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LLL - Q1 2017 L3 Technologies Inc Earnings Call

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OVERVIEW:

Co. reported 1Q17 consolidated sales of \$2.669b and diluted EPS of \$2.07. Expects 2Q17 sales to be approx. \$2.7b and diluted EPS to be \$1.90-2.00.



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PRESENTATION

Operator

Good day, and welcome to the L3 Technologies First Quarter 2017 Conference Call. (Operator Instructions) Please note that this event is being recorded. I would now like to turn the conference over to Mr. Mahmoud Siddig. Please go ahead.

Mahmoud Siddig - *Joele Frank, Wilkinson Brimmer Katcher - MD*

Thank you. Good morning, and thanks for joining us for L3's 2017 First Quarter Earnings Conference Call. With me are Michael Strianese, Chairman and Chief Executive Officer; Christopher Kubasik, President and Chief Operating Officer; and Ralph D'Ambrosio, Senior Vice President and Chief Financial Officer.

After their formal remarks, management will be available to take your questions. Please note that during this call, management will reiterate forward-looking statements that were made in the press release issued this morning. Please refer to this press release as well as the company's SEC filings for a more detailed description of factors that may cause actual results to differ materially from those anticipated. Please also note that this call is simultaneously broadcast over the Internet.

I would now like to turn the call over to Mike Strianese. Mike, please go ahead.

Michael T. Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Well, thank you, and good morning, everyone. Thanks for joining us. Pleased to report that we had a strong start to the year. In the first quarter, we generated net sales of \$2.7 billion, which was a 13% increase versus last year's first quarter, and most of that increase was organic. Margins were 9.5%, which was on track with our expectations, and reflected measures that we put in place last year. And consistent with our plan for the year, we expect double-digit margins for 2017.



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Earnings per share for the first quarter was \$2.07. In light of our strong first quarter, we've increased our guidance for sales and diluted EPS for the year. And Ralph will give you more details on our results and our updated guidance in a few minutes.

Before discussing highlights in the quarter, I'd also like to acknowledge an important milestone for us. This week, L3 will celebrate its 20th anniversary, which will be on April 30. Some of you were with us right from the start, and we appreciate that. It's worth taking a moment to reflect on some milestones to see just how far we've come. I'm proud to say that we've created a tremendous amount of value for our shareholders over that time. In fact, the CAGR for L3's stock price, including dividends since our IPO is over 16% for the 20-year period. L3 has grown from a base of \$700 million in sales to over \$10 billion today. The combined efforts of all of us at L3, past and present, represent significant achievement. Together, we've built a company that's risen to become a recognized industry leader with a reputation for agility, performance and customer focus.

I'd like to just take a moment to thank our employees, management team and our board for all they've done and continue to do to contribute to our success. I'm certainly proud to be part of what we've built over the past 2 decades, and look forward to future achievements under the new L3 Technologies name. I know we'll accomplish still greater things ahead.

Turning now to our performance for the quarter. Although we've only just recently realigned our segments, I'm happy to say that the newly created Electronic Systems and Sensor Systems segments are performing very well. Well, we're already seeing early benefits by reducing some management layers and enhancing the focus on new and upcoming initiatives to support our long-term growth. Both segments posted very healthy increases in sales and operating income. It's an impressive start for these 2 segments and our new management team. Todd and Jeff are both working hard to accelerate growth and further optimize their business areas.

In each of our defense, commercial aviation and security markets -- aviation security, we are implementing a strategy centered on delivering highly advanced technologies, increasing market share and meeting demands for affordability and performance. I'd like to discuss some of the highlights in the quarter and our growth strategy in each of our markets.

We've achieved a number of important performance milestones, including the successful delivery of the first KC-10 aircraft to the U.S. Air Force as part of the \$1.9-billion contract we won last year. We delivered the aircraft on-time and on-budget, and our Air Force customer is very pleased with those results. These milestones affirms their confidence in our ability to provide innovative maintenance and logistics solutions for mission-critical aircraft.

Also, on the topic of military readiness, just a few weeks ago, L3 won recompetitions for sustainment and logistic services in support of U.S. Navy and U.S. Air Force C-12 aircraft, and we're awaiting the Army's decision on their C-12 aircraft.

With regards to the DoD budget, the debate continues and we're watching for the completion of the fiscal '17 appropriations. We expect this will include additional OCO funding focused on readiness as well as other DoD priority areas, including ISR, protected communications, power systems and night vision. Each of these areas is core to L3. And it seems clear that there'll be upside from increasing classified budgets, another area where we're also positioned for growth.

In summary, with respect to our core DoD markets, we remain well aligned with key priority areas. And as the DoD procurement strategy comes into better focus, we should be able to benefit more over time. We're certainly listening to our customers and firmly believe that our ability to anticipate their needs and quickly deliver tailored products is among our strongest competitive advantages.

Turning now to international markets. We strengthened our operations in major regions by adding additional experienced personnel for opening new facilities and intensifying our business development efforts to enhance our in-country value in keeping with our "key people in key location" strategy.

International is an important market for us. We're driving efforts to both secure long-term growth and to ensure our international military allies in commercial customers have better and more direct access to our products. We're encouraged by the new administration's efforts to bolster global military spending, and this push from the U.S. government is positive for our FMS customers. You'll notice in our guidance that we've raised our international sales outlook.

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In commercial aviation, we're expanding our Commercial Training Solutions, or CTS business. CTS is our one-stop shop, providing customized and affordable training solutions to support the growing demand for pilots from the global aviation marketplace. CTS is a central organization that offers flexible training options for both the airlines and experienced pilots and also provides career development services.

Following our announcement about our London Gatwick training center, which we plan to open in early 2018, we started receiving requests from large international airlines that need our help in addressing their anticipated pilot shortages. For example, our innovative curriculum is enabling our airline partners to recruit and train their best pilots so they can now preselect candidates for first officer positions while they are still in the process of completing our programs.

Turning to security. As today's environment continues to illustrate, unfortunately, only too clearly, we are living in a world facing even greater threats across transportation hubs. As a result, demand for improved global security is likely to increase. We are one of the leaders in this area, and we are responding aggressively to meet this need. I'd like to highlight this as one of the spaces within L3 to watch over the coming years. Our aviation security business is another application of our whole systems approach. We've built out this business with the acquisitions of Mac H and Implant, and both are doing great. We are now able to offer our customers a more complete integrated solution at a better value than anyone else in the industry. One example is our ClearScan carry-on baggage screener. We recently received European certification for this explosives detection system, which was designed to meet new regulatory and operational requirements. The system is currently in use at Amsterdam's Schiphol Airport as well as in Singapore and Johannesburg. Right now we're working closely with TSA to have an operational deployment in the U.S. This model takes advanced technology and puts it at the checkpoint, letting the machine do the detection work, greatly increasing throughput and the detection capability.

Also, a U.S. -- major U.S. air carrier recently unveiled the demonstration of our airport security solution at a major metropolitan area airport. And the early reports saw that passenger throughput has significantly improved. I think as it remains operational, we'll be able to report on how much throughput has improved. And I think it's going to be a very compelling story once the benefits of this comprehensive integrated solution are fully realized. These businesses are examples of our ability to build market-leading positions from the ground up. And that's been part of our success, part of the story.

If you look throughout the company, there's a number of areas that were not here 20 years ago, yet are here today, and they are world leaders. And that was done through our investment in R&D and a very focused acquisition strategy. Some of them, like night vision, our EO/IR business, the pilot training that I've just talked about, the collision avoidance systems for airlines, general aviation, the aviation security business and U.S. government classified space are always -- we've been executing on that strategy, and have built world-leading brands that are really #1 or #2 in each of their spaces.

Moving to the other side of capital allocation. We are also focused on returning cash to shareholders. And during the quarter, we had another dividend increase and delivered \$61 million in cash to shareholders in the form of dividends. That would've been our 13th consecutive dividend increase. With respect to M&A, we're going to remain opportunistic. We continue to evaluate prospects that will further enhance our core business. We're realizing good success with our small- to medium-sized acquisitions. I guess commonly known as bolt-ons, but that strategy has worked for us, where we can assimilate a business area through some well-chosen acquisition candidates to bring technology, customers, solutions to us, and we're -- we've been very successful in integrating them and getting them in front of customers.

We like the approach, it's worked for us and continues to work for us. And there are also very digestible-sized deals that are readily integrated into existing operations. We'll continue to execute these types of deals that have been so successful as opposed to the larger [bet perform] type of transactions.

Some of you might have noticed that this past quarter, we added Unmanned Undersea, UUV, if you will, capabilities through the small but very strategic acquisition of L3 OceanServer. This business provides L3 with an all-new growth platform that is highly aligned with the Navy's priorities and enables us to enhance our relationship with that branch. OceanServer also positions us to be a prime contractor in the emerging UUV market.

Further to the topic of strategy and innovation. In 2016, R&D spending accounted for about 2.5% of our sales and we're anticipating an increase of about 10% in 2017, with an emphasis on both near- and long-term innovation. As an example, in the realm of precision strike, we developed

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our innovative Advanced Low-Cost Munitions Ordnance known as ALaMO. ALaMO reached a performance milestone by passing a Navy critical design review in support of a guided projectile program. ALaMO is capable of hitting a moving surface target at significantly longer ranges than what is possible with unguided projectiles. This improved accuracy requires fewer rounds per target, which can result in a significant reduction in cost.

Other focus areas for 2017 include networked autonomy, next-generation multispectral sensors, protected communications and assured positioning, navigation and timing. Some of these are new areas for us, but they represent a natural evolution of our existing portfolio and will help achieve long-term profitable growth.

Along with driving results based on performance and innovation, we're deploying capital and resources in areas where they make the biggest impact on our growth and a meaningful difference in delivering shareholder value.

Let me conclude by saying that our market strategy and priorities remain consistent. We are focused on markets that are aligned with the current threat environment in areas of customer need, with the goal of increasing our leadership positions and developing best-in-class technologies. We're very pleased with our results for the quarter, which reflect our focus on disciplined growth, margin improvement and delivering value for our customers and shareholders. And we're confident in our ability to maintain our positive momentum.

With that, Chris will discuss some of our operational initiatives and wins during the quarter. Chris?

Christopher Eugene Kubasik - L3 Technologies, Inc. - President and COO

Okay. Thanks, Mike, and good morning, everyone. From an operational perspective, we're making good progress. As a team, we are driving hard on our objectives, which includes an intense focus on growing organically, executing on our commitments, having a strategic M&A process and investing in markets where we see the biggest opportunity. Our plan to accelerate organic growth is focused on early identification of customer needs, appropriate R&D allocation, proper teammate selection when needed and enhanced internal collaboration. To accomplish this, we are demanding more and pushing harder to improve our business processes and systems.

Our realigned segment structure has intensified our ability to align our technologies and markets, which is enabling us to increase responsiveness to customers and better maximize growth opportunities. Our 2 new segments are performing well and our leadership team has shown real energy in taking on the challenge to identify and implement cost reductions and efficiencies across the organization.

We are capturing synergies across L3 to leverage our collaborative strength as well as increase our business development capability. This allows us to develop affordable and innovative technologies that meet customer demand as well as expand the solutions we provide in higher returning businesses. We've taken steps to consolidate business units and manufacturing facilities, and are reviewing several other scenarios. We expect that over time, there will be second and third-order benefits. For example, we recently closed a small aviation product facility in Florida and distributed work to other L3 units in a seamless transition. Also, our consolidation of 2 Traveling-Wave Tube businesses within our Communication Systems segment is currently on plan. This process will continue through the early part of 2018, and Ralph will discuss the lumpy nature of this accounting.

Touching briefly on our portfolio, we are evaluating businesses across our core market and continuing to review potential acquisitions that enhance our technologies, provide access to new markets or further strengthen our leadership position.

In 2016, we completed 4 deals. So far in 2017, we closed on 2 acquisitions: Implant Sciences and OceanServer. And we also closed on one small divestiture, Coleman, out of our Electronic Systems group.

As Mike mentioned, with L3 OceanServer, we acquired a new field-proven UUV platform that has the potential to add to our military, commercial and international customer base. While a small deal, this acquisition starts to increase our anti-submarine warfare and mine countermeasure capabilities and create pull-through opportunities for existing L3 sensor, sonar and ISR products. As Mike mentioned, this approach has worked well over the past 20 years, and we expect that, that will be the case again as we focus on the UUV market.



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Our addition of L3 OceanServer is a perfect example of our strategy of aligning with customer needs and the evolving threat environment. We have additional M&A opportunities across all segments that are currently under evaluation. And on the divestiture front, as we said in the past, the major divestitures are behind us, but we will continue to assess our portfolio and we'll divest businesses when it makes sense.

Turning to contract wins and milestones across the business. Let me start with defense. We received a wide range of awards across all service branches. I believe our diversified customer base is one of our key differentiators. We're well known around the world for our ISR and integration capabilities on mission-critical platforms. In fact, we were selected by the U.S. Air Force to serve as the lead system integrator for the Compass Call cross-deck effort. Once the Federal funding process is complete, we'll get to work. We also received more than \$160 million in periodic maintenance and modification contracts in support of the Air Force on a variety of platforms.

For the Navy, we were again selected for Chief of Navy (sic) [Naval] Air Training Aircraft. It has a potential value of over \$100 million through 2022. L3 has been the incumbent on this program since 2008. We are also providing a high-definition visual system and network upgrade to the Navy's F/A-18 C/D tactical operational flight trainers, and we won additional contracts for our Universal Modular Mast for the E60 aircraft.

Our wins from the Army include a \$90 million firm fixed-price multiyear contract to supply mortar fuses and related equipment. If fully exercised, this award has a potential to exceed \$230 million.

Across the military, our Communication Systems segment provides contract logistics support for many programs, including the Air Force Predator, Navy Triton and the Army Gray Eagle. Altogether, these awards have totaled approximately \$70 million thus far this year. This type of legacy work positions us well for future competition, such as the Hawklink and the MH-60S helicopter programs. Both represent key naval opportunities for L3 and would be worth nearly \$175 million over the next 4 years.

Finally in defense, we've seen significant new business in the classified arena, with us as a prime contractor.

Turning to our international defense business. We received a \$53 million option on our Canadian CF-18 contract and additional funding of \$22 million in support of the CC-150 fleet. Moving to the Asia Pacific, we secured a contract to manufacture counter IED devices for the Australian DoD.

In February, we were awarded a contract to provide transmission kits for the Korean army. And in Indonesia, we received a follow-on contract for a helicopter ocean sensor equipment.

We continue to see strong demand for our night vision products. In the quarter, we added another NATO member to our customer base. In total, 7 NATO nations are using L3 image fusion goggles. And we expect to see ongoing international orders for these systems in the future. Finally, we will reach a milestone in May with the delivery of our 4,000th MX-Series EO/IR turret since the project -- the product launched in 1997. We're pleased with the new international wins and we continue to focus on opportunities in this important market.

Commercial aviation, as Mike highlighted earlier, remains an active growth area as North America and Europe recapitalize their fleet. Additionally, markets in parts of the world such as Asia and the Mid East are focused on fleet growth and global expansion. To achieve this, they will need significantly more trained pilots. In the quarter, we received contracts for 8 Full Flight Simulators from airlines in China as well as other parts of Asia and Europe, totaling over \$90 million.

Our CTS airline academy continues to grow and the Aerosim acquisition from last year has increased our capability. CTS saw strong enrollment in Q1 from customers in the U.S., China, the Mid East and Southeast Asia.

In Aviation Products, we have been selected as the prime contractor to supply our deployable and fixed-flight data and voice recorders to Airbus for their entire family of commercial aircraft. These innovative recorders enable rapid location and recovery by rescue teams, both on land and over water.

Finally, in aviation security, we continue to report solid orders for our solutions. We received a competitive award from the TSA for a number of explosive detection systems as well as a follow-on contract from the Canadian TSA. We continue to receive orders for the ProVision 2 advanced

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imaging system throughout Europe and Asia. And our cargo and airport screening businesses have received international orders in South Africa and Kuwait.

Overall, we are encouraged by the progress we've seen so far this year. We will continue to sharpen our focus on achieving earnings growth through a culture of continuous improvement, cost containment, better program execution and operational excellence.

Our focus on organic growth is paying off. And while small, we were pleased to have secured new orders in Indonesia, Korea, China, South Africa, France, Japan and Kuwait in this quarter alone. We'll continue to push hard internationally for defense, commercial and aviation security opportunity. We have a great team in place and our disciplined growth strategy is driving long-term shareholder value.

With that, I'll now turn it over to Ralph to discuss the financials.

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

Thank you, Chris. I'll discuss some details about the first quarter, and then review our 2017 guidance update. We had a strong first quarter with diluted earnings per share of \$2.07, which was ahead of our expectations, driven by higher organic sales growth and lower taxes. We either met or exceeded every first quarter financial metric that we provided in our January outlook. Our first quarter benefited from our accounting calendar, wherein we had an extra week in the first quarter compared to the 2016 first quarter. This extra week will reverse entirely in the fourth quarter.

Consolidated sales were \$2,669,000,000 with 11% organic growth and 2% growth from acquisitions net of divestitures. Excluding the extra week, sales grew a very healthy 7%, including approximately 5% organic growth. Sales were strong in all 4 segments. Areas of strength included simulation and training, munition fuses and avionics equipment in Electronic Systems; aircraft maintenance in the Aerospace Systems; UAV communications, tactical terminals and classified work in Communication Systems; and EO/IR turrets, night vision equipment, space payloads and launch electronics in the Sensor Systems segment.

Consolidated operating margin was in line with our outlook of 9.50%, and declined compared to the 2016 first quarter, primarily due to lower-margin in Aerospace Systems. You may recall that we had abnormally high favorable performance adjustments in the 2016 first quarter at ISR Systems due to contracts which completed last year. And they raised Aerospace's first quarter 2016 margin to 10.5%, setting up a very tough comparison for margin this first quarter. That said, we expect margins to improve the rest of this year at Aerospace Systems.

Margins are tracking to our full year estimates in all 4 segments. Also at the segment level, Communication Systems margin was 8%, primarily due to \$9 million of restructuring costs to consolidate our Traveling-Wave Tube businesses. Excluding these restructuring costs, margin there was 9.7%. And as we explained in January, the quarterly margins for Communication Systems are being affected by this consolidation. We'll incur approximately

\$28 million of restructuring cost this year, which we fully expect to offset with a gain on a sale of a property that we will vacate during the fourth quarter. Consequently, there is more seasonable variability in Communication Systems' quarterly margins in 2017.

Our tax rate for the first quarter was 22.2%, and it was lower than our full year estimated tax rate primarily due to the timing of stock-based compensation deductions, which mostly occur in our first quarter. Free cash flow was \$44 million and consistent with our seasonal first quarter pattern.

Now moving on to our 2017 guidance update, we increased EPS at the midpoint by \$0.10 to \$8.60, which will grow 5% over 2016. The EPS guidance increase is driven by higher estimated sales. We increased our consolidated sales at the midpoint by \$125 million or 1% to \$10,850,000,000, which is a 3% increase over 2016, including 2% organic growth.

Our Aerospace Systems sales guidance continues to have conservatism of about \$75 million for the 2 large contract recompetitions at Vertex Aerospace and a new program start that could be delayed if there's a prolonged FY '17 continuing resolution. We also have some cushion in the Communication Systems sales estimate for a potential disruption from the Traveling-Wave Tube business consolidation and for softness in the space market.

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With respect to consolidated operating margin, we continue to expect an increase this year of 70 basis points to 10.3%. This will represent an important milestone for us, of returning to double-digit margin. We expect consolidated operating income to grow 11% compared to 2016, and our free cash flow estimates stays at \$865 million.

Regarding capital allocation, we are opportunistically shifting cash deployment to acquisitions. During the first quarter, we invested \$139 million to acquire Implant Sciences and OceanServer. For the remainder of the year, we have a \$500 million placeholder for combined acquisitions and share repurchases, and we are assuming to end this year with a cash balance of about \$450 million.

Taking a quick look at the second quarter of 2017, we expect sales of approximately \$2.7 billion, which calculates to about flat organic growth.

With respect to the sales outlook, in the second quarter of last year, we delivered 2 aircraft on an ISR contract for an international customer, which added \$90 million of sales to Aerospace Systems, and those sales will not repeat in 2017. For the second quarter, we also expect margin to be in the high 9% range, diluted earnings per share between \$1.90 and \$2. And finally, free cash flow in the \$50 million to \$150 million range.

To conclude my financial review, we had a very good start to 2017, and the company is clearly focused on continuous improvement. This year we expect to grow orders, sales, operating margin, operating income and earnings per share. We're executing on our disciplined growth strategy as well as our capital allocation strategies.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from the line of Carter Copeland with Barclays.

Phillip Carter Copeland - Barclays PLC, Research Division - Associate Director and Senior Analyst

Just a couple of quick ones. One, Ralph, on the -- you highlighted in the release the work day differential year-over-year that reverses in Q4. Just trying to understand, was that contemplated in the prior guidance that you had given for Q1? And is the entire reversal a Q4 number? And then secondly, just on the commentary on M&A and the strategic shift toward M&A from repos, does that mean you've taken the -- how should we think about the repurchases that were in the guidance initially? Are those somehow factored? Or is there a -- how should we think about that \$500 million? Does that still have the full contribution in it? Or is there some of that, that's been reduced?

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

Sure. So on your first question, our outlook for the first quarter, it contemplated the extra days that we had this year. And those days will fully reverse in the fourth quarter. That said, we typically provide a conservative first quarter outlook, and we did the same thing for 2017. With respect to the cash deployment and shifting it opportunistically from share repurchases to acquisitions, I said that we have a \$500 million remaining placeholder for combined share repurchases and acquisitions. But if you take a look at our guidance update, you'll see that we increased our estimated diluted shares for the year by about 500,000 or 0.5 million. And that's because we're slowing the pace of share repurchases and have moved most of them into the second half of the year. And depending on what happens with the acquisitions, our preference would be to make acquisitions. But if we can't find good ones that are attractive and that we can execute on, we'll default to buying our stock later in the year. So that's how we've positioned and updated our guidance for this year, Carter.



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Phillip Carter Copeland - *Barclays PLC, Research Division - Associate Director and Senior Analyst*

Okay. I was just trying to clarify that the combination of repo and M&A for a \$500 million number, how that split, but appreciate the color.

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

We don't have a specific split. Well, the same thing we talked about 3 months ago on the January call.

Operator

Your next question comes from the line of Richard Safran with Buckingham

Research. Your next question comes from the line of Robert Spingarn with

Credit Suisse.

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

Okay. All right. Ralph, on the margins, you said you're tracking, but you've got to get up to, I think, about 10.6% for the rest of the year to hit the targets. Just steadily through the year, is there a peak quarter?

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

Well, we're going to have our highest margins for the year in the fourth quarter, which is typically the case. This year, it's more pronounced because I talked about that property gain that we expect to have as an offset, the \$28 million of restructuring charges in Communication Systems for consolidating those 2 businesses. For now, we're assuming that happens in the fourth quarter. There's a possibility it could happen sooner. So that's pronouncing our seasonality, if you will, of a higher margins in the fourth quarter. And if you look -- in our first quarter, you see that the margins were very high in Sensor Systems and we took those margins up slightly for the year. That was a combination of favorable sales mix and some performance improvement adjustments, and we clearly have some more upside there in margins for the remainder of this year.

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

Okay. And then programmatically, I think, Mike or Chris, one of you mentioned the Compass Call, the transfer from the old airframe to the new business jet airframe. You mentioned that earlier. What is the latest thinking on that in terms of which aircraft you would use, et cetera? And what do you think the timing is on a move forward here given what's going on?

Michael T. Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Well, that -- as a new start, Rob, that will be impacted by the CR. So we need to get to work at some point on it. I cannot comment at all on which way it's going to lean because that work hasn't been done. And even if it had been done, I really would not get out ahead of our customer on it. So -- but I am encouraged by the direction of this procurement because that is critically important for L3, being an integrator and being an equipment provider, that it gives us a very nice place on the recapitalization of some of these ISR platforms, many of them are due to be recapitalized over the next several years, as you know. So we're very focused on doing an excellent job for our customer. And hopefully, they'll maintain this as a position for other platforms as well. Hopefully, this will be a new way some of these acquisitions are done.

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

Okay. And then just on a related thing, I've asked you this before in prior calls. But the Air Force has finalized requirements for Air Force

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One. And are you any closer to thinking what subsystems you might be able to provide to the prime?



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Michael T. Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Well, typically -- I'm talking in generalities here. I mean the typical areas for us would be on the communication suite because of the criticality of that system. There are other areas that we would be able to work on, but again, this is the old model. We are not the lead systems integrator. And therefore, our -- basing whatever we get asked to provide on whatever the prime is going to compete. So I'm sure, we'll be -- or whatever the customer specifies as a requirement, whether they specify an L3 datalink or an L3 comm suite. So those are hard to predict at this point. But I mean, there will be some level of content. I just can't tell you how much.

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President and COO*

And Rob, what we've seen in the last year, several customers are looking at us to continue to move up the food chain and be more of a subsystem integrator and provider. So our aspiration would be to continue to do that. And there are some benefits of having someone like L3 do that work, given our experience. And it's less suppliers for the primes to deal with, so it seems to be a trend. And I'll just clarify on the Compass Call, because your question was a little leaning towards business jets, that decision has not been made. It could be a 737. It could be one of multiple business jets. And once the CR is behind us, the team will go through that process and make sure that, that was clear.

Operator

Your question comes from the line of Richard Safran with Buckingham

Research. Your next question comes from the line of Noah Poponak with

Goldman Sachs.

Noah Poponak - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Ralph, so CS is a \$28 million gain in the fourth quarter. Is it then also an additional \$19 million of restructuring in the second and third, combined, to get to a \$28 million total of restructuring for the year?

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

Correct. Just that the incremental restructuring of \$19 million will happen over the remaining 3 quarters. More of it in Q2 and Q3 than Q4.

Noah Poponak - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay. So the reported margin in CS is going to be in the second and third quarter, is going to look something like that 8%. It sounds like a little higher in the second and third quarter, and then it's going to be in the mid-teens in the fourth quarter?

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

Correct.

Noah Poponak - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay. And then similarly on the ES margin, should I be adding back the \$3 million of severance? Or I guess, what is the likelihood of more of that throughout the year? And then should I be adding back 150 basis points of margin for -- I couldn't quite follow what that was referring to in the release. But is the real kind of recurring underlying margin in ES in the quarter over 14%?



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

So the recurring margin in Electronic Systems first quarter was a little above 13%. So it was \$3 million in severance that you referenced. There will likely be more severance but not at \$3 million per quarter. And then we divested 3 businesses, Coleman Aerospace division and 2 smaller product lines in the first quarter this year, and that caused the \$4 million loss. Whereas in the first quarter of '16, we sold a product line that had a gain in it. So you should only be adding back \$4 million to normalize the margin for 2017. And that would get you a little above 13%, which is right where we expect it to be for the full year.

Noah Poponak - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Got it. And then could you just give us maybe an update on Fort Rucker, Army C-12 and SOF GLSS? Any change in time or changing in your thoughts around likelihood of win or anything else on those big programs for you?

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President and COO*

Yes, I'll go through those real quick. On Fort Rucker, just to remind everybody, we turned in our proposal back in February. As you can imagine, all of us watched that program rather closely and we actually just finished March with probably one of our better months ever, with mission availability at basically 100%. So the team is performing well in a pretty stressful environment relative to the availability of aircraft and their usage. So it's the best value proposal like we've talked about before. We've put in a compliance proposal. We have the experience, we're performing well. So we, like everything, if you wanted me to put a number, we'd probably say 50-50. But I think the team did a good job there. And on SOF GLSS, that goes back to December submission, so we'll hear about that one first. We have a very strong team, as we've talked about before. We haven't disclosed all of our teammates, but I'm very pleased with the team we pulled together. And again, we've had a strong proposal. It's a best-value contract. And through the normal acquisition process, I'd say we're having productive dialogue with our customers in the normal Q&A process. So again, given our past performance and experience, we feel pretty good about our chances there. And C-12, there's actually 3 pieces. Mike mentioned the wins for the Air Force and the Navy. But the big one, of course, is the Army. We're the incumbent, and our customers are looking for reliable contractors that perform well. And when I look at our performance, it looks pretty darn good to me. So we've got to feel confident based on that. So we'll -- should hear that in the next quarter or 2. So once you submitted a proposal, it's kind of hard to get a whole lot of insight. But we feel good based on what we've done.

Operator

Your next question comes from the line of Seth Seifman with JPMorgan.

Seth Seifman - *JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst*

Just looking at the book-to-bill in the communication segment. It's been -- on a trailing 12-month basis, it's been a little below 1 for some time now. I'm wondering if you're tracking in line with your expectations this year and when we might expect that to tick up a little bit.

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

Hi, Seth. It's Ralph. The short answer is that we are still estimating to have a book-to-bill there that exceeds 1.0 for the year. There were a couple of orders that slipped out of the first quarter into April, and that's the primary reason that the book-to-bill was below 1.0 there in the first quarter. So...

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Christopher Eugene Kubasik - *L3 Technologies, Inc. - President and COO*

And I'll just chime in. I think this is a tough metric on comparability because our practice is to record our backlog and orders as a funded value and I think a majority of the industry has the contract value method. So you're naturally going to have a lower number, so I'll just remind you that, that's funded and not contractual and probably makes comparisons to others a little more difficult.

Seth Seifman - *JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst*

Great. And then maybe just as a quick follow up. Chris, the comment you made about maybe moving up to become more of a subsystem provider to your customers. If you could speak a little bit more about that, what it might entail, where the opportunity is in terms of the product segments that you're in and if it's something that you see unfolding over a long period of time.

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President and COO*

Yes. I see it mainly in the Sensor Systems and Communication Systems and some meetings that we've all had with some of the OEMs. One of their challenges is managing tens if not hundreds of suppliers. And given our capabilities with sensors and avionics and such, we've had dialogues about letting us step up using our products, procuring other guys' products where it makes sense and integrating them and providing them. So I'd see that more on aircraft, maybe launch vehicles, those types of larger platforms. As we said before, we're also not averse to being a prime contractor. And our customers, as we've talked about, are looking at this aggregation and more affordable -- the few, going from few to many. And we mentioned the one very small acquisition we made and I alluded to some comments in the classified world, where those strategies are being successful. But it will take time to build that up, and we expect that to fuel our growth in the years ahead.

Michael T. Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Yes, let me just take one on that one. There's some other pieces that we need to do well. We had the OceanServer acquisition, which gives us a platform for us to integrate sensors and comm systems on and compete as a prime in that space. We have been, just like there's a prime in classified mission areas, notably space and next-generation air dominance application. I mean, the ALaMO product that I talked about earlier during my remarks is providing a guided projectile as a prime. And globally, on the aircraft side, in many countries and even here at home, we have been consistently selected ahead of OEMs and other primes to do significant mission systems on aircraft, whether it's maritime patrol aircraft, on business jets for customers in Korea or in Japan, the thing in the Middle East and a host of other areas where we are, based on our experience, on what we've delivered, like the Airseeker in the U.K., which is a U.K. version of a similar U.S. platform. We need to use our experience credentials further that trend, and we're very, very focused on that. The story cannot -- the story has to have grown beyond the old merchant supplier story. But yes, some areas we're merchant supplier, but we would be remiss in not harnessing all our capabilities and competing head-on as a prime in many areas where we are recognized as a world leader, and we have the credentials to prove it. So we try to capitalize on that trend.

Operator

Your next question comes from the line of Myles Walton with Deutsche Bank.

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

I was hoping to circle back around on the performance in the quarter on the top line. I know, Ralph, you said that you're usually conservative but I want to couple this. You're obviously beat by a couple hundred million versus your guidance, and then you raised the outlook and you absorbed the divestiture. So I mean, it does look like you're outperforming for the full year and you outperformed in the quarter. And I just want to make sure I'm clear, the level of conservatism you had, was that pinned to the fact that we don't have a full budget? And what's the level of conservatism you still have for the rest of the year?

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

Okay. So far, the conservatism clearly pertains to the fact that we don't have a budget yet. We don't know if we're going to have an extended CR until when, and we don't know the outcome of any supplemental for FY '17. And I also talked about the two recompetitions, which we continue to carry some conservatism for and any potential slowdown in the commercial space market in the Comm Systems segment. So if we look at last year, we started the guidance in sales conservatively, especially in the U.S. government or the DoD market, and we're being conservative as well this year.

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

Okay. Were there bookings that came through that you weren't expecting in 1Q? Or was it -- I'm just trying to reconcile, I mean, you outperformed by a hell of a lot. That's all I'm trying to...

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

Well, I didn't talk about it. If you look at our end market organic growth guidance update, we moved the U.S. government DoD from plus 1% to plus 2%. And then international, which is a much smaller part of our business, we previously expected that it would decline about 3%. Now we see it growing 1%. And there is some new business that we had in our upside category on the international side that we've been selected on, on the night vision area, and that's part of the increase in international. On the U.S. government side, we've seen some upticks in flying hours in the Vertex business and we're also seeing very strong demand for Communication Systems, specifically for UAVs and in the munition area, which our Fuze & Ordnance business serves.

Christopher Eugene Kubasik - *L3 Technologies, Inc. - President and COO*

To your question on the quarter, I mean, it's no surprise that the op tempo has picked up and it's not unusual. When requested, we'll work multiple shifts in some of our factories. When you look at the release and Ralph answered, we talk about fuses, we talk about precision weapons, we talk about sensors, I mean clearly, you pick up the paper and see that these types of things are needed sooner and quicker. And we try to accommodate our customers, so a lot of that contributed to the 20-some percent growth in a few of our segments just for the quarter-to-quarter comparison.

Operator

Your next question comes from the line of Peter Arment with Baird.

Peter J. Arment - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Mike, you mentioned the Aviation Security business. You've received the European certification for kind of the explosive detection system, and I'm going back to your Investor Day, where you kind of highlighted some of the international security opportunities that were, I think, a few hundred million. Does this one may pave the way for that? And then maybe if you could just bracket what you're seeing just in general about the growth opportunities on the aviation security side. And then just, Chris, you mentioned on the R&D front, you guys are making a lot of investments there. Are you -- is this in response to kind of the -- what we're seeing from kind of the DoD? Or is this a lot more geared to the kind of commercial pursuits that you've been after?

Michael T. Strianese - *L3 Technologies, Inc. - Chairman and CEO*

Yes. The airport security side, yes, this is part of the -- addressing the growth opportunities we see. The certification of our ClearScan is an important milestone for us that we deployed in Europe, and we hope to get there in the U.S. as well. It will greatly, in our opinion, increase throughput at the

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checkpoints because it leaves the detection to the hardware, if you will, and should greatly improve the throughput. It also, depending on how the requirements are written, we don't make the rules, unfortunately, it could serve to eliminate the need for passenger to divest liquid or a computer or an iPad from their carry-ons because the machine can tell whether it contains something that shouldn't be there or not. So and that could greatly aid in the throughput, along with other technologies that have been brought into L3s through a couple of those acquisitions, Mac H notably is one of them. The U.S. demand is going to be based on where the funding goes, but I think it's no secret that the airport, especially during peak times in summer and holidays, the lines have become really unmanageable and intolerable for the traveling public. And I mean, the folks in TSA know that and it's caused all kinds of issues in airports. And any package of technologies that are networked together that will serve to improve throughput by numbers of 20%, 30% or more should be in demand. Now actual results may vary. I mean, you have to put that disclaimer. This is going to be based on budgets and things like that, but getting it past the regulators in Europe has been a good milestone for us because they are starting to -- we're starting to ring up sales there at certain of the more progressive airports that are leaders in the technology. Schiphol has always been one of the first to move to new technology. I'm happy to see South Africa taking that step. And the threat environment is just not abating over the years, so the demand for that type of equipment is still there.

Christopher Eugene Kubasik - L3 Technologies, Inc. - President and COO

Peter, I'll answer your question on the R&D. We're forecasting about at a 10% increase, '17 over '16 on IRAD. And part of that is aligned with our disciplined growth strategy, with a focus not only on M&A but on organic growth. But to answer your question specifically, I'd say about 1/3 of that increase is on the commercial arena, and then 2/3 would be DoD and some of that in the classified area. I think the DoD customers have been pretty clear that they're looking for companies to invest in R&D, to be innovative, and I believe speed-to-market is going to be a differentiator. And we have some things that we've talked about this past hour that are coming along nicely, and we'd hope over time these become program of record and somewhat game changers. So that hopefully answers your question, Peter.

Operator

Your next question comes from the line of Cai Von Rumohr with Cowen and Company.

Cai Von Rumohr - Cowen and Company, LLC, Research Division - MD and Senior Research Analyst

So first question would be Fort Rucker. At one point, I think you guys expressed some concern about some of the fixed-price aspect of that bid. Have that -- have those been changed?

Michael T. Strianese - L3 Technologies, Inc. - Chairman and CEO

We're working through the process, Cai. Some of them are being addressed, but I don't think everything we've raised have been addressed. I really can't say more than that because we're in the middle of the process. It will certainly be under terms that we consider acceptable. We're not going to sign up to a loser for the next 5 years. So we're focused on that and we just have to trust in the process.

Cai Von Rumohr - Cowen and Company, LLC, Research Division - MD and Senior Research Analyst

Okay. And then it just sounds broadly that the international arms market has basically picked up, has a lot more support from the current administration. I think you mentioned that. Could you tell us, are there any other -- any relatively large potentials that you see today that weren't there before, specifically ISR opportunities in the Mid East?

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Christopher Eugene Kubasik - L3 Technologies, Inc. - President and COO

Yes. Cai, I'll say when we talk about our international growth, some of that does include our commercial and aviation security. We don't - I mean, arms, we don't actually sell any, what I'd call, weapons, internationally. But ISR is an area that we talked about and have great expertise. They take longer than any of us would like, but I think the government, as you said, is being supportive. We're getting more things approved quicker through the system. And I think in the quarters ahead, we'll have more to share with you, but we are in competitions and we have some unique relationships that we probably don't want to highlight to everybody. We talk about these night vision, Warrior Systems products, and they really seem to have caught on here late over the last couple of years. And I'd expect some more orders in the rest of the year. And I mentioned in my comments, we delivered our -- about to deliver our 4,000th EO/IR vol and everybody is lining up for our WESCAM business out of Canada to get their product, which seems by all account, to be the best performing turret, by far, in the industry.

Michael T. Strianese - L3 Technologies, Inc. - Chairman and CEO

I mean, the dynamic, Cai, it's not only the fact that the administration, the president, has requested our partners to step up their spending and pick up their share of their own security costs, whether it be the 2% request for NATO countries, et cetera. But that, coupled with the fact that the FMS program is pretty much supportive to that end, and the export process has been more, I would say, thoughtful about what can be exported, especially when some of the things can be bought on international markets from other countries anyway, night vision was a good example. Well, that's kind of eased up. I mean collectively, I'm quoting somebody that spoke in the government, we are in an unprecedented time, something that may only happen once in a generation, where international sales are going to be very favorable for the defense community. Meaning it's got support from 3 or 4 different constituents here. So it's hard to point to any one area, although we do know there seems to be an unabated appetite for our persistent ISR due to regional problems and the like. And we stand ready to lead in that area given our capabilities, not only in the sensors and the cameras, but the ability to integrate it, to put it in ground stations, to make sense of all the data. So we're in numerous discussions and we'd like to be on the forefront of this trend. And we'll see in future quarters whether it gets in the numbers. I certainly think we will have some upticks in that area.

Operator

Our final question comes from the line of George Shapiro with Shapiro Research.

George D. Shapiro - Shapiro Research - CEO and Managing Partner

Yes. Two questions. One, Ralph, in Sensors, I mean, you talked about a \$440 million -- 440 basis point benefit from lower returns, and so you're really above your guidance. I mean, what's the outlook for that for the rest of the year?

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

Well, I said in response to an earlier question, George, that we do have more margin upside, especially in Sensor Systems, and I guess we got to continue with our good contract performance to realize it. It's only the first quarter.

George D. Shapiro - Shapiro Research - CEO and Managing Partner

Okay. And then I just wanted to pursue, too. To get the organic growth down to the 2% that you're guiding to with 11 in Q1 and 0 in Q2, I mean, what's your thinking as to Q3 and Q4? I guess Q4 could be pretty negative because you make up for the days that you got this quarter. But give us some color on what Q3 and Q4 might be just to put to your numbers?



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

Well, our Q3 would have a low single digit organic growth at a minimum and which would cause the fourth quarter to be a modest decline. But I explained it, we have some upside and some conservatism, which will certainly be wrung out by the time we get to the fourth quarter.

Michael T. Strianese - *L3 Technologies, Inc. - Chairman and CEO*

And we're operating without the benefit of a new budget, which we expect should have some favorable trends in it as it relates to things that we do. So hopefully, that answered your question, George.

Let me just wrap up by saying that we are very encouraged by the first quarter results and optimistic for our prospects for the balance of 2017. Looking ahead, we continue to prioritize our excellent performance, our disciplined growth strategy and superior technology in improving our portfolio. We're not only executing well but we're deploying capital and resources where and when they make the biggest impact on our growth and shareholder value. Today's uncertain geopolitical climate makes our advanced capabilities more relevant than ever, and we continue to communicate with our customers to ensure we're aligned with their evolving requirements. As always, our main goal is delivering value to all of our stakeholders through consistent program performance and staying focused on customer needs. We look forward to speaking with you again in July. So thank you for joining us this morning.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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