Our first session of the day is L-3 Communications. Ralph D'Ambrosio is joining us this morning, just over the road for you really, Ralph.

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

Yes.

Rob Stallard
RBC Capital Markets - Analyst

To go through a few things. Maybe we'd kick it off first of all with perhaps a broad overview of what you're seeing in your end-markets. Because whilst you're predominantly a defense company, you have got some of your commercial and non-DoD export markets as well. I was wondering if you could characterize some of the trends you're seeing there.

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

Sure. I'll start by saying good morning.

Rob Stallard
RBC Capital Markets - Analyst

Thank you.

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

So, Rob, you're correct. L-3 is predominantly a US military contractor. When you look at our sales base, about 70% of our sales will be to the US military in 2016; and the remaining 30% is almost split equally between commercial sales and international, which is the same thing as foreign governments, foreign militaries.

We are seeing some good, positive signs in our US military market in that the US defense budget in FY16 is growing about 4%, which is very encouraging because from FY10 through FY15 the budget -- the defense budget, that is -- declined about 20%. So we believe that we're at the beginning, entering a new up-cycle in the DoD budgets or US military spending.

We'll see what happens with the next administration as to where the growth rate goes for the DoD budget, but for now we think it's going to be in the low single digits at a minimum. And even though we still have to contend with sequestration, Congress did reduce the first five years of the sequester cuts; and we suspect that they'll do the same for the next five years beginning in FY18. So that's good news.

In the commercial markets, most of our exposure is tied to commercial aviation in one way or another -- and I'll elaborate on that -- and then also tied to satellite and wireless communications. Within our commercial business, we have three broad areas that fit into commercial aviation.
One, we provide a variety of aviation products or avionics across all the segments of the aerospace market, the largest being in large commercial transport, which is about 40% of our avionics sales. Total avionics sales are about $300 million.

We also are involved in simulation and training for commercial aviation, again mostly in large transport. We do the full gamut including providing the simulation devices as well as the air crew and pilot training services.

That's an area that we see having a good long-term growth, not only tied to expected growth in air traffic over time but also demographically: a large portion of today's pilots will be retiring over the next 10 to 15 years. It's estimated that about 0.5 million pilots, so that's going to drive incremental demand for pilot training.

Then lastly, through our security and detection systems business we supply a variety of checked baggage, checkpoint, and other screening systems that are used mostly in airports. So a lot of exposure to commercial aviation.

Then on the commercial side, we provide RF microwave and power devices and products that are used in satellite communications systems and wireless communications systems.

Then lastly, the international or foreign government markets, those are declining for us in 2016, but we do see good long-term growth prospects there. That's largely tied to geopolitical conditions, situations, and risks as well as the broader global economic activity. So, generally speaking the total outlook for our end-markets is an improving one.

Rob Stallard - RBC Capital Markets - Analyst

This is a relatively positive view. Used to be you were depressed all the time.

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

Well, I wouldn't call it depressed. I would call it realistic.

Rob Stallard - RBC Capital Markets - Analyst

Okay. Maybe homing in on the DoD side, because you mentioned the FY16 budget, a big improvement year-on-year. The investment accounts in particular were strong within that.

How do you expect that to flow through to L-3 in terms of maybe book-to-bill to start with, and then on to revenues?

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

Sure. For 2016 our guidance contemplates about a 2% organic sales growth decline in the DoD business. That's due entirely to the final runoff of our Afghanistan support sales, which is -- those sales will decline about $150 million this year versus 2015.

But except for that, the DoD business is flat in our guidance, and there is some upside to have some organic growth there. We'll see how the rest of the year goes.

We do expect that we're going to have a positive book-to-bill ratio for the DoD business this year. I would put it somewhere between 1.02 and 1.03 right now, which means that we expect to grow the US military business organically beginning in 2017.
Rob Stallard - RBC Capital Markets - Analyst

Yes. Is the lead time on this, if you get the bookings this year, you ship it the next? Is that generally on average how your business works?

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

Most of our business, I would say the majority of it, turns over on an annual basis. We do have some longer-lived contracts, mostly in the Communication Systems segment and some in ISR Systems within the Aerospace segment.

So you're correct. There is a big jump in investment accounts budget for FY16, and then it's requested to be down a couple percent in 2017; but over time we think it's going to work out to a low single-digit growth rate, the way we see it now.

A lot of our business is also tied to O&M, or operations and maintenance. Actually, 60% of our sales in the US military business are funded from the O&M account. An emerging trend -- and you've been hearing a lot about it lately -- is that there is a renewed interest to invest more budget in readiness and readiness support. It's been discussed frequently by the Pentagon including OSD and the Armed Services Chiefs.

A lot of what we do supports readiness: areas like training the forces, and that includes aviation, flight training. We provide, again, the devices as well as maintaining the training aircraft.

Readiness also entails equipping and supporting the force. We do a lot of that through our Warrior Systems and our Communication Systems business areas.

It also includes spares and repairs and sustainment on all platforms. We do a lot of that work not only in our Logistics Solutions business in Aerospace, but also across the Communication and Electronic Systems segment, where a lot of our products and subsystems are used for sustainment as well as upgrades, in addition to going on new platforms.

So we think that's a positive emerging trend for L-3: the increased, renewed interest in readiness support.

Rob Stallard - RBC Capital Markets - Analyst

You mentioned the 60% that's O&M. But it was -- probably been higher than that in the past. (multiple speakers)

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

It was about 65%, maybe.

Rob Stallard - RBC Capital Markets - Analyst

So it's come down a bit.

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

It's come down a bit.

Rob Stallard - RBC Capital Markets - Analyst

Would you say what you're left with is a much more margin-secure business than what you've owned in the past?
Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

Clearly. Why, last year we divested the Marine Systems International business. That had a lot of exposure to not only commercial shipbuilding but also oil and gas, and we’re happy to have exited that business.

At the end of last year we announced an agreement to sell NSS, and that was completed on February 1. That was also a business that was contending with challenging market and competitive dynamics.

We believe that most of our businesses that we have today, the competition is more rational when it comes to price. Our businesses for the most part are characterized by having strong, durable, competitive discriminators, which is the reason why the price competition is more rational.

Rob Stallard - RBC Capital Markets - Analyst

Yes. Now you mentioned that your export sales this year are down. I’d say it’s probably below the rest of the industry at this point.

But I was wondering if you could call out some of the factors that are maybe more one-off in nature that are causing that, and where you see things reverting to, maybe from next year.

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

Okay. What we’ve explained about our international sales trends for this year is that most of the decline is coming from nearing completion on three large ISR system jobs in Aerospace Systems, and those are each with solid, long-term customers for L-3. Each of those countries procure and upgrade their ISR aircraft in cycles.

And as it turns out we’re entering a trough in the cycle this year and a little bit next year, and that’s what’s driving that $150 million sales decline. But we do see sales to those customers in particular ramping up again within a couple years as we get to the latter part of this decade.

Rob Stallard - RBC Capital Markets - Analyst

And if you look (multiple speakers)

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

That’s the main reason for the decline in our international sales this year versus last year.

Rob Stallard - RBC Capital Markets - Analyst

Right. So it’s not like there’s an end-market change there. It’s just a product-specific cycle that’s rolling through the system.

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

That’s mostly correct, although we definitely are seeing some deceleration or slowed procurement activity in the Middle East, and it’s probably related to what’s happening to oil prices. That’s definitely an impact, I would suggest.
Rob Stallard - RBC Capital Markets - Analyst

Do you put your VIP aircraft conversion in the export bucket?

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

No, no. Those are technically made to commercial-type customers, so it falls within our commercial sales, which this year will be about 13% or 14% of sales. This year it’s about $75 million in sales.

We have three contracts that we’re working on. We’re going to deliver one aircraft. Each contract has one aircraft, so we expect to deliver one aircraft this year and the second and third next year, probably finishing sometime in summertime of 2017.

Beyond that, we don’t see any head of state work on the horizon. We’d be very careful about entering or signing on any new contracts in that space, given what happened to us last year.

Rob Stallard - RBC Capital Markets - Analyst

Yes. I mean it seemed to me that, like, you just had your results a few weeks ago, that this didn’t get any attention. Is it fair to say that no news is good news on this front?

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

Correct.

Rob Stallard - RBC Capital Markets - Analyst

Yes. As you look at what went wrong with these aircraft, what are the lessons that you’ve learned from this that you’ll be applying to the future?

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

Well, we definitely accepted some contract terms and conditions which I would describe as onerous and favoring the customer. That’s mostly around acceptance criteria.

Acceptance criteria needs to be objective, otherwise you can get into trouble with those types of terms and conditions. So that’s a lesson.

The business -- to the extent that we ever do it again, and I don’t think we will -- needs to be priced higher to factor in the risks that come with it. And I’m not even sure that we’d be willing to do that type of work again on that scale on a fixed-price basis, unless the prices were very high.

Rob Stallard - RBC Capital Markets - Analyst

Right. I would imagine that each aircraft is relatively bespoke, and so you don’t really know how much it’s going to cost, because they’re all different.

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

Well, we certainly estimate what the cost is going to be. But we had some programmatic and operational issues as well, in addition to the onerous contract terms and conditions.
Rob Stallard - RBC Capital Markets - Analyst

Yes. As you step back on that conversion business, does that have an impact on the capacity in that business? Is there too much capacity now, if you’re not going to be as involved?

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

It clearly does have an impact. That was the reason why we pursued the head of state work years ago. So when that ends we’re going to need to replace those sales, and we’re beginning to do that.

We recently booked in order to do some depot maintenance on the U.S. Navy FA-18 aircraft. So that’s an example of the type of work that we want to bring into the Aircraft Systems sector or the operation in Waco: DoD, steady, predictable type work like maintenance on FA-18s.

So we’re making progress there and there’s other opportunities that we’re pursuing, and we hope to succeed on those, certainly by the time we get to the end of next year when this head of state work drops off.

Rob Stallard - RBC Capital Markets - Analyst

You mentioned that the last of the op-tempo headwind will be done this year. But on the flip side, are you seeing any more pull from the customer from some of the new things that are going on, be it in Iraq, Syria, or in Eastern Europe? Is that leading to some more demand?

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

We are seeing signs of increased demand in the tactical ISR and communication areas, so that would benefit ISR Systems and the Broadband Communication business within the Comms segment.

I talked about there could be some upside in the US military business. That’s part of it. We’ll see how that unfolds the rest of this year.

Rob Stallard - RBC Capital Markets - Analyst

Right. And the leadtime on that is relatively short compared to some of the other things.

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

Yes. It’s quick turn, usually over 12 months.

Rob Stallard - RBC Capital Markets - Analyst

Right. Now if we go to your Q1 results, perhaps a highlight this was the operating margin related to your very realistic guidance. You kept your guidance for the rest of the year pretty conservative, though, and I was wondering if you could run through why -- even though you had a stronger than expected result in Q1 -- it still looks fairly grounded for the rest of the year.
Ralph D'Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

We did have very solid, strong first quarter, particularly with the operating margins in ISR Systems in the Aerospace Systems segment. Electronic Systems and Comm Systems were basically in line with our plan and the full-year guidance, with the exception of a $15 million charge to increase a product returns allowance in Electronic Systems. Otherwise, those two segments are fully on track with our full-year estimates.

We did have some very favorable performance in ISR Systems on some work that is transitioning, including the Afghanistan work. The reason we only raised the segment margin guidance by 50 basis points is, as I explained on the earnings call, given what happened the last couple years in Aerospace, I think a little bit of additional conservatism is prudent.

That said, I also explained that we do believe that there's additional upside in Aerospace Systems this year, depending on how we perform on our contracts.

On the whole topic of program performance or operational performance, what really happened to the Company the last couple years is that we had some large disappointments in a few isolated areas which, frankly, were obscuring the good, solid performance everywhere else in L-3. Those areas were the problems we had in Logistics and Aircraft Systems, the problems in NSS -- and NSS has been divested, so that's no longer going to be an item for us. And we're working aggressively to improve and repair Logistics and Aircraft Systems. But the rest of the portfolio is going to continue to perform the way it has performed, and you saw that in the first quarter because we didn't have any of these large isolated negative items to obscure the good performance. And we expect to have more of that in the future, which is good, solid programmatic operational performance.

Rob Stallard - RBC Capital Markets - Analyst

Now the other topic we've obviously had a lot of conversation with folks about has been the hiring of a new COO and bringing Chris onboard. I was wondering if you could give us some of the background to that decision.

Then looking forward longer-term, not just next quarter or stuff like that, what is his remit to improve things from where they are today?

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

Well, Mike decided to hire Chris as COO to help Mike and myself and the Group Presidents manage the operations of L-3 and to accelerate the improvement objectives that we're going after. A lot of those pertain to the operations or in operating margins, so that's why Chris is here, and he's helping the Company tremendously in that regard. So it's another set of capable hands to work on those initiatives and also to provide additional oversight at corporate.

We do see additional opportunity for margin expansion across the three segments. We've been talking about it for a while, and so I'll just repeat what I've been saying about each of the three segments.

For Electronics Systems, we've explained that by the time we get to 2017, we expect the margins to be in the 13% to 14% range. I think we're on pace for that.

Our midpoint guidance was 12.5% before that product returns allowance charge in the first quarter, so it's 12.1% now. But I think we're going to be in 13% to 14% range next year, certainly at the lower end of that range -- and I'm more comfortable at the lower end of the range.

Within Communication Systems, we've said that we expected the margins be in the 10% to 11% range by 2017. Our midpoint target this year is 10.4%, so we're already there; and I expect that we'll be closer to the high end of that range next year.
Then recently what we said about Aerospace Systems is that it’s a -- it should be a high single digit rate operating margin segment, which means 7%, 8%, or 9%. The guidance after raising it 50 bps for 2016 is 7.1%, so we have some room to do better there. It’s going to be conditioned and contingent upon repairing Logistics and Aircraft Systems and also bringing in additional international mix, particularly in the ISR Systems sector.

Rob Stallard - RBC Capital Markets - Analyst

As you look at these targets you put out there, have you benchmarked them against peers in the industry? Because when you look at Electronics, for example, obviously there are some electronic companies that have higher margins than you. But no company is exactly the same.

So do you see a pathway to do better than that going forward, given what some of the other companies in the industry do?

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

We do benchmark ourselves against peers for each of our businesses. If you look at the EBITDA margins, generally speaking we have slightly more amortization expense than most of the peer companies. If you look at EBITDA margins both for Electronic Systems and Communication Systems, I’d suggest -- I do suggest to you that they are in line with the peers.

The targets that I talked about for next year, we want to get there first; and then at that time we’ll start talking about what the further upside potential is. If we can get to those ranges for next year -- and I expect that we will -- it’s certainly going to be moving higher within the comparison set among the peers.

Where we have the most work to do is in Aerospace Systems. And I talked about the three items that were going to drive the additional improvement in margins in that segment a few minutes ago.

Rob Stallard - RBC Capital Markets - Analyst

One of the other things that was covered in some detail on the call by all three of you was the deployment of capital.

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

Yes.

Rob Stallard - RBC Capital Markets - Analyst

I thought it was interesting, the amount of time that Mike and Chris were talking about this. Is this a sign that perhaps you’ve opened the aperture a little bit more on this than maybe where you were 12 months ago, or that you see more opportunities? How does that work?

Ralph D’Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

Clearly we have more appetite for M&A right now than we have had in the last several years. It’s a function of the improving DoD budget environment, for sure. It’s easier to make good acquisitions when you’re in an up-cycle in the defense budget, and the exact inverse when you’re in a down-cycle.

So good acquisitions get amplified in either direction; and bad ones especially get amplified in down-markets. So we’re more willing to take M&A on in a growing environment.
On the conference call we also talked about the fact that we don't expect to have any additional major divestitures going forward. There's still some small things that we're looking at; but frankly, they are very small and it's trimming around the hedges more than anything else -- or the edges. So I don't view that as meaningful.

We definitely would like to devote more capital to acquisitions, but we're going to continue to be disciplined as we always have been when it comes to making business acquisitions. That means that we acquire businesses that we understand and fit well with the rest of the portfolio, and we'd be careful about paying reasonable prices such that we can generate good economic returns on the investment.

Rob Stallard - RBC Capital Markets - Analyst
What are you seeing on that front? How have prices for assets, at least in areas you care about, changed?

Ralph D'Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO
Well, the market is at -- the public equity markets are at near highs, near historic highs; and therefore the multiples in the public or the private M&A market are also high. So we need to be careful about what we pay for acquisitions.

Rob Stallard - RBC Capital Markets - Analyst
Is that just straightforward benchmarking versus the public? Or is it reflective of too much demand in certain areas? Everyone is chasing the same sort of assets?

Ralph D'Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO
I think it's more of a correlation with public equity valuations. There frankly is not a lot of stuff in the pipeline right now, at least there are not a lot of targets that L-3 finds attractive.

Rob Stallard - RBC Capital Markets - Analyst
Right. Would you be relatively indifferent in terms of if it was US or if it was in Europe? Is there any geographical framework you have for this?

Ralph D'Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO
Not specifically. Again, anything that we acquire needs to fit well with our existing businesses. So for that reason, there will be a bias towards US operations.

But we'll also make acquisitions overseas when we see good opportunities. The acquisition of the CTC Aviation Group that we did about a year ago is an example of that. That's based in the UK and they have operations in New Zealand as well.

Rob Stallard - RBC Capital Markets - Analyst
I think when we had a chat last year about things, I think you sounded a little bit more nervous -- or you could say realistic, again -- about the balance sheet situation. How do you stand on that now? It was, Ralph, got more positive.
Ralph D'Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO

Well, we've made it clear to everyone that we -- or one of our objectives in that we are committed to maintaining our investment-grade credit ratings. Those are BBB- and Baa3, so we're the lowest tier of investment grade and that's where we want to stay. We don't intend to improve the ratings; but we don't want to lose them and become high-yield. That is not a constructive dynamic from our perspective, particularly from my perspective.

For that reason, we repaid $300 million of debt in December of last year, and we're repaying another $300 million in a couple weeks on May 20 -- less than a couple of weeks.

What I said on the conference call -- on the earnings call -- was to the extent that we achieve our plan and guidance for this year as well as the growth that we're expecting in operating income for 2017, we will not be required to make additional debt repayments. So that's where it stands.

Rob Stallard - RBC Capital Markets - Analyst

But on the flip side, you as a team seem to be more open to doing M&A.

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

Yes.

Rob Stallard - RBC Capital Markets - Analyst

So just as you brought the debt down, you want to bring it back up again.

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

Well, some of the M&A could be funded from our existing free cash flow. And I said that to the extent we do M&A we're going to be disciplined on purchase price, so that means that the returns that we make on M&A or that we achieve from M&A should be comparable to buying our own stock.

Rob Stallard - RBC Capital Markets - Analyst

Right. Is this a one-for-one ratio? So if you do the M&A, it's in lieu of doing the buyback?

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

Not necessarily. Because if we do M&A, we expect it to be profitable businesses, which will bring with them some additional debt capacity, and that will be around 3 times EBITDA that we could fund from -- generally speaking, that we could fund from additional debt.

Rob Stallard - RBC Capital Markets - Analyst

Right. And the dividend within this construct?
Ralph D'Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO
Dividend? We've been increasing at since we introduced it I think 12 years ago, at a very modest pace, which for the last seven or eight years has been $0.05 per quarter or $0.20 per year. I expect that we're going to continue to have modest growth in the dividend prospectively.

Rob Stallard - RBC Capital Markets - Analyst
Any last questions on the floor? Great. Well, we're out of time, Ralph. Thanks so much.

Ralph D'Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO
Okay.

Rob Stallard - RBC Capital Markets - Analyst
Always appreciate it. Great seeing you.

Ralph D'Ambrosio - L-3 Communications Holdings, Inc. - SVP, CFO
Thanks for having me, Rob.