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LHX.N - Q2 2023 L3Harris Technologies Inc Earnings Call

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OVERVIEW:

Company reported cash flow of \$300 million.

CORPORATE PARTICIPANTS

moving forward to close in the next day or so. I look forward to extending a warm welcome to Aerojet's team of over 5,000 employees who will soon become part of L3Harris. This acquisition represents a pivotal moment for both our company and the defense industry and is poised to generate shareholder value beyond initial expectations.

Budgets are increasing for munitions and the DoD has committed DPA, Defense Production Act funding for the expansion and modernization of Aerojet Rocketdyne's operations. Upon closing, this acquisition will strengthen the defense industrial base, foster healthy competition and accelerate innovation in support of the war fighter.

In conjunction with this exciting news, we continue to focus on execution across the enterprise and have delivered on our financial commitments again in the second quarter. Our results reflect the momentum we have been building over the last year as the team delivered the fourth consecutive quarter of top line growth, which accelerated to 13% with increases in each segment. We don't talk much about our sectors, but 13 of the 14 grew their top line in Q2 and 13 of 14 had a book-to-bill greater than 1.0. This gives me confidence that we've been investing in the right technologies and we are aligned with customer priorities.

Operating income was up 7% and margins expanded 50 basis points sequentially as we had anticipated. In total, we delivered earnings of \$2.97 per share ahead of consensus and free cash flow was positive, in line with prior commentary at over \$300 million.

Given our performance to date, we are increasing revenue and EPS guidance for the year and reiterating our free cash flow commitment. With easing supply chain constraints, operational improvement initiatives, and accelerating sequential growth in product-centric businesses, we remain focused on delivering second half results for 2023.

With that, let's open the line for questions, Rob.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Peter Arment with Baird.

Peter J. Arment

Relative to your question about the consent agreement, we did not negotiate or sign a consent agreement. We gave assurances to the DoD that we would be a merchant supplier of rocket motors and rocket engines. We have a long legacy of being a merchant supplier, and we'll continue with that model once we close Aerojet Rocketdyne. I can assure you, we are highly motivated to sell rocket engines and rocket motors to anyone who wants to buy them within the rules globally. So some of the theories that were bounced around never made a heck of a lot of sense to me, to be honest to you, we bought this company to sell engines and motors and that's what we're going to do.

We'll be ready to hit the ground running on day 1. We did have integration office with representatives from both teams. So a lot of time and effort on planning and again, given the L3Harris merger, we had a playbook that we'll use. This is obviously an acquisition, but every function, every decision has been made. We're ready to go on day 1. So thanks, Peter. Appreciate the kind comments.

Operator

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

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

Yes, congratulations, Chris and Michelle. Maybe I'll just continue along the Aerojet line here. I guess, Chris, it kind of seems to me that the Defense Department has had a problem sourcing solid rocket motors and L3Harris has kind of raised their hand and volunteered to help solve that problem. So now it's got to get solved. And so as you think about Aerojet and we've seen various complaints from their customers over the years and kind

So relative to your question on operations, we obviously comply with the rules. There's this concept known as gun-jumping, which is something you don't want to do. So we did not gun jump, which means we really couldn't get too involved in their businesses. But through the diligence process, we were able to engage with their team. They have a plan to go forward that we've reviewed. It's a real focus on deliveries and quality of critical missile programs. You mentioned a fair amount of those. And most of that surrounds the modernization of the Camden Arkansas production operations and expanding production across other sites. And as you mentioned, the DPA, the \$215 million, we've looked at that plan. That money will go mainly to those facilities and the programs you mentioned, but it also money in there to digitize their engineering. So we're quite excited about that.

So we've developed some tools since the merger to improve operations and processes. We utilize capability modeling. We have zero defect planning, just as a couple of examples. So we're going to take those processes and merge them into what Aerojet has, and we'll be ready to hit the ground running on day 1. We'll be at the key sites and we have a plan to execute. It's going to take some time, as you would imagine. But they're excited about the acquisition. We're excited about it. And next 48 hours or so, we just want to close it and get ready to go from there. So thanks, Seth.

Operator

Our next question is from the line of Robert Spingarn with Melius Research.

Robert Michael Spingarn - Melius Research LLC - MD

Sticking with the topic at hand, I wanted to ask a financial question. Given that you've just updated guidance, but yet you're going to close this in the next day or 2. I was wondering, Chris, if either you or Michelle, could talk about the guidance with Aerojet included for the rest of the year, both from a P&L perspective? And then just maybe to follow on to Seth's question on a CapEx or investment perspective for the rest of '23. And then in that CapEx vein, how do you think about that long term?

Michelle L. Turner - L3Harris Technologies, Inc. - Senior VP & CFO

Yes. So I'll start, Rob, good morning and thanks for joining. So as Chris pointed out, we're focused on closing the deal first and then welcoming all the new Aerojet employees for the day 1 celebratory events. So we certainly are going to get to the guide. We do plan to update the guidance on

Rocketdyne, update and refresh how our trusted disruptor strategy is performing and then some of the other organic growth drivers that we have in our portfolio. So more to come, but we look forward to seeing, hopefully, everybody in person in December.

Operator

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

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

I want to switch gears a little bit here. When -- if you look at where a lot of things are going right now in DoD and elsewhere. With the TDL acquisition, in principle, having Link 16 combined with other assets you've got in comms, space, IMS, it should put you in a pretty interesting position to provide some really integrated system solutions. Now I'm just interested in how you see the opportunity there. How large could that be if, in fact, you see that.

And then trying to -- assuming you do, trying to make that work, how do you go after something when this is a company that historically you've operated in many small silos as businesses, and this would involve really an integrated approach that I don't think we've seen so much in the past here.

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

Okay. Well, thanks, Doug. Yes, a lot of questions there. Look, I think the bottom line here is the TDL acquisition is really looking better than maybe we had expected. It's probably too early to declare success, but we're off to a real strong start. I'll just pick up on the operations first and then get to your more strategic question, but part of the plan was to integrate and move the production to Salt Lake City, where we have our BCS, broadband communication systems sector headquartered, which will co-locate these properties.

So as of today, we've actually moved more than half of the production lines successfully. We're slightly ahead of schedule, which is always good. And we've already built first articles with no issues related to the production lines that we've moved. So we kind of expected that to be the case, but it's never easy to move a production line or several production lines, but that's going better than planned and actually more employees have agreed to relocate than we had planned for, which I think is contributing to the success. Sam Mehta, our segment President and I will be out there next week for a few days and the topics you're talking about are clearly on the agenda.

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

And I'll just chime in. I think we tried to highlight within IMS, the challenges on these few select programs were we're within the ISR and the maritime sectors. I will say that there continues to be a lot of demand for those products and capabilities. We do a fair amount of undersea test ranges for the U.S. Navy, and we've been successful in winning work just recently for the similar capability in Australia.

We've talked about Compass Call here for the U.S. Air Force. There's similar capabilities for European country that will be mainly focused on modernizing the aircraft, which will have higher margins since the aircraft have already been procured. We're continuing to pursue undersea test range and sensing capability here in the U.S. Navy kind of a follow-on to something that we started winning 4 or 5 years ago.

We talked about the business jets and the strategy years ago to start missionizing business jets. We have an opportunity in the Far East. We have another opportunity in Europe. And then here in the U.S., you saw that we won the ATHENA-R program, which we're very excited about. I think the other day, we announced that we're teaming with another OEM on ATHENA-S, we kind of hope to win 1 of the 2, and now we're going to go 2 for 2.

And then the Army has a program known as HADES, which could be up to 10 aircraft. So there's a lot of opportunities in how I want to tie this back to the margins is IMS has the longer-cycle backlog relative to the other businesses, they see us in particular. They have a lot of fixed-price contract, probably some fixed price development programs, which I think I've publicly said, we're really going to be selective on bidding going forward, especially when the customer is asking for a fixed price production or low rate production, simultaneous with development. That's just a bad business and makes no sense. We're going to continue to push back and not bid those because very hard to price something that you haven't developed, but I have discussions on that topic regularly with our customers, and we will continue to no bid those until the contracting vehicle is appropriate.

So I throw that in that some of these challenges, which Michelle laid out well is really the lagging effect of attrition and inflation because of the long cycle business. We've taken those lessons that we've learned or we've more bluntly or clearly updated these bids based on the latest performance, the latest cost. So every single program I mentioned is double digit and sometimes more than double-digit margins or higher double digits. So we get those wins, we'll get those in backlog, and that gives me confidence that we'll be able to improve the margins in IMS with John and his team.

Michelle L. Turner - *L3Harris Technologies, Inc. - Senior VP & CFO*

Yes. The only other thing I would add to that is just as a reminder, when we set out our guidance this year, we were purposeful not including any international binary events. We still have a strong pipeline that we're chasing there. Just the recognition that we know we've disappointed historically when we put those in and then not been able to get them over the goal line because of the timing constraints. And so we continue to have a strong backlog there as we -- our pipeline as we look into 2024 and beyond.

Operator

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

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

Chris, I was wondering if you could add more color on the strong first half book-to-bill at space in particular. And I know you guys have obviously done well with some of the low earth orbit awards, but it seems like there's a lot of other things going on for you in space as well. So wondering if you could talk more about what you're winning there and kind of your approach, how you're winning it and how big the opportunity set is there?

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

Yes. Thanks, Pete. We've talked about this trusted disruptor strategy at the L3Harris level. And as you would expect, it really flows down to each and every one of the sectors. And I mentioned we have 14 sectors when we closed Aerojet Rocketdyne will be up to 16 sectors as they'll have 2 sectors within that segment. But it's hard to think of a better example than maybe space where they really been able to embrace this strategy and execute upon it. And at the highest level, we talk about doing more prime work with the end users being more innovative, being more agile. And I would just sounds like buzzwords, but it's clearly working in space. And to back it up, at the time of the merger, we had 5 satellites, mainly experimental demo satellites under contract.

And today, we have over 50 contracts for satellites. I mean that's a 10x in 4 years, which I think reinforces what's implied in your question that what we're doing is working. We actually have 2 classified operational constellations. Again, 5 years ago, we didn't have any. We might have had parts on other people's satellites on their constellation. So we really have disrupted this market and we're viewed as a prime and a legitimate competitor, and we're winning and we're performing. We've invested a fair amount in R&D to get us in this position in capital. We're actually facilitating -- we have 2 facilities, one in Fort Wayne, Indiana that we expanded and one here down in Palm Bay, Florida for satellite manufacturing.

So we're investing capital for growth, which will allow us to continue to perform. I mean, just since the merger, our revenue is up in space alone, over 50%. We have record backlog. We have solid execution. We can always do better. We've had some challenges with certain suppliers. We don't call anybody out by name, but we just kind of work with those companies to bring them along.

So in the space world, it all comes down to launches. We have a bunch of launches coming up in October, and that's where the money hits the road. We're excited about a launch we have co-manifested payloads, both our SDA Tranche 0 satellites will be going up with the MDA's HBTSS satellites. So I think that worked out real, real well. Upcoming opportunities. We do a lot of work going back decades for NOAA for their weather satellites, about \$700 million opportunity coming up this year. We feel really good about that. It's called the sounder program, as always, a lot of classified opportunities, which I know is never satisfying for you and others to hear, but they are there.

The SDA tranche 2 for tracking the RFP is coming out. So we'll be prepared to respond there. And I think at the end of the day, you hear me talk a lot about prioritization and aligning with customers' needs. Secretary Kendall, the Air Force their #1 operating imperative is all about space. So we have the mission sets. We have the phenomenology's, we've adapted to the rapid acquisition process, and we've been quite successful. So I couldn't be more proud of the team. And it's just one example where the strategy has been laid out, it's been executed, and it's working. So more to come.

Michelle L. Turner - *L3Harris Technologies, Inc. - Senior VP & CFO*

I would just add to that, because along with the top line, this team is also fully embracing our performance first initiative. They're also driving really strong cash performance as well. So 9-day working capital improvement within from Q1 to Q2. And so kudos to Ed and Kelly in the Space chain because sometimes it's easier to grow the top line without doing the cash along with it, and they fully embraced all the financial metrics to really drive this business.

Mark Kratz

Rob, in the interest of time and to stop at 40 minutes, we'll go ahead and take the last question this morning.

Operator

Our final question is from Myles Walton with Wolfe Research.
