Corporation Participants
Ralph D'Ambrosio L-3 Communications - CFO

Conference Call Participants
Rob Spingarn Credit Suisse - Analyst

Presentation
Rob Spingarn - Credit Suisse - Analyst

With that we're going to get started with our first Company which is -- I'm very pleased to introduce once again L-3 Communications. We have Ralph D'Ambrosio who's the Chief Financial Officer. He's going to start. Mike Strianese is I believe in the building signing big international contracts and will probably come in during the presentation to join Ralph up on the podium with me. And with that, a warm welcome to all of you and to Ralph and L-3. Thank you.

Ralph D'Ambrosio - L-3 Communications - CFO

Thank you, Rob, and good morning, everyone. So, I have several charts here. I'm going to go through them quickly so that we can get to the Q&A which I'm sure is what you're most interested in. So, I think you're all familiar with L-3. We're an aerospace and defense contractor, both a prime contractor and a supplier. We're a prime in a variety of areas. We're not a platform OEM but where we do work as a prime contractor is in the areas of ISR systems including intelligence analysis and support, aircraft modifications, sustainment of equipment, simulation and training, and enterprise and mission IT systems and support including cyber security. On the supplier side we're a broad supplier of a variety of products that are used both on military and commercial platforms in both electronic systems and communications systems. We're a prime in about two-thirds our revenues as direct sales to the end customer and the supplier are the remaining third. So, one of the key attributes L-3 is that we're a very broad, diversified technology Company. We don't have any concentration in any single or even a handful of contracts. Our top ten contracts comprise about 15% of our sales and our top 40 contracts comprise around 40% of our sales, so the concentration drops off dramatically. We're a US government end customer business in 71% of our sales, the balance in international and commercial and we've been focused on growing the international and commercial end markets the last several years to offset some of the decline that we've experienced in our DOD or US military business as a consequence of the downturn that began several years ago. The Company has a very flexible cost structure given that we don't have any significant investment in plant and equipment. Most of our value add is people oriented, engineering, assembly and test, and technical services. The Company has a very efficient capital structure. We think we use debt in an appropriate manner to enhance the returns to our shareholders while continuing to be an investment grade credit and one of the key characteristics of L-3 is that we continue to be a high cash flow conversion Company, historically converting well north of 100% of our earnings and net income to cash flow. It's been about 135% to 140% the last couple of years and we expect it to be the same in 2015.

In terms of our strategy and priorities, they really have not changed much the last several years. We continue to be focused on building strong businesses with high barriers to entry and strong competitive market positions striving to be one or two in each of our niches. We're focused on expanding those market positions, gaining market share, and those are a few of the ways that we're doing it. Sizing the Company properly, providing our customers with innovative and affordable solutions, investing IRAD, good contract performance, and M&A where it makes sense, and also focusing on the customer relationships and pursuing adjacencies and trying to expand our content on various platforms. Lately we've talked about doing some more portfolio shaping, the aim there is to increase the margins of the Company on a consolidated basis and to strengthen the stronger, structurally stronger businesses at L-3 and at the same time take a hard look at the structurally weaker or less attractive businesses. Key employees as well as maintaining strong internal controls are critical to any business strategy as they are in L-3 and we're focused on growing EPS and as I just mentioned a minute ago, generating solid, robust cash flow.

A couple of comments on the US government markets, the geopolitical situation is becoming increasingly more complex. The threats that the country is facing are certainly not abating in any shape or form. And on the fiscal side, the deficit has been improving, declining the last several years which is a good thing for the Company, I mean for the country and for the defense budget. The defense budget began its downturn about
four years ago and the budgets are now stabilizing and set to start regrowing again within a year or two depending on what Congress does with the sequestration cuts for FY16 and beyond, and we hope that Congress takes actions just like they did for the first three years of sequestration where they reduced the annual budget cuts by about $13 billion from the scheduled $50 billion a year in defense budget cuts under the BCA legislation. Despite the fact that we’re in a downturn we see several opportunities for L-3 to gain market share in the US government and military markets and that’s something that we’ve been doing the last few years.

The situation on the international and commercial end markets has been a better one. On the international side, we have a situation where we have a large addressable market for L-3 where the last two and three years we’ve been introducing more of our products for export. Those products and our capacity for them in the earlier years were being consumed almost entirely by US military demands and with the downturn we’ve been able to offer more of those products overseas and including, one of the bright sides of better buying power, where the US government has taken actions to increase the exportability of military equipment out of the United States. That’s definitely helped the industry and it’s helping L-3 as well. We’re targeting international growth in several markets, on the chart a few are summarized.

On the commercial business, which is 14% of our sales, generally we have good long-term favorable fundamentals that are tied to GDP growth around the world. So, as long as the economy continues what it’s doing, growing at a slow pace, that should bode well for our commercial businesses and we’re involved in very attractive end markets, including avionics, civil aviation simulation and training, security and detection systems, and SATCOM communication equipment.

Our business mix has shifted over the last several years and I talked about that where the DOD had gone from about 75% of our sales down to about 60%, 66% in 2014. That’s been a consequence of the declining DOD budgets. Our objective is to grow consolidated sales as quickly and most efficiently as we can and not to really manage to achieve any kind of end customer mix.

We’ve had some very good wins in our DOD business this year. These are some of the areas, small ISR aircraft, proprietary, classified work on aircraft, communications and data links on UAVs including the Gray Eagle, simulation and training services for the C17 fleet. We recently won a recompete of our T45 logistics support work and in the last year into this year we booked some new business supporting the reserve component of the Army, providing services for the reserves.

On the international and commercial side of our business, we recently booked an order for our international SPYDR aircraft with the Saudis. We booked a C-130 avionics upgrade for Argentina. We’ve continued to win new business modifying VIP-Head of State aircraft, we’re doing some international CLS logistics and maintenance work and we continue to have good success in selling our security and detection equipment both in airports and for cargo applications.

The cash deployment for 2014, very similar to what it’s been the last several years. We continue to invest in IRAD. Most of our IRAD is where you would expect it to be. It’s in our product intensive segments, so it’s led by electronics systems and communication systems. We’re continuing to generate solid free cash flow after investing in the IRAD and that cash flow continues to exceed our earnings by a significant amount. We continue to pay dividend and are modestly increasing each year. We’ve just had our tenth increase this past February and I expect it will have similar increases each of the years going forward and we’ve been taking most of our cash flow and using it to repurchase our common stock and this year we expect to repurchase about $825 million of it.

In terms of cash flow returned to shareholders, here you can see how each of the last three years including the estimates for this year we’re returning either close to 100% or in the case of 2014 we expect to return more than 100% and most of it’s been in the form of buybacks. And I expect that we’re going to continue to return a significant amount of our cash flow to our shareholders respectively unless we can find some good M&A opportunities which seem to be far and few between nowadays.

In terms of the segments, electronics systems is our largest segment in terms of sales. It also has our highest core margins. Those margins are expanding and that’s where we expect to drive most of our margin expansion prospectively and we’ve talked about that all year long. The business is nearly 50% international and commercial and continuing to grow. We’re making significant investments to increase our market positions both in IRAD, primarily in IRAD and where we can we’ve been finding some niche acquisitions to enhance our portfolio of businesses there and we continue to reduce our costs through a variety of means. A key area going forward is going to be the supply chain. Aerospace systems, this has
been our troubled segment this year. In addition to the problems that we had that caused the internal review earlier this year, the business has been confronting headwinds on the top line stemming from the drawdown in Afghanistan which continues into next year and sequester related budget constraints and DOD budget shortfalls which has been impacting some of our legacy businesses, particularly in the platform systems sector. That said, the DOD in this budgetary environment continues to require low cost solutions around upgrading and maintaining fleets and that's something that we do well and we're well-positioned to do in the future. We're investing in ISR and multi-mission aircraft, C-130 upgrades and select commercial aero structures. The margins have been under pressure. It's a combination of the volume and the lower sales in Afghanistan, mix changes as we pursue adjacencies in commercial and the international markets where we're having to make investments. There's also been some impacts from the better buying power initiatives and lastly, the logistics solutions margins and that's where most of the problems were with respect to internal review. We recently reset our expectations lower there largely due to customer behavior around pursuing lower price.

Communication systems, this segment continues to have solid long-term positions, virtually in all areas, in all platforms when it comes to data communications. The last couple of years we've had some sales pressures stemming from first the drawdown in Afghanistan and Iraq which caused lower tactical ISR funding as well as tighter Army budgets. But the good news is that those pressures are abating and we see less top line pressure there for 2015. It's going to be in the low single digits compared to double-digits that we've seen this year and in 2013. We're growing our international and commercial business here by introducing new products. We're continuing to invest in next-gen advanced and covert communications and antennas and related products and the core margins here also expanding, improving, and I talked about this being the second driver of the Company consolidated margin expansion opportunities and those are coming from manufacturing productivity I would expect to start realizing next year. We implemented a significant amount of new ERP systems about 1.5 years ago and we're going to enjoy some productivity on the labor side beginning in 2015 there and we also recently, earlier this year, combined our microwave products and legacy communications systems into this segment so we expect to have realignment savings synergies that will begin to earn next year and then into 2016 as well.

Lastly, National Security Solutions, this is our smallest segment. It's been under the most pressure in terms of the marketplace the last few years but the good news is it has been performing very well competitively. We've been gaining market share, winning prime contract positions on several major multiyear IDIQs and we've been building our cyber security business by targeting select new business contracts and contract takeaways from other competitors and we're beginning to enter some of the FMS markets including with cyber applications. And the margins, while they're low here, they're stable. And we should be able to have some improvement in the margins but it's going to be modest improvement in NSS.

We provided our 2015 preliminary outlook on October 30 when we reported our third quarter earnings. Summarized here again, we expect top line reduction of about 2% or 3%, driven by about a 5% reduction in our DOD and US government business. A little more than half of it coming from the draw down in Afghanistan and it's being partially offset by an expected 5% growth in our international and commercial business. Our margins are going to improve modestly but the margins are being adversely impacted for two primary reasons. One, we're going to have a pension expense headwind where the expenses are going to increase by about $73 million or 60 basis points of margin. That's being caused by the decline in interest rates that's occurred this year as well as the impacts from the legislation on the highway and transportation funding act which was enacted this summer and had the impact of stretching out CAS recoveries for pension expense. But the good news there is it basically took those recoveries and straight lined them where you can project them at a new uniform rate over the next several years. So, that's going to bring some stability to our cash flows going forward and that said with expect our pension expense and our funding contribution requirements to decline over time because we froze the pension plans to new hires in 2007. Naturally and actuarially the pension expense will continue to decline over the next several years.

The tax rate is going to be a little higher because we're not expecting a Federal tax R&E credits, but there's recent activity in Congress in that regard so we do expect to have the R&E credit at some point whether it happens this year or next year. That's important for L-3 because we're a technology Company and we invest a good amount of our resources in IRAD. So, the R&E credit is an important benefit for L-3, it's works out to about $0.19 of EPS and about $15 million to $20 million a year of cash flow. And lastly, we continue to have robust free cash flow and we expect it to be about $925 million next year converting more than 135% to about 140% of our earnings in 2015.

So, to summarize, the Company has a broad, diverse portfolio of technologies that fit well with our customer requirements. We provide our customers affordable solutions and we're aligned -- we believe that we're aligned with the priorities our customers have. The DOD budget is stabilizing, which is good news, and it's going to return to growth which is going to help our top line the next few years. We're continuing to grow the international and commercial markets. We expect that will supplement the DOD growth that we will have in the next couple of years, continuing
to gain market share and we're going to continue to maintain robust cash flow. So, the Company is healthy. We're agile. We're focused. If anything we're going to sharpen our focus with the portfolio reshaping that we recently talked about.

So, that concludes my comments. I know that was a lot of info. Let's get to your questions.

QUESTIONS AND ANSWERS

Rob Spingarn - Credit Suisse - Analyst

Okay. Thank you, Ralph. Anybody wants to grab a seat, now's a good time to come up. Ralph you can stay over there, you can come over here. It doesn't make a difference. I'll -- thank you. I'll kick it off. I wanted to ask you if you could provide any kind of more specific framing of the budget that you contemplated when you put the guidance together. In other words what were you specifically assuming with regards to the outcome on the '15 budget vis-a-vis CR, that sort of thing, and sequestration, if it matters in calendar '15?

Ralph D'Ambrosio - L-3 Communications - CFO

So, with respect to our preliminary outlook for next year, we basically with respect to the defense budget have assumed that we've got a budget that's very close to the administration's request for FY15 which is consistent with the bipartisan budget agreement for 2015 which provided a $10 billion or so of sequester relief. That's what we're expecting. Now, the CR runs out in about ten days or so. We think that soon, whether it's this year or early next year, we're going to have an authorization and appropriation for FY15. So, '16 budget and what happens with sequestration is not going to have a lot of impact for 2015 for us and as I said a few minutes ago, I expect that Congress will take further action to trim the sequestration cuts in FY16 just like they have in each of the first three years. But nobody seems to want full sequestration in Washington DC. Regardless of whether you're Republican or Democrat or Congress versus the administration. I think ultimately that's what we'll have, some relief to those cuts.

Rob Spingarn - Credit Suisse - Analyst

If -- two ifs. If we get a CR into March or if we get sequestration as written, do you see some kind of an impact? I guess on the sequestration side it would be Q4. But if the CR goes to March it would maybe be earlier. So, if either of those happen, is there sensitivity in your guidance?

Ralph D'Ambrosio - L-3 Communications - CFO

With respect to FY15 CR, I really anticipate that would have minimal impact on most of our US government and DOD business. Now, with respect to sequestration for FY16 if there's no relief, it could pressure some of our orders and sales in the logistics support side where they've -- that's where a lot of cuts have gone the last few years. It could also pressure some more activity in NSS and it could also have some more impact on some of those legacy programs I talked about in the aerospace systems like the P3 modifications sustainment work and the Compass Call modifications work for the US Air Force. That's where I see most of the -- if we get a full sequester, most of the adverse impacts to L-3.

Rob Spingarn - Credit Suisse - Analyst

Okay. I'm going to go out to the audience in a minute for questions. One of the other hot topics, and you touched on it up at the podium, is potential portfolio shaping. And to what extent can you give us some sense of the types of businesses that may no longer be a good fit? And in which segments those reside?
Ralph D’Ambrosio - L-3 Communications - CFO

Sure. So, we talked about this. Mike talked about it on the third quarter conference call. You asked about it. What I said earlier this morning is that we’d like to focus more of our resources in our structurally stronger, more attractive businesses, and it’s not by coincidence that’s where we have and generate higher margins. And the Company is diverse as you all know. We do have a collection of businesses and some of them have lower margins. Those businesses are not weak businesses in their own right. But they probably don’t fit as well at L-3 and probably could do better elsewhere. We did have a lot of success with the [Engility] spin off that we had a little over two years. That company continues to do really well. I think spinning them out really allowed them to pursue their new low cost strategy. So, this is like those. It may make sense to sharpen the focus of the portfolio. If we do that, it’s definitely going to enhance our margin profile and probably also our free cash flow generation profile. So, one of the ones we talked about specifically was logistics solutions, especially after resetting our margin expectations for that business and October 30th we talked about how we entered 2014 expecting that would be 7% or 7.5% ROS business and it looks like it’s a 4.5% business going forward prospectively. So, that’s a prime example of something that may do better elsewhere but we’ll see how it goes. Portfolio shaping is tricky because we’re focused on growing our EPS and there’s tax consequences. So, it’s a careful analysis that needs to be done and we want to be responsible and do things that best serve our shareholders and enhance our shareholder value.

Rob Spingarn - Credit Suisse - Analyst

Right. And just to give people some context, logistics solutions is around 10% of sales?

Ralph D’Ambrosio - L-3 Communications - CFO

Yes. About $1.2 billion in sales next year. About $1.3 billion in 2014.

Rob Spingarn - Credit Suisse - Analyst

Okay. Anything in the services area that might come up for discussion?

Ralph D’Ambrosio - L-3 Communications - CFO

That question has come up a lot over the last couple of years. As Mike said, we’re not contemplating any other major divestitures in services.

Rob Spingarn - Credit Suisse - Analyst

And it sounds like spinning could be an option because it worked before but it could also be a sale process or something like that?

Ralph D’Ambrosio - L-3 Communications - CFO

Yes. We’ll see what happens. It could go either way.

Rob Spingarn - Credit Suisse - Analyst

Do we have a question in the audience?
Unidentified Audience Member

Yes. There are a lot of A&D companies that are pursuing cyber security, the cyber security market. Can you give us any insight into what differentiates what you have to offer to customers there? Is it technology? Is it some special partnerships? What is it?

Ralph D'Ambrosio - L-3 Communications - CFO

For L-3 it's a combination of technology that we have in our communication systems segment, a lot of it having to do with encryption and other types of analysis. In NSS or National Securities Solutions, it concerns solutions around intelligence and analyzing data and similar activities that you can conjure up along those lines. A lot of cyber security activities by necessity are classified in nature and growing because cyber security threats continue to increase in all the areas that you can conceive -- government, industrial, commercial, et cetera. Most of what we do is geared towards the US government side. And I said we've been successful in targeting take away and new contracts to build our cyber security business and it's something that we'll continue to do prospectively.

Unidentified Audience Member

Do you have a way of framing the size of what you consider to be cyber?

Ralph D'Ambrosio - L-3 Communications - CFO

Sure. Within the communications systems segment, probably about $300 million a year in sales or thereabouts and within NSS it's about 20% of our sales. So, that would be just above $220 million or so in that segment. Depending on how broadly you define cyber, you could come up with higher revenue numbers.

Rob Spingarn - Credit Suisse - Analyst

You've said in the past, Ralph, that your OCO business this year is about $700 million I think and that should come down by about 40% or so next year?

Ralph D'Ambrosio - L-3 Communications - CFO

$250 million is what we anticipate presently.

Rob Spingarn - Credit Suisse - Analyst

So, down about $450 million? Would this then continue to lead to a bottoming the following year at around a $300 million or $400 million level?

Ralph D'Ambrosio - L-3 Communications - CFO

That's what we said the last couple years and that continues to be our expectation, that it's going to bottom in that area. $300 million to $400 million. The reason it doesn't go to zero is that a lot of what we do supports special operations forces activity and that type of activity is not going away. If anything it's migrating to other parts of the globe and we also do a lot of intelligence, a good amount of intelligence support work that's also not going to go to zero.
Rob Spingarn - Credit Suisse - Analyst

How much of those numbers we just talked about are in the logistics area?

Ralph D'Ambrosio - L-3 Communications - CFO

None.

Rob Spingarn - Credit Suisse - Analyst

Completely?

Ralph D'Ambrosio - L-3 Communications - CFO

None for next year. About $15 million for 2014.

Rob Spingarn - Credit Suisse - Analyst

Back to the portfolio shaping but more on the M&A side, if you were to essentially move a piece of the business, we just talked about roughly the size we could be contemplating, do you see M&A in a similar size offsetting at some point?

Ralph D'Ambrosio - L-3 Communications - CFO

At some point. But M&A is -- it is and it has been largely opportunistic for L-3. So it starts with what's available to acquire. And then it has to be good fit with our existing core businesses and the economic returns have to be attractive. So, we need to have those three elements coming into alignment.

Rob Spingarn - Credit Suisse - Analyst

So, given the current pipeline, what's out there today or in the foreseeable future when something could potentially happen, some time not too distant, would the first order of priority be M&A given what's out there today? Or would you, depending on whether you had a spin with some proceeds or a sale with some proceeds, or would you go back to shareholders?

Ralph D'Ambrosio - L-3 Communications - CFO

The first priority would be M&A if it's available, if it fits and has good returns. So, most of our M&A last really five years has been small, niche, bolt-on in nature. And mostly on the product or hardware side. I expect that's what's going to continue to be, at least for next year. I don't see any sizable meaningful M&A activity right now unless something comes to the market which makes a lot of sense. I don't think you're going to see us going after public companies on an unsolicited basis where the only thing that's certain to happen is overpaying. That's not the way we do M&A and the way to do M&A at L-3. So, to the extent that M&A is not available, I said we're going to continue to modestly increase our dividend. I expect that's what the Board and Mike will do as they've done each February. So, we'll buy back more of our stock. We're also paying attention to our investment grade credit ratings. We said we want to preserve our existing ratings. And because we expect that we'll be growing our operating income soon, we shouldn't be required to make any kind of meaningful debt reduction. But it's something we pay attention to, investment grade rating is important to us. The short answer is I think a lot of our cash flow ends up getting returned to our shareholders which is what I said earlier in my commentary.
Rob Spingarn - Credit Suisse - Analyst

Anybody else in the field with a question before we wrap up? Up here. I've got one or two small ones. Okay.

Ralph D’Ambrosio - L-3 Communications - CFO

I think there's a question.

Rob Spingarn - Credit Suisse - Analyst

I didn't see it. Okay.

Ralph D’Ambrosio - L-3 Communications - CFO

You want to give someone else a chance.

Rob Spingarn - Credit Suisse - Analyst

I think that's very reasonable.

Unidentified Audience Member

I'd like to know what are you trying to do to drive affordability, streamlining efficiencies throughout L-3? You mentioned a little bit about ERP. What other activities are you doing?

Ralph D’Ambrosio - L-3 Communications - CFO

Well, we've been continuing to consolidate our business units and a lot of people recall the beginnings of L-3 where we did an enormous amount of acquisitions, over 100 transactions. That hyper M&A activity really ended after we acquired Titan in 2005. And since then, we've actually consolidated, combined more than half of the business units that we started with and that we combined and we acquired subsequent to our formation. And so I think there's more opportunity for us to continue to combine and condense the business units, particularly in the electronic systems and communication systems segment. Not so the case in the other two segments where the consolidation is largely completed with the exception of Logistics Solutions [in Aerospace Systems] where we're going to combine the three divisions into one mega division to improve the cost synergies and the cost profile and hopefully margin potential. That's whether or not we divest it. That's something we're doing regardless for that business. We're also going to be focused on the supply chain and trying to drive down our material and subcontractor cost. Price continues to be an important competitive factor in all of our businesses, in all of our end markets, and we don't see that changing. That means we need to continue to be aggressive on our cost structure and we continue to investment our money in IRAD in a disciplined, hopefully fruitful way because we just can't afford to spend whatever we like. So, we're trying to balance a number of equations, price, margins, returns to shareholders. So, it's a delicate balance.

Rob Spingarn - Credit Suisse - Analyst

One quick programmatic one. We're really up against the time here so I'll just throw this out as kind of a group question. You've got several big air force competitions here. There's LRSB which is highly classified. We've got trainer, we've got maybe U class. We've got a bunch of different things here. You guys in the electronic and communication systems have a lot of capabilities. Are you well represented on all the various bids here?
Ralph D'Ambrosio - L-3 Communications - CFO

I think we have significant participation on most of the bids, particularly on the communication systems side where we tend to be strong everywhere in the data side. We've also been making a lot of investments recently in the E&W and other classified domains which I didn't talk about. But it is a key growth area for L-3. Prospectively we see the classified budgets continuing to grow within the US government. We're spending a lot more money there in terms of IRAD and we're going to definitely step it up in 2015, 2016. So, we see good opportunities to drive medium-term growth in the classified markets. I say medium-term, I mean one or two years out, more than one or two years out --

Rob Spingarn - Credit Suisse - Analyst

Not in '15?

Ralph D'Ambrosio - L-3 Communications - CFO

Mostly it's going to be the investment stage for the next couple of years.

Rob Spingarn - Credit Suisse - Analyst

I think with that we will close. Ralph, as always, thank you for joining us.

Ralph D'Ambrosio - L-3 Communications - CFO

Thanks for having me.