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LLL.N - Q1 2019 L3 Technologies Inc Earnings Call

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OVERVIEW:

Co. reported 1Q19 sales of $2.7b and adjusted diluted EPS of $2.89. Expects 2019 sales to be $10.9b and 2Q19 sales to be $2.6-2.7b.

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PRESENTATION

Operator

Good morning, and welcome to the L3 Technologies First Quarter Conference Call. (Operator Instructions) Please note, this event is being recorded.

I would now like to turn the conference over to John Kim, Vice President of Investor Relations. Please go ahead.

John H. Kim - *L3 Technologies, Inc - VP of Investor Relations & Analytics*

Thank you, and good morning. I'd like to welcome everyone to our first quarter 2019 earnings conference call. With me today are Chris Kubasik, our Chairman, CEO and President; and Ralph D'Ambrosio, our Senior Vice President and CFO. After their formal remarks, management will be available to take your questions.

Please note that during the call, management will reiterate forward-looking statements that were made in the press release issued this morning. Please refer to this press release as well as the company's SEC filings for a more detailed description of factors that may cause actual results to differ materially from those anticipated.

Please also note that this call is simultaneously broadcast over the Internet.

I would now like to turn the call over to Chris.

Christopher E. Kubasik - CEO & President

Thank you, John, and good morning, everyone. As you saw earlier today, we had an exceptional start to 2019 with orders, sales, operating margin and free cash flow all exceeding our plan for the quarter. We set several records for our first quarter performance, including funded order growth of 28%, book-to-bill of 1.25 and organic sales growth of 14%. Operating income rose 24% and margins improved 90 basis points to 11.5%. This strong margin performance in Q1 positions us well to reach our 12% target for the year as productivity savings and program performance improves. Free cash flow was $146 million, excluding merger-related items.

During this premerger period, the leadership team and I have continued to emphasize a business as usual approach, maintaining focus on operational excellence and delivering on our customers' expectations. I want to take a moment to thank and congratulate the entire L3 team for record performance in the first quarter and maintaining focus on our customers and program performance.

Our results demonstrate the power of our portfolio: a diversified, mission solutions, technology provider. Growth in the quarter was led by many of our core businesses, including ISR aircraft missionization, night vision goggles, electro-optical/infrared sensors, SATCOM data links, UAV communications and precision weapons. We have leading positions in many areas that are aligned with making our war fighters more agile, lethal and survivable.

Given the multitude of threats from both near peer nations and rogue elements, there is support from both sides of the aisle in continuing to invest in national defense. The President's 2020 budget request of $750 billion is a solid endorsement of our national defense priorities. The budget requests a 5% increase in the O&M account where L3 derives roughly half of our DoD funding, including many of our larger ISR programs such as Compass Call and River Joint. The RDT&E account was up 9.5% and supports our work on various modernization and development programs such as the Future Attack Reconnaissance Aircraft known as FARA, next-gen jammer and unmanned systems. By leveraging L3's market position through targeted R&D investment and business development activities, we continue to set our sights on gaining more than our fair share of business, and we're seeing this rekindled determination beginning to take hold in our numbers as demonstrated by our recent performance.

Since taking over as CEO in January of last year, I've been discussing with you our transformational journey to become a more integrated company and to bundle our technologies to compete for and develop larger mission-critical solutions. I reference our strategic Canadian Surface Combatant win as one such example. This transformation by its very nature is a multiyear endeavor and will accelerate when we close merge with Harris.

As I think about the integration and where we will be in a few years with Harris, there is enormous potential. The combined company will be well on the path towards becoming a company with the necessary scale and resources to invest in and deliver the most mission-critical solutions to our global aerospace and defense customers. The chance to build a new A&D company is an exciting and engaging challenge, one that Bill and I and the entire leadership team are ready to take on. And in the many visits with L3 and Harris employees in the field, this excitement is broadly shared throughout.

Since announcing this merger of strength last October, our L3 and Harris teams have been deep in integration planning. While merger integration activities are occurring throughout the company, our segment teams have not altered the pace in the slightest, and we continue to hammer our progress on streamlining and consolidating operations. For example, in our Communications & Networked Systems segment, we consolidated from 5 sectors to 3, and within the Integrated Maritime Systems sector, we are going from 14 divisions to 7. In our Electronic Systems segment, we combined our Security & Detection business into Commercial Aviation and are evaluating steps to rationalize further our facilities footprint. Not only will the new organizational structure remove overhead and redundant cost, but also better align our capabilities with customer needs, sharpen focus on technology investments and intensify business development efforts to better serve our customers.

Improving business performance through better data collection and analytics is a key part of managing a more integrated company. Last year, we rolled out a series of standard financial and operating metrics throughout the company as part of L365. Closer tracking of capital efficiency metrics as well as changes to our incentive compensation plan to emphasize cash flow have been helping to drive working capital improvements. Even with sales up 14%, our net working capital only increased 4%, leading to a reduction in working capital days compared to the prior year. Operating metrics that track manufacturing quality and vendor performance is supporting our supply chain and program management teams to identify and address problems earlier, enabling the management team to clearly see the interdependencies in their operations.

I continue to make customer engagement a priority for the company, for myself and the entire leadership team. During the first quarter, we met with key members of Congress, the administration and the U.S. military to discuss L3's unique and disruptive capabilities and to highlight our technology solutions. My team and I went out again to meet customers in the Middle East. As you are aware, international business development relies upon building long-term relationships and listening to our customers to understand their challenges. We continue to make more and more inroads, seeing an improved tenor to our meetings and have received positive reception to our merger with Harris from our international customers. Bottom line is we are seeing a great demand worldwide for an innovative, agile company who wants to partner with their customers.

Several recent awards highlight our capability in delivering integrated mission solutions. In the recently announced $1 billion Peregrine award for the Royal Australian Air Force, L3 will deliver 4 next-gen EW aircraft on a biz jet platform. This includes a ground communications infrastructure that will integrate with the Commonwealth's joint war fighting networks, providing a critical link between platforms, including the F-35, the Growler and maritime assets.

Our selection to compete for the design of FARA for the U.S. Army is another demonstration of our ability to engage customers with disruptive technology and to partner on an important platform, integrating various communications and mission systems. Many of our capabilities align with the Army's top priorities, and we continue to allocate resources to meet these needs. Our business development activities are now more ambitious and focused and also better integrated with bid & proposal, engineering and R&D functions. I see many more instances of collaboration across divisions as we execute upon our strategy. Leadership throughout the company is buying into the notion that we can win more and better serve our customers if we work together.

Next, I want to touch on the progress we are making on the talent front. Attracting, developing and retaining top engineering and managerial talent is the lifeblood of the company. We began leveraging our HR organization to develop strategies to become more efficient at planning our talent needs, recruiting and retention and at identifying and training our emerging leaders to take on larger roles in the company. We made significant progress in the past year engaging our workforce.

Overall, the investments and changes we are making to improve the business are beginning to generate tangible benefits to growth and margin. Our employees are increasingly embracing the change and the fabric of integration, collaboration and innovation is becoming woven deeper into the way of our thinking.

Now let's turn to a review of our segment performance. Our strong quarterly performance was led by the ISR Systems segment which grew funded orders 58% and sales 23%. Book-to-bill was 1.38. Operating income increased 40%, generating a margin of 10.4%, up 120 basis points from the prior period. Growth was most impressive in our aircraft procurement and ISR missionization business as several key programs accelerated, including the U.S. Air Force Compass Call, Australian Peregrine and the U.S. Missile Defense Agency HALO program. In addition, EOIR sensors, soldier systems and space & sensor businesses all grew double digits. Given the broad-based growth in this segment, we continue to expect ISR Systems to be our fastest-growing business with improved margin.

Communications & Networked Systems returned to growth with funded orders up 26% and sales up 11%. Book-to-bill was a strong 1.19. Operating income rose 31% and margins improved 160 basis points to 10.7%. Sales growth was led by the broadband sector which rose 15% driven by higher UAV communication and ground-based SATCOM system shipments. Operating margin improvement was driven by program performance, sales mix and cost reduction.

Lastly, Electronic Systems sales grew 2% and operating income rose 3%. ES' segment-leading margin improved 20 basis points to 14.7%. The quarter was impacted by a sales decline in the Defense Training Solutions business due to last year's loss of the C-17 training contract to the OEM. However, key highlight at Electronic Systems include double-digit growth in precision weapons which grew sales 18% in the quarter. Due to the headwinds from the C-17 loss, we expect modest sales growth in 2019, but we continue to expect improved margin from ongoing cost takeout and favorable contract performance.

Given our strong performance in the first quarter and improving order momentum, we are increasing our 2019 guidance.

Now I will turn it over to Ralph to review our financials and provide details of our updated guidance.

Ralph G. D'Ambrosio - *L3 Technologies, Inc - Senior VP & CFO*

Thanks, Chris. I'll review some details about the first quarter and then our 2019 guidance update.

Reviewing the first quarter, as Chris explained, we had a very strong start to the year and we exceeded our plan. Orders increased 28% and sales grew 14%, all of which was organic. Segment operating income and adjusted diluted EPS each grew 24%, and segment margin increased 90 basis points to 11.5%. We also generated positive free cash flow which is meaningful because we usually have negative cash flow in our first quarters.

Next, I'll comment on some details about the 2019 first quarter. Adjusted diluted EPS was $2.89, an increase of $0.55 or 24% over the 2018 first quarter driven primarily by operating income growth stemming from our 14% sales growth and our 90 basis points of margin expansion. Adjusted diluted EPS excludes integration and transaction expenses related to the L3 Harris merger and a $2 million business divestiture loss.

Sales increased 14% to $2.7 billion driven by strong growth in our DoD and international markets. At the segment level, sales grew 23% at ISR Systems, 11% at Communications & Networked Systems and 2% Electronics Systems. The growth rates for ISR and Communications included some favorable quarterly timing items, which will lower their second quarter growth rates. At Electronics, sales were negatively impacted by last summer's C-17 training contract loss which lowered growth by 440 basis points in that segment.

Operating margin performance was very good. Total segment operating margin increased to 11.5%, 90 basis points higher than the 2018 first quarter. Lower pension expense increased margin 50 basis points. And favorable contract performance, which includes productivity and cost reductions, accounted for most of the other 40 basis points of margin expansion. As a reminder, most of our productivity improvements and cost reduction actions manifest in favorable contract performance. Every segment had double-digit margin. Compared to the 2018 first quarter, ISR margin increased 120 basis points to 10.4%, Communications increased 160 basis points to 10.7% and Electronics increased 20 basis points to 14.7%.

All segment margins benefited from lower pension expense, stemming from the service credit accrual freeze that we implemented effective January 1. Other contributors to margin expansion primarily included sales growth, a lower G&A rate and business divestitures at ISR, and favorable contract performance and reduced G&A expenses at Communications and Electronics.

The tax rate increased to 14.7% from 11.1% for the first quarter of last year, and that was primarily due to lower stock-based compensation expense deductions.

We also generated positive free cash flow of $146 million compared to a cash outflow of $85 million for the 2018 first quarter and that improvement was due primarily to better working capital performance and growth in earnings. Also compared to the 2018 first quarter, we reduced our working capital days by 10 to 82. As Chris explained, we have placed more attention on improving working capital and generating free cash flow earlier in the year, and we're seeing benefits from these actions.

Now moving to our 2019 guidance update. We raised our midpoint sales estimate by $150 million to $10.9 billion, which is expected growth of about 6.5% over 2018. Most of the guidance increase is in ISR Systems. And I'll add that given our recent strong orders and healthy backlog, we should be able to drive more upside to this year's sales. At the segments, we expect sales to grow 9% in ISR, 6% in Communications and 3% in Electronics.

Our planned 2019 margin expansion of 120 basis points to 12% is unchanged and firmly on track. Recall that on our January 29 earnings call, we explained the 3 drivers of our 2019 margin expansion: L365 productivity cost savings, lower pension expense and lower losses in the Traveling Wave Tube business. Each of these will contribute about 40 basis points of margin expansion. With respect to the Traveling Wave Tube business improvements, we continue to expect those to mostly occur in the second half of 2019.

Our combined sales growth and margin expansion this year will result in segment operating income growth of 18% over 2018. We held our segment margin guidance midpoints at 11.2% for ISR, 11.1% for Communications and 14.4% for Electronics with the segments expanding margin 110 basis points, 200 basis points and 70 basis points, respectively, compared to 2018.

We lowered our tax rate to 19% from 20% primarily due to lower expected foreign income taxes.

And for free cash flow, we increased it to $1.055 billion, which is about 13% higher than 2018 with a cash conversion rate of 113%. Cash at the end of March was $1.1 billion.

And regarding capital allocation, in February, we increased our quarterly cash dividend by $0.05 to $0.85 per share. We still expect no debt repayments, and as we previously explained, we suspended share repurchases until the L3 Harris merger is completed.

Looking at the second quarter, we expect sales between $2.6 billion and $2.7 billion with growth of about 3%, operating margin in the high 11% range, with margin expanding more than 100 basis points over the 2018 second quarter, and free cash flow between $100 million and $200 million.

Finally, to conclude my financial review, we had a very good start to the year with our first quarter results. The company is growing at a healthy pace, becoming more efficient and profitable and also expanding margin. For 2019, we expect to grow orders, sales, operating income and free cash flow, and we are also firmly tracking to our 12% operating margin objective.

Thank you, and I'll now turn it back to Chris.

Christopher E. Kubasik - CEO & President

Thanks, Ralph. As you saw on April 4, both L3 and Harris received shareholder approvals for the merger, and Harris also recently announced the sale of their night vision business, both important steps to consummating the deal. We continue to work with all regulatory authorities to obtain the necessary approvals. And as you heard on the Harris earnings call this morning, everything is tracking to plan and there's no change to our expected midyear merger close.

The 50-plus members of the joint integration team are working diligently and integration planning is going well. The integration management office recently held a value capture offsite at the ISR facility in Texas. As L3 and Harris teams gain more exposure to each other's operations and people, the more we become appreciative of the technology and talent of the combined company and the potential for what we can do together. I've been working closely with Bill on the integration, and we will provide details on the Board, organizational structure and management near deal close.

Given that this is likely L3's last conference call as a separate public company, I want to personally thank all of the men and women of L3 Technologies for the hard work and dedication throughout the years for making L3 a great place to work. And a special thanks to my executive leadership team for their leadership and performance during the past couple of years, especially with the pace of change. As this chapter in the company's history comes to an end, a new and exciting chapter begins. I have to acknowledge the 2 CEOs preceding me, Frank Lanza and Mike Strianese, for their vision and hard work to get L3 to this stage. By combining what makes L3 such a special company with the best of what Harris has to offer, I have no doubt we can create a company that is even more agile, innovative and customer-centric, a best-of-breed aerospace and defense technology company that delivers superior value for employees, for customers and for the shareholders.

Ralph G. D'Ambrosio - *L3 Technologies, Inc - Senior VP & CFO*

Yes, Chris. I was thinking about this yesterday, and I counted that it has been 52 consecutive quarterly earnings calls for me. It's been a tremendous experience and I'm very grateful for it. So I also want to thank everyone on the call today for their past and continued interest in L3 and soon to be L3 Harris, especially the analysts on the call, as well as the analysts who previously covered L3.

Christopher E. Kubasik - CEO & President

Outstanding. All right. Kerry, why don't we open the lines for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question will come from Cai von Rumohr of Cowen and Company.

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

It's Gautam actually on for Cai. Congratulations on a great run obviously at L3. I want to just ask on the free cash flow improvement in the quarter and some of the working capital initiatives more broadly, if you could just explain sort of how much low-hanging fruit you perceive there to be? And then just as a follow-up, when you just take the LTM free cash flow of both Harris and L3, we're at just under $2.4 billion. I'm just curious how you view, Chris, the longer term $3 billion free cash target given we've already chopped a lot of wood here.

Christopher E. Kubasik - CEO & President

Gautam, thank you very much for the question and the compliment. We're quite excited about the first quarter, but a long way to go for 2019 obviously. I think the focus on working capital and cash generation was something that we put together in late December. We even changed the incentive comp plan to highlight the importance of generating free cash. And Bill and I talk a lot about the $500 million of synergies and the $3 billion of cash flow in year 3. And I would say we have more confidence in achieving those numbers today than we did when we first announced this deal on October 14. I'll let Ralph talk about some of the improvements we made here in the first quarter.

Ralph G. D'Ambrosio - *L3 Technologies, Inc - Senior VP & CFO*

Sure. So as I commented, we had a dramatic reduction in our working capital days quarter-over-quarter. And if you may recall, the first quarter of 2018 was our high-water mark in terms of working capital and cash usage and that's why there's a dramatic reduction compared to this year's first quarter. But certainly what we're doing is placing more attention on basic blocking and tackling, trying to collect our receivables sooner, continuing to grow the company and grow inventory at a slower pace and taking actions to convert our unbilled receivables and to bill receivables sooner. So it's a concerted effort across all those fronts. For the full year, we're expecting working capital days reduction as well, and we think that's going to be at least 2 to 3 days year-over-year. So we should see more improvement the balance of this year as well. And obviously, we're going to try to do better.

Operator

The next question will come from Carter Copeland of Melius Research.

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

I wondered if you could comment on the book-to-bill. I mean obviously very strong in the quarter even despite the strong sales. Was there anything in there that surprised you from a timing perspective or magnitude perspective that we saw early on this year? Did we pull anything forward or is the pipeline a little bit better than you were originally thinking?

Christopher E. Kubasik - CEO & President

That's a great question. I'll tell you, we've really tried to reinvigorate the BD organization and function. We've made investments that you've heard me talk about in the past in systems and standardizing policies and procedures. There were a couple of ISR accelerations. We're talking maybe second quarter to first quarter, which is why we came in a little higher not only on the orders, but the sales. But I'm equally excited about what we still have looking ahead. There are clearly F-16 training opportunities. We won a U.S. and an international customer. And we probably have 3 to 4 additional bids outstanding that could be worth $100 million each. So there could be $300 million to $500 million of more orders of F-16 as an example. C-130 AMP, hopefully we'll hear on that. As I mentioned, the team and I have been spending time in the Middle East.

I think we have some interesting strategies and partnerships there that could lead to significant growth. And the classified world is really picking up. That's an area we've been focused on and have seen some growth, given some of the next generation capabilities we have, I expect more wins there. So for the whole year, I would want book-to-bill to be at least 1.1 in each and every segment. And maybe $12 billion of orders overall is what our stretch goal is. But that's what we're working towards.

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

Great, that's great. And just a quick clarification on the org structure and leadership announcements you said nearer to close. Should we assume that's just an 8-K disclosure very near, meaning just before your intended close?

Christopher E. Kubasik - CEO & President

Yes. I mean, I think that's fair. Bill and I still have to work out the details. It depends on when we're going to close and the timing and such. But yes, it would be in that general time frame. We'll do what makes sense for all the people involved, internal and external. So I'll be seeing Bill next week and we'll continue to work on a plan. But I think both he said and I said we're ahead of the internal plan that we've laid out on a lot of the different milestones we're going for. And I think even people outside who are helping us have been impressed how far ahead we are. So we're going to hit the ground running on day 1. And that's one of the reasons we're gaining more and more confidence in some of the financial targets that we've laid out for you.

Operator

The next question will come from Sheila Kahyaoglu of Jefferies.

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

Congratulations on closing it out, guys. Ralph, it's been something less than 52 quarters for me. So congrats on that. Chris, I guess you've resegmented the businesses. You've tried to maximize the potential here. And then now as you head towards integration within Harris, how do you maybe think about the challenges of that? Whether it's going to market or manufacturing efficiencies, if you could maybe just give us a little bit of insight on that.

Christopher E. Kubasik - CEO & President

Yes. Thanks, Sheila. I was actually thinking about that, there's a lot to do with changed management and such. But looking back at the last couple of years, it really hit me the other day how much change L3 has gone through. And as I talk to the employees, I tell them, well, there may be change when the merger is consummated, given what we've been through together over the last year or 2, it's probably going to be the same or even less change. So the team is used to the changes that we've made in our strategy, our transformation and as you suggested, even the organization structure. So I think some of these results that we've seen are obviously a result of improved leadership, but also organization changes and even something that may seem as obvious as putting all of our 14 maritime divisions under a single leader gets you the synergies, not only on the cost side, but on the revenue side to see those types of results. When we look at the combined portfolio, which we believe is definitely complementary, I think we're going to have that opportunity again to lay the 2 portfolios side by side and even further optimize them and be able to bundle solutions to get to our customers, to maximize our technology investments. And I think it's going to be an exciting opportunity. And I think both companies have been through changes in the last couple of years, and I think we're up to the challenge. And I think it's going to be an exciting time for both.

Operator

The next question will come from David Strauss of Barclays.

Matthew Carl Akers - *Barclays Bank PLC, Research Division - Research Analyst*

This is actually Matt Akers on for David. Wanted to ask about the guidance. So pretty strong growth in the quarter. Guidance implies sort of a slowdown for the rest of the year. And I know Q1 was obviously really strong, but just sort of how do you think about the cadence of growth as we go throughout the rest of the year?

Christopher E. Kubasik - CEO & President

Yes, Matt. Thanks for the question, at a high level, and I'll pass it over to Ralph. But when I'm looking at first half, it's about 8% top line growth, second half's about 5%, which gets to our guidance, I think Ralph said depending on how a lot of these orders come through in the months ahead, there could be upside to that. But I'd rather start the year with 14% than end the year with 14%. And Ralph, do you want to talk about maybe some of the other things that got front loaded?

Ralph G. D'Ambrosio - *L3 Technologies, Inc - Senior VP & CFO*

Sure. I mentioned that we had some quarterly favorable timing items in the first quarter. And a lot of that pertains to the ISR recap and special missions lead expansion work that we're doing and Chris talked about where most of those contracts begin with us procuring a green aircraft that we subsequently missionize and ultimately sustain. So the timing of those aircraft purchases this year is such that we had the biggest impact in the first quarter. And that turns around a bit rest of the year, particularly in the second quarter. So that's the single biggest item. And then there were some shipments on night vision equipment and some tactical terminals that also have some timing elements to them. But we expect a strong top line performance for the full year, and we're going to try to do better as well in every quarter.

Matthew Carl Akers - *Barclays Bank PLC, Research Division - Research Analyst*

Got it. Okay. Yes, that's helpful. And then I guess one more on your pilot training business. What are your thoughts on kind of the 737 MAX. And there's obviously been some discussion of more pilot training related to that. And sort of what opportunity could be there for L3?

Christopher E. Kubasik - CEO & President

Yes, good question. I mean, as we look at the market, there's training that's going to be mandated and mandatory that's being suggested. So clearly -- and that has not occurred yet, but that could be some upside. And then there are airlines, and one in particular that we work closely with that is doing some voluntary training. So it's going to depend on the airline leadership and the rules and regulations, but you would think over time, there could be some additional upside. But clearly, we're supporting our customers and airlines in however they want in this uncertain time.

Operator

And the next question will come from Seth Seifman of JPMorgan.

Benjamin Efrem Arnstein - *JP Morgan Chase & Co, Research Division - Analyst*

This is Ben on for Seth. I just wanted to kind of hone in on some of the booking strength in the quarter. And a lot of that fell into ISR with the Peregrine award, it seems. I guess, is there a good framework to kind of think about the growth for ISR Systems now, including the kind of the old sensors business that was in the segment as long as the ISR recapitalization and upgrades that seems to be driving lot of growth right now?

Christopher E. Kubasik - CEO & President

Yes, that's a great question. I think it's another example of the benefit of aligning the organization based on capabilities and having the sensors and the ISR team together to maximize the R&D investments and the customer relations. I think the historical sensor business is clearly a double-digit growth. When we look at the Army's priorities as an example, they've been very clear on their 6 priorities, that I'm sure you're familiar with relative to combat vehicles, vertical lift, networking and soldier lethality, just to name a few. I mean, that's where we're aligning our investments and that's where a lot of those orders are coming from. International has been a focus that we've really, really turned up the game there quite a bit. And I think we're seeing that come through, not only on the what I call the legacy sensor business, but clearly the legacy aero. And Peregrine is a good example given the length that's probably about a 6- to 7-year program with a couple of hundred million of revenue each and every year. And then that opportunity in Australia will probably increase the likelihood of other countries, Five Eyes, or otherwise have an interest in that capability. So those are some thoughts, I don't know, Ralph, if you got anything you want to add on that or...

Ralph G. D'Ambrosio - *L3 Technologies, Inc - Senior VP & CFO*

I mean, ISR is our fastest-growing segment this year, and we expect it to continue to be the fastest-growing segment for legacy L3 going forward.

Operator

(Operator Instructions) The next question will come from George Shapiro of Shapiro Research. And we will move on then to our next question from Michael Ciarmoli of SunTrust.

Jorge Baptista Pica - *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

This is Jorge Pica on for Mike Ciarmoli. I just wanted to ask a quick question on the opportunity set going forward for L3. Looking at the list, there are 3 things that kind of jump off the page: sensor, the radar network reconstitution for the entire United States; Overlord, which you've got some participation on for the Navy; and actually future air crew training for Canada, which is a fantastic opportunity to kind of be part of a full turnkey solution for aircraft training. When you look across the opportunity set going forward, how do you think about these, specifically those 3? And as a short follow-on, looking at the cost savings for the merger, some have commented as -- about the $500 million number being conservative in the cost synergies. If you can provide any clarification or comment on that also would be appreciated.

Christopher E. Kubasik - CEO & President

Okay. Maybe I'll take those in reverse order. I can assure you the $500 million is far from a layup. We have, as I mentioned, 50 people working very hard every day on the integration. Bill and I talk multiple times a week, text, e-mail, and we're building a road map to get to the $500 million. And as he said this morning and then as I'm going to say now, we're gaining more and more confidence. But you got to look at the supply chain, the headquarter savings and some of the other synergies we've identified. So I'm glad people think it's easy, but for those of us that are accountable to do it, I can assure you there's going to be a lot of hard work. And we'll keep you abreast of that as it goes forward. Relative to the opportunity set, I think there's some interesting things here in both of our companies and capabilities. Sometimes we prime and sometimes we're merchant suppliers, if you will, and sometimes we get exclusivity with the prime contractor. I think on the sensors with the FAA, Harris has a great FAA franchise that I'm learning more about. I think there's going to be capabilities to look at our combined portfolios. I think in that case, probably some sort of partnership or teaming makes the most sense. Overlord, I appreciate you calling that one out, we've made investments years ago in Navy unmanned, both surface and undersea, and I think everybody's seen the doubling of the navy budget in this area, which we're quite proud of. I mean, it's not easy to try to invest ahead of the curve, but I think we may have gotten that one right and the team's working hard there. So I think we're in good shape on Overlord, which I think they renamed it because it's the same name as a movie or something. But -- and then of course on training, I think we're -- it's one of our key areas. We have a great presence in Canada. I don't know if we're the largest U.S. contractor up there, but we're pretty close if we aren't. I think we are. So again, another example of why this transformational merger makes sense, more scale, more capability to team and again, we have great relations with all the primes and I think and know that we're in discussions with 1 or 2 on the specific examples. And we'll let you know more as these awards are announced.

Operator

The next question will come from Robert Stallard of Vertical Research Partners.

Christopher E. Kubasik - CEO & President

Is this the real Robert or somebody's sitting in for Robert?

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

It's definitely me, Chris. I can tell you. It's been quite a run, and especially it's been a long time with Ralph. So thanks for your help over the years. Chris, something you've alluded to and, Bill's alluded to, in the past is that as you merge the 2 companies, there could be parts of the portfolio that maybe don't fit. Now as you've been working through this initial integration process, has there been anything that has sort of moved up that list as perhaps not fitting in the combined portfolio?

Christopher E. Kubasik - CEO & President

Yes. I think you would expect like any large merger, you're always going to relook at your portfolio and update your strategy. And I think there's expectations that there may be a couple of things that would fall in that category. I mean clearly, step 1 is to actually close on the merger. And then anything that Bill and I are thinking about, we would review with our new Board, which has not been identified yet. So -- no, I think that's just a normal course when you put together 2 big companies, and there's limitations as to what you can sell to protect the tax-free status of the merger and everything. So I'm not looking for anything dramatic, but we'll look at it and inform you at the right time. But I think nobody's surprised that would be something that would occur.

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

Okay. And then as a follow-up, this might be a tougher question to answer, but as you look at the broader industry and the merger takes place, have you seen any of your competitors changing their stance and perhaps becoming a little bit more aggressive so as to try and counter the additional scale and heft that you'll have in the overall industry?

Christopher E. Kubasik - CEO & President

No, I guess that might be a little tougher. I would say, I haven't seen anything yet. I would think in the normal regulatory review process, I'm sure our competitors were contacted. And again, this thing is so complementary, other than the night vision business that Bill talked about. We have great relations with everybody. And when I've talked about being a prime and Bill has as well, we've really talked about the mission solution prime and a lot of what you might think of as our competitors have these platforms where our capabilities, whether it's EW or secured comms or even the integrated processor that Harris has on the F-35, make these platforms, new or old, more capable. So our strategy has been and we continue to be in discussions. And even some of the recent orders we have in the quarter are a result of our partnership. And what we're bringing together is more capabilities to these primes or to these partners. So to say it's going to increase might be a stretch, but I keep referencing the Canadian Surface Combatant as an example where we have multiple divisions come together. And now that we won that award, or the company that we were supporting, that was a team of BAE and Lockheed Martin specifically, it gives us a foothold as they expand around the globe. And hopefully we were their go-to partner. So you might think otherwise, but so far, so good.

Operator

The next question is from George Shapiro of Shapiro Research.

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

I just had a quick question. Given that the S-4 projections are pretty stale at this point, can you comment at all on if you're going to update them or what you're going to do with that?

Christopher E. Kubasik - CEO & President

All right. Well, I don't know. Stale, that's a little harsh, George. I mean, we filed the S-4 in compliance with the rule. I think both Bill and I have reported our earnings that are better than the projections in the S-4, so that's step one. We both gave you a new guidance for the rest of our year, so that's the second step, and the merger's going to close would be the next goal. And then shortly after closing, I would think maybe in the month of August, Harris would report on their 12 months ended June 30. And the new combined company would probably give some sort of outlook for your -- the stub period of the second half of calendar '19 and some direction maybe beyond that. But yes, we'll update it in the normal course. So we increased our guidance, they increased their guidance, and we're both more confident in the $500 million and the $3 billion. So I don't want to say it doesn't get any better than that, but that's, I think, a pretty good day.

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

No, that's why I was asking that the S-4 is pretty stale.

Christopher E. Kubasik - CEO & President

Yes, yes. It's a document that's out there.

Operator

The next question will come from Robert Spingarn of Crédit Suisse.

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

So Chris, I just jumped in from another call, so I missed a couple of things. But I wanted to ask you about enhanced night vision and about the funding trends that you expect there. It looks strong in the [FIDIP], but it also looks like DoD is looking at the IVAS headset as well. And so I wanted to see where you -- how you think that competition stacks up and how those 2 programs compete against one another?

Christopher E. Kubasik - CEO & President

Yes. Thanks. I'm aware there's another call, we try to get our notice out about 30 days earlier, so I know it's putting everybody in a tough position. So thanks for bouncing back and forth. I'm sure you can listen to it later tonight. But the funding looks good on both programs. And IVAS, which is a modified Microsoft HoloLens, and what we're doing in enhance night vision we believe are in fact complementary. We've had meetings as recently as 2 weeks ago with the Army, and I think there's -- both programs are clearly supported. They aligned with their priorities. There's plenty of money for both in the budget. And we're focused on performing and delivering our products on time. I think our first delivery is in August. I was up there with my team in New Hampshire just several weeks ago, and the new production line looks great. The team is incentivized and motivated.

We have the right metrics in place. The supply chain is supporting us. So we're going to focus on enhanced night vision. We do have some augmented reality capabilities and technology. And the Army -- I think what we do best is listen to our customers, and they want both, and we're supporting. Do they converge down the road in some form? Maybe, but it's a priority, and we're going to perform in our program for the 10,000-plus that are under contract. And there'll be competition for the remaining 90,000 ENVGs, as you know, over the next couple of years, and we expect to bid and win those and deliver to the Army. So...

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

Okay. Okay. And then the other thing I wanted to ask you is higher level. And again I hope this didn't already come up. But you're now 3 months further into the planning process with Harris. The deal looks like it's poised to happen in the end of second quarter, early third quarter. Anything incremental that you and Bill have discovered here that you'd want to note in terms of opportunities?

Christopher E. Kubasik - CEO & President

Yes, I'm not sure if there's anything I would highlight. What we're working on here is just increased confidence. We had pretty thorough due diligence during that several months leading up to the announcement. But now that we have more people involved and dedicated resources working full time on this, we're completely aligned in what we want to do and how we want to operate the company. And we're going to roll out and clarify our combined strategy. We both believe in having an absolute world-class team surrounding us to do the work. We like common systems, common policies, common processes. We listen to our customers. We engage the workforce. And when we do those types of basic blocking and tackling, the results will be outperformed returns for our shareholders. So there's a lot more to it than that, but at a high level, that's what we're doing. And nothing new to highlight other than renewed or more confidence in what we have previously committed to.

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

Given the strength of your -- both of your business lines, do you think the combined company can be the growth leader in the sector in the next few years, top line?

Christopher E. Kubasik - CEO & President

I actually heard that question a couple of hours ago.

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

I wonder where.

Christopher E. Kubasik - CEO & President

I think I'll just say in the interest of time, my answer is exactly what Bill told you 2 hours ago. So...

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

Okay. Fair enough.

Christopher E. Kubasik - CEO & President

That's fair. And again on October 14 when we talk to you guys, I try to go back and relook at what we were saying and believed these are 2 companies on an upswing that are merging, and that's not always the case, usually there's one that maybe has troubleor -- you know better than I how that work. Both companies are strong. We have good strategies, good teams. We're growing and performing. And I think today further highlights that you got 2 companies on the upswing coming together, which should accelerate and result in better performance and that's what we're going to do.

Operator

And this concludes our question-and-answer session. I would now like to turn the conference back over to Chris Kubasik for any closing remarks.

Christopher E. Kubasik - CEO & President

Okay. Well, I also wanted to actually take a moment and thank Ralph. I didn't know he was going to -- I was counting up and came up with 52 earnings calls myself for Ralph. So I got to tell you, I appreciate on behalf of the shareholders what you've done over these years, and especially the support you've given me.

So with that, I want to thank everybody who called in today, and look forward to talking to you probably when we're wearing our L3 Harris hats.

Operator

The conference has now concluded. Thank you all for attending today's presentation. You may now disconnect your lines. Have a great day.