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# EDITED TRANSCRIPT

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

## CONFERENCE CALL PARTICIPANTS

**Seth Seifman** *JPMorgan - Analyst*

## PRESENTATION

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**Seth Seifman - JPMorgan - Analyst**

Good morning, everyone. Welcome to the JPMorgan Aviation, Transportation & Industrials Conference.

I'm Seth Seifman, the aerospace and defense equity research analyst here at JPMorgan. We are glad to be back after the snow shut us down yesterday and we have three aerospace defense companies with us this morning.

First up is L3 Technologies and we are very grateful to have Ralph D'Ambrosio presenting. Ralph has been with L3 from the beginning and he has been the CFO for about 10 years.

Heidi Wood is here, as well. And she is the Senior VP for Strategy and is also a familiar face to many of you who followed the sector over time.

And Ralph is going to start off with some slides and then we will shift over to Q&A. So Ralph, I will hand it over to you.

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

Okay, thank you Seth. Good morning, everyone. We are glad to be here.

Thanks for making it into the city this morning. It's messy out there with the snow.

So I think most of you know who L3 is but I will quickly review the Company for you. We are an aerospace and defense contractor. We are both a prime contractor and a supplier.

However, we are not a platform OEM. In 2016, we did \$10.5 billion of sales and the last couple of years we transitioned the Company, reshaped the portfolio and now we think we are ready to start growing again. So we are transitioning from portfolio shaping to what we call disciplined growth.

Some of the key attributes about L3 is that 70% of our sales or so are to the US Department of Defense. And we have a very broad, diverse exposure to the US defense budget, which is good news because the budget began growing again in 2016. And that should lead to continued top-line growth for L3.

Historically we've always had very high earnings to cash flow conversion. And we expect that will continue for the next several years or for the foreseeable future.

We think we use a very efficient capital structure. We are an investment grade credit at the first tier of investment grade and that's where we intend to remain. And we have a very experienced management team.

And our key objectives start with satisfying our customers. And then we want to grow our top line, expand margins and employ disciplined capital allocation to include acquisitions, continuing to pay a dividend and buying back our stock if we can't find good acquisition opportunities.

I have a couple of charts on our key markets. First of all, the US government markets, and as I said a moment ago we are about 70% US government. Most of that is the Department of Defense.



We think that the geopolitical situation around the globe supports continued growth in military spending, especially here in the United States. Generally speaking defense spending and budgets are expected to be higher under the Trump administration compared to the Obama administration, and as I said last year the defense budget in the United States grew 4%. That was the first year of growth after about five or six years of declines.

So we think that marks the beginning of a new up cycle. Where under the Obama administration the budgets were going to grow about 2% per year on average, so we think we are going to have something better than that with the Trump administration.

We are under a continuing resolution for FY17 that goes through the end of next month. The classified budgets are not only growing but they are expanding as more work migrates from unclassified to classified designations for obvious security reasons. And lately there has been increasing attention on readiness of the US military which should benefit L3.

And lastly we expect that there will be more trimming of the sequester cuts and continued OCO relief for the US defense budgets. Some of the key capabilities that L3 offers in the US government markets include secure communications, intelligence reconnaissance or ISR Systems, sensor systems, night vision equipment, power systems mostly used by the U.S. Navy. We support the readiness of the entire armed forces, particularly when it comes to training whether it be simulation and training devices used for fast jets and helicopters as well as maintaining and sustaining various training aircraft for all of the armed services. And then, of course, we also do a lot of work supporting special operation forces.

So we have an improving situation for our US government markets. And we look forward to continued growth there over the next several years.

The international commercial markets comprise about 30% of our sales almost split evenly between foreign governments and commercial customers. These markets are affected by global economic conditions as well as security conditions. And in the international market we see a very large addressable market for L3 where over the last several years we have continued to introduce more of our products and solutions for export, and we will continue to do that the next several years.

Some of the key areas for us in the overseas markets are ISR Systems, simulators, communication terminals, night vision equipment and sensor systems. We've had some near-term softness mostly due to the procurement cycle for ISR Systems by our large foreign government customers and we see that changing over the next couple of years and hopefully return the international portfolio to growth in 2018 and possibly 2017 depending on what happens with some new business pursuits.

In the commercial market we see continued favorable long-term fundamentals. Our key end markets are all tied to aerospace in one form or another whether it be avionics equipment coming, aviation security and mostly in the airports and simulation and training for commercial pilots and aircrews.

Here are highlights for 2016. We grew sales organically at 2%. That was the first year of organic growth since 2010.

And most of that growth, in fact all of it came in the US military market where we grew 5%. We expanded our operating margins by 110 basis points and we think we have more room to improve the margins. We grew operating income by 13% and EPS by 19%. We also grew our free cash flow to \$900 million which is about 3% more than it was in 2015. Orders also increased to \$11 billion which was 11% better than 2015.

In terms of the portfolio shaping that I talked about at the beginning of 2016, we divested our national security solutions business and then we acquired four businesses later on last year. We also stabilized our investment grade credit ratings in the early part of 2016 and we renewed our five-year revolver and also refinanced about \$0.5 billion of our debt on very favorable terms.

The key trends for 2017 that we have been talking about the last few months are, one, we expect growth in the US government markets and our commercial markets. We also expect to increase operating margin, operating income and EPS in 2017 and we are also increasing our investments in IRAD and CapEx to fuel our organic growth.

We have some very large contract competitions in 2017 that are all centered around our maintenance and logistic support business area which is Vertex Aerospace within the Aerospace Systems segment. It's an unusual year in terms of the amount of recompetitions that we have. And we've been talking about two of those for a while, which is they both are through the Army. It is the Fort Rucker maintenance support contract which basically maintains the entire U.S. Army helicopter training fleet 24/7. We are also recompeting our Army C-12 transport contract. And then we have a very large new business pursuit supporting logistics for the special operation forces around the globe that's also happening in 2017. What we have been saying all along is after having won a new contract for the U.S. Air Force last summer supporting the KC-10 tanker we want to win at least one of the two contracts, the Fort Rucker recompetes or the special operation forces worldwide logistics contract. We'd like to win both but we definitely want to win one of those. And those will both be decided sometime in the second half of 2017 along with Army C-12. If we



don't succeed in winning the both of those contracts we will likely have a goodwill impairment charge on the Vertex Aerospace business. And we talk about that in our 10-K that we filed about a few weeks ago.

Also we are undertaking a significant business consolidation within our Comm System segment combining our two Traveling-Wave Tube businesses. That started in the middle of last year. It's going to continue through the early part of 2018. And while we expect to offset all the restructuring charges this year, which will be about \$25 million or so with a gain of a property that we are going to sell after we vacate it as part of the consolidation, it's going to impact the quarterly timing or quarterly margins within the Comm System segment because we will be incurring those restructuring charges all year long and we expect to sell that property in the fourth quarter and possibly sooner.

Our free cash flow is going to continue to be strong this year. It's down a little bit versus 2016. That's due mostly to higher income tax payments as well as additional investment in CapEx.

We acquired Implant Sciences at the beginning of January for \$115 million. That business like the MacDonald Humfrey acquisition that did last November builds and strengthens our aviation security business area. And we have earmarked another \$0.5 billion in 2017 for a combination of acquisitions and share repurchases, and we will continue to be very disciplined about how we deploy our cash flow in 2017.

Here's a look at our consolidated guidance. I covered the highlights already, so I will skip over it.

And the next chart shows our segment guidance for 2017. We now have four segments having segregated or split Electronic Systems effective March 1 into potential systems and the new electronics systems. So there are the four segments.

In terms of our cash deployment you see that we continue to have a balanced deployment strategy which starts with paying a cash dividend and we increased it \$0.05 per quarter early in February. We've been increasing it at that rate for the last eight or nine years, and I expect that we will continue to have modest dividend increases over the next several years.

And then I talked about the acquisition and the placeholder for the combination of share repurchases and acquisitions of about \$0.5 billion for 2017. We don't expect to have to make any additional debt reductions or debt repayments like we did in 2015 and 2016 after having stabilized our investment grade credit ratings. And now the business is growing again, so that leads to natural deleveraging as we grow operating income.

And we expect to end the year with about \$450 million of cash on the balance sheet. We do not need \$450 million to manage the business. So if the opportunity arises we could deploy some of that to make more acquisitions.

Here's a look at our capitalization and leverage or the balance sheet if you will. The trends here are all improving. Our growing cash balance is improving leverage metrics.

We expect that our debt to EBITDA or the leverage ratio will be down to about 2.5 times by the end of 2017. And we continue to have our full \$1 billion revolver available to us. And we renewed that for another five years at the end of last October.

So to summarize we believe that we entered a new DoD budget up-cycle last year which is great news for L3 because we are mostly a US government contractor, DoD contractor. We believe that our products, solutions and technologies are aligned with our customer priorities and at very affordable prices which is important in the competitive markets that we operate in. And we are focused on satisfying our customers and continuing to grow the Company and generating robust cash flow and using it, deploying it to further enhance and grow and increase shareholder value.

So that concludes my comments. Happy to answer your questions, Seth. I know you have a lot of them.

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**Seth Seifman - JPMorgan - Analyst**

Yes, that's right. Thank you, Ralph. Thanks for the overview and we will move into Q&A, and maybe I will start off asking a few questions and then we will open it up to the audience, as well.



So maybe we will just start off since there has been a lot of news out of Washington today or recently, your take on the development there. We are looking tomorrow at potentially a budget release for fiscal 2018 along with some more information about fiscal 2017 supplemental. What are the key things that you are looking for both tomorrow and in the coming months?

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

Well, very simply we are looking for more details about the defense budget not only for FY17, which we are almost six months into FY17 and still operating under a continuing resolution authority. That said, as the news about an additional supplemental request that the Trump administration will likely provide details on tomorrow or very soon, it's expected to be \$20 billion to \$30 billion above the Obama administration's initial request of \$59 billion. So that works out to another 3% or 5% growth in the FY17 budget depending on where that \$20 billion to \$30 billion shakes out.

Obama, the Obama administration had a request to the FY17 budget to be about flat versus FY 16 which grew about 4%. So we think we are going to have a growing budget again in FY17.

And for FY18 a few weeks ago there was some news on what the base budget will be, which was about \$580 billion which was a \$20 billion or so more increase over what the previous administration had requested or projected for the base budget in FY18. But we need to know what that OCO budget is as well for 2018. You need to look at the budget in its totality: base plus OCO.

We think we are going to have growth. That's probably going to work out to high low single-digits or mid-single-digits growth over the next several years. And we will learn more about that over the next month or so.

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**Seth Seifman - JPMorgan - Analyst**

Great, thanks. And then zeroing in maybe a little bit on the issue of readiness and O&M funding which you touched on in the presentation, if we look at your revenue profile for L3 of the almost \$11 billion of sales companywide it's probably \$7 billion and change to DoD and then if you take what's in there for O&M it is probably somewhere in the mid-\$4 billion range. And when I think about what is exposed to readiness with L3 and what's in the O&M budget, I think of those as coinciding.

Is that A, the right way to think about it? And then when we think about what's in that mid-\$4 billion chunk of O&M revenue you've got Vertex is probably \$1.3 billion, \$1.4 billion. And then what are some of the other big pieces of that that we should be looking at as we think about where we could see growth in the nearer term as a result of some of these changes in the budget that are coming up?

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

Okay. So, first of all, you are correct. More of our DoD sales come out of the operations and maintenance account which funds readiness. So we are about 63% operations and maintenance and the balance in procurement in RDT&E in our US military business.

So we do have good exposure to readiness. We also have good exposure or high correlation to four structure levels because not only do we do a lot of work to train the forces which I talked about earlier whether it be simulation and training devices out of our Electronic Systems segment or the maintenance and sustainment of training aircraft in the Vertex business in the Aerospace Systems segment, but we also supply communication terminals which are used by all the forces, night vision equipment, image intensification equipment and we also do a lot of work in terms of tactical ISR.

So those are the key areas, plus special operation forces support, that are highly correlated or levered to readiness, an increasing readiness support activities. So there's been a lot of talk about the need for more readiness. Also the fact that we are going to start growing the fourth structure again, which is good news for the Company.

So we look forward to hearing those details. But those should all fuel continued organic growth in our US military business.

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**Seth Seifman - JPMorgan - Analyst**

And then you provided some helpful details about the recompetes and the opportunities coming up at Vertex this year. When you think about the work at Fort Rucker with the helicopter training fleet and you had spoken about this on our conference call that the contract type was a little bit different than expected, and it introduces



some more uncertainty as to whether you keep that work, if that work goes away, should we think of that as an annualized EPS headwind of something in the \$0.20 range?

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

It's about that. It's about \$0.20, maybe a little more than \$0.20 when you factor in the overheads that contract absorbs.

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**Seth Seifman - JPMorgan - Analyst**

Right. Okay. And when you think about Vertex going forward, I guess there's a whole range of outcomes with the recompetes and the new opportunities coming up this year.

If Vertex was to exit 2017 without the Fort Rucker work and without the additional special operations were, how do you think about the future of that business? Do you still see opportunities out there to add new business at acceptable profit margins?

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

The short answer is yes, we do see a lot of additional opportunities to grow that business organically. And we think that we will grow that business organically. We are not contemplating making any acquisitions in that area at the present time.

There are a lot of other opportunities over the next couple of years in terms of new business pursuits, which will mostly be competitive takeaways. But if this dynamic of increasing readiness support comes to pass, that's going to benefit the Vertex business. So we see that happening, which should be good news for Vertex regardless of the outcome on the Fort Rucker contract recompetition.

So we will see what happens. We like our chances there, but that's going to be an intense competition just like the special operation forces contract competition will also be.

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**Seth Seifman - JPMorgan - Analyst**

When you think broadly about all of your work and the change that was made to the Fort Rucker contract in terms of making, putting more risk on the contractor basically, and we saw the evolution of the TX competition in recent months which caused two of the bidders to leave the competition in part because, I think because of what was expected of them during the development phase, a separate issue we've seen the criticism of the F-35 program from the President. When you think about all these things, are they a coincidence? Or is there a more concerted effort on the part of DoD to deal differently with contractors?

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

So I think the dynamics of what happened on the Fort Rucker recompetition and on the TX competition, those are coincidental. We don't see any special trend or new emerging trend there. Obviously, we know a lot more about Fort Rucker because we are the incumbent on that contract.

And what happened there due to some changes on the contracting or procurement side the new contract competition was shifted from one part of the Army to another component, that new component mostly dealing with procuring services for installation or Army base management. That work is typically transacted on a fixed-price basis for obvious reasons. We don't think it makes a lot of sense to procure sustainment and maintenance of aviation equipment or helicopters in this case on that basis. It just is totally different in terms of risk levels and what's required by the Army. So that's why we talked about being surprised or displeased about the contract going from core reimbursable to fixed priced on the new contract. But, again, I think that just was an unusual item on the circumstances for that contract.

No particular new trend emerging in terms of contract procurement. And certainly no relationship to what's happening in the TX competition from what we see.

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**Seth Seifman - JPMorgan - Analyst**



Right, right. Okay.

You guys increased your R&D spending last year and you mentioned in the presentation taking it up again. In a growing budget environment as a merchant supplier in a lot of your work on the product side, do you see opportunities to drive the R&D significantly higher and do more commercial-type contracting with products that you have developed in-house?

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

So we did increase our R&D in 2016 by about 13% or \$30 million more than we spent in 2015, and we also expect to increase the IRAD again in 2017 by at least 10% or \$25 million over 2016. That is because we are making investments to grow the business organically. A lot of that new investment is happening or geared toward growing our US government classified business, and I commented earlier that we see the classified budgets not only growing but also expanding.

And today about 15% of our US government business is classified. So we see that growing and good opportunities, and that's where a lot of the incremental R&D is going.

In terms of commercial contracting and pricing models, I don't really see our US military business changing more towards that. So that's not why we are putting more money in R&D, we are investing to grow the business organically.

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**Seth Seifman - JPMorgan - Analyst**

Great. Can you talk a little bit about the outlook for international sales across the Company, and if US allies were to step up their spending where you think L3 might benefit most? And then specifically we are in a down-cycle in terms of the ISR Systems business internationally, but when you see that turning around.

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

Sure. So last year our international sales declined a little more than 10% organically. This year our guidance calls for them to decline about 3%. And we said earlier in the year that depending on what happens with some new business pursuits we could actually have flat or modestly growing international sales in 2017 and that by the time we get the next year, we should start growing our international business again.

The two main reasons that we are in this trough, if you will, when it comes to international sales, you talked about one of them which is the main reason which is the where our large foreign customers are in terms of procuring ISR aircraft including upgrading those aircraft. We have several customers that are in a lull right now. Some contracts continue to near completion, but we see that ramping and starting to grow again over the next few years, certainly by the time we get toward the latter part of this decade.

And then in 2015 we had a large communication terminal sale to Australia. That didn't repeat in 2016, but we see those sales, some more sales of terminals happening in 2017 and more in 2018. So those are the two main reasons.

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**Seth Seifman - JPMorgan - Analyst**

Okay. Maybe at this point I will just look out to the audience and see if there are any questions from the room. Or we can keep going up here, as well.

And maybe let's talk a little bit about the security and detection business because that's something that is kind of unique among the bigger defense contractors. And you've done some deals here recently, business probably up to about \$0.5 billion or so this year, I would say.

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

This year we should do about \$550 million including Implant Sciences.

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**Seth Seifman - JPMorgan - Analyst**



Excellent. And so can you talk a little bit about the organic growth prospects for this business as we move out beyond 2017 including everything that you've acquired recently?

And how much of that growth comes from the fact that this is a growing market? How much of it comes from any refresh cycles?

And also maybe a little bit about the competitive landscape. We know some of the other companies that are here. I guess how you are thinking about this particular market playing out over the next three to five years?

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

Okay. We see our aviation security business growing this year organically about 6% or 7%. And with the acquisitions it's going to grow over 50%, and we just talked about that.

That growth is coming not only from the need to recap existing security detection systems in the airports not only here in the United States but overseas, but also there is a demand or new investment required to increase passenger throughput through the aircraft, through the airports, not the aircraft, as well as continuing to enhance security within the airports including at the perimeter of the airports. And there were some unfortunate events that happened in that area over the last year or so. So we see incremental investment happening in those areas in addition to the equipment recap cycle.

There has been some consolidation. We've done some of it. Smiths has done the rest of it, I guess, over the last year.

But that said, there's still healthy competition in this space and we see ourselves as a leader, obviously a stronger, more diverse player with the two acquisitions that we made where we can provide our customers with more integrated, complete solutions when it comes to security. So we really like our prospects in this area, aviation security, over the next several years.

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**Seth Seifman - JPMorgan - Analyst**

And when you think about just looking at when we look here at commercial aerospace companies and you think about where growth is in aviation, the biggest chunk of the pie in terms of revenue passenger miles now is in Asia. It's also the fastest growing. Are there opportunities there on the security side?

Does the fact that so much of the growth in air traffic is coming from there mean anything in terms of the security opportunities? And also I assume there's not at this point any homegrown competition there yet. Is that fair?

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

There are one or two players, mostly on the lower end of the security screening equipment market. But we do see that as a key growth area for our commercial aerospace business. Not only have we won new business in terms of security screening systems, but we have also had some very good awards in terms of selling aircraft simulators and training services into the Asia-Pacific market over the last six months or so. And clearly that's where most of the growth is coming in terms of passenger miles and equipment and security screening and training, obviously. So that's the key growth driver for the space.

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**Seth Seifman - JPMorgan - Analyst**

Can you talk a little bit about the M&A environment? L3 was back to doing deals last year, and when you look out to this year how you think about what's out there now. Does the rising budget cycle change the number of opportunities that are out there, the multiples that are out there? Maybe just an update on the M&A opportunities.

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





Okay, so we are, we have returned to acquiring companies. We also acquired four companies in 2015, but we had a lot more on the divestiture side that year. And we expect that we are going to continue to make acquisitions.

Generally the beginning part of the year is seasonally slower in terms of M&A activity, particularly in the private markets where we do most of our acquisitions and we expect that we will make more acquisitions this year. We are looking at a few smaller companies at the present time. And that should change as the year progresses, and if it doesn't we will be patient and look for good opportunities because eventually they will emerge.

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**Seth Seifman - JPMorgan - Analyst**

And maybe I will just check one more time and see if we have any questions in the room. Okay. Well, we will continue. I guess one question I had just in terms of looking at the financials last year and what you guys disclosed is that in the 10-K, you had EAC adjustments were a strong contributor to profits last year, stronger than usual.

Is that a change that maybe we will see continuing going forward? What accounted for that? And how did that evolve over the course of 2016 and what do we expect?

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

Sure. So generally speaking, or first and foremost, I would say that we did have much better contract performance or program execution in 2016 compared to the last couple of years before that. And one place where you see that is in the net aggregate adjustments to EACs. So they were much higher in 2016 and that continues to be a key focus area for the Company in terms of growing or improving our operating margins.

We have been talking for a while, at least a few years, that we generally have always had very good contract performance from the customer or operational perspective being on time and on budget with the solutions that our customers need. But we also talked about our objective to also improve the financial returns on our contract performance because that really is the key driver for improving operating margins in addition to top-line growth.

So that's been a concerted effort across the Company and all the business units and segments. And that better contract performance manifested in 2016 and we hope to continue that not only in 2017 but in the future, as well.

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**Seth Seifman - JPMorgan - Analyst**

And then we talked a little bit about ISR Systems on the international side, but on the domestic side with the JSTARS replacement coming up, is that one of the bigger opportunities for L3 going forward? And how are you positioned in that area of domestic ISR Systems?

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

Well, ISR Systems is a key business area for L3. So we expect that we are going to participate in a meaningful way in terms of the recapitalization of ISR aircraft, both here in the United States and overseas. We do see a trend where the next-gen platforms are going to migrate to business jets and we expect to be a player, significant player in that regard.

On JSTARS we are not the incumbent, as you know, but we are on the team of the incumbent. So it's an opportunity for L3. It's not a key driver of our growth companywide or in Aerospace Systems, but it is an opportunity that we are teamed with the incumbent on that contract.

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**Seth Seifman - JPMorgan - Analyst**

I think at some point last year maybe we had been talking about an opportunity for teaming with the business jet OEM. Is that something that still potentially out there?

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



It is definitely out there. And it's happening as we speak, but those are competitive sensitive situations. So I'm not going to get into any details in terms of the teammates and the actual procurements, but we expect to be a player, a significant player on the new ISR biz jet platforms.

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**Seth Seifman - JPMorgan - Analyst**

Excellent. Okay, and with that I think we are running down toward the end here.

So maybe we will wrap up. But Ralph, thanks so much for being with us. We really appreciate it.

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

Thanks for having us, Seth. Good day, everybody.

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