main reason we increased our full year sales about $250 million in the guidance midpoint for 2016, with most of that growth, in fact, all of it coming from the US DOD market. So I hope that -- I hope that we have similar positive increases to our US military sales in 2017. And the year hasn't even started yet, so clearly there will be opportunity to do better.

Noah Poponak - *Goldman Sachs - Analyst*

What's driven that 0% to 3% this year?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

It's actually been broad-based slightly better performance across most of the portfolio, so it hasn't come in any one particular area. It's really -- it's happened in all three segments with most of it, believe it or not, in the aerospace systems segment. So --

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Noah Poponak - *Goldman Sachs - Analyst*

So that -- interesting. So that sounds more like you started the year with a reasonable conservative forecast. The end market's getting a little better, then it was broad based upside. It wasn't one thing that came through. Is that right?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

That is a fair characterization?

Noah Poponak - *Goldman Sachs - Analyst*

And so the hope would be that in 2017 and market environment is similar, you possibly started with a forecast that's similarly conservative and you may have a similar amount of upside potential to that number?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Yes. I would say that our outlook is appropriate and there's some conservatism factored into it and we'll see how next year unfolds.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. And then international and the commercial pieces, what are they doing in 2017 and then how do you think about their growth potential on more of a three to five-year basis?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Okay. So in 2017, we expect our commercial sales -- commercial and international are each about 15% of our total sales, and we expect the commercial to grow organically about 2%. Were it not for the declining sales that we have had on the head of state aircraft modification contracts, commercial would be growing about 4%. So we think the commercial business should continue to grow at that rate the next few years.

And on the international side, we presently expect our sales to decline about 1% organically in 2017 which is a significant improvement compared to the minus 12% decline organically in 2016. So we expect that eventually we'll start growing our international sales again particularly as we get closer to the latter part of this decade when we see a resumption of growth in our long-lived ISR-system mission integration-type contracts.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. What is left levered to the operating tempo at L-3 now? And has that actually been getting better recently or is it stable.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

So. We came into 2016 expecting that our Afghanistan-related sales would decline about $150 million to approximately $400 million to 2016 and that's where it stands. We expect that those sales would continue to be at about the $400 million level prospectively including in 2017. And that's because a lot of that work is supporting the special operation forces which we don't see declining further in 2017 or after 2017. So it's right on -- it's spot on with what we had been expecting for the last several years.

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Noah Poponak - *Goldman Sachs - Analyst*

So in the 2017 U.S. government up to -- that seemed flat.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Correct. Correct.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. What are L-3s handful of largest programs now?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Sure. So our largest program continues to -- and these are in terms of annual sales. The largest program is the Fort Rucker helicopter maintenance program for the US Army. That's about $450 million in sales. It also happens to be our largest recompetition that the company has for the next several years, and that will be recompeted next year. That's the largest program.

The second largest program is a classified contract with the US government doing ISR-type work, which is about $400 million in sales. That's stable going forward. Then we have another large ISR platform with the US Air Force that is also close to $400 million in sales. So that's the top three.

And then the next largest contract would be the U.S. Army C-12 contract which is almost $190 million in sales this year. And then the fifth largest contract would be another classified job in the communications area, which is almost $200 million in sales. So those are the top five. So top five programs represent about 15% of sales or so. Our top ten would be about 20%, and then the top 30 would be about 35% percent. So then the numbers start to drop off dramatically in terms of revenue contribution from individually large programs, which shows you how diversified the L-3 revenue base is in terms of contracts.

Noah Poponak - *Goldman Sachs - Analyst*

So three of your five largest programs total company are classified.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Correct.

Noah Poponak - *Goldman Sachs - Analyst*

That's a fun modeling exercise.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

It is. But we have -- we have good visibility in what's happening to these programs. The classified space is a very good part of the market to be in now.

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Noah Poponak - *Goldman Sachs - Analyst*

Yes.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Because it's not only growing, but it's expanding as more and more programs move from unclassified to classified for obvious security reasons. So that's an area we're investing considerably in terms of additional R&D, spending not only last year but this year, and that will continue because we see good additional growth opportunities there in the next several years.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. So it sounds like there's no large one or two platforms that drive out growth, and so we should sort of think of a well diversified defense business that should grow relatively in line with the defense budget, although positioned towards classified and Intel and electronic work there in ISR and therefore things going faster in the budget so maybe grows a little faster than the budget.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Yes. That's our intent.

Noah Poponak - *Goldman Sachs - Analyst*

Okay.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

And, of course, the outcome of the Fort Rucker recompetition, that could be binary because it's $450 million of our sales. But the margins there are very low compared to the company composite, so it's less of an impact on our earnings and cash flow as compared to the top line.

Noah Poponak - *Goldman Sachs - Analyst*

Is that a sub-5% margin program?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

It's a mid single digit program.

Noah Poponak - *Goldman Sachs - Analyst*

Okay.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

So --

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

Noah Poponak - *Goldman Sachs - Analyst*

Any other -- I know you mentioned that's the largest recompete? Anything else we should be keeping an eye on that's above$100 million.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

It's the army C-12 contract which I mentioned as being in our top five.

Noah Poponak - *Goldman Sachs - Analyst*

Yes.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

That's about $180 million to $190 million in sales. The new contract is segmenting into two different contracts. One will deal with the C-12 aircraft that are ISR oriented, so that would include the Guardrail aircraft, the MARSS and the EMARSS aircraft, and then the larger piece will deal with the transport staff utility on normal C-12s. So those are both in our source selection and we expect that the Army will make award decisions on those sometime next year. But once you get beyond those two, we don't have any individually large recompetitions for the next several years at L-3.

Noah Poponak - *Goldman Sachs - Analyst*

That's good. Can you give us a little more precise likely timing on next year for C-12?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Sure. the timing on both of the programs, Fort Rucker and C-12 is very similar.

Noah Poponak - *Goldman Sachs - Analyst*

Okay.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

So we expect award decisions would be made middle toward the end of next year and that the new contracts would start at about the beginning of 2018. It's possible that they could happen a little sooner and maybe impact the fourth quarter of next year somewhat, but we presently see them starting in about January of 2018. So they will be 2018 impacts for L-3.

Noah Poponak - *Goldman Sachs - Analyst*

Great. Okay. So that's a pretty comprehensive look at the top line. So maybe moving -- moving to the margins of the business. So the company, obviously, had some execution issues over the last few years and just had some margin pressures. But it's a company that has a long track record prior to that of performing really well. You've brought in some new -- new members of the management team. There's been -- it seems like to me there's been discussion of sort of a turnaround plan and I'm focused on better margins but coincidentally with that management change, there has also been a discussion of -- trying to win new business and maybe doing some acquisitions. So I guess how -- how bad did the focus and execution actually get versus being one or two one offs and, therefore, how much change needs to take place and how much change already is taking place in terms of operations on margins?

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Okay. So you covered a lot there so let me try to answer the questions.

Noah Poponak - *Goldman Sachs - Analyst*

It's been a long time.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

So we did have some challenges in both 2014 and in 2015. It was the old Army C-12 contract in 2014 and the Head of State aircraft modification contracts in the first half of 2015. So those were isolated but individually meaningful program contract performance problems that we had. We did not have a pervasive problem with respect to contract or program performance across the company. The rest of the company is performing very well, despite those challenges that we had in 2014 and 2015, and that's why you're seeing much better performance in 2016, particularly on the margin front. It's because we don't have those singularly meaningful one off programs to drag -- overall performance lower.

So the company has always been focused on good program performance, not only in terms of satisfying our customer with respect to on time, on schedule performance but also on budget. And at the same time we're trying to generate good financial returns on our contracts so we can deliver the right type of performance and returns to our shareholders and that's something we remain focused on. And we've always had tight controls over the costs, particularly the overheads, and that's something that continues in 2016 and will continue in 2017.

So I wouldn't call it a turn around. It's just -- we continue to manage the company to grow operating income, EPS and cash flow and the way you do that is by ultimately having a good and improving performance on our contracts because we are a business comprised of a collection of contracts.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. Should an investor be concerned that in looking for margin improvement in the business, the margin -- that the total segment margin of the company has actually declined sequentially from the last two quarters from where you started the year?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Well, it's something that definitely -- requires attention, but our margins for the full year are on track to what we initially guided, except for the charges that we've had on the weapon sights issue which is a one off issue for certain. And we did have an anomaly with respect to the better margin performance in the first quarter in aerospace systems and what happened there is we have some more profitable contracts that are ending and there were some margin improvements that arose on those programs early in the year. So -- so in the final analysis I think our margin performance and improvement plan is on track.

Noah Poponak - *Goldman Sachs - Analyst*

What happened to the CS margin in the third quarter?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

A couple of things happened there. So coming into 2016, we did have a couple of sales headwinds that would impact and are impacting communication systems segment. We talked about these for a while and what they are is, one, we have a SATCOM terminal contract with Australia which we mostly delivered in 2015 and the sales are declining on that contract by about $60 million or $65 million, 2016 versus 2015.

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

And then secondly, in the commercial space where we supply power device or traveling wave tubes that are used in commercial satellites, there's been a decline or there was a decline in commercial SAT OEM orders in 2015 and that translated into about a $75 million reduction in sales in the, for us in 2015 -- I mean 2016. The brunt of what happens on those two negative sales comparisons happens in the second half especially in the third quarter. So that's the first impact.

Additionally, we had some cost growth on some new product development in the space and power sector on some ground-based power amplifiers, and that was about $7 million in the quarter. And then lastly in May we announced that we're starting a significant consolidation of our two traveling wave tube businesses in California, and we began to see restructuring expenses from that in the third quarter. And those will continue through the end of 2017.

Noah Poponak - *Goldman Sachs - Analyst*

Okay.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

So those are the items. But now if you take away the space and power sector, which is where most of these events have occurred, the margins for the rest of the communication systems segment were above 10%, approaching 11% in the third quarter. So --

---

Noah Poponak - *Goldman Sachs - Analyst*

Okay. So how -- it sounds like -- I think that guidance implies margin bounces back in the fourth quarter. Is that right?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Correct.

Noah Poponak - *Goldman Sachs - Analyst*

What in everything you just listed is sort of nonrecurring that would allow that to happen?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Less negative sales comparisons year over year, not expecting another hiccup on the product development side -- and those are the two major issues, coupled with the normal seasonality that we tend to have in the fourth quarter in both communication systems and electronic systems segments?

Noah Poponak - *Goldman Sachs - Analyst*

What $7 million of product development was actually one time?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Well --

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

Noah Poponak - *Goldman Sachs - Analyst*

It could happen again, but it's --

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

It's comprised of higher design and manufacturing cost on the labor side. So I believe it's one time with respect to these new products, but we're always spending nonrecurring effort on new products. So something like that could happen again in the future, but I expect it to be a nonevent with respect to the margin performance.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. Just if I add that back, you were much closer to 10ish in the quarter. If I add back the one-time item you were in the mid 13s, all of a sudden the margins look much more normal. Is that the right way to think about the performance in the third quarter?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

I -- yes. We're improving the margins in 2016, and those improvements continue into next year. So we could have some quarterly blips, if you will, but the full-year trend is intact toward improving those margins.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. Why don't I see if there are any questions in the audience before we continue? Any questions for Ralph? Up here in the front. If you could just wait one sec for that mic there.

Unidentified Audience Member

All right. Thanks. So this week Moody's just changed the ratings outlook on L-3 from negative to stable. I'm just curious to hear your thoughts on capital allocations around M&A and share buy backs and also in the immediate term where do you feel comfortable in terms of leverage?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

So we're investment grade credit at the lowest tier of credit ratings, which is BAA-3 for Moody's and BBB- for S&P and Fitch. And we've said and I'll repeat it again today that we're committed to maintaining our investment grade ratings, not improving, them so more to stay where we are. And with Moody's improving their outlook for us from negative to stable, I think that further demonstrates our commitment to maintaining our credit -- investment grade credit ratings which we think are important to the company.

As a general matter, I -- our analysis is that we use debt more efficiently which means more aggressively in our capital structure than any of our peers, particularly the larger ones. So we don't see any reason to employ even more leverage. So that's why we think where we are makes sense in terms of the leverage and the credit ratings.

In terms of the capital allocation strategy, which is a mix of continuing to pay a cash dividend and modestly increasing it each year, which we've done since we instituted a dividend 11 or 12 years ago, so we want to keep doing that. And then our capital allocation calls for a combination of acquisitions or share buy backs, and we think that we can finance most of that through our free cash flow. And the trade-off between share buyback and acquisitions is going to be largely a function of what's available for us to pursue and acquire in the M&A market.

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

So M&A for us by definition is opportunistic. The targets have to be available for us to try to acquire. It doesn't mean that we can't go out and find targets that are not for sale. But generally when you do that, you could be in a situation where you overpay for an acquisition. And that's something that we try to avoid doing. So we want to continue to be disciplined on the prices that we pay for acquisitions so that we can generate good returns for our -- our shareholders on both accounting returns and economic returns, which are more important.

Noah Poponak - *Goldman Sachs - Analyst*

Any other questions? Okay. I have a few more in that case. Do we need to worry anymore about Head of State?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

It's not a significant worry. I'll say it that way. Our performance for more than the past year has been stable on those three contracts. We're achieving the schedules that we baselined early in 2015 and we had expected to deliver one of the three aircraft this year which we did earlier in October. And the next two aircraft are scheduled to be delivered next year, and we're on track to do that. So those programs are well controlled and stable.

Noah Poponak - *Goldman Sachs - Analyst*

Is there anything about the remaining aircraft that's inherently more risky or less risky than the aircraft that you already delivered?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

No. I would say it's actually the opposite of that. The first aircraft was clearly the most challenging because it was the first time we're doing certain things in a long while. So we had the benefit of that experience that we're bringing to bear on the second and third aircraft. And the third -- and the final and third aircraft is meaningfully less complex and ornate than the first two.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. Do we need to worry about the tech weapon sights anymore?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Well, we entered into an agreement in principle in the third quarter to settle the class action litigation that we have there. Like all agreements concerning class actions, they're subject to court approval, which is customary. So we need to go through that normal process with this matter. But that -- that should resolve any major remaining issues on the weapon sights.

Noah Poponak - *Goldman Sachs - Analyst*

What's the aerospace systems segment margin in three years?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

In three years. Well, I've said our target margin range there is 7% to 9%, and I had outlined what needs to happen for us to go from 7% to 9%. And our objective that we're managing for is to get to that 9%. So three years from now, we should be closer to 9%.

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

Noah Poponak - *Goldman Sachs - Analyst*

Okay.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

And that's what we're here to do.

Noah Poponak - *Goldman Sachs - Analyst*

What does pension do for you beyond 2017?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Beyond 2017, excepting any continued or new aberrations in the credit markets, in other words, interest rates go even lower, so if that doesn't happen and Congress doesn't change the CAS recovery amortization schedules, our pension expense should be declining at least $20 million pretax year over year for the next three years after 2017.

Noah Poponak - *Goldman Sachs - Analyst*

Each year --

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Each year on average.

Noah Poponak - *Goldman Sachs - Analyst*

That's on the P&L.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

On the P&L pre-taxes.

Noah Poponak - *Goldman Sachs - Analyst*

Okay.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

And so systematically, over the next several years since we froze our pension plans to new hires in 2007, almost a decade ago. Today about 20% of our work force is pensioned. Over the next ten years, most of those employees will retire based upon their age demographics. So that means over the next several years, next decade, we should have continued improvements in terms of pension expense and pension funding, which should help EPS, cash flow and margins to some extent.

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Noah Poponak - *Goldman Sachs - Analyst*

How many more years can your free cash flow exceed your net income by the 25% to 35% it has?

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Well, it actually -- our conversion rate has been closer to 140% and 150% the last few years.

Noah Poponak - *Goldman Sachs - Analyst*

I stand corrected.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

I've been suggesting for a long while we should at least be at 120% for the next several years.

Noah Poponak - *Goldman Sachs - Analyst*

What do you mean by several.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Well, let's say for the foreseeable future.

Noah Poponak - *Goldman Sachs - Analyst*

Okay.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

I think we should be at least at 120%

Noah Poponak - *Goldman Sachs - Analyst*

Okay. We're just about out of time with that. I appreciate the lightning round style of the last ten minutes there. But that was that's fun. Thanks so much for being with us.

Ralph D'Ambrosio - *L-3 Communications - SVP, CFO*

Thank you. Thanks for having me. Good day, everyone.

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2016, Thomson Reuters. All Rights Reserved.

©2016 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.