THOMSON REUTERS STREETEVENTS
EDITED TRANSCRIPT
LLL.N - L3 Technologies Inc at Credit Suisse Industrials Conference

EVENT DATE/TIME: NOVEMBER 29, 2017 / 4:15PM GMT
We will get started with the next session. Always a pleasure to welcome Ralph D’Ambrosio, Chief Financial Officer for L3 Technologies. And first time I get to say that up here. You were L3 Communications last year, right?

Ralph G. D’Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
We were.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
Okay. So welcome back to Florida. Thanks for coming.

Ralph G. D’Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
Glad to be here.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
That’s good. Rob’s got some slides and maybe an opening remark or maybe a forward-looking small print or something. Why don’t we start with that.

Ralph G. D’Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
Okay. Good morning, everyone. So I have about 5 charts that I’ll go through quickly, and then will get to Rob’s long list of Q&A.

L3 Technologies. I think you all understand what L3 is and who we are. We’re a leading aerospace and defense contractor. What’s different about the company is that we’re hybrid in many ways in terms of what we provide to our customers, and that we’re both a prime contractor and a supplier. About 2/3 of our sales are direct to our end customers. And we’re not a platform OEM but we do prime contract several important systems and solutions for our customers. And this year, our sales are just under $11 billion, and that includes the Vertex business, which we announced a few weeks ago that we’re going to divest and sell. Vertex is approximately $1.4 billion of that $10.9 billion estimate. So ex-Vertex, we’re about $9.5 billion in sales in 2017.

Some of the key attributes about L3, and these have been recurring in nature. One is kind of new. So first of all, while about 70% of our sales are made to the U.S. government mostly to the Department of Defense, our business mix is very broad and diversified in terms of where we derive our sales and profits. We don’t have any significant concentrations. And to give you some statistics on that, our top 10 contracts comprise about 20% of our sales, our top 40 contracts generate about 35% of our sales, and thereafter, the numbers drop off very dramatically. The company has always generated a significant amount of cash flow compared to its earnings. The conversion has always been north of 100% and that’s simply because...
we have a lot noncash expenses, and I expect that we’re going to continue to have free cash flow conversion of at least 120% for the next several years.

We have a very efficient capital structure and that we employee a healthy amount of debt in our financing of the businesses. That said, we are an investment-grade credit at the lowest tier of investment grade. And one of our objectives is that we maintain or preserve those investment-grade credit ratings.

And if anything that’s new this year is that, while we continue to have an experienced management team, it’s been refreshed in many ways starting with Chris Kubasik, who’s presently our COO. He became COO about 2 years ago. And on January 1, he’s going to succeed Mike Strianese as the company’s third CEO. Additionally, if you look at our 4 business segments, 3 of the segment presidents are new. In fact, we announced this morning that Andy Ivers is going to succeed John Mega as the segment President for Communication Systems beginning January 1, and he has been with us for several years and he presently manages broadband communications sector, which is more than half of that reportable segment. Additionally, Electronic Systems and Sensor Systems had new Presidents starting in March, Todd Gautier and Jeff Miller. And we also have a new General Counsel, Ann Davis; and a new SVP of Strategy, Heidi Wood. So the company’s management team has been reenergized, if you will, and we’re all focused on growing the company and enhancing the competitive and economic position of L3. And we’re undertaking several initiatives to do that, including incremental investments in R&D, accelerating the restructuring and consolidation of our business units. And we are still sharpening the portfolio of businesses. And I noted at the very beginning that we’re divesting Vertex Aerospace.

Our primary objectives remain unchanged. They all begin with satisfying our customers and that really is the beginning. We want to exceed our customer expectations and do that while we grow the company financially and generate value for our shareholders. And we’re -- with respect to our cash deployment or capital allocation, we think it’s very targeted and it’s shifted over the past year or so to favoring acquisitions over share repurchases after we pay our dividend.

Some of the highlights for our 2017 is that we’re growing our sales in our U.S. government and commercial end markets. The strong areas for sales or demand continue to be UAV communications, munition fuses, full flight simulators both for the military and on the commercial or civil side, EOIR sensors for the U.S. Military and for foreign military customers and the same for a night vision equipment. We’ve had some struggles with some maintenance and logistics contract recompetition losses that has led in many ways to our decision to divest Vertex Aerospace. And we’ve also been experiencing some new business delays elsewhere in Aerospace Systems, and that’s what’s put most of the pressure on the international sales growth this year. And in the third quarter, we did take action to reposition and strengthen Aerospace not only by deciding to divest Vertex, but we also did some downsizing to right size the workforce there as well as combining the 2 remaining sectors, ISR Systems and Aircraft Systems into one sector called Mission Integration. And we’ve also upgraded our business development talent, especially in Aerospace Systems.

We’re growing all of our profit metrics in 2017. That, of course, excludes the goodwill impairment charge that we recorded in third quarter. That impairment charge was caused by those contract recompetition losses at Vertex. And the company continues to generate robust cash flow. And as I said a moment ago, we’re favoring acquisitions after paying our dividend.

A couple of points on the major end markets that the company serves. So first, the U.S. government markets, which are growing and they began growing in 2016, and that was after 6 years or so of decline. The DoD budget grew 4% in ‘16, it grew 4% in FY ’17 and the request from the Administration would have it growing 5% for 2018, which did begin about 2 months ago. So that is still have to be resolved given the continuing resolution but we expect that we’re going to have continuing increases or growth in the U.S. Military spending the next several years. And that’s a very positive item for the industry and for L3.

Within our 2 other end markets, commercial and international. And International here means foreign governments and foreign military sales. We think we have very good growth opportunities here as well over the next several years. Economic conditions and security conditions around the globe support that continued growth. In international, the outlook is beginning to improve. We expect that we’ll have some growth in 2018 following a couple of years of decline. And we still see ample opportunities to expand the products and solutions that we export overseas to grow these international sales. And on the commercial side, most of our commercial sales, about 2/3 or 70% of it is someway linked to commercial aerospace whether it be avionics equipment, simulation & training, and aviation security. And we think we’re going to have good growth there
over the next several years. The fundamentals support that. And this year, we're dealing with some softness on the commercial side and on the satellite or SATCOM area as well as in aviation security. But overall, we see good growth here as well the next several years.

When we reported our third quarter results a few weeks ago, we gave a preview on 2018, which is summarized on this page. And we're going to have a lot more to say about that next Tuesday when we hold our Annual Investor Conference on December 5, in New York City. So I'm going to skip over this. Rob probably has some questions on it anyway.

And that brings on to my summary, which is the company operates in very attractive end markets underscored by the U.S. Department of Defense. All those end markets should be growing the next several years. We have affordable solutions that are aligned with our customer priorities and requirements. We're growing sales and all of our profit metrics. We are going to continue to generate robust cash flow and allocate it in a way that grows value for our shareholders and we're enhancing that growth through the incremental growth investments that we will be undertaking next year, as well as the continued restructuring consolidation activity and the sharpening of the business portfolio.

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

QUESTIONS AND ANSWERS

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

Okay. Thank you Ralph. So that's a good summary. We've gotten into -- we've been dominated a little bit by Defense presentation this morning. So everybody's kind of geared up for more. When you think about -- you just described L3 on its own. I want to turn the discussion a little bit more relative to others, okay? You're not the size of the big -- the largest primes but you're not really a small company either even with this divestiture that's coming up. You're kind of in between.

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

Yes. So I commented that we're a hybrid.

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

You are hybrid.

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

In many respects and all good, I would add.

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

It is. And you're streamlining the portfolio a little bit. How do you think about your future growth once you're past this restructuring relative to the big guys? Can you outgrow them because you're more nimble and you have more -- a more diverse portfolio?

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

So one of the benchmarks that we use when it comes to growing the company is since -- since we're a predominantly a U.S. military contractor, the Department of Defense or DoD budget is very relevant. So at a minimum, we'd like to grow at the same rate as that budget and our objective is to actually grow at a faster rate. So that's where we'll start looking at initially. And if you look at 2017, we're growing in total about 4%, 2%
organically, which is below the 4% growth for the DoD budget that have been in 2017. However, if you look at 3 of our 4 segments, Electronics, Communications and Sensors, we’re actually growing organically at 6% in 2017. And the drag on our growth has been Aerospace Systems. And as I commented earlier, we’re taking actions, several of which, Chris initiated to strengthen that segment, with the intention of returning it to a profitable growth in the near term. So 2018 is going to be a year of transition for Aerospace Systems.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
Okay. So let’s talk a little bit about what you’re doing there. Because you’re exiting Vertex.

Ralph G. D’Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
Yes.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
And it sounds like that will be -- is that only contemplated through divestiture? Or could it actually be wound down?

Ralph G. D’Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
We said that we expect that we will sell it and -- and we began that process. And I expect that some time towards the middle of next year, we’ll complete that process. Vertex in terms of maintenance and logistics company is a very solid company in their space. So I think that it will be a very desirable asset for any of its near peers. When it comes to L3, and this is part of capital allocation, we have many diverse businesses, which have different competitive and economic characteristics. So we want to focus our attention and our resources on the stronger businesses. And that’s why we’ve decided to divest Vertex. But in its space, maintenance and logistics, it’s a solid business and will do well in those areas.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
Okay. So -- and then you restructured the remaining business into this Mission Integration entity. Can we talk a little bit about what’s in there? It’s Waco and it’s Greenville, currently your 2 Texas properties. And those have changed so much over the years as I was around when you acquired them. But we’re talking 15, 16 years ago, right? 2001?

Ralph G. D’Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
Yes.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
And -- so let’s talk about what’s there and what the prospects are.

Ralph G. D’Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
Okay. So it is mostly Greenville and Waco. We also have a business in Canada called Military Aviation Services, which has about $150 million, $200 million sales, which is a very small part of the segment. But Greenville is really the primary heritage of Aerospace Systems and it is the lion share of this segment. It was formally called ISR Systems, which is slightly above $2 billion in annual sales, so about half of the segment, including Vertex, and that’s where we do our ISR systems work, the missionization work on the U.S. aircraft fleets and on the foreign military fleets. So that is the
strongest and healthiest part of the business and where we see good growth opportunities over the next several years, especially as the DoD and the foreign militaries move further along on their recap of ISR platforms. The Waco operation is much smaller and that's where we've experienced most of the declines in Aerospace, and it's due to a combination of declining legacy military -- U.S. Military work like P-3 and the Compass Call -- the legacy Compass Call, the existing Compass Call program as well as the C-27J. And that's also where we had the head of state aircraft modification work, which is also declining. So the growth engine is going to be Greenville, and we are combining it with Waco. We have combined those 2 operations to make them more efficient or to really improve the efficiency of Waco. And as I said, we see some opportunities to grow there in the next several years.

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

So you want to keep Waco. Waco is a keeper.

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

Yes. Yes.

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

Okay. Doesn't sound like it's a grower, but it's a keeper.

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

It's not grower now but it's definitely a keeper. In many ways, it will be difficult to sell or divest on its own. And we don't think that make sense (inaudible).

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

How about the margin profile of these pieces?

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

The margins -- the healthier margins are in the Greenville operation as opposed to Waco.

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

Okay. With Vertex being at the low end of all of this?

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

Yes.

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

Right. Okay. How do we think about the mechanics of what a Vertex transaction would look like? I mean, this is a very low-margin business...
Ralph G. D'Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
It's low margin but it's a -- margins are in line with its peers.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
Understood. So there's a value...

Ralph G. D'Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
It's a good performing asset in its space. I want to make that very clear.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
Okay. So I think some people are going to say, "Okay, this can be bunch of cash coming in." And now...

Ralph G. D'Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
There'll be some cash coming in.

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

Ralph G. D'Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
So we're assuming -- we have some modest expectations, and we'll try to do better. And it's an active sale process that we're going to be beginning the -- probably start contacting buyers, potential buyers very soon. So I don't want to get in a lot of details but I will try to answer your question.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
So one with the -- and I know you're going to talk about a bunch of the stuff next week, so just -- obviously, we can differ what...

Ralph G. D'Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
And I mostly do not want to talk about Vertex. I want to talk about the rest of L3.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
Well that's where I want to go now...

Ralph G. D'Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
Hopefully you have some questions on the rest of L3.
Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst

Well, I'm going to go right to one. Okay. So when you take Mission Integration, right, which is basically what's left of aircraft and you line it up next to Comm Systems, Sensor Systems, Electronic Systems, on a forward basis because I see -- you have this average here on the slide. But how do we -- if we wanted to rank those in terms of their longer-term trajectories, how do you think about those?

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

Trajectories in terms of?

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

Growth.

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

Growth and margins?

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

Growth and -- growth and margins. And where, if you can at this point, might you see some nonorganic growth? Acquisitions?

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

So I'll take the second part first because it's a fast answer. If you look at really all of our acquisitions the last several years and longer than that, it's mostly been in Electronic Systems, in Sensor Systems followed by Communication Systems, very little recently in Aerospace. And that's something we may try to change. But as it stands, most of the M&A opportunities and the available targets have been in those 3 other segments. So those segments also have higher growth and higher margins presently than Aerospace, and that is going to continue to be the case in 2018. And with respect to the margins, while we do expect to improve them meaningfully over the next several years in Aerospace, they're going to probably continue to lag the margins in the other 3 segments.

And what's happening in Aerospace, in addition to dealing with several order and award delays on new business not only on the international side but on the U.S. Military side, our business there is also undergoing a transition. In that we are starting development, prototype work on a few recap ISR platforms where initially, we're doing that work on a cost-reimbursable basis, which makes sense given the risks inherent with it. And that also entails procuring green aircraft, which is very little margin in doing that. So over the next few years as we migrate from development and prototyping into more of a production phase on those new ISR aircraft, that should be a margin enhancer for Aerospace Systems, coupled with what we hope would be a -- an improving, growing sales profile with all of our end customers.

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

Okay. When you think about these 4 segments on a return on invested capital basis, it seems to me they would probably line up more evenly than they do on just a basic operating margin basis, right?
**Ralph G. D'Ambrosio** - L3 Technologies, Inc. - Senior VP & CFO

Yes, so as it turns out the returns on assets or returns on capital, correlate highly with return on sales or margins. And that's because the numerator in both cases is the same, operating income. And as a general characteristic across all the segments, our businesses are not very capital intensive. So we only spend about 2% of our sales each year on CapEx. So not a lot of capital investment anywhere across the segments because most of what we do is engineering value add, assembly, test and people oriented as opposed to plant and equipment. And that's a common characteristic across the 4 segments.

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

So when you think about the business or when you think about opportunities, does some of the consolidation that we see elsewhere so we've got columns getting acquired, we've got orbital getting acquired, does this create opportunity? Not -- it could be organic, doesn't have to be inorganic.

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

Well it could and has the potential to create some opportunities for L3 organically to the extent that the integration of those acquisitions causes a distraction. And on the inorganic side, to the extent that those companies decide they want to -- they don't want to retain certain parts of what they have acquired. So we'll see whether or not, any opportunities materialize in those 2 areas.

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

And I'll bring it up, and I'll get a little specific now. But just to put United Technologies and Rockwell Collins, you've got obviously, major avionics business changing hands. You guys are small avionics player, and I just wonder if this is going to shake up the chessboard a little bit in such a way that maybe some customers say, "I want to maybe move over to someone else?"

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

That may very well happen. We'll see. And if it does, we'll try to capitalize on it.

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

On -- staying on this theme with industry consolidation. So you're selling a business. The business has a little over $1 billion in sales. You're going to dip below $10 billion for the first time in a while...

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

We'll be very close to $10 billion and...

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

Right.

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

Above it in short order.
Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst

Right. Well you grow back up, but you will also -- it's at one point, what? A $15 billion company, there was a time.

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

Yes.

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

And a $15 billion, $16 billion -- it seems to me that there could be an appetite to do something more significant at some point. If you feel you've got the balance sheet set up the way you wanted for something like that. What's the thought process on something sizable?

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

There's always potential for that. But most of our focus presently is on improving internal operations coupled with niche acquisitions. But in the future, there could be opportunity for larger acquisitions. The key thing for us is that we're going to -- we'll continue to be disciplined on what we pay for acquisitions, particularly, for larger ones because we need to make sure that we get an adequate economic return on investment. And M&A are the biggest investments that a company undertakes. And if you make a mistake, it could be very costly. So we want to avoid that. And also when it comes to acquiring larger businesses, typically, that entails acquiring a public company, which means you're going to pay a control premium. By definition, public companies have boards, boards have fiduciary duties. They need control premiums to do the right thing. So if we start paying the controlled premium on top of today's already historically high equity valuations across the entire market, you need to be very careful. We don't like to justify an acquisition based upon our own synergies that we're expecting to generate. And that we don't want to pay -- at least we don't want to pay for all the synergies that we expect to generate. That is not a way to create value for L3 shareholders. So the opportunity exists, but we're going to be very careful. And it's difficult to get the math to work when you make large public company acquisitions.

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

And continuing the discussion on value for shareholders. As you improve the internal business, which you just said was a big priority in the current strategy, is there any kind of segment color you would offer as to where the best opportunity -- or how the opportunity from margin enhancement ranks among the segments? Obviously -- and we sort of already touched on the aerospace business. There's a lot of wood to chop there. What happened to the other 3?

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

Well, in terms of absolute margin increases in terms of basis points, it's obvious that the largest opportunity and it's also a challenge, is in Aerospace, given where we are today at about 7%. So there's...

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

Ex Vertex tax.
Ralph G. D’Ambrosio - L3 Technologies, Inc. - Senior VP & CFO

Ex Vertes tax is going to be closer to 8%. So there’s opportunity there but there’s a lot of wood to chop to use that crude analogy in terms of changing the margins there. So because we need to grow the business base and as soon as we get beyond the business mix that’s transitioning, which I talked about. I would say that we have -- we continue to have good margin expansion opportunities across all the segments.

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

It’s somewhat similar if...

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

And then if anything that probably is going to be easier to attain in the ones beside -- other than Aerospace because it’s already happening and will continue to happen.

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

Which segment would you say lends itself least to LPTA? Where do you have the highest sort of best value propositions here?

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

I would say well after we divest Vertex there’s little LPTA anywhere in business. There’s some in certain pockets but it is not a meaningful characteristic in any of our businesses.

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

I wanted to turn -- and again, if there are questions in the room, just don’t be shy, raise a hand. I wanted to turn into one of your favorite areas to talk about, which is cash flow.

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

Yes.

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

And maybe consolidate a whole bunch of things into one discussion here. From an outlook perspective, I think you put in some -- you have the tax rate at 27%, but that’s a book rate, right?

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

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

So the cash rate -- how tax reform might affect things? What’s going on with pension? When do -- I asked you this question all the time but since -- I think it's always relevant. When do some of the tax benefits from prior acquisitions roll off? If we can just have a large discussion about cash flow.

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

Okay, so you have several questions there. I'll try to answer the ones that I can remember.

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

(inaudible) Yes. Okay.

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

So tax reform, as you know -- as we all know, there are both, there's proposed tax reform in the House and the Senate, which are presently being deliberated. So if that comes to pass, it's going to lower our effective tax rate. It is the short answer. And there's a couple of important items that are still in flux. But as a general observation that I'll make is that, if tax reform passes the way it's mostly envisioned today, our effective tax rate, which is 27% that we gave the outlook for next year probably declines by about 4 or 5 percentage points.

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

Okay.

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

So many of them -- the important tax law and regulation attributes that are important to L3, those being the R&E credit for R&D activity and structuring of acquisitions looks like they're not going to change in any of the proposals on tax legislation. So I expect that we will continue to have a cash tax rate that's lower than our effective book or GAAP tax rate. And we'll see how that plays out.

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

Okay. But what you said there is it'd be lower just like it is now, but not necessarily lower than it is now?

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

Correct.

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

Okay. So cash tax rate it's -- stay roughly the same?

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

Well I think if tax reform is enacted, it's going to lower both our book tax rate and our cash tax rate.
Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
Okay. I just wanted to be clear. Okay.

Ralph G. D'Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
Not at the same rate, probably more so on book side.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
Okay. Fair enough. Okay.

Ralph G. D'Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
So in terms of the some of the tax benefits that have come from the tax shields from the asset purchase acquisitions, those have been declining the last couple of years. Are they going to continue to modestly decline by $10 million to $15 million per year over the next several years. And that, of course, assumes that we don't make any new acquisitions that we could structure with tax shields. And one of our major objectives when it comes to the capital allocation is more acquisitions. So that's going to be enduring cash tax benefit, I will suggest to you, that we are going to continue to be able to make acquisitions that have tax shields that come with them. So not a large impact there on the downside in terms of cash flow conversion. And the other characteristics of our cash flow, which allows us to have the above 100% earnings-to-cash flow conversion will remain intact. And that is the business has little capital intensity. We're going to continue to have intangible amortization that comes from the acquisitions in addition to the tax shields. We are able to finance most of our business on good terms of trade when it comes to working capital, so nothing particularly onerous. And we'll continue to have the stock-based compensation expenses which are noncash as well as the 401(k) match, and we are very transparent about those and how they affect our cash flow and cash flow conversion.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
So your positive conversion sort of ongoing?

Ralph G. D'Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
I said that I expect it that it will be 120% at a minimum for the next several years in terms of cash -- earnings to cash flow conversion.

Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst
Okay. Okay. Anybody out there for anything? Look at Jim. Look like you have a question.

Ralph G. D'Ambrosio - L3 Technologies, Inc. - Senior VP & CFO
Jim always has questions.

Unidentified Analyst
Is there any lessons learned from the kind of customers, particularly the army customer reasonably?
Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst

The questions is, lessons learned from the army customer.

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

I think one of the lessons is, that while we are in a growing DoD budget environment, the services have more demands or requirements than are being fulfilled by the growing defense budgets. So -- and that -- so they still in some areas -- there is funding constraints. And including and what they are willing to pay for certain types of services like those where Vertex operates. So -- and I think you see that and that because we look at what the administration requested for FY '18, the proposals that have come out of the Republicans in the House and Senate had both exceeded what the Administration requested in terms of 5% growth for FY '18. So there is more funding requirements that military has than is being satisfied today by the growing defense budgets and hopefully that translates into better, higher defense budgets in FY '18 and thereafter. That's what I'll say about that.

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

If no one -- do we have any other questions? We're -- we've run out of time. So Ralph, we've run out of time, I can let you off the hook. I appreciate you coming down here.

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

Thank you. Thanks for having me. Hopefully I will see you -- many of you next week at our Investors Conference. Yes.

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

Absolutely. Thanks again, Ralph.

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

Have a nice day.