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EDITED TRANSCRIPT

LHX.N - Q4 2021 L3harris Technologies Inc Earnings Call

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OVERVIEW:

Co. reported 4Q21 non-GAAP EPS of $3.30. Expects 2022 revenue to be $17.3-17.7b and EPS to be $13.35-13.65.

REFINITIV

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PRESENTATION

Operator

Greetings, and welcome to L3Harris Technologies Fourth Quarter Calendar Year 2021 Earnings Call. (Operator Instructions) As a reminder, this call is being recorded.

It is now my pleasure to introduce your host, Rajeev Lalwani, Vice President, Investor Relations. Thank you. You may now begin.

Rajeev Lalwani - *L3Harris Technologies, Inc. - VP of IR*

Thank you, Rob. Good morning, and welcome to our fourth quarter 2021 earnings call. On the call with me today are Chris Kubasik, our CEO; and Michelle Turner, our CFO.

First, a few words on forward-looking statements and non-GAAP measures. Forward-looking statements involve risks, assumptions and uncertainties that could cause actual results to differ materially. For more information, please see our press release, presentation and SEC filings. A reconciliation of non-GAAP financial measures to comparable GAAP measures is included in the Investor Relations section of our website, which is l3harris.com, where a replay of this call will also be available.

In addition, following our 8-K filed earlier in the month, we'll be speaking to our 2021 results in our prior 4 segment structure, and our 2022 outlook will be in our realigned 3 segment structure that also shifts pension items to the corporate level, furthering operational transparency.

With that, Chris, over to you.

Christopher E. Kubasik *- L3Harris Technologies, Inc. -*

We also expanded our external investments to broaden overall offerings in various capability sets. We're making calculated investments in partnerships and companies so we can bring unique technological solutions to global defense customers. There will be more on this topic throughout the year.

Next, let me update you on the progress we've made as a non-traditional prime, what we call being a trusted disruptor. Our positioning at the nexus of traditional defense players and new experimental commercial entrants aligns well with the U.S. government's desire for agile, advanced and affordable solutions to address near-peer threats. We expect budget dollars to continue gravitating in this direction.

A notable example is within the space domain and the need for responsive satellites that can be rapidly procured and deployed to address a range of threats. We were awarded over $0.5 billion in responsive satellite contracts as a prime in 2021, including the $200 million award for a classified mission within the Intel community in the fourth quarter and we have considerable and exciting opportunities ahead of us.

Turning to International. We continue to see demand for our defensive solutions that are aligned with U.S. export policies and ensure partner security. And with a book-to-bill of 1.1 on solid revenue growth in 2021, our strategy is solid.

We had a strong growth in our ISR aircraft missionization business from a key NATO customer with awards of over $600 million, including $70 million in the fourth quarter, which is part of a broader multi-billion dollar opportunity set we're pursuing in 2022 and beyond.

In addition, our international Tactical Communications business continued to experience robust order activity for land modernization in the U.K., Australia, and a Mid-East country that totaled approximately $500 million for the year and over $200 million in the quarter. This pairs well with the expanding DoD modernization goals, supporting multi-year growth potential for our business.

In fact, just last week, we were awarded a $750 million IDIQ by the U.S. Marines to manufacture the Falcon IV multichannel advanced handheld radio that meets modern crypto security standards, while providing them resilient networking capabilities.

Overall, I'm pleased with the tangible progress we made in 2021 as we delivered a funded book-to-bill above 1.0 and grew our organic backlog by 5%.

Let's pivot to operations. Our integration efforts were quite successful and will wrap up in early 2022. We also continue to drive a performance culture through our e3 program, that pervades the organization and has been key in mitigating the unforeseen challenges related to the pandemic.

We talk about the key components of our e3 program, factory optimization, engineering excellence, supply chain and overhead management. In 2022, we expect these factors to at least offset predicted inflationary pressures for both labor and materials, which we'll look to improve upon as the year progresses.

We're off to a good start with our segment and business consolidation efforts. And over the last 2 quarters, we've delivered margins at or above 19% on a consolidated basis or approximately 16% on a segment basis using our new reporting structure.

We've also reached several key operational milestones this quarter. Within Space, we successfully completed critical design reviews for 2 major responsive satellite programs. First, the Space Development Agency's tracking layer and second, the Missile Defense Agency's Hypersonic and Ballistic Tracking Space Sensor, known as HBTSS. We are gearing up for prototype launches of 5 satellites over the next 2 years.

Within our ISR business, we completed a key flight test and received a supplemental type certificate for the first Compass Call Cross Deck aircraft, the U.S. Air Force's missionized business jet. This strategic aircraft arrived in our Waco, Texas facility in the fourth quarter, where we began the next phase of modification. It is scheduled for delivery to the customer later this year.

Lastly, our WESCAM product line within our electro-optical business concluded its transition to a new state-of-the-art manufacturing facility and delivered a record high number of turrets in the fourth quarter as well as for the year.

Concerning our supply chain, the environment continues to be fluid. For 2022, we expect supply chain disruptions to continue into the first half. As a result, our team is set to continue utilizing the various tools we outlined to address the challenges, such as engaging with lower tiers of the supply chain, accelerating our purchase commitments, utilizing DPAS designations and leveraging smart inventory in selected areas.

Shifting to capital allocation. Our focus remains on maximizing cash generation and strengthening our portfolio, while sustaining a shareholder-friendly approach. Growth in free cash flow per share is a key metric for us. This will remain a 2022 focus as we drive our profit growth, reduce working capital days, continue tax planning and manage capital expenditures. When combined with our share repurchases in 2021 and our current target of $1.5 billion of repurchases this year, we expect free cash flow per share growth of 10%, assuming the R&D tax credit is repealed, contributing to double-digit annual growth since the merger.

Regarding the dividend, it remains part of our balanced capital allocation framework with opportunities to grow it further as we've done in prior years. Finally, with respect to M&A, we'll be opportunistic and use our balance sheet capacity judiciously to complement our capital return program.

Let me now provide details on our 2021 results and the consolidated guidance for 2022, and I'll ask Michelle to fill in the segment and other details on the outcome.

So let's start on Slide 4. I'll refer to all 2021 figures in our prior 4 segment structure given our realignment became effective in early 2022.

Fourth quarter organic revenue was down 1% versus the prior year. CS and AS were down 11% and 5%, respectively, with electronic component

Segment operating margins are expected to be 16% to 16.25%, positioning us for another year of expansion and are expected to follow sales with more profit in the second half of the year. This, combined with a 4% lower share count, will result in 2022 EPS of $13.50 at the midpoint. On free cash flow, our $2.15 billion to $2.25 billion guide includes a $600 million to $700 million headwind from the R&D tax policy.

So with that, I'll turn it over to Michelle.

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

Thank you, Chris, and good morning, everyone. I look forward to my engagement with the analyst and investor community at upcoming events and conferences.

I'll continue now on Slide 10 with our 2022 segment details and our realigned 3 segment structure as well as provide additional color on the 2022 EPS bridge and cash flow.

Integrated Mission Systems revenue is expected to be $7.1 billion to $7.3 billion, up 2% to 4% driven by Maritime expansion, classified growth in defense aviation and continued recovery in our commercial aerospace business. ISR aircraft timing from a tough compare is expected to drive a low to mid-single-digit decline in the first half with high single-digit growth coming in the back half of the year. Segment operating margins are anticipated to be within a range of 13.5% to 13.75%, with e3 program savings more than offsetting program mix impacts.

In Space and Airborne Systems, we expect revenue of $6 billion to $6.1 billion or flat to up 2%, driven by our traction and responsive space, along with classified strengths in Intel & Cyber, which we moderated by continued pressure in our airborne businesses as we transition to modernization over the coming years. Segment operating margins are expected to be within a range of 12.5% to 12.75% as e3 program savings offset mix headwinds from key growth programs within space.

Communication Systems revenue is expected to be $4.4 billion to $4.5 billion or up 2% to 4% from modernization demand in Tactical Communications, with supply chain delays netting an expected mid-teen decline in the first half and strong double-digit growth in the back half of the year, along with recovering sales in Public Safety. Growth will be moderated by a flattish outlook in broadband and integrated vision solutions. Segment operating margins are anticipated to be within a range of 24.25% to tishiadband a6aed ydnd a6avrowthon or flat to uplltC.1 eymand in r8r8rbe w cV 4 F©(C

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question is from David Strauss with Barclays.

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

Thanks, good morning everyone and welcome Michelle.

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

Good morning.

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

Operator

Our next question comes from the line of Peter Arment with Baird.

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

Thanks, good morning Chris and welcome Michelle. Chris, maybe you had $0.18 at least baked into your '22 guidance for the supply chain adjustment, and that's obviously better than the $0.29 in '21. So maybe just your confidence around the supply chain? And what kind of visibility, what's baked into the $0.18? And then just also, Michelle made a comment about just modest working capital improvement. Maybe you could just discuss a little bit what's behind that?

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

Yes. Thanks, Peter. No, relative to the supply chain, we think we're doing a pretty good job over the last maybe 6 or 9 months, as I mentioned, with getting more visibility into the second, third tier supply chain. We've invested in tools that give us that visibility. So we've talked previously about a $200 million revenue headwind in '21. We see that continuing in the first half of 2022.

And I think where we've been maybe a little more conservative than in October as we see that recovery bouncing back in the second half of '22 and then also in early '23. So think of that about a $100 million headwind each quarter in 1 and 2, and then maybe getting $100 million back in the second half and $100 million back in early '23 from a revenue. And of course, that brings along the related operating income.

So that's how we see it. But it's a dynamic area. It's mainly been focused on electronic components. But we're monitoring it and managing it at all sectors and all segments. And it feels like we've turned the corner, but we'll keep you up to date kind of quarter-to-quarter as things change.

So relative to working capital, as we try to get to the guidance, we ended the year at 52 working capital days. We'll bring that down a couple of days as we go to that $2.8 billion to $2.9 billion guide. Michelle?

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

Yes. And just to add a little bit more color on the working capital. If you think about it, we built smart inventory at the end of 2021. And so we expect a Tactical Communications comes back in the second half. We'll bring some of that down. And then there's also an advantage from an ISR perspective on advanced payments that we're anticipating at the end of the year as well. So it's going to help free cash flow within 2022.

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

And I'll just throw in, Peter, just our definition of supply chain is pretty broad. We're throwing in the labor. We're throwing in material and we're throwing in inflation. So all that contributes to the $0.18.

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*

If you were to think of 2022 without these headwinds having been there, what would you see Communication Systems looking like in terms of growth margin? And is this something, given that there's a headwind there, is this something that we should see all coming back when we move out to 2023? Or is there just going to be some lost demand and margin here?

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

Yes. Doug, that's a great question. Something we spend a lot of time looking at. I don't see any loss. I think this is just a timing issue. And as we were looking through the business, just the other day, I mean it's had a great book-to-bill in 2021. Now some of that is due to less revenue, but we have a record backlog, an all-time high in backlog, which is an indication that we continue to win new business.

And I mentioned just the marines recently, which is a winner-take-all competition. So we're very excited to have won that $750 million IDIQ. And throughout '21, I think we were pretty clear in all the head-to-head competitions we won the majority share. So the demand is there. The modernization is happening that's in our backlog. And everything indicates to be going quite well.

As I said, the big change is in SAS, and we can argue how big a change that was. But clearly, downward pressure on the top line. And as I mentioned in an earlier comment or response, most of that is driven by the air domain and F-35 specifically.

The good news is that's a well-known program that everybody has visibility into. So we have confidence that as we negotiate Lots 16 and 17 and prepare for the cut in of our technology on Lot 15, that there's a lot of certainty and predictability in our revenue stream. So we do see '23, '24, '25 coming back.

Longer term, just within SAS, I mean I really like what we're doing in the Space business, both on the satellites and the ground stations. We pretty much control our own destiny. You've heard us talk about the missile defense area, and we'll be launching 5 prototypes in the next 2 years.

And then I think there'll be further opportunities to down-select from 2 to 1. And if we perform and have success, there could be billions of dollars of opportunities. So I really like where we are in Space with the responsive SATS.

We still work with a lot of our industry partners, providing them payloads for the exquisite SAT. And we've been successful in winning a lot of ground stations. So I'm excited about the space.

Intel & Cyber continues to grow. That's an international business doing work with the Five Eyes countries. It's probably the hottest market that we have. And again, I think long term, there's just going to be more and more. Mission Networks, we have a competition, a recompete, coming up for the FAA and hopefully sometime this year, but that continues to be a good business and solid and steady.

And then it's really all about air and the F-35 program, the EW capabilities for the F-16. Internationally, we're on the B-52, and that's a complete overhaul relative to EW capabilities. And then we think we're well positioned on next-gen aircraft, but all that is classified as you know, and more to come as those decisions and down selects are made. So longer term, SAS, just like the other 2 segments, should be able to grow. And that's our plan.

Operator

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

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

Thanks so much, and good morning everyone. Chris, you commented about -- so you had a good year on the export side in 2021. I was wondering what your expectations are for 2022? Whether these various tensions around the world, particularly in Eastern Europe could have some benefits for orders?

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

Yes. No, Robert, good point. I mean for the last couple of years, our international business has been growing double digit. And I think our strategy, which is somewhat unique, I think, compared to others. We have focused countries, 10 focus countries, where we have executives full time in the countries. And then we use our distributors and reps more for the product. So it seems to be paying off, and we've been able to see that growth.

I mean beyond '22 and beyond, we're seeing a mid-single-digit growth. But as you said, anything can change rather quickly, especially in the

Richard Tobie Safran - *Seaport Research Partners - Research Analyst*

Michelle, welcome to the call. Once again, you're highlighting e3 as a tailwind in '22. I was curious as to how much runway you think you have left with respect to e3 cost savings?

You've been reporting the e3's benefit to margins for quite some time. And I was just curious if you think longer term, you have continued room for meaningful improvement? In your answer, if you could get a bit more specific about where you think the additional benefit comes from?

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

Thanks. Great question. And the answer is obviously going to be yes. I think the system and the methodology we've put in place has been a success,

Elizabeth Grenfell - *BofA Merrill Lynch - Research Analyst*

It's actually Elizabeth on for Ron this morning. I just wanted to follow on to the last question, I think you hit on a little bit. But given what we've seen in the new administration, do you think in general, the environment for defense M&A has changed? So you said not for you, but maybe just in general, do you think it's changed? In many ways, do you think big defense M&A is over?

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

Yes. No. Elizabeth, I would think these decisions and policies change administration by administration. So with the current administration, it would appear that, that big M&A, if that was considered big, is potentially over, at least until there's a change in administration at some future point who may or may not have new policies.

So as I said, I haven't really looked at and probably won't have the time to figure out what the specific case was. But I think it's always a predisposition for more competition and less vertical integration. And when I look at the L3Harris merger, that went through relatively quickly. It was complementary. We're now in all 5 domains.

It made perfect sense. It was just a very small business that wouldn't allow for competition. So it was divested. So I think you can look at these things pretty quickly and figure out if they're going to go through or not. And I continue to believe that from our perspective, there will be plenty of opportunities.

I think at some point, there's a reluctance to have really big guys get bigger. So I kind of like where I am relative to the real big guys. So that's how I see it from my perspective. We're going to run our playbook and see what happens. And others either will or won't be in the game, but I like where we are.

Operator

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

Robert Spingarn - *Melius Research - Research Analyst*

Welcome, Michelle. Two quick things. Chris, on the talent side, how difficult is it to get people? And what kind of labor inflation are you seeing? And how is that impacting fixed-price contracts?

And then, Michelle, just on the tax situation, if you could give us the mechanics? We've been talking about this with everybody for a week. But what are the mechanics of this higher tax rate? Will you pay cash taxes at the higher rate quarterly until you find out what's going to happen and then it gets refunded? So if you could just clarify that.

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

Yes. So I'll start from an R&D perspective. And you're right, there has been a lot of fluidity in the calls this week. And so just to reiterate what we have in our guidance. So our free cash flow assumes with the $2.15 billion to $2.25 billion, it assumes $600 million to $700 million related to the R&D tax amortization.

And I think it's important to note that this is the tax law that's in effect today, right? So as part of the 2017 Tax Cuts and Jobs Act. And so barring a repeal or deferment, this will have an impact on our results. And so for us, it's about $2 billion over 5 years, and then it goes away. So that will go down to 0.

I think to the point about paying it, not paying it, that's certainly something that we're looking at right now. But just to give you a sense of kind of the fluidity you're seeing through the other primes, it really comes down to a couple of different things. One is, clearly, you have everybody understands what they're paying from an IRAD perspective. But where the interpretation comes in is around the CRAD. And then what you apply to the CRAD in terms of overhead and fringe on top of that.

And so that's where you're seeing the ranges across each of the different peer companies. And so we're going to work through in terms of what the cash payments will look like, and that's discussions that we're having internally right now. But I think what's more important if we were to take this back to a macro level, it's important that we continue to press on the real issue here, which is we need to get this repealed or we need to get it deferred. It is going to be a huge impact from an overall U.S. competitiveness perspective. And so ensuring that this gets delayed, is important to continue to drive the innovation that we think about and keeping the U.S. at the cutting edge of innovation.

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

Thanks, Michelle. And then Michelle and I have spent a little bit of time with the tax department in her first week. And it's just a world class organization. And when you look at the metrics, whether it's our effective tax rate relative to others, if you look at our R&D tax credit, which is not what we're talking about now relative to others and the percentages, I think we just got a great organization there.

And we're seeing that in our financial results. So going to the talent question, which is a great question. Actually, in 2021, we hired 8,000 new people. And I talked about COVID earlier, and we opened the office and kind of got back to whatever the new norm was in December.

And it was interesting because at that time, half of those employees, 4,000, have never even been to a L3Harris facility. We FedEx them laptops and do everything via Zoom. So talking about a new kind of world here. But we've hired 8,000. We're probably going to hire another 8,000 this year.

We're seeing a little bit of inflation or most of the inflation is at the entry level. We haven't really seen that at the higher levels or the executive levels yet. Maybe that comes later in 2022. But a lot of this depends on geography, and half our workforce seems to be in Florida and Texas. And those seem to be places that people enjoy living and working or moving to.

So we've been a little more fortunate maybe just based on the geography. We get about 1,000 new college grads a year. We have a whole process as to how to recruit those through key schools, focused schools. And we've maintained our internship program the last 2 years, even during the pandemic. Unfortunately, those were all remote. But I think I told you back in 2020, we extended offers, we honored those offers. All those things kind of contribute and pay off.

And my goal and the team's goal is to have an engaged workforce that's excited to come to work every day and help with our mission. We do periodic engagement surveys to track that. So I think we're doing everything we can. A big believer in flexible work schedules. And we've got a whole variety of ways to have the workforce stay engaged and contribute.

But clearly, a watch item. But so far, so good. I mentioned F-35 earlier and some of the challenges that, that program has had. We've been fortunate to have a highly engaged workforce holidays, weekends, over time and been able to maintain that staffing even through the pandemic and meet our milestones.

So hopefully, that helps, Robert.

Operator

Michael Frank Ciarmoli - *Truist Securities, Inc., Research Division - Research Analyst*

Welcome, Michelle. Chris, I just wanted to go back, I think, to maybe Sheila's question on what really changed in SAS? And maybe even dovetailing in kind of programs that are being impacted by the continuing resolution. But I think you kind of called out the biggest, being the F-35. And it seems like that would have been a known sort of headwind, I guess, in October.

So were there any other big specific programmatic changes or programs that you can't start up because of the continuing resolution that are weighing on that kind of growth rate?

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

Yes, good question. No, I mean, the F-35 is a pretty dynamic program, right? So we follow the prime and as quantities and strategies change relative to what's going to be retrofitted and what's not and such, and I'm talking about all F-35, which we have crypto capabilities. We have displays. We have bomb racks and of course, TR3.

So it's a broad portfolio of just under $1 billion of revenue. So it changes on a regular basis. I can assure you. But it's a fair point. We didn't have it at $150 million last time we talked.

But relative to the CR, this probably won't be a satisfying question. The fact that we have a CR has caused the contracting organization and our customers just to defer and delay making awards. Which is kind of an indirect impact.

I mean there are programs that have been awarded that the follow-on work is limited to the prior year dollars. The new work can't get started. So these aren't getting awarded. And we just see a huge backlog of things that just haven't been awarded.

So a lot of these are in the space of the classified arena. And most of the space work is domestic. They don't have a big international footprint as an example. Electronic warfare and Mission Avionics, again, most of those programs we're supporting an OEM. So we need them to go ahead and get their orders before putting us under contract.

So it just feels like a big delay. I think as soon as we get a budget, as soon as there's more certainty, things will kind of open up and then the floodgates will open. But until now, we're probably erring on the side of conservatism. But like I said, based on the current conditions, we're standing by this guidance until things change for the better. And if and when that happens, we'll update you accordingly.

Operator

So yes, IMS will take the lead, but we'll be able to pull through. The E-6Bs, I think that's one that we were hoping for last year, and it continues to slide. We'll have to follow up with you with the exact dollar opportunities. It's on our priority of pursuit list to get both of those programs. But I think it's a '22 program.

But with all the things that I talked about, it could slip into '23. So -- we'll get you more information on that one, Pete.

All right. Well, look, before we sign off, again, I want to welcome Michelle. It's obvious, she's hit the ground running. I'd also like to acknowledge the dedication and hard work and perseverance of our 47,000 employees worldwide. We've continued to perform well in a constantly changing environment. They've had to deal with different work schedules, locations, vaccine mandates, all while navigating through a pretty large merger of equals.

So -- at the end of the day, we have a great team here at L3Harris. I'm excited about the opportunities ahead as our company enters the third year post merger. Look forward to meeting and talking with everyone over the next few months, introducing Michelle. And then we'll be back in April for our first quarter call. So thank you all for joining. Have a great day.

Operator

This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.
