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LHX.N - Q2 2021 L3harris Technologies Inc Earnings Call

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OVERVIEW:

Co. reported 2Q21 EPS of $3.26. Expects full-year 2021 organic revenue growth to be 3-5% and EPS to be $12.80-13.00.

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

Well, thank you, Rajeev, and good morning, everyone. I'd like to thank the entire L3Harris team for a job well done as we began our third year as a new company.

We are executing the integration plan and have exceeded many of our targets despite challenges such as the pandemic. The high-performance culture and leadership team we've created are set to carry this momentum forward, which is reflected in today's results.

We reported a strong second quarter. Organic revenue was up over 6%, with growth across our key end markets and all 4 business segments. Funded book-to-bill was 1.0 for the quarter and 1.05 year-to-date. Margins increased to 18.6%, resulting in EPS of $3.26, up 15%. We had solid free cash flow of $685 million, which contributed to shareholder returns above $1 billion dollars, including repurchases of $850 million in the quarter and over $1.5 billion year-to-date.

Our first half performance, coupled with our expectations for continued execution in the back half, more than offset the divestiture headwinds and supports another raise to our EPS guidance, which Jay will cover. Execution against our strategic priorities, that are on Slide 3, continue to deliver results and create value for the company's stakeholders as we make progress and build momentum with top line opportunities, operational performance, announcing and closing divestitures and delivering on our capital return commitments.

In terms of the top line, we had our best quarter since the start of the pandemic, with progress against our key end market growth objectives, while seeing data points that validate our focused R&D strategy. Our government businesses were up 6% in the second quarter, driven by double-digit growth internationally. Our international revenue benefited from increased aircraft ISR and radio sales to regions in the Asia Pacific and Europe.

And on the domestic front, the growth was broad-based with our responsive space and maritime programs as well as land modernization for night vision and SATCOM products leading the way. Our strategy to deliver end-to-end mission solutions utilizing the capabilities and scale across the broader organization continues to gain momentum. Our space business strategy is working as we grew 10% in the quarter, capturing classified awards totaling over $300 million for ground and responsive satellite solutions. These awards are also part of the revenue synergy capture efforts and bring awards to date to over $700 million on a win rate of 70% from our growing $7 billion-plus pipeline.

Turning to our Commercial Aerospace and Public Safety businesses, they were up over 5% in aggregate and were led by our Commercial Aerospace business up double digits off a low base and from strength in product sales. On the Public Safety side, there was a modest decline, but with sequential improvement and increased bid and proposal activity from a more stable backdrop.

Our solid top line was accompanied by backlog growth as we continue to win strategic programs that includes several prime roles. Backlog increased 7% organically year-over-year to over $20 billion, with notable award activity across all domains.

On the space side, our revenue synergy awards came from combining electronics and optics capabilities across the company to deliver solutions for an increasingly contested environment. These are incremental to the pathfinder programs we previously won, which have billions of dollars of potential over time. Customers are viewing L3Harris as a trusted disruptor. They see us as a company that understands the complexity of the mission and can offer fresh and creative solutions. With a 3-year space pipeline of nearly $20 billion, there's more opportunity for continued growth.

Within the air domain, we strengthened our existing F-35 franchise with initial production awards for the Aircraft Memory System and the Panoramic Cockpit Display Electronic Unit under the TR3 program. This brings total orders year-to-date on the platform to about $500 million. We're progressing on all 3 TR3 systems through integration and qualification this year, and in support of the planned lot 15 cut in of the production hardware. We also secured a roughly $100 million IDIQ with SOCOM for infrared EO sensors on rotary platforms furthering our modernization opportunities across L3Harris.

Moving over to the land side. We signed several key contracts that touch both international and domestic markets. First, we received a $3.3 billion 5-year IDIQ for foreign military sales to a range of partner countries from our new broader portfolio of products, including radios and SATCOM

So to wrap up, I'm pleased with the execution against our strategic priorities, confident in our ability to consistently deliver double-digit EPS and double-digit free cash flow per share growth, and I'm excited about the next phase for L3Harris.

With that, I'll hand it over to Jay.

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

Thank you, Chris, and good morning, everyone. First, I'll provide more color on the quarter. I'll cover the segment results and finish with our updated outlook.

Starting with the second quarter. Organic revenue was up 6.2%, with a return to growth in all 4 segments. IMS led the way up 12%, followed by a return to growth at AS of 4.7%. Margins expanded 40 basis points to 18.6%, primarily from E3 productivity, program performance and integration benefits, partially offset by higher R&D. The sequential decline in margin was also due to timing of R&D as expected. These drivers, along with our share repurchases, led to EPS being up 15% or $0.43 to $3.26, as shown on Slide 5. Of this growth, volume, synergies and operations contributed $0.18, a lower share count contributed another $0.18 and pension, tax and interest accounted for the remaining $0.07.

Free cash flow was $685 million, while working capital days stood at 57 due to receivables timing. And shareholder returns of over $1 billion were comprised of $850 million in share repurchases and $207 million in dividends. Of note, our last 12 months of share repurchases have totaled over $3 billion at an average price of $195 per share, well below our current share price.

Now turning to the quarterly segment results on Slide 6. Integrated Mission Systems revenue was up 12%, led by double-digit growth in ISR aircraft missionization on a recently awarded NATO program. In addition to mid-single-digit growth in Maritime from a ramp on key platforms, including the Virginia-class submarine and Constellation class frigate. This more than offset the low single-digit decline in our Electro Optical business that was due to the timing of WESCAM turret deliveries, which we expect to increase in the back half.

Operating income was up 2%, while margins contracted 150 basis points to 15.3%, reflecting expected mix impacts, including a ramp on growth platforms and programs. Funded book-to-bill was 0.81 in the quarter and 1.06 for the first half with strength across the segment.

In Space and Airborne Systems, organic revenue increased 3.2% from our missile defense and other responsive programs, driving 10% growth in space, along with mid-single-digit classified growth in Intel & Cyber. This strength outweighed the impact from modernization program transitions in our airborne businesses, the F-35 Tech Refresh 3 program within Mission Avionics and F-16 Viper Shield advanced electronic warfare system.

Operating income was up 7.7%, and margins expanded 90 basis points to 19.7% as operational excellence, including program performance, increased pension income and integration benefits more than offset higher R&D investments. And funded book-to-bill was over 1 for both the quarter and first half, driven by space.

Next, Communication Systems' organic revenue was up 3.2% with mid-single-digit growth in Tactical Communications that included international up double digits, driven primarily by modernization demand from Asia Pacific and Europe and an anticipated decline in DoD from last year's second quarter 40%-plus growth. U.S. DoD modernization continued to benefit the integrated vision and global communication businesses, leading to high single-digit and double-digit growth, respectively. Conversely, broadband was down low single digits on lower volume for legacy unmanned platforms due to the transition from permissive to contested operating environments, as expected. And public safety was down 7% from residual pandemic-related impacts.

Operating income was up 8.3% and margins expanded 170 basis points to 25.5% from higher volume, operational excellence and integration benefits. And funded book-to-bill in the quarter and first half were about 1.3% and 1.1%, respectively.

Finally, in Aviation Systems, organic revenue increased 4.7%, driven primarily by our commercial aerospace business that was up 20% from recovering training and air transport OEM product sales. We also saw mid-single-digit growth in Defense Aviation from a ramp on fusing and ordnance programs and emission networks from higher FAA volume. Operating income was up 17% and margins expanded 200 basis points to 14.5% from operational excellence, integration benefits and higher volume. Funded book-to-bill was about 0.9 for the quarter and first half.

Okay. Shifting over to our 2021 outlook. Overall, organic revenue growth is unchanged at 3% to 5%, with our top line trending as expected at 4% for the first half and supported by a 1.05 funded book-to-bill year-to-date. Our U.S. government businesses are expected to accelerate in the back

And our first question is from Doug Harned with Bernstein.

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

I wanted to understand a little more about the outlook for Communication Systems. I mean you already had strong growing positions on radio modernization and night vision. And then you got some big awards in Q2, and those should add to growth, and I would expect this should be high margin as well. And so when you look at the longer-term growth here, look at the revenue trajectory over the next 3 to 5 years, how do you see that now? And is there a potential to take margins up above their current 25% levels here?

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

Yes, Doug this is Chris. Thanks for the question. And yes, you absolutely got it right. We've been quite successful in the communication segment of late, with some of those wins, not only here domestically, but internationally as well.

So I think what we're seeing is some upward pressure for revenue growth and margins over the longer term, like we've talked about before. We had a great quarter when you look at the book-to-bill and the continuation for modernization of the land forces, whether it's the radios, the night vision goggles, SATCOM, we're really in a good position. So maybe I'll throw it over to Jay to give you a little more color.

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

Sure. Just -- maybe just another quick comment on revenue growth over the medium term. Doug, if you recall, if you look at the future, it's somewhat similar to what we had this year. If you look at our segments, we had SAS at [4 to 6], IMS at 4 to 6 , and now it's followed by CS and AS. If you look to the future, we would expect the 2 -- those 2 top segments to continue to be the leaders in growth.

I will say, as Chris mentioned, that this gives us more confidence in the CS outlook, but we probably expect those 2 to drive a little bit higher growth than CS in the medium term. On the margin profile, you see this year, we are taking, from the first half, we are going back a little bit, and that's really a reflection of the mix on the new programs. We have the Army -- the HMS modernization programs. We also have in our broadband communication, the next-gen jammer program. So we have some pretty sizable programs that are actually margin dilutive.

The good thing about that is the team has a track record of being able to take cost out, drive the margins better over time. So if you look at the first half, it shows you what the potential of the segment could be. And so when we end the year this year, we'll be in that, say, 24 -- but right now, we're saying 24.5% at the midpoint. We delivered over 25% in the first half of the year. That gives you kind of a view of what the medium term could look like over time.

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

And I'll just chime in that yesterday, we signed a contract with the Mid-East country for the first phase of a multiyear next-gen SDR standardization program, and this has the potential for up to $1 billion over the next several years. So a lot of good positive momentum.

Operator

Our next question comes from the line of Kristine Liwag with Morgan Stanley.

Kristine Tan Liwag - *Morgan Stanley, Research Division - Equity Analyst*

Chris, in space, can you provide more color on the competitive landscape, the available programs for bid and how you're performing?

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

Absolutely. Now we've had a good run in space. And as I mentioned, we had a good quarter. Book-to-bill in space was 1.2 so far this year. And we've been successful in winning 10 of 18 prime positions just in the last 18 months. So that's something that we're quite proud of, and we've also moved into the missile defense arena.

So maybe a little longer answer. The approach we're taking in space is similar to what we've done in all 5 domains, and it's really understanding the customers' mission. We have 47,000 employees and 20,000 engineers and 20,000 employees with clearances. So we're looking at our capabilities. We're looking at how we're spending our IRAD. We're trying to develop solutions and alternatives that meet their needs.

We've talked a lot in the past, as you know, about our responsive sats where we were able to develop and launch satellites within 20 months. So that's helping us win a lot of these prime positions. We understand the mission, we have innovative solutions. The focus is on the payload and the integration and speed. So strategically, I think that has been a needle mover.

When I look at the exquisite satellites, we continue to have some of the best payloads out there. So we're working with partners, usually, the larger primes, and that's contributed to some success, and we have some awards coming up in the next few months that are classified.

And then we're working collaboratively with some of these new entrants, just like we do with the traditional primes and find where we can partner, As Chris mentioned, E3 is the key driver. It's going to drive us, and we talked about 20 to 25 basis points per year over the medium term of being able to continue to drive expansion, and we feel pretty confident in that. The pension, if you think about this year, all-in, between FAS and CAS benefit of about $470 million on an absolute basis. We expect that next year, the CAS element to decline a little bit as a result of the ARPA legislation or if it was enacted earlier in the year that pushed out funding requirements for pension, our recovery for CAS will come down a little bit. But that should be offset by some FAS income so net-net, I would expect the year-over-year pension to be pretty much flat.

Operator

Our next question is coming from the line of Robert Stallard with Vertical Research.

Robert Alan Stallard - *Vertical Research Partners, LLC - Partner*

Chris, it's probably one for you. You mentioned that the disposal process is now pretty much done. I was wondering how the prices on the assets that you've sold have compared versus your expectations? And do we now see maybe a shift in strategy and perhaps start to look again at acquisitions?

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

No, thank you for the question. No, we've had numerous transactions that comprise the $2.7 billion. I went back and looked at our original estimates, and we've -- generally to answer your question, been able to meet or, in some cases, slightly exceed what we had projected. We talked way back about maybe about $2.8 billion of gross proceeds from all these divestitures, we're at 2.7. And as I mentioned, a couple of small ones. So we'll will clearly get that within the range of our expectations.

On the M&A front, we did come out of the box 2 years ago and said we really were going to stand down on M&A and focus on the integration and the divestitures. And as I've highlighted, that's gone very well or maybe even better than expected. But even during that 2-year period, we watched the market. I'm highly confident we didn't miss anything in that 2-year period.

So we'll continue to survey the market. We're looking at anything that is a "must-have" as we call it. And when I look at the portfolio, as we've said over the 2 years, we're in all 5 domains. I don't really see any glaring needs or gaps. So we'll either proactively approach companies or respond to inbound calls, but we're really going to continue to hold the discipline, look at things strategically, look at them operationally, make sure the financial hurdles make sense. So not really in a rush and very pleased with what we've been able to win organically. So hopefully, that gives you some insight, Robert. And we'll let you know as things progress.

Operator

Our next question is from the line of Myles Walton with UBS.

Myles Alexander Walton - *UBS Investment Bank, Research Division - MD & Senior Analyst*

I was wondering if you could comment a bit on the second half implied step-down in SAS margins. I think you talked in the past about R&D and mix. And maybe just quantify those? And also, Chris or Jay, could you just update us on Next Generation Jammer? I know the second protest has been -- or is being adjudicated, I guess, by GAO, and I guess that's due for a decision here in the next couple of weeks. Would that have a swing factor on this year's top line or guidance anyway?

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

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A lot of what we do is focused on more defensive systems. We're hearing from our international customers. It's ultimately, they want situational awareness and the ability to communicate in a contested environment. So I look at our portfolio and the things we're doing on ISR aircraft, whether it's something like a river joint to a business jet and in some cases, to a single prop aircraft. We have a broad portfolio that allows them to get situational awareness. We've talked quite about -- a bit about our resilient comms capability, our waveforms library, which is second to none. And relative to the regions, it's the usual place, the Mid East, the Far East and Asia Pacific, and we're seeing growth opportunities in all those areas. So that's probably a longer answer than you wanted, but we're optimistic, and I think we're in a good position and executing on the strategy we laid out 2 years ago.

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

Just to quickly add to that, Richard, our growth framework, we had laid out a target of mid-single-digit plus growth over the medium term for international. We feel very comfortable with that. Obviously, we're going to be doing that this year, if not, a little bit better. And it's kind of what Chris said some of these capabilities. The ISR aircraft missionization, if you recall back in our March investor briefing, we've talked about taking the exquisite Rivet Joint capability, bringing that to business jets is also bringing it to pod capability based on customer affordability, and there's a significant amount of demand around the world for that.

If you look at Tactical Communications, we see a lot of these foreign countries following the same DoD modernization path. And so we see opportunities there. And I'd say the other area is maritime, both in manned and unmanned requests for support in the capabilities that we provide, both, in say, electrical distribution and power control as well as things like autonomy. And so we just continue to see a growing pipeline there. We're pretty comfortable with our growth objective over the medium term.

a piece of our base business. And so you have a little bit of a reduction there with growth -- solid growth on the monetization programs, Army being the largest program that's really in the early innings. And we've got the start of full rate production here coming in the back half of this year.

Internationally, Chris mentioned that before. There's a demand around the world for some significant upgrades as far as modernization. And -- but again, I would put the growth rate right now in that low to mid-single digit. As new countries come on, other countries fall off. And so obviously, we're going to drive that to more of a mid-single digit. But for now, I think that's the best way to think about it and look at it.

Christopher E. Kubasik

Robert Michael Spingarn - *Crédit Suisse AG, Research Division - Aerospace and Defense Analyst* lot of -- it's kind of in the 70% range as we look forward. So going back to December of 2020 when we put out our guidance for '21, a pretty good visibility, 70%. There's maybe 10-ish or so of follow-on. So to answer your question, I guess you could say maybe 15%, maybe 20% at most is revenue

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

Jay, if you could go through the working capital days you expect for the end of the year, the goal I thought had been 52 days. This quarter, it looks

I don't want to underestimate the importance of understanding the mission. So we know the mission. We know the customers. And can we take that with our industry-leading R&D investment and position ourselves for growth? JADC2 is something that's out there that we can talk about more in future calls, but we really want to position ourselves to help our customers solve their problems and focus on the organic growth, focus on the margin improvement, the double-digit free cash flow per share metrics, I think, are all going to drive value. So look, I ultimately want to be the most valuable defense technology company in the mind of our shareholders, in the mind of our customers, and that's not necessarily the largest.