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LHX.N - Q2 2022 L3harris Technologies Inc Earnings Call

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## OVERVIEW:

LHX reported 2Q22 results.

## **CORPORATE PARTICIPANTS**

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

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

**Rajeev Lalwani** *L3Harris Technologies, Inc. - VP, Investor Relations*

## **CONFERENCE CALL PARTICIPANTS**

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

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

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.

With that, Chris, I'll turn it over to you for some brief comments.

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

Okay. Thank you, Rajeev, and good morning, everyone. I'm encouraged by our progress as we continue to execute our trusted disruptor strategy. We're investing in targeted capabilities in and outside of the company, and we've had over \$1 billion of notable prime awards this month alone. And we're pursuing international expansion as our customers need mission-critical solutions in a rapidly changing threat environment.

We're also encouraged by how budgets are shaping up globally. The threats are evident, and there's growing urgency to support defense spending in the U.S., NATO and elsewhere. This is a stark contrast to a couple of years ago, where budgets were expected to be flat at best.

Our book-to-bill of 1.14x in the quarter supports this shift in the budget environment. At the same time, there are factors outside of our control, such as supply chain, inflation and labor markets tightening that are offsetting and masking our progress as well as the opportunities ahead. Our results, however, highlight that we're working to mitigate these challenges.

Our second quarter results are consistent with prior commentary of a back half weighted year for revenues, margins and cash. Nonetheless, we kept EPS relatively stable year-over-year and our free cash flow snapped back from breakeven last quarter to more than \$700 million.

In addition, while we're reiterating our guide, we're now pointing to the low end of the range across the board.

Based on the timing of some key awards, including protest activity and a prolonged supply chain recovery, we decided to take a more measured approach, especially given the macroeconomic and geopolitical uncertainties that are somewhat unpredictable. So despite the noise, we continue to execute on our strategy.

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

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## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Our first question comes from the line of David Strauss with Barclays.

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

Chris, can you give us a lay of the land on F-35 and Tech Refresh 3? And whether you still see about \$150 million headwind there this year before beginning to recover in '23? And then bigger picture, the investor letter did a great job of highlighting the budget upside that came through in '22 and the plus ups could look likely in '23.

When do you think that really begin to materialize for the industry in terms of seeing it come through in terms of the numbers? And how do you think your strategy positions you to capture that upside relative to your peers?

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

All right. Thanks, David. I think there were about three questions in there. Let me see if I can get them. Let me start with F-35.



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

Yes, I'll take the first shot, and then maybe ask Michelle to give a little more color on the sector. But space is clearly our fastest-growing sector in the company. This win that we had earlier this month for SDA tracking Tranche 1 is just a huge opportunity.

If you recall, we won Tranche 0 for 4 satellites. This is 14 satellites. Pretty excited about this particular win. And again, it's an example where we're priming. We have the payload capabilities, and that's ultimately where the value resides.

So as a reminder, \$700 million award, 14 satellites, and it really ties into our responsive satellite strategy. A couple of years ago, it was nonexistent. Now we have satellites in low earth orbit, medium earth orbit and geosynchronous orbit. So it's really going well.

I think at the date of the merger, we had no business with the Missile Defense Agency. Now we're smack in the middle of that growing business line. So I'm really pleased with where we are. I think the other day, Michelle and I were looking, we have about a \$20 billion pipeline in space alone.

And when you look at our capabilities in missile defense, weather, like I mentioned, all orbits and even ground capabilities, it's quite exciting.

But Michelle, you want to talk about the rest of the sector?

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

Yes. No. You did a nice summary in space in terms of high to mid-single digits in terms of growth. From a Mission Avionics perspective, this is the ramp that we talked about on F-35. So as we head into production, you'll see that come in the second half.

And then also, Chris didn't mention it, but Intel and Cyber, right? Our classified business is continuing to grow as well, and we'll expect to see that ramp in the second half as well.

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**Operator**

The next question is from the line of Ron Epstein with Bank of America.

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**Elizabeth Grenfell** - *BofA Merrill Lynch - Research Analyst*

This is Elizabeth on for Ron. Can you give some color on what you're seeing on the chip side of the supply chain and whether you're seeing an easing there? Or any sort of color you might be able to provide would be great.

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

Yes. Let me start. Just at a high level, I think at least at L3Harris, I think the whole industry has now realized there's a new norm in supply chain. And we're adapting to that as quickly as we can.

In the past, the whole focus was just-in-time inventory, inventory reductions, single sources. And you'd always go with the low-cost bidder without serious consideration on the certainty of supply and delivery.

So we have multiple work streams going in parallel. And I think we're doing a pretty good job in the short term, trying to mitigate and avoid the disruptions, but we're also looking how we revamp our supply chain resiliency for the long term.

So I've mentioned in the past, we've invested in tools to get end-to-end visibility beyond Tier 1. We're investing in critical materials, smart inventory, safety stock, which I understand builds our inventory balance. You'll see that on our balance sheet, but I think it's the right business decision.



So we kind of have to wait and see. Hopefully, something comes out in the next week or 2. And I think it's a key one to watch, in my opinion. I know it's important to our company, and it really would validate our strategy and the thesis for the merger because we invested in the innovation.

We started with a clean sheet. It's another opportunity to be a prime integrator, it has international potential. And it also has pull-through of our products, Wescam turrets, radios, weapon carriages and EW capabilities.

So we'll see what happens. I'm pretty excited about it. And maybe with that, we'll go to Michelle.

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**Michelle L. Turner** - *L3Harris Technologies, Inc.* -

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

I wanted to try to understand what's going on in Tactical Communications a little bit better. You've had a rising backlog, but at the same time you've been constrained with supply chain issues.

And what I wanted to get is to understand first, once the supply chain constraints ease up, what kind of trajectory do you expect to see as radios are delivered, a big surge or more of a long-term better growth outlook?

And then along with that, we've seen you keep your margins. Margins have held pretty well, even though we've got a lot of inflation exposure and you've got the supply chain issues. I mean, how do you see the risks around margin there as you go forward, if we see persistent inflation?

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

Okay. Thanks. Let me make a few points, and then Michelle will give you the numbers. I mean, you're absolutely right. There's high demand for our radios, and I think that's one thing that the conflict in Ukraine has highlighted, the importance of resilient comms.

So we have opportunities in Australia, 300 million for what's called Delphic Phase 2 with the Australian Defence Force. That's over 6,000 radios. We should hear on that maybe in the next month or 2.

We've talked about the Kingdom of Saudi Arabia and the radios there. The first 4,000 or so cleared congressional notification. And in August, we're going to have our first article acceptance up in Rochester, and they've ordered a couple of thousand more. So that's going through the congressional notification process.

In the U.K., the Morpheus program, again, \$100 million award approximately. So all those things are building the backlog, as you say. I will highlight that I think it was last year, we knew there was a supply chain shortage and we'd have to surge. So we invested in the capacity.

So we now have more capacity. Michelle will give you the numbers, but we can clearly do better and grow without any constraints.

Last year, we had about 20 suppliers on our red list, and now we're down to 5 that we're watching carefully. And obviously, we need all the parts, but that's been pretty helpful.

The last thing I'll mention before giving to Michelle, I've talked in the past how we reengineer and redesign our products or our components, based on availability.

And just this week, I was looking at our data, we've actually redesigned over 1,000 component parts in our products, whether it's radios, night vision goggles, WESCAM balls to be able to make these commitments and continue to deliver our products. So I'm pretty proud of our engineering team and how they've been able to adapt.

So that's kind of at a high level. Michelle, you want to talk about the capacity and the ramp capability?

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- L3Harris Technologies, Inc. -



We do have an elevated backlog, to your point. It's about 1.5 billion. So we have a healthy backlog that we'll be looking at as we go into 2023.

And additionally, I'd note to the international question, the international book-to-bill within Tactical Communications is 1.15 within the quarter. And so this really speaks to the overall conflict environment, Ukraine opportunities that we're seeing.

And we expect that, that will be a benefit for us as we go into 2023, but a lot of these orders are also being considered over a couple of years. And so you should think about it in terms of 2023, 2024 and into 2025.

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**Operator**

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

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

Chris, I was wondering if you could comment on this NSO situation and what happened there? And in conjunction with that, whether you have any additional M&A deals potentially in the pipeline?

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

Yes. I would say, clearly, relative to our M&A pipeline, we're looking at opportunities all the time, looking for game-changing solutions that are going to help us with our customers.

So yes, we're looking at a handful. We continue to look at M&A on a regular basis. We're also watching the regulatory environment and seeing what could potentially be approved and any potential overlap or antitrust issues.

So I'd say, we have a healthy process. We look at things all the time, and I don't see us in a position to announce anything in the next quarter or 2, but we'll continue to look.

Relative to NSO, we're fully aligned with the U.S. national security leadership on this matter. And I think all the reporting out there made it clear that no deal is going to happen, at least with us. So maybe someone else is talking to them, but not me. So I hope that helps.

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**Operator**

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

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

Chris, something you're probably super frustrated about, but this next-gen jammer, low-band ongoing protest. Can you give us any sense of key dates or milestones in terms of kind of getting that resolved? I know it's dragged on probably way longer than anyone expected.

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

Yes. Yes. Well, Pete, I don't really get frustrated about much, but this has taken a longer time than anybody wanted. So there's going to be a re-procurement between us and Northrop. We all signed an agreement as to a path forward. So I expect to get into RFP in the next month or 2. We'll update our proposal.

And I would think, in mid-2023, hopefully earlier, 2023, that maybe we'll make a selection and we'll move on. It's really about the capabilities that the Navy needs and the threats that we keep talking about.

And we respect the process to allow people to protest, and I think there's been 4 or 5 different judges and reviews and such, but it's progressing. So it was over \$100 million of revenue we had in our plan for this year.

So that's kind of given us a little headwind. We'll move it into '23. The team is ready to go. We like our technology. We like our solution, and we'll wait for the Navy to select us again, hopefully.

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**Operator**

Our next question is coming from the line of Noah Poponak with Goldman Sachs.

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**Noah Poponak - Goldman Sachs Group, Inc., Research Division - Equity Analyst**

Wondered if you could just talk a little bit more about the back half as you see it now, relative to the prior guide? The acceleration in organic revenue growth to mid-single, how much of that's 3Q versus 4Q? How much visibility you have versus things that could slide? And then if there's anything on the cash flow side in terms of payment timing that you're looking at as well?

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**Michelle L. Turner - L3Harris Technologies, Inc. -**

So when we give the guidance for the second half that Michelle laid out, we want to let you know it's harder than it has been in the last several decades to predict the future and the visibility, given the uncertainty and the volatility that changes literally on a daily basis.

There are some days where we get a call from a supplier that they're going to be a week late. And the next day, someone shows up a week early. I mean, it's really very, very dynamic. We're trying to stay calm and relax and control what we can control and mitigate those things that we can't and then communicate to the best of our ability what the upside and the downside is.

The interesting thing is we're just talking about a bow wave in all cases. We're not losing things. Sometimes they take longer to get awarded and sometimes they slip, but we're looking forward to the new norm and some of these uncertainties dissipating.

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

And Noah, just to go back to your question in terms of cash. The expectation for the second half is really split between Q3 and Q4, more like a 30-70 split.

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**Operator**

The next question is from the line of Morgan Stanley, and Kristine Liwag with Morgan Stanley.

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

You were down selected for Phase I of the stand-in-attack weapon. So a strike weapon like this sounds like relatively new territory for LHX. And you're up against competitors with strong missile heritage.

Can you talk about your strategy here? Is the missile market something you're focusing on more generally? Or is there something about this program that plays to your traditional strengths?

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

Yes. No, that's a great, great question. We started investing in weapons, I think, going back 4 or 5 years. When I mentioned we set up the Agile Development Group. This is right in their sweet spot. We have multiple classified opportunities.

This is an air-to-ground tactical missile. I think it's when you look at the budget, you look at the threats, you look at our capabilities, I think we're in really good shape here. We've taken a clean sheet approach. And I think that's what's going to be the differentiator.

I mentioned that on Armed Overwatch. I mentioned it here, right? We're not taking an existing capability that's been successful for decades and tweaking it. We're taking a clean sheet approach.

We're investing in our in our seekers, which I think is unique and has great capabilities. And I'm proud of the team to see us get down selected on this one. There's classified things where we're also getting down selected.

Like anything, it starts out a little slow. I think there's 3 of us. I know there's 3 of us. And sometime in August, we'll get the Gate 2 award. And I think in 2023, early '23, they'll probably down select to 2, and then the fly offs and the fun begins.

So this is clearly a core competency for us. It's a market that I like. And I think it's similar to what I've talked about. It's going to disrupt the market. And I think a lot of people were surprised when they hear L3Harris won a stand-in-attack weapon. And there'll be more of this in the years ahead.



Of course, they'll hopefully get next-gen jammer. So we've made those investments up in Canada. We've invested in a new facility for WESCAM, where we're seeing the surge in the turrets. We mentioned the extra capital that we spent in Rochester.

So for the product quick turn businesses, I think we have the capability. Labor is probably more of a potential constraint than the actual facilities themselves. If we get the supply chain turnaround, I think we'll be okay.

And we've been doing pretty good on the labor front. We've hired over 4,000 people so far this year. We have the same challenges with attrition that the rest of the industry does. But we're hiring interns. We're hiring new college grads.

I think it's a company that people find interesting and exciting, and we're getting literally hundreds of thousands of resumes to come work for us. So I feel pretty good about that.

Relative to '23, we're actually going through our strategic planning process now. We talk about low to mid-single-digit growth, but some of the stuff is pretty lumpy. And we should be in a position if we can get these wins to continue our top line and bottom line growth. Michelle?

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

Yes. So in regards to the question on CR, our guide assumes that there is some level of a CR in Q4 of this year.

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**Operator**

Our final question will be from the line of Michael Ciarmoli with Truist.

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

Maybe can you guys just quantify what the margin headwinds are that are coming from inflation and labor? I don't know if you could parse out what's sort of the bigger impact. And I think the investor letter mentioned that you've got a relatively quick turn or short-duration backlog.

Maybe you can walk us through how long it takes to flow through price increases on raw materials or higher billing rates? And how we should maybe think about the margin evolution as you can pass through some of those prices?

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

Yes. Thanks for the question, Michael. So consistent with what we shared back in our last call, we anticipate about \$100 million of gross inflationary impacts within the year. We had about \$20 million of that play out within Q2.

And to your point about our overall program mix, about 50% of our portfolio is fixed price. It's about a year in terms of duration. And so we're starting to see some of the inflationary pressures prior to having EPA clauses in our contracts starting to play out here in the second half of the year.

We'll see that into 2023. Where we're focusing on what we can control right now is ensuring a new contracts that we are placing clauses that allow for this inflationary environment. But we anticipate that through the middle of next year to probably Q3, Q4. We'll see some remnants of the impacts of the current economy and the inflationary environment.

Okay. So before ending the call, I want to take a moment to recognize our 47,000 strong L3Harris teammates around the globe. And thank you for remaining focused on creating value for all of our stakeholders, particularly in support of meeting our customers' critical missions.

What you do matters in terms of making the world a safer place. Thanks, everyone, for your time today, and have a great weekend. We look forward to connecting again in the next few months.

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#### Operator

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

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