

THOMSON REUTERS STREETEVENTS

# EDITED TRANSCRIPT

LLL - L-3 Communications Holdings Inc at Jefferies Industrials  
Conference

EVENT DATE/TIME: AUGUST 10, 2016 / 2:00PM GMT



## CORPORATE PARTICIPANTS

**Ralph D'Ambrosio** *L-3 Communications Holdings, Inc. - SVP & CFO*

## CONFERENCE CALL PARTICIPANTS

**Howard Rubel** *Jefferies - Analyst*

## PRESENTATION

**Howard Rubel** - *Jefferies - Analyst*

Good morning. I am Howard Rubel with Jefferies. I am a managing director in the equity research department; follow aerospace companies. And I am here with Ralph D'Ambrosio, who has been Chief Financial Officer and Senior Vice President of L-3 since January of 2007. I can't believe it's that long. It's almost 10 years; this is like getting a -- that's pretty cool.

And so Ralph has had a number of experiences with L-3 over the years, but he is one of the smartest accounting guys that I know and I continue to find that out every once in a while in terms of why did it happen this way? Well, he explains it and then you get it.

So he is both a CPA and he graduated summa cum laude from Iona College. I guess you could almost say you are pretty New York native, if you wanted to find somebody who is a New York native.

I'm not going to say anything else. Ralph, it's great to have you here again and look forward to your presentation. Thank you.

---

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

Thank you, Howard, and good morning, everyone. Glad to be here again. I hope everybody is enjoying their summer.

I have a few charts on L-3 that I will go through quickly and then we will have Q&A. And I know Howard has plenty of questions for me. I look forward to those.

So L-3's key characteristics, I think you all know that we are an aerospace and defense company. We're both a prime contractor and a supplier or subcontractor. We are not a platform OEM.

And we do most of our prime contractor work in a few key areas, including ISR systems, which is intelligence, surveillance and reconnaissance; aircraft sustainment, which includes not only maintaining aircraft but also modifying, upgrading them to extend their service lives. We also are a leader in simulation and training for both the military on the fast jet and helicopter side and also in the commercial side in civil aviation.

Then we are one of the leading providers, if not the leading provider, of night vision and image intensification equipment. And we are also a prime contractor in security screening systems. Then we have a very diverse portfolio of electronic and communication systems, where we are largely a supplier.

Some of the additional key attributes about L-3 is that the Company's sales and profit base is well diversified across several contracts, several technologies, and product lines. So we don't have any significant or meaningful concentration in sales or profits in any single or handful of contracts. To give you a couple of statistics on that, our top 10 contracts comprise about 20% of our sales, our top 30 contracts about 30% of sales, and thereafter the numbers drop off very dramatically.

We continue to have a very efficient capital structure which means we use a good amount of debt to finance the Company. We are an investment grade credit at the lowest tier, which is Baa3, BBB-; that's where we intend to remain. Keeping the investment-grade credit ratings is important to us, but we do not want to increase them. We are very comfortable at the lowest tier of investment grade.



And then another enduring characteristic of L-3 has been the fact that we continue to generate very high earnings to cash flow conversion. Very simply, that is because we have a good amount of non-cash expenses on our income statement.

In terms of our business objectives and strategic objectives, it starts with satisfying our customers. We are focused on growing the Company -- again, both organically and through acquisitions -- improving our margins, and disciplined capital allocation or cash deployment to achieve those objectives. And while I don't have it listed there on the page, obviously continuing to provide a healthy, prosperous environment for our employees, including management, is critical because they're the ones who make it all happen in terms of achieving those objectives.

Couple of comments on the US government markets, which represent about 70% of our sales; most of it to the Department of Defense. I think it's a fair statement to say that the geopolitical situation around the globe certainly supports continued increased military spending.

Here in the United States we just went through a downturn in terms of the US defense budget, which over the last five years declined almost 20%. In FY16, which we are presently in, the budget is growing again and we expect that it's the beginning of a new up cycle in terms of defense budgets, where we expect to have at least low single-digit growth in the total defense budget for the next several years.

The classified budgets are an important area of the overall defense budget and probably comprise about 25% of the investment accounts. That is a key investment area for us where we have been putting additional resources into R&D, business development, and marketing and selling, and we think that's going to be a good growth area for us over the next several years.

While the defense budget is growing, there are still constraints in that the armed services or the DoD is not obtaining all the funding that they need and that they are asking for. So there are still trade-offs that need to be made across the services in terms of procurement of hardware and services. But that is an environment that we are accustomed to managing in and we are very comfortable living in that environment.

Some of the key capabilities that we offer to the US government and to the US military are protected communications. That includes not only secure data network systems but also advanced communication systems and command control information, as well as signals intelligence.

We are also a leader in ISR systems. We not only missionize aircraft to perform ISR functions, but we also supply the ISR systems, including the EOIR sensors that are needed to collect and sense whatever information is being targeted and then also the communication systems that transmit the collected information from the platform to the users of that information.

We are also leader in providing naval power systems on virtually all the U.S. Navy surface ships and submarines. We talked about night vision equipment already. We are a key provider in the area of readiness support and that's a topic that has received a lot more discussion, particularly in the FY17 budget request. And FY17 begins in less than two months on October 1.

What we do to -- in the readiness support area is we not only maintain and sustain equipment, we also provide simulation and training, which includes aviation, flight training, and training on missions and weapon systems. Then we also do a lot of sparring and repairing of parts on different platforms that are considered readiness.

Lastly, we do a lot to support the special operation forces. That has been a priority area, a growing area despite the downturn, and one that we can continue to see growing the next several years.

The international and commercial markets, which comprise the other 30% or so of our sales, almost split equally between them. We all know that these markets are affected by global economic and security conditions, which are presently evolving.

On the international side -- and this includes sales directly to foreign governments as well as foreign military sales, brokered through the US government -- some of the key things that we do there are ISR systems, simulators, communications equipment, night vision, and sensors. We are experiencing some near-term softness in these markets, but we expect that they will be a long-term growth market for L-3, just not growing this year. And they look like they are going to be kind of flat for 2017 as well.



On the commercial side, we continue to see very favorable long-term fundamentals. A lot of what we do is tied to commercial aviation in one form or another, starting with the avionics equipment on aircraft, security screening in airports, and then aviation training and simulation for pilots and aircrews. And then we also do a variety of RF microwave communication and power devices.

Here is a closer look at our commercial sales. As I just said, you can see that nearly half of it or a little more than half of it is tied to commercial aviation. And then 20% or so in RF microwave and power, and the rest is spread across some small niche areas.

A few comments on each of our three business segments. Electronics Systems is our largest, most profitable segment. We do about 40% of our sales here and about 50% of our operating income. It's a very diverse portfolio of products with high barriers to entry, significant installed base, and discriminating technologies to go with it.

We have six sectors in this segment, which are summarized on the chart. I'm not going to go through those; maybe we will talk about them in Q&A.

We continue to invest significantly in R&D here, as well as acquisitions, and we also have done a lot of portfolio shaping or divestitures to further strengthen this segment over the last couple of years. Given that it's our largest segment, we still have opportunities to take more costs out and we are focused on items such as supply chain, the back offices, and facilities.

Aerospace Systems, our second-largest segment; about 40% of sales, 30% of profit. The margins are lowest here, but we are beginning to improve them in 2016. And we're making investments here in next-generation ISR or recapitalizing ISR assets. We see a lot of that activity happening toward the end of this decade, a few years out. We are also investing in aircraft depot maintenance and the service life extension programs that I talked about earlier.

Then lastly, Communications Systems, which is both about 20% of sales and operating income for the Company. We probably have our most long-lived solid positions in terms of platforms on -- in this segment and we continue to invest in secure, protected, and advanced communication systems. Our DoD or US military sales have stabilized here and it looks like they're going to begin to grow next year. We have some near-term pressures that will resolve themselves in the commercial and international markets this year and I've talked about those for a while. We continue to make improvements here in terms of increasing our manufacturing and labor productivity and wringing out synergies from some recent small acquisitions that we've made.

So those are our three segments. Here is a summary of our 2016 consolidated financial guidance, which we provided at the end of last month, a couple weeks ago or so, when we reported our second-quarter earnings.

About \$10.2 billion in sales. Organic growth of about minus 1%. Operating margins at 9.8%. Diluted EPS growth of 12% and very solid, robust cash flow of \$825 million.

So to summarize, we believe we are at the beginning of a new up cycle for the US defense budgets, which is good news for L-3 because the DoD comprises 70% of our sales. We continue to make investments in affordable, innovative solutions that our customers need and require; generating robust cash flow; and a focus on growth organically, supplemented through acquisitions, improving margins, and deploying the strong cash flow that we generate in a way to enhance and grow shareholder value.

So I know I said a lot there, but that concludes my comments. We will now do the Q&A.

---

## QUESTIONS AND ANSWERS

**Howard Rubel** - *Jefferies - Analyst*

Ralph, why don't you join us -- join me here and we will chat about some of the things and see where we go?



First, I made the point you have been CFO almost 10 years. The first 10 years of the Company's life was really built on acquisition and the last 10 years I think has been a little bit more consolidation and buying back stock. Now you seem to be going through a phase where you might do a little bit of both.

Talk about how you arrived at that conclusion and talk about the trade-off between doing a deal and buying stock.

---

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

Just to fill in some more history to what Howard just commented on, while we have continued to make one or two small acquisitions in each of the last several years, 2006, which is now 10 years ago, was the last year where we had done a significant amount of acquisitions. And then I talked earlier about the DoD downturn in terms of defense budgets. It started in about 2010 and just finished in 2015.

Generally you don't want to make a significant amount of acquisitions during a downturn, because if you make a mistake they tend to be amplified in a down cycle. So we are more comfortable making acquisitions where we see an upturn and have more confidence in where the funding levels are going to be in terms of priorities. And then we will go out and try to make acquisitions to address those priorities.

We are now at the beginning of an upturn, so naturally we are more inclined and more comfortable to make acquisitions. And when we reported earnings a couple weeks ago we talked about the fact that we deliberately slowed down the share repurchases this year because we intend to shift some of that cash deployment into acquisitions. And I said say that would probably be somewhere in the \$200 million, \$300 million of acquisitions in the second half of this year.

---

**Howard Rubel** - *Jefferies - Analyst*

You get a better -- what we saw in the past is you got a better multiple as you did accretive deals, and so maybe you get a little bit of that going back as well?

---

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

We definitely like -- not only do we want our deals to be GAAP accretive, but we want our acquisitions to generate good economic returns on the investment. And, obviously, that's after finding targets that fit well with our existing businesses and core capabilities. Then, of course, they have to be -- the target has to be available, because when they are not available certainly you can do things to pursue targets, but that can tend to drive the price up dramatically.

Last thing you want to do is buy a good company or even a great company at a very high price, because it turns out in most cases to not be a good investment. So we want good companies that are good investments for our shareholders.

---

**Howard Rubel** - *Jefferies - Analyst*

It's clear platforms are not where you are going to do things and it's more either connectivity or sensors or --. I'd say -- I mean look at your -- you own a terrific microwave company, so those are --. I'm not putting words in your mouth, but I'm just trying to sense is that as we look at the strategy we would expect things that enhance platforms as a way of looking for deals. Is that fair?

---

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

That's generally correct, Howard, so we are looking at things that enhance platforms, including a variety of payloads. That said, we do have interest in some small niche-type platforms. In fact, we already are a provider of small UAVs and we are interested in some other small platforms.

But when it comes to being a platform OEM, it's either you are or you are not. The installed bases are very large and entrenched, so typically if you are going to be a large platform OEM, you need to acquire your way into it, especially in the US defense market. So that's why our interest would be in the smaller-type platforms where we see better, easier entry or access into those markets.

---

**Howard Rubel** - *Jefferies - Analyst*

Value-added partner might be a way of thinking about what you're going to do with some of these primes. One of the changes that has occurred in the last six to nine months has been, I will call it, forward-looking on bidding and forward-looking on I will call it focus, focusing both your R&D and your customer-funded R&D. Can you address that? Have we seen any evidence of a change, either in terms of bookings or --?

---

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

I guess the key change when it comes to R&D is that we are increasing our R&D investments this year and over the next several years. Putting a lot more resources in targeting and going after the US government classified markets, which I talked about earlier, and we have always had a significant focus on R&D and in bidding and proposing.

Just the last couple years we had some unfortunate isolated issues which really obscured the strength of the rest of the Company. And I think what you are seeing in 2016 and the beginning of -- or near the end of 2015 is that the Company is actually very strong across all the segments and you see that now in our results.

---

**Howard Rubel** - *Jefferies - Analyst*

So we usually look in parts of the markets to reasonable sizes; you are usually number one or number two in most of the individual businesses that you compete against. Is that sort of a --?

---

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

That's our ambition and, in most cases, we are one or two. We think we need to have a leading position to compete effectively and to generate the right type of returns that we are going after.

---

**Howard Rubel** - *Jefferies - Analyst*

Representative Thornberry has said there's not enough money being spent on training and mission support, and you've got a very capable business and you've got some capacity to do some things there. How do you --? You have to take advantage of the market changes, but how do you approach that market?

---

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

What you are talking about is readiness support, Howard, which I mentioned earlier. I think it's a fact that during this downturn, including the drawdowns from Iraq and Afghanistan, a lot of -- there was some neglect in the readiness support areas, which includes mission training and maintenance equipment.

Not only have the Armed Services recognized that, but also Congress has, and that's why I think we are going to see more funding budget being moved into readiness. There was also some reprogramming that recently occurred where I think \$4 billion or \$5 billion was moved in the FY16 budget from investment to O&M for readiness-type support activities.



So we do a lot there. We maintain aircraft. We do mission simulation and training systems. We equip the force, special operation forces; sparing and repairing across several platforms. That's all part of readiness support.

---

**Howard Rubel** - *Jefferies - Analyst*

One of the platforms that you are probably more in the middle of than anything else is the C-12, which is the modified King Air. You had a great program called Project Liberty and that's gone, but there's been other needs the Army has exhibited, whether it's intelligence collection or I'll call it mission support. Then there's a program called EMARSS which has been in and out of the budget. Where do you stand with that? What do you see the market for the C-12?

---

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

So we think it's going to --.

---

**Howard Rubel** - *Jefferies - Analyst*

There's really two parts to it really. There's -- I will call it the hardware part and the support part.

---

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

Yes. And there's the C-12s that are geared toward ISR-type functions and those that are geared toward transport utility. I will focus on the ISR-type stuff, which includes the platforms that you mentioned.

The Liberty platform or program has been reduced and some of those aircraft have been dispersed to special operation forces, the Army. What the Army is doing is converting some of those into EMARSS configurations and we're doing that. Then some are also going to the National Guard and some are being retained by the U.S. Air Force.

We continue to see opportunities for C-12 type small turboprop aircraft in the US military and also overseas, but admittedly, the pursuits that we've gone after overseas are taking longer than we anticipated to come to fruition in terms of awards and bookings and orders. So we see the DoD market kind of flat for the next several years, with growth opportunities overseas to the extent that we can convert some of these orders. As I said a couple weeks ago, that's really not happening in 2016, but we made up for it with upsides and increases in orders in our Electronic Systems and Communication Systems segments.

---

**Howard Rubel** - *Jefferies - Analyst*

Let's talk about those two segments, those two items for a moment, on Comms and then also on Electronics. More and more, this is not only about a kinetic war. It's about knowledge of where the bad guy is and tracking him.

And so how do you expand the platform opportunities? Whether it's Westcam, which is really a great example, or the broadband capability in terms of just streaming high-quality video for either the soldier so he understands situational awareness?

---

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

The short answer is we mostly do it through R&D investment. So to give you an example: you mentioned broadband communications. That's about half of our Communication Systems segment in terms of sales, about \$1 billion.



So what has happened with the threat evolving to near peers from asymmetrical threats, the focus nowadays is on countering A2AD environments, or anti-access/area-denial, and that's all about having communications that are anti-jam with low probability of intercept. So we've made significant investments in those areas over the last several years. An example is our Chameleon waveform technology which allows that anti-jam LPI to happen.

So we see those type of capabilities becoming a critical requirement, a necessity on essentially all the major platforms in the US military and, of course, our allies. So we see that as a good growth area for us in the next several years.

You talked about Wescam, which is our business in Canada that Chris and I actually visited a few weeks ago. Essentially what they do there is they are experts at stabilizing cameras and related type of equipment on any type of platform.

What we are doing there to improve the technology and the capabilities is just putting more and more capability in terms of sensors and designating abilities, targeting abilities on those turrets or stabilized cameras. And also making size, weight, and power reductions so that you can have a smaller turret do the same function, have the same type of capabilities that a larger turret would've had years ago. That's what we are doing in the Wescam business area.

---

**Howard Rubel** - *Jefferies - Analyst*

I can't let a defense contractor get off the stage without talking about pensions for a moment, but you have a unique position --

---

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

Pensions, they're either a headwind or a tailwind, right?

---

**Howard Rubel** - *Jefferies - Analyst*

Exactly. Or a nuisance to a -- they are important, but you're in a different position from most and maybe you can talk about how it becomes less -- I don't want to use the word relevant, because it's not -- but less of a factor in terms of earnings and cash flows going forward.

---

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

Sure. We do have defined benefit pension plans, which today about 20% of our employees have or participate in the defined benefit plans. And they tend to be our older employees. We expect that over the next 10 years or so most of them will retire.

We had frozen our pension plans to new hires almost 10 years ago, so we are in a situation where naturally, actuarially over the next decade our pension expense and funding contributions should continue to decline and be sources of additional earnings and cash flow. In the meantime, we continue to have and can have aberrations and that's what's happening this year with the once again dramatic drop in interest rates that has happened since the end of last year.

We talked about this on the second-quarter earnings call and we explained that if we had set the pension expense assumptions today for next year -- and we won't to that until December 31 -- given the drop in interest rates, which we estimate is somewhere around 90 basis points, that's going to increase our pretax pension expense by about \$45 million for 2017 versus 2016. But that is not a situation where you can have the same thing happen year after year, unless you assume that interest rates go negative and then further to the negative category, which doesn't seem possible or plausible.

Beyond next year -- and who knows what could happen between now and the end of this year with the interest rate markets -- we definitely see the pension expense systematically declining year over year.



**Howard Rubel** - *Jefferies - Analyst*

Right. At some point you will never hear this question again from people, or if you do, you will go, why are you asking me this?

Then last, you've got -- you do the examiner for the TSA. And I can't just -- if you could figure out a way to just walk through this thing and get it done, you know you'd be able to make millions more than you do. What you doing in --? Is there more opportunity there? I mean going to end it on a high note, because everybody touches and feels that product. There's something that can change.

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

There is more opportunity there and we've seen how the security threats have changed. They've moved away from a checkpoint, because the checkpoints have been generally well secured in airports, whether it be passengers as well as checked baggage. Now it's being moved into before the checkpoint.

So you can be sure that the TSA and other airport and government authorities are thinking about how to improve the security situation and we are doing the same. There should be more opportunities emerging where there will be more standoff-type applications before you get to the checkpoint. We will see what happens in that regard, but there's going to be new technology brought to bear, for sure, to deal with this evolving security threat.

**Howard Rubel** - *Jefferies - Analyst*

So maybe to sum it up, you've got some big duty programs, but then outside of the big ones there's I will call them multi-options for growth. So we have to find that balance between thinking about -- at some point you're going to be able to grow again consistently faster than the DoD budget as most of us think about it, but it will take a little bit of time for it to happen.

**Ralph D'Ambrosio** - *L-3 Communications Holdings, Inc. - SVP & CFO*

We think it could happen as soon as next year so --.

**Howard Rubel** - *Jefferies - Analyst*

Well, thank you, Ralph.

**DISCLAIMER**

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2016, Thomson Reuters. All Rights Reserved.