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LHX.N - Q2 2020 L3harris Technologies Inc Earnings Call

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OVERVIEW:

Co. reported 2Q20 YoverY organic revenue growth of nearly 2.5% and non-GAAP EPS of $2.83. Expects 2020 organic revenue growth to be 3-5% and non-GAAP EPS to be $11.15-11.55.

CORPORATE PARTICIPANTS

Christopher E. Kubasik *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

Jesus Malave *L3Harris Technologies, Inc. - Senior VP & CFO*

Rajeev Lalwani *L3Harris Technologies, Inc. - VP*

William M. Brown *L3Harris Technologies, Inc. - Executive Chairman & CEO*

CONFERENCE CALL PARTICIPANTS

Carter Copeland *Melius Research LLC - Founding Pf5XFrn, Presidentlans ResearchAnalyst of Aerospaice& DefenseP* of non-GAAP financial measures to comparable GAAP measures is included in the Investor Relations section of our website, which is l3harris.com, where a replay of this call will also be available. And to aid with year-over-year comparability following the L3Harris merger, prior year results will be on a pro forma basis.

With that, Bill, I'll turn it over to you.

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Okay. Well, thank you, Rajeev, and good morning, everyone. I want to start by thanking L3Harris employees for their hard work and dedication over the last several months. The pandemic has challenged us all to find new ways of working effectively, and our team has responded well to ensure we continue to meet the mission-critical needs of our customers, even as the virus spreads across southern states where we have a large presence. And as the environment evolves, the health and safety of our employees will remain our top priority. All of our facilities are up and running and adhering to well-established protocols such as daily health screenings, face coverings, social distancing and adjusted work schedules. Our work-from-home policy remains in place for about half our workforce, and we are prepared to operate under these conditions over the coming quarters.

We continue to pay close attention to our supply basesie we have a large

market is a significant differentiator compared to legacy systems to take nearly a decade to become operational. As warfighting capabilities accelerate in the space domain, we are well positioned to participate and capture new business and have a strong pipeline that exceeds $10 billion to support growth in the medium and long term.

On Slide 8, Communication Systems revenue was up about 2.5% for the quarter, as DoD tactical and Integrated Vision Systems benefited from modernization demand, both were up double digits. This strength was partially offset by international tactical radio sales timing and headwinds in our Public Safety business, both of which were down in the mid-teens, consistent with prior expectations. Segment operating income was up new awards. On international, we're holding our flattish view for the year based on our second half visibility, with upside opportunity in ISR. So overall, relatively minor changes with a clear line of sight to our sales outlook, which is supported by a funded book-to-bill of 1.1 in the first half.

Shifting to margins. We've increased our outlook to 17.5% plus, with the plus indicating potential upside of 10 to 20 basis points versus the prior guidance of 17.5% due to performance to date, cost synergies, E3 progress and expense management. Margins stepped back in the second half versus the second quarter due to higher R&D investment as well as a placeholder for higher COVID-related mitigation costs or disruptions but still, continued margin expansion progress on the full year of nearly 100 basis points. On EPS, we're holding the full year guidance range of $11.15 to $11.55 with the contingency at the midpoint from the margin upside to account for the uncertain backdrop amid the pandemic's progression. On capital allocation, we're in a strong cash position and should remain so after completing our committed repurchases with divestiture proceeds here in the third quarter.

Beyond that, we'll continue to monitor market conditions for deployment opportunities such as capital returns and employee pension plan contributions.

Moving to free cash flow. Our guide of $2.6 billion to $2.7 billion remains intact, with similar upward pressure from earnings upside, working capital traction and lighter CapEx. Finally and briefly on the segment outlook. We've maintained our guidance for all line items, but for margins at IMS, where we see likely upside. The improvement is coming from synergy drop-through and operational excellence via E3 productivity, both year-to-date and going forward. So a great example of the merger benefits.

So to put it all together, a solid growth outlook supported by our year-to-date performance and forward visibility, with an upside bias assuming a stabilizing environment. And with that, I'll ask the operator to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Seth Seifman with JPMorgan.

Seth Michael Seifman - *JPMorgan Chase & Co, Research Division - Senior Equity Research Analyst*

Bill, you talked in the slides about the potential for cash flow growth beyond '22, and you mentioned the working capital. I just wanted to confirm, a, is that the chief source of cash flow growth in those out-years, number one? And b, are there others? And if so, kind of what are they? And if you could speak a little bit, maybe qualitatively to the magnitude and relative importance of those other drivers.

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Yes. So Seth, thanks for the question. So between now and '22 time frame, mid-single-digit plus type of revenue growth that we expect because we're seeing good visibility in the '21 budget, which we think is going to get passed some time in the next 6 months or so. Our programs are very well supported there. A lot of unspent dollars from prior years, good opportunities on revenue synergies, growth opportunities international. So deploy it in the near term, certainly in the next year or so towards share buyback that will reduce our share count. So overall, you put all those pieces together, we continue to see double-digit growth in free cash per share.

Operator

Our next question comes from the line of Robert Stallard with Vertical Research N 6CE 648 lvUo6,94 N 6 rg0,94 N l rg0,94 736 647,94 736 76 647.5 l576 648 l

Carter Copeland - *Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense*

So I wondered -- or Chris, I wondered if you might tell us a little bit more about this -- the comments on trimming the IRAD pipeline or narrowing the focus of that IRAD pipeline. Just help us think through the prioritization in that thought process. Are you looking to prioritize capabilities or ROIs or customers? Any granularity you can give us on how you're thinking through that process?

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Carter, it's a great question. And really, I'm glad you asked it because I think it's a fundamental part of the value creation story that we have in front of us. We've been talking about this for a couple of years of taking, as Chris has mentioned, $700 million worth of IRAD that previously was distributed very deeply and broadly across the company, not centrally coordinated, no clear business rationale across the individual investments. And through the work that the CTO, Ross, has done here to really get at and categorize where all that money is going, we looked at it, and we saw 30% of the projects that were -- didn't have a business case or were overlapping, were duplicates. And we've provided to investors some examples of that. So it allows us to focus that firepower that's pretty potent on a smaller set of opportunities really around the areas around multi-function open systems architecture, software-defined everything. That really is the heart of what we're trying to do.

In spectrum superiority, sensing solutions delivering actionable intelligence, that's where we're really focused. And as I think about this, that is going to enable us to continue to invest in these new opportunities that we're seeing coming through in revenue synergies. We've won quite a few here. They're small today in terms of revenue impact. They'll grow over time. But the pipeline is large, it's getting bigger and really positions us in, I think, in a fundamentally different way. So when you think about value creation potential into the future for a technology company, we call it L3Harris, this is fundamental to the value creation story.

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

Yes. And I'll just chime in, Carter. I mean this is what we've been talking about for almost a year. And internally and externally, this is about optimizing look to the back end of the year with $1.3 billion, $1.4 billion-ish in free cash generation in the second half, we'll end the year with a pretty strong balance of cash in the $1.7 billion, $1.8 billion kind of range. So still opportunities beyond that for deployment.

As we've been talking a lot, we see that growing to $3 billion by '22. There's no debt paydown requirements at all. We'll refinance some debt, but at a 1.7 going to 1.5 leverage ratio. We've got, I think, a good leverage basis. We don't see any significant M&A on the near-term horizon. So it gives a lot of opportunity to deploy upward to $3 billion every year in free cash generation back to owners as we said we would. And that, just to remind everybody, is after significant investments in development internally, hiring people, training people, spending investment on capital; driving IRAD to close to 4%, as Chris mentioned a couple of minutes ago; significant investments inside the company, even with that give us an opportunity to deploy that cash effectively with shareowners.

Operator

Our next question comes from the line of Gautam Khanna with Cowen.

Gautam J. Khanna - *Cowen and Company, LLC, Research Division - MD & Senior Analyst*

I wanted to ask, Bill, if you could maybe numerically express the revenue synergy opportunity in some reasonable time frame. So whether it's '22 and '23, what should we be anticipating what you're going to get incrementally from some of these captures you're pursuing that combine the capabilities of L3 and Harris? And how do you see that playing out over the next 5 or 10 years? If you could just give us a quantification of it.

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Yes. So again, we won 13. It's in the tens of millions of dollars, and it's actually growing. It's -- we're seeing good traction there. It's -- you'll see it a little bit in the '20 results, will start to grow in '21, a little bit beyond that. The pipeline itself is north of $5 billion, and it's growing every time we meet with the team. And it's pretty substantial. The opportunities that we won are in the $1.5 billion to $2 billion of lifetime revenue. So I would expect -- I don't want to commit to Chris and Jay to something here, so maybe I'll let Chris jump in here. But I would expect that it will be something growing north of $100 million a year. But Chris, maybe you could...

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

Yes. No, I'll sign up to at least $100 million a year. And would you say 10 years from now? No. As Bill said, it's growing better than we expected. And we have a very strict definition of what we're calling revenue synergies. These are bids that neither company would have submitted had we not merged together. So we're getting the momentum. A lot of these are the initial wins, some from DARPA, some from Rapid Capabilities Office. And then we got to win from 4 to 2, 2 to 1, but we like the momentum. And I would expect that this will contribute to our top line growth for the foreseeable future. And we'll quantify it for you as we start to move up and get some of these wins.

Operator

Our next question comes from the line of Doug Harned with AllianceBernstein.

Douglas Stuart Harned - *Sanford C. Bernstein & Co., LLC., Research Division - SVP and Senior Analyst*

If I think back, Chris, to what L3 look like not that long ago, and you had all of -- with an 80-or-so businesses with overlapping overhead functions and the sense of need to rationalize the supply chains and facilities. And if we roll forward, where does -- where do things stand today in terms of addressing a lot of the opportunities on cost that you had before? Because I'm just -- you continue to find new cost synergies. So I'm trying to figure out what the pathway looks like in terms of the things you've gotten done, the things that are still to go here and where you can potentially be.

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

Yes. No, that's a great question, Doug. And I'd say we made really good progress in the last 13 months. But a lot of the progress we made was a result of starting early, even premerger. I'd say we're ahead of schedule on the synergies that we talked about. But everything that we've looked at shows continued margin upside and cost takeout opportunities well beyond the initial 3-year period. The facility consolidations are ongoing. Those will take the most time, as you would expect. I think we've made great progress on the supply chain. And that's just something we're going to continue to work on year after year. And also not only on the value capture, but improving the resiliency given some of the recent challenges in the COVID environment.

So if this were a baseball game, we're probably in the second or third inning, as I see it holistically and really hitting the ground running on day 1. The benefits of the HR and all those initiatives were done on the first cycle, which was pretty impressive. So I think there's a lot more to go. And we see this as part of our culture of operating excellence, and it's just going to go year after year, and I think there's a lot more to go.

Operator

Our next question comes from the line of Sheila Kahyaoglu with Jefferies.

Sheila Karin Kahyaoglu - *Jefferies LLC, Research Division - Equity Analyst*

Bill, I think you mentioned 6 businesses with high working capital, and you quantified the opportunity, which is quite big at $500 million. I'm guessing the size of these businesses might be fairly large. But is there anything structurally different about them? And how do we think about that working capital drive-down contributing to intermediate results?

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

There's nothing structurally different about them. What's happening is we're getting into a lot of detail of what's driving the working capital to be where it happens to be. And as I mentioned, a lot of it is inventory. Sometimes, inventory is north of 100 days. And it's about just prudent management, improving forecasting, improving the performance with suppliers because of lack of confidence in when a supplier is going to deliver a component drives management to increase buffer stock. It's managing better the development of new product so that you are leveraging components that exist across other products. So you reduce sort of both SKUs as well as the parts that go into the SKU. So it's really across all of those fundamental pieces.

Chris, and I and Jay have a weekly -- and just right next to our integration meetings is the focus on working capital, and we've been doing this since day 1. We've got dedicated teams focused on this. It's driven by the general managers themselves. The teams are incentivized to improve cash. We incentivize them to drive working capital. So we expect to make a big achievement in those 6 businesses, but the reality is we have 19 different sectors, all of which have opportunities to improve working capital, and we're going after every single one of them. That's what gives us confidence of taking the 55 to below 50 and hitting 40 over the next couple of years.

Operator

Our next question comes from the line of Richard Safran with Seaport Global.

Richard Tobie Safran - *Seaport Global Securities LLC, Research Division - Research Analyst*

So Bill and Chris, I thought -- I had another question on your revenue synergies. I thought you might try to explain the driver of the revenue synergies. And if they continue, why the potential is north of $5 billion and why they've come so much earlier than expected? To me, Pentagon is giving

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awards to nontraditional players in major platform markets. You have SpaceX with launchers and you recently with Maritime. So is that the driver here, why you stand to benefit? Is the Pentagon looking for more competitors and bringing in nontraditional players? And I guess, is there room now for moving LHX to the next level as a sixth prime?

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

Bill, I want to circle back on the budget kind of topic. We get a lot from investors about maybe L3Harris' exposure to kind of the OEM -- O&M side of the budget, and I think it's reasonably high. How should we think about that part of the budget if that -- if the overall budget starts to compress, how that impacts you? I know there's a lot of ISR missions and activities that flow through there. But maybe just some color on how we should think about that.

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

Well, it's -- I think we size it in the 40%-ish range of our business is O&M funded. I think in this year, the DoD is underrunning the spending on O&M. So it does create actually some additional opportunities for O&M dollars. And you mentioned that exactly right, some of that does fund some of the ISR missions that we happen to have here. So we think we're well positioned on that. I don't think it's a major concern as we go into '21. I don't know, Chris or Jay, if you have any thought on that but...

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

No. I think it's just good diversity in various sources of colors of money, I think, is actually a strength. So yes, I echo what Bill says. We're -- I think we're in good shape.

Operator

Our next question comes from the line of David Strauss with Barclays.

David Egon Strauss - *Barclays Bank PLC, Research Division - Research Analyst*

Bill, I wanted to follow up, you mentioned E3. If you could maybe talk about what kind of organic margin upside you've seen so far from E3. How much further do you think it can go? And then on the synergy side, you said a bunch of times, there's upside to $300 million. Any sort of quantification of how much upside there could be beyond that?

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

So David, look, we're making really good progress on E3. In fact, at L3, Chris instituted a program called L365. We had our own program here at Harris HBX. The combination of it, I think, has yielded a process, internal process that's been driven deep into the organization. We typically would expect something like 2% to 3% net of inflation that are given back to the customer as well of cost coming out. And we're seeing E3 in that range. Over the course of the year, it's getting a little bit better. I think we would sustain that in '21 and '22, so that sizes it a bit.

As we get beyond the calendar '22 time period and integration starts to wind down in terms of that focused process, the drive to achieving cost savings will continue. It all merge into what we now call E3. So we do expect to hit $300 million net in '21. We do see opportunities beyond that. Some of the things that Chris mentioned a minute ago about facility rationalization, they do take a bit longer. They won't be fully complete in '21. So we'd see a little bit of step-up in -- beyond '21 on just the consolidation of the facility. So we can't really size it today. As we get further down the path, we'll continue to update investors on this. But as you think about where we've been over the last 6 months, we started out the year guiding to about $115 million net. We went up to $165 million and now we're at $185 million in an environment that's very uncertain with the COVID pandemic. So we continue to make great progress here, great progress on E3. And all of this is going to drive us north of 18% margin next year with some upside beyond that.

Operator

Our next question comes from the line of Pete Skibitski with Alembic Global Advisors.

Peter John Skibitski - *Alembic Global Advisors - Research Analyst*

Just on the really strong second quarter margin rate at IMS. Was there any one-off benefit in there? And it looks like guidance is assuming kind of a lower rate sequentially in the second half of the year. Jay kind of touched on it a little bit. But any color that you could add there?

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Sure, Pete. Really strong synergy drop-through, over 200 basis points. They do have a benefit of pension running through because that's predominantly legacy L3 business. But they also had strong productivity, E3 productivity dropping through which pretty much offset any mix headwinds, and a little bit slower on R&D there. And as I mentioned, we expect R&D to step up in the back half of the year. For the full year, they're just -- they're doing well. We originally had 13.5%. It does step down, as I said, for the R&D as well as a little bit of a mix as we induct some aircraft. But bottom line there, you're going to see some solid margins there, around 14.5% for the year.

Operator

Our next question comes from the line of Michael Ciarmoli with SunTrust Robinson Humphrey.

Michael Frank Ciarmoli - *SunTrust Robinson Humphrey, Inc., Research Division - Research Analyst*

Maybe just to stay on that R&D. Looking at the second half margins, they obviously come down a bit. You talked about that COVID placeholder, and I think you called that out maybe as a contingency in the earnings bridge. So maybe that's $10 million or so. But how big -- how do we think about the R&D step-up? And I guess I'm thinking about it too in the context, you're talking about 30% of IRAD, but it sounds like cutting 30% of that IRAD, but it sounds like some of that's just going to be reinvested. Is that the right way to think about sort of the reprioritizing of the IRAD and kind of funneling it back into higher areas of opportunity?

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes. A lot of the reprioritization occurred as part of our planning process for the year. We're going to step up around 3.5% to about 3.7% in the back half of the year. And what we're talking about as part of the CheckPoint process is really just a process for defining and prioritizing those projects. There might be some timing differences here and there, and we continue to monitor them as part of that process. But there's not been any type of effort to actually reduce R&D spend as we dealt with some of the headwinds with COVID, and that's really been more other expense type of discretionary spend items that we've been dealing with. And so our goal has been to hold our R&D and protect the investment and for all the items and revenue synergies that Bill referenced before.

Christopher E. Kubasik - *L3Harris Technologies, Inc. - Vice Chairman, President & COO*

And I'll just chime in with the 1.19 book-to-bill in IMS specifically. A lot of these, as you know, start out as more developmental programs. And then over the course of the life of the program, you get into low-rate production and ultimately, production and the margins increase. So a little bit of the second half pressure is coming from some of these recent maritime wins, which are good margins but dilutive in the near term, but will ramp up as we continue to deliver on them.

Operator

Our next question comes from the line of Robert Spingarn with Crédit Suisse.

Jesus Malave - *L3Harris Technologies, Inc. - Senior VP & CFO*

So on taxes that the impact in '22 is north of $500 million if the loss stays as it is. As you know, others as well as us believe that, that wasn't necessarily the intent of the legislation, to penalize R&D investment. And so that's something, obviously, we're continuing to work. But just to answer your question specifically, it will be north of $500 million.

On pension, if you look at gross pension this year, it's about $300 million of benefit. Year-over-year, it's about $60 million. It's $100 million in the FAS pension benefit that's offset by about $50 million of lower cash recovery. And so net-net, you're talking about $50 million, $60 million. Right

William M. Brown - *L3Harris Technologies, Inc. - Executive Chairman & CEO*

And certainly, there's not -- we're not beholden to a platform. There's not a loss -- risk of loss of revenue from moving from proprietary to open systems. We're building the organization from the start with a focus on open systems architecture, which we believe is an opportunity for us and certainly what we're geared to do.

So I want to thank everybody for joining the call today. And I'd like to close by, again, thanking our employees as well as the leadership team for their hard work, for their dedication as we wrap up our first year as L3Harris and for continually meeting customer commitments during these very challenging times. So thank you to everyone and be safe. Thank you.

Operator