Okay. I think people are still transitioning, but we'll try to stay on the clock and stay on time. So thanks for joining us today. My name is Myles Walton, the Airspace Defense Analyst here at Deutsche Bank. We are coming towards the, I guess, the third session of day 2. And presenting is L3 Technologies, no longer L-3 Communications.

And for the company, Ralph D’Ambrosio, as the Chief Financial Officer. Ralph has actually been with the company since it was LBO-ed back in ’97, and has the best history of anyone in the company in terms of where it's come from and where it's going. So Ralph has got a few slides to go through, and then we’ll go into a fireside Q&A discussion. Raise your hand if you have any questions, and we’ll fold you into discussion. So Ralph?

Thank you, Myles, and good morning. It’s a pleasure to be here. So I have a few charts on L3. I believe that most of you are familiar with the company, so I will go through these charts quickly. So to -- for an overview, L3 is a leading Aerospace and Defense contractor, but we're not a platform OEM. We're both a prime contractor on several important subsystems that include ISR Systems, training & simulation, night vision equipment, Communication Systems and some other areas. And then we’re also a broad supplier of sophisticated electronic products that are used on several, if not almost all, military platforms as well as several commercial platforms.

This year, we estimate our sales to be just under $10.9 billion. And over the last couple years, L3 has undergone a transformation, if you will, a transition where we did a lot of portfolio shaping, including divestitures, to reshape and reposition the company to perform better from a competitive perspective and to take advantage of the new upcycle that we believe we're in, in terms of U.S. defense budgets and defense spending.

Some of the key attributes about L3 is that, while we’re predominantly a U.S. Military or Department of Defense contractor and we generate almost 70% of our sales from the Department of Defense, we do have a very broad diverse exposure to the various components and elements within the U.S. military. And we don’t really have any meaningful significant sales and profit concentration in any 1 or 2 contracts. And just to give you an idea of the diversity in our business, our top 5 contracts, many of which are sole source in nature, generate about 15% of our sales, and our top 40 contracts only about 30% of our sales. So thereafter, the numbers drop off in terms of individual contribution very dramatically.

So we think we're well positioned to take advantage of the growing defense budget, and that's supporting organic growth this year and also for the next several years. The company has always had a very high earnings-to-cash flow conversion that has been one of our hallmarks. And we expect that to continue into the foreseeable future. We also believe we use and have a very efficient capital structure where we use debt efficiently to enhance returns to our shareholders, but at the same time, we're an investment grade credit and intent to continue to be an investment grade credit. And lastly, we have a very experienced management team, and we augmented it over the last 1.5 years or so. The most notable addition was Chris Kubasik joining L3 as President and COO, and he certainly brought -- has brought a lot to L3 to enhance, accelerate the strategy that we have. And he’s making significant contributions that are well received across the entire company. So, I really enjoy working with him.

And then lastly here, our objectives start to satisfying our customers. We don’t have a business if we don’t take care of our customers, and thereafter, we’re focused on growing the company now through a combination of organic growth and acquisitions, while we also are working on increasing and improving our operating margins. We’ve made some progress the last year, but we believe we have a lot more opportunity ahead of us. And...
then, of course, we generate a lot of free cash flow, which I talked about, and we want to continue to deploy that cash flow in a balanced and disciplined manner to grow and strengthen the company.

A couple of comments on what’s happening in our major end customer markets. So first, the U.S. government, I said that we’re predominantly a U.S. Military or Department of Defense contractor. And the situation here has been improving. We believe that 2016 marked the beginning of a new upcycle in defense budget and defense spending with the U.S. defense budget being up 4% for FY ’16. It’s also up 4% based upon the enacted FY ’17 budget, which is -- was only resolved about a month ago. And then the administration’s recent request for FY ’18 shows 5% growth over 2017. So we think that’s very favorable for the industry and for L3. We believe that classified budgets will continue to expand. That means there’ll be more work migrating from unclassified to classified designations for obvious security reasons. And then across the -- we also believe the classified budgets are growing, in addition to the migration of work from unclassified to classified.

There’s going to be increasing attention on readiness. We saw that in the FY ’17 enacted budget and in the request for FY ’18. That’s very important for L3. Most of the readiness activity is funded out of the operations 7 maintenance accounts within the Department of Defense budget, and we derive about 60% or 65% of our U.S. Military sales from funding sources in the operation & maintenance accounts or account. The rest comes from procurement and RDT&E.

And then lastly, we’re still living in a world of the Budget Control Act and the related sequestration cuts, but we expect there will continue to be relief from those cuts provided by Congress as well as continued relief from the OCO, or Overseas Contingency Operations budget. So we expect the budgets will continue to improve and increase on the -- under the Trump administration, and that’s despite the obvious legislative challenges that we have out there.

We’ve been living in a world of continuing resolutions for each annual budget, and that’s clearly disruptive and takes away from being able to plan military spending on a more productive basis. Hopefully, that’s something that changes. But despite those challenges, we think that budgets will continue to rise.

And here’s a quick budget chart for the DoD budget. It shows how the budget declined almost 20% from FY ’10, its previous peak, through FY ’15, and I talked about the increases in FY ’16, ’17 and what’s requested for FY ’18. So this is a very good, favorable, improving trend.

A few comments on the international and commercial end markets, which generate about 30% of our sales collectively. It’s almost split evenly between commercial and international. And international for L3 means foreign governments and foreign military sales. On international, it’s a very large addressable market, so we think it’s going to provide opportunities for us to continue to grow there. In 2017, we’re returning to organic growth in that end market, although very modest, but it’s a positive change compared to the last couple of years.

And on the commercial side, most of our exposure relates to civil aviation in one form or another, whether it be avionics, aviation security and training and simulation for airline pilots and aircrews. A smaller market for us is commercial space, and we’re seeing some softness there due to the slowdown in new commercial satellite OEM orders.

Key trends for 2017, and we covered these when we reported our first quarter results at the end of April and updated our guidance. We’re expecting about 3% growth in sales. 2% of it is organic. We talked about some of the upsides that we had -- or that we do have on that call. We’re expanding our operating margins this year by 70 basis points, which takes us over 10% to 10.3%. And as I said, earlier, we think we have room to continue to improve operating margin. That translates into operating income growth of about 11%, with EPS growth of 5%. That’s because we have some higher taxes this year. In our free cash flow, we expect a modest decline, but we’re certainly going to try to do better than that modest decline for this year.

So sales are growing in all end markets. We’re improving all of our income and profit metrics, and that’s even after increasing our investment in R&D and CapEx by about 10% each this year over last year. This year is an unusual year in terms of recompetitions where we have a couple of large recompetitions happening in the Aerospace Systems segment in the Vertex Aerospace sector. They’re the Fort Rucker and Army C-12 contracts. Collectively, they generate about $600 million in annual sales. And we just learned last week that we lost the smaller Army C-12 contract, which is
about $150 million to $160 million of sales prospectively after 2017. But that has not been resolved ultimately yet, and we will see what happens on Fort Rucker.

And then there’s a very large new business pursuit, which is larger than both of those 2 contracts combined. It’s a worldwide logistic support contract for the Special Operations Command. And that’s something that we’re pursuing aggressively, and we hope that we do well and win that competition.

And then, I already talked about our high cash flow or robust cash flow, and we’re continuing to deploy on disciplined basis. And we have more emphasis now on investing and making more acquisitions because of what we see happening in our end markets, particularly the U.S. Military market. So we prefer to make acquisitions and -- over buying back our stock right now. That’s going to be subject to what’s available out there for us to acquire and our ability to succeed in transacting acquisitions.

We have 4 reportable segments. Aerospace Systems, which is our largest segment in terms of sales, almost 40% of sales. And in there, we’re basically an aftermarket aircraft prime contractor providing modernization, missionization, sustainment and maintenance solutions to our customers. That’s mostly military customers. Electronic Systems, our second largest segment, almost 30% of sales. There, we provide a broad array of products in various niches where we have leading positions. Those include simulation & training, avionics, precision engagement and power & propulsion systems. Next or the third segment in terms of size would be -- or is Communication Systems segment, about 20% of sales. And there, we provide a wide variety of communication systems used on military platforms. And then lastly, Sensor Systems, almost 15% of sales. And there, we supply sensors that are used in every domain, whether it be airborne, maritime, space, ground, and also for the warfighter.

Here’s a look at our segment guidance for 2017. We're growing in 3 of our 4 segments, and we're expanding operating margins in 3 segments, flat in the other. So, that translates into healthy 70 basis point improvement in margins over 2016.

Our cash flow continues to be robust. We're going to convert about 124% of our net income to free cash flow this year. It's a little less than last year because we have -- we expect that we're going to pay more in terms of income taxes and are making more investments in CapEx. That said, we do have a lot of noncash expenses. The business is low capital intensity, and we do not have onerous working capital requirements, and that should translate into continued robust and high earnings-to-cash flow conversion, that should exceed 120% in the next several years.

I talked about our disciplined capital allocation or cash deployment. And we pay a cash dividend that we've been modestly increasing each year. I expect that, that will continue. We don't expect to be required to make any additional debt repayments after what we did in '15 and in 2016. So, the balance of our cash flow will be used either to make acquisitions or to buy our stock. And we're going to decide that opportunistically. And again, our preference is for acquisitions.

And then lastly, we have a very solid balance sheet, with ample liquidity. Our cash balances are growing. We expect that we will end the year with a cash balance of about $450 million based upon what’s in our guidance and what we’ve said about capital deployment or cash deployment. We renewed our $1 billion revolver for 5 years at the end of last year, and that’s fully available to us. So we believe that we have ample resources and liquidity to grow the company, which brings me to my summary page.

We’re growing in all end markets, especially the most important one, which is the U.S. Department of Defense. We believe that we have affordable solutions, technologies, products, et cetera, that are aligned with our customer priorities. We’re growing our income metrics, generating robust cash flow and using it to grow the company. And we expect and aim to continue to build upon our strong performance in 2016, and that which we had in the first quarter of 2017.

Thank you. Now we'll go to Q&A, I guess.
QUESTIONS AND ANSWERS

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

So you mentioned a couple times margin expansion, so maybe you can frame us with how much margin expansion do you think there is for in terms of opportunity, maybe in each of the segments. Obviously, they are each a little bit different in terms of where they're coming from and where they can go. Maybe just give us a picture as to where you think potential are.

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

Sure. So we've talked about this recently over the last year or so. So, I'm going to basically repeat what I've been saying because it has not changed. So on a consolidated basis, we expect our margins this year will be 10.3%. And when the budget last peaked, the DoD budget last peaked in 2010, as well as our sales and margins, our consolidated operating margin was 11.4%. So, we believe we're heading back at least 11.4% over the next few years, and our objective is to do better than that. At the segment level, I've been saying for a while that our target range for margins in the Electronic Systems and Sensor Systems segment is between 13% to 14%. We're there in 2017 in Electronic Systems; close to 13% in Sensor Systems. And I -- so I think we're going to achieve that. And then once we get there, we'll talk about what else we can do, and there should be additional opportunity. Within Communications Systems, the target margin range that we've talked about is 10% to 11%. We're in that range right now. I think we're trending to -- we should be doing somewhere between 11% or 12% in the next couple of years. So, we have some more room there. And then lastly, in Aerospace Systems, which has our lowest margins there, about 7% this year, which is the low end of the margin target range that we've talked about of 7% to 9%. And for the present time, based upon what we're seeing and pursuing, I think we're going to be closer to the low end of that range. How we will get to 9% would require a significant increase in international sales as well as meaningful growth in the -- in terms of sales across the entire segment in the different end markets. So we do see our international sales ramping up nicely in a couple of years there, so that's going to help. So we do have a path to get to 9%, but I think we're going to be closer to the lower end of that for the next couple of years.

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

And then staying with Aerospace Systems where you finished up, you mentioned the C-12 decision. Have you formally filed the protest, do you anticipate doing so?

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

Well, the Army is going to debrief us on the award. And after that, we'll decide whether it makes sense, whether we have a meritorious protest. So, that is still ahead of us.

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

Okay. And the outcome on the decision for the other 2 just to level set us on the time line?

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

Sure. So we expect the award on Fort Rucker to happen sometime in September, which is the other recompetition. And then the new business pursuit, which is called SOF-GLSS or SOF-GLSS, that's with SOCOM. We expect that, that's going to be announced sometime in August. So that's the time line on those 2 remaining maintenance and logistics-type competitions.
Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

The other big contract that's out there right now, Compass Call, which you've been selected for as the prime, but there's, I think, 2 protests about selecting the platform on which you're going to be using as a prime and selecting your platform. Can you talk about that program? How big it is to you today? What the opportunity is of the new program you have and the status of it?

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

Sure. So first of all, today, we do sustain the existing Compass Call fleet, and that's something we've been doing for several years. And L3 has a long history, actually, over 7 decades, of providing highly sophisticated, highly modified special mission aircraft to the U.S. Military, especially U.S. Air Force. So in many ways, we think that we're uniquely qualified in this regard. And we think that's why we were selected as the aircraft prime contractor integrator for the Compass Call Recap or the new Compass Call fleet. You're correct, 2 of the OEMs that will -- that are competing, will compete to supply or to provide the aircraft have filed protests with the GAO, and the GAO will resolve that. But in the meantime, we are committed to providing U.S. Air Force with the best solutions for highly integrated, missionized, sophisticated systems.

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

In terms of just the revenue net program, the potential, does it affect this year, whatever the outcome?

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

When we updated our guidance at the end of April, I talked about some conservatism or cushions that we had in Aerospace Systems. And I mentioned a new program start. That is Compass Call, so there's nothing in the forecast or in the guidance. There will be some small upside for this year, probably in the $40 million range, after we're awarded the contract, which we think will happen sometime in the third quarter. So no downside exposure this year. And it's going to be an important program for us that will be worth over $1 billion for L3 over the next 5 to 10 years, depending on how the Air Force schedules the new aircraft deliveries.

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

Okay. If there are any questions, feel free to raise your hand. On M&A, you mentioned this -- the $500 million placeholder, your preference is for deals. You have gotten more into deals over the last 18 months or 24 months than you had probably the last 10 years. Where are you -- where's the pipeline looking right now in terms of robustness? Is the deal activity higher or lower than it was 12 months ago in terms of the presence of properties and the prices you're seeing?

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

So we do spend a lot of time, that is Mike, Chris and myself and others, strategizing and collaborating on where to invest our M&A capital, if you will. And that -- the activity on the M&A pipeline is a lot higher the last year or so compared to what's been in the past. Today, we're looking at a handful of smaller-type businesses, which fit into the traditional acquisition that L3 does, which is typically a niche-type company where we like to pay prices anywhere from $50 million to $200 million or so. So we do have several targets that, if you will, that we're looking at, at the lower end of that range today.

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

Okay. And I think you said you finished the year -- if you do it, you said, as a placeholder, you'll finish the year at $450 million cash on hand?
Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

Yes. And that’s after deploying another $450 million for acquisitions beyond what we already completed this year.

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

Right. So what is the comfort -- I mean, is $450 million the right carry balance for cash on an ongoing basis that we should think about?

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

Oh, well, we don’t need to carry a $450 million balance because the businesses are cash generative. So we only actually need a very low or no cash balance, especially when you consider our revolver. But I’d like to modestly grow the cash balance because it provides us a little more flexibility in terms of cash deployment for acquisitions. So that’s how we’re presently planning.

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

Okay. One of the areas of your business is in the bomb detection area, passenger screening. It’s obviously a potential area of growth, depending on what happens with -- what’s going on with the airlines globally. Where do you currently sit on the technology curve, competitive landscape for passenger screening?

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

So we think we’re at the top of the technology curve in terms of staying close to what our customers, the transportation authorities and aviation authorities require in terms of security screening. So that’s a collaborative process with them. We just don’t go out and invest money in detecting threats that we think are emerging. It’s based upon what we’re learning from our customers. So I think we’re at the forefront of detection capabilities. And our recent acquisitions in that space augment our detection capabilities, especially in the explosive trace detection area, which is -- which was the -- or is the Implant Sciences acquisition that we completed early in January of this year.

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

As most of your business in the area domestic, how much is international?

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

Our total sales this year will be about $550 million, and it’s almost split equally between domestic and overseas; if anything, slightly more overseas.

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

Okay. I guess, last one to round out, have you seen pickup in border activity or inquiries in that particular business over the last 6 months?

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

There -- the order flow continues to be healthy. I wouldn’t say we’ve seen a marked increase in order flow, but there are some new security threats out there that the TSA is deciding how they want to handle it, and we think that’s going to provide opportunity to L3.
Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

Questions from the audience? Maybe one on -- you mentioned at the beginning, the management that has evolved over the course of the last, I guess, 18 months, bringing Chris on board as well as some of the other business unit changes. How has that affected day-to-day running of the company? Where do the divisions of labor sit, COO versus CEO, at this point in time? Just give us some perspective.

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

So we're all working very effectively and constructively and collaboratively together. So, it's working out really well. We enjoy working with each other. And between Mike and Chris, they have the traditional functions that would be accorded to the CEO and the COO. And then Chris as COO is also working, and when Mike hired him, he put him onboard to help us accelerate what it is we're trying to achieve strategically and operationally. So in addition to making sure we have a better handle and tighter controls on the operations in terms of program performance, Chris is also very focused on improving the productivity and the cost efficiency of the business, and he and I work a lot together on that. And then Chris has also brought new energy to the M&A growth objectives, as well as the organic growth objectives, especially doing a lot with Mike on the collaborations side. And that's something that we've been working on for years. Where we've been aiming to harness the power of the different L3 businesses to allow us to pursue larger -- more opportunities, more content, moving up the value chain on a variety of platforms. So that's where the individual and collective energies are being expended these days, and it's working very well, very effectively.

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

Just one other -- if you look at over the next few years, the defense budget will give you a natural trend in the upward direction. But what programs, in particular, should we externally be most focused on as your, I guess, additive sources of growth, those that are trending above general market for defense budget and growth environment?

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

So earlier, I talked about the broad, diverse nature of our business, especially in the U.S. Defense market. So there are a lot of really numerous, smaller-type contracts that we go after. The bigger pursuits that garner more attention generally tend to be in the Aerospace Systems segment because that's where we're more of a prime contractor. So we talked a lot about those already. SOF-GLSS, Fort Rucker, Compass Call. JSTARS is also important to us. It's much smaller though than any of those programs. And then we do see several ISR recap opportunities the next several years internationally with our -- with the U.S. strong allies. And so those are the bigger opportunities, but there are numerous other ones to track in the other segments as well.

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

Okay. Anyone else? I think you might have covered everything else. I think we're good.

Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

All right.

Myles Alexander Walton - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

Appreciate it.
Ralph G. D'Ambrosio - L3 Technologies, Inc. - CFO and SVP

Thanks for having me. Have a nice day, everyone.