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LHX.N - Q4 2022 L3harris Technologies Inc Earnings Call

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OVERVIEW:

Co. reported 4Q22 EPS just above recently guided midpoint.

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Second, are there some areas for cost reduction beyond just corporate costs? Because I know the facilities are difficult to move, for example. Third, are there things that you can do to improve operations and better performance for the end customers? And then last, when you're in this pre-close period, how do you ensure that the value of this asset doesn't deteriorate some over time?

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

Well, thank you. Let me see if I can hit all of those. I'm sure there'll be several Aerojet Rocketdyne questions, but maybe I'll give a longer answer than usual and try to preempt some of those. So when we look at acquisitions, I'd like to start with the market. And when we're looking at the market data outside of platforms, the 3 largest global markets for defense are C2, which is command and control; sensors and weapons. So I'm very comfortable with how we're positioned on the first 2 especially after the TDL acquisition. Our weapon presence in this \$75 billion market is practically nonexistent.

So we believe that weapons, munitions, missiles, whatever you want to call them, are absolutely aligned with the current and emerging customer demand. It is a growth market for the future fight. And solid rocket motors, especially for products like Javelin, Stinger, many that we know and hear about on a regular basis is a great way to position us in the missile and missile defense market. So I look at that from the munition side on the space, we have a long history of working with NASA and NOAA, so relative to space exploration and observation. We already have these relationships. We're honored or they're honored and soon us to be able to support SLS and Artemis, and there's visibility there for several years to come.

And then the RL10 is a premium upper stage engine with well over 100 engines under contract with the ULA for the new Vulcan launch vehicle. And I think hypersonics doesn't really get the attention it deserves. And the other day, someone said hypersonics is the future. And the reality is hypersonics is now. And I think this could be the crown jewel of the acquisition, and we believe there's significant growth opportunities that are well supported by the budget and the customers.

So when I look at those 3 markets, I see growth. If I jump to the financials, if you will, as it relates to Aerojet Rocketdyne and what we can do, I mentioned the \$7 billion of backlog, so longer-cycle business gives us more visibility. I believe this will grow faster on the top line than our current portfolio. I believe we have the ability to improve margins and get those to be more in line with potentially what we're doing on a consolidated basis now over time, and there are several multi-year programs that will be coming up for renegotiation in the next year or 2. And I believe as we continue to negotiate milestone payments, we'll be more cash-favorable. So I throw that out there to maybe answer a couple of the questions.

On the cost synergy, we believe there's something in the \$50 million range easily from eliminating the public company cost and some of the duplicative overhead. You're right. We have no plans to move facilities, but I look at the footprint. We both have offices in D.C. We both have offices in Huntsville. There's some low-hanging fruit there, and we really didn't anticipate or plan at this point any synergies relative to supply chain. So we need to dig into that and of course, take the power of the new enterprise.

So I think that gets to your question, Doug, on cost synergies. And from L3Harris, we overachieved. And once we get into details, there's potential to continue to exceed those numbers from the cost synergy.

Revenue synergy, given that these are new markets, and there's no overlap, we have no revenue synergies at this point in time. So that, I think, is a straightforward answer. I guess on the operations, I think we have great opportunities here to bring our skill set and enhance the performance of Aerojet Rocketdyne.

And I look at what we did at L3Harris before the merger. I look at the TR3 program as an example, and maybe our Waco facility. The TR3 program was over budget and late. Waco facility was losing money, and with the scale of the new company, more talent, processes, policies, controls, the ability to attract new people, we were able to turn not only that program but that business around. And I think those are the capabilities that we'll be able to bring to Aerojet Rocketdyne.

Relative to pre-closing exposure, I don't think there's anything unique in this relative to other acquisitions. The integration team meets on a regular basis. I would think it's next week or the week after, we'll start having people on-site at some of these facilities as part of the integration process.

As you would expect, Eileen Drake and I meet on a regular basis. So we, in fact, I had a call yesterday and we have one every week and sometimes more.

So I think that's how we're going to stay in touch, and we can do whatever we can to help them. I'm optimistic that this is going to be a very accretive and successful acquisition. We're excited. The employees are excited, and I apologize for the long answer, but I wanted to try to hit all 5 or 6 of your questions, Doug.

Operator

you're focused on and these technologies accelerators that you're working on? And how do they contribute to your top line returning to mid-single-digit growth?

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

Yes. And yes, IRAD is something that we have been investing in year-over-year. We have industry-leading IRAD kind of in the 3.5% range. We've significantly increased what we call ERAD, our external R&D from customers. When I look at the 2 together, we're well over \$2 billion. So we have a very good process to prioritize how we spend that money.

So I think through some of the exciting things, if I start in space, we're excited about the investments that we've made in some new optics that we'd refer to as replicated composite optics. Basically, this is a replacement for glass mirrors in telescopes made out of carbon graphite. So the exciting thing is it's about half the weight. It takes about 2/3 of the time to manufacture, and it's significantly less expensive. And we're going to be launching the first ever replicated optics in the middle of the year. So I think this is going to reduce risk. We'll see how it performs, but this could be a game changer for a satellite business.

In the air and land domains with ViaSat. We're investing in the Advanced Tactical Data Link with a lot more resiliency. So that's part of the whole strategy there to modernize Link 16, and I think we have the largest library of waveforms. So we're very excited about that. And then maybe on the maritime front, I'm pretty excited that our Iver vehicle in the past. This is our autonomous undersea vehicle, just recently has achieved the first-ever repetitive submerged launch and recovery from a torpedo tube. This is a significant step for our company, and I think it gives us an opportunity to considerably enhance the nation's autonomous undersea capabilities.

So trying to give you some tangible examples, and each of those will result in new business programs of record and maybe give you some insight to what's coming out of all the money that we're spending, whether it's IRAD or ERAD. As you probably saw in the letter and other release, we have 2 new segment presidents joining us this year, and I can speak for them and say as they went through our portfolio and looked at the IRAD and some of the things we're working on, both John and Sam were pretty excited about the potential. So thank you, Sheila.

Operator

Our next question is from the line of Scott Deuschle with Credit Suisse.

Scott Deuschle - *Crédit Suisse AG, Research Division - Research Analyst*

Congratulations on the progress this quarter. It's great to see. Michelle, are there any large ISR missionization contracts and the guides that haven't been finalized yet, particularly on the international side? I'm just trying to get a sense of whether there's any timing-related downside risk from that. Or if that's more just an upside opportunity if one or more contracts do go your way?

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

Yes. No, I appreciate the question, Scott, and thanks for this because it is important to note that, as we think about our guide for this year, we did take a different approach on a couple of things. Our ISR missionization business is one of them. So to directly answer your question, no, there are not any large international ISR pursuits in the plan. We do have one domestic pursuit, which we're anticipating in the first half of the year. We already have the aircraft. So that's minimizing the risk, and it's funded from a budgetary perspective. It's our C3D program. So we have 4 aircraft tied around that.

And I think this is important because as we walk through the guide, this along with supply chain, were the 2 key components when we think about how '22 played out, that's really influencing how we're thinking about our guide for '23. And so I'll just hit supply chain upfront because I'm assuming we're going to get the question. I'd be disappointed if we didn't get the question.

But when we look at our guide for the current year, what we're assuming is something consistent with what we did in the second half of '22. Coming off of the strong Q4 results, we're incredibly proud of all the teams across our product-based businesses in particular. So I want to do a shout-out to our Tactical Communications team, WESCAM, PSPC, along with Commercial Aviation. We had a really strong finish to the year. And as we're building on that momentum coming into '23, we're assuming that we're having consistent results in the second half of '22 throughout the full year of the '23 guide.

And so to your point, Scott, around using what we learned in '22 and influencing our '23 outlook, there's really 2 key components. One was around the ISR missionization demand. And although we're continuing to pursue a handful of those programs with budgets being up, we're optimistic that we're going to be able to land a contract. We thought it was prudent at this point to not put that into our guide and it would be upside.

Operator

Our next question is from the line of Michael Ciarmoli with Truist.

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

Maybe just to go back to Aerojet and thinking about these cost synergies, I know they had previously executed on a \$240 million cost takeout program. It seems like all of those savings went to the customers. And I'm just thinking about maybe the lack of margin expansion we've seen there. There's obviously been challenges in the rocket motor supply chain. I think Raytheon has been pretty outspoken there. Northrop is picking up, I think, the entire GMLRS motor production this year.

What's the status of their production system? Do you think you have to make any investments? Is that sort of contemplated in the cost synergies? And I guess maybe your level of confidence in margin expansion at that entity.

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

Yes. Thank you, Michael. We do have confidence in margin expansion. I think when you look at the customer or you look at the portfolio mix, they have a combination of cost plus and fixed price. So I'm not sure it would all go back to the customer. They should be able to keep it on the fixed price, but that's in the past. I'm looking going forward.

Like any of these acquisitions, there are systems that are fragmented or maybe older technology just like when we put L3 and Harris together. Our IT organization knows how to convert these. I used my reference to ViaSat, the fact that those employees are already on our systems, and it hasn't even been a month.

So most of the challenge program, and I know they've talked about it at length, seems to be at one facility. Like I said, we'll have people down there in the next week or 2. And everything has been contemplated in our business case. One of the benefits of being part of a larger organization, again, this is an acquisition, not a merger, I just like to make a -- an important distinction.

We are buying them. They're about 1/10 of our market cap, and this will be a quick integration relative to decisions that need to be made, and a lot of their systems will migrate on to ours, whether it's benefits, payroll, et cetera. On the ERP manufacturing execution systems, they've been putting those in. We're familiar with those systems, familiar with the technology, and all that has been contemplated. With our scale, we have the capital. We have the IRAD. We prioritize it, and we have the ability to invest as they have been doing to make them world class.

Operator

Our next question is from the line of Seth Seifman with JPMorgan.

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

Chris, I wonder if you could talk a little bit about the kind of the medium-term outlook for the Communications business. We recently saw a management change there, and the details of the management change suggest that you're looking for some really fresh and different thinking in a business that's been kind of the core of the earnings for the company. And we've seen some good growth in the radio budgets in recent years. But when we look out to the middle of the decade and beyond, it doesn't necessarily look as good. So can you tell us about your medium-term thought process for Communications?

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

No. Absolutely, Seth. Yes. I mean, Sam joined us at the beginning of the year. I know a few people were asking questions relative to Sam and the business. I mean CS is a short-cycle business with a global footprint, a lot of Army and Marine business. And when I hired Sam, like I do everyone, I look first and foremost for someone who's a leader versus a manager. And everywhere he's been, he's had success strategically, operationally and financially. Whether it's Collins, Sikorsky, UTC, he's led production. He's led programs. He's familiar with foreign military sales, direct commercial sales and a lot of experience globally. So I have no doubt he's going to be very successful and add value to the corporation.

When I look at the medium-term on comms, I don't want to underestimate the significance of the ViaSat acquisition and the focus on JADC2 and the ability to connect the networks, which the customer has been talking about, it seems like, for a decade. And I'm sure there's frustration on their part that we haven't, as an industry, been able to get that across the goal line.

So when I look at the Tactical Radio business, we continue to see growth in the low to mid-single digits, not only here domestically where the modernization is going to continue. Internationally, in the fourth quarter, we got another contract from Australia that has been a great customer of ours. So the visibility we see continues to look good. As the modernization continues, the need for resiliency continues. And then I still think there is ability for the more of a soldier as a system that's been talked about but never quite brought across the goal line.

And when I look at the IT systems, the ERP systems have come down substantially. I think we used to say there were about 100. By the end of the year, we'll be in the 20s. So that's good progress. We've got consistent manufacturing execution systems that we're implementing. The one in Greenville should be done this year. We have a couple in other facilities, done a good job on all the shared services. So in that case, that would be done. The facility moves have been done. But the team is looking at each and every function and process and continuing to optimize it.

So like I said, we did the easy stuff and now we're going function by function, relooking at the policies, the procedures, the systems and continuing to look at ways to optimize the business, which will make us faster and ultimately take cash out. So I'll go with 2/3 of the way through. I'll lateral to Michelle, see if she agrees with me and then have her give some supply chain insight.

Michelle L. Turner

Operator

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

Robert Michael Spingarn - *Melius Research LLC - MD*

So Michelle, just on the back of all of that, it seems like the positives are there might support higher margins in '23. Now I know the guidance range allows for that. But what would cause the downside?

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

Yes. No, great questions. So let me walk through from a margin perspective. I'll start from the overall enterprise, right? To your point, Rob, we are assuming flattish margins, 15.4%, 15.5-ish. From a headwind perspective, we are assuming continued macro inflationary challenges of about \$400 million, so about 2.5% of our overall revenue.

And we also have some headwinds from a mix perspective. Chris talked about where we're investing in space. Kelly and her team are doing phenomenal in terms of growing the business. At the same time, however, that will be a drag on our margins. As these new programs come on board, we typically book them at lower rates. And as we mitigate the risk, we start to see the profitability in those programs improve.

So from a headwinds perspective, inflationary challenges and mix, that is being offset by our continued strong e3 savings program, as Chris alluded to earlier. Real estate is a great example of that. Another great example is the voluntary retirement program that we announced at the end of Q3 last year. That's going to help to pay dividends and offset the merit increases that we're planning for from a human capital perspective. And then we've also assumed some level of commercial pricing.

To your point, specifically, Rob, like what is the downside? The downside, from my perspective, is this continuation of the unknown unknowns from an inflationary challenge perspective, right? There was a lot that permeated within 2022 that it felt like it was more of a reactionary year. And so as a result, we're doing everything that we can to control the controllables. And we will prudently manage through that as we make our way through 2023.

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

And I'll just chime in that, if you recall, last time we talked about the importance of our workforce, keeping them engaged that call, Tw1 05 Tthin a.266 TT

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

Yes. Great question, and good morning, Kristine. Yes, I said we closed it in 92 days. We have been forecasting mid-year. We made all the appropriate filings for HSR. We responded to all the questions within the 30-day period, for ViaSat that is. There are some international approvals. And I think when you just looked at it, it made a lot of sense, and we weren't sure how that process was going to play out.

Relative to Aerojet Rocketdyne, mid-January, we made our HSR filing. We all know the FTC is reviewing it. We've been very responsive in answering their questions, and we'll see how that process works out. Eileen and I met with key customers jointly in the Pentagon to explain the rationale and answer their questions. So I think it's just transparent, being responsive and getting the data request in, in a timely manner so the process can work. So we'll see how it plays out. But so far, everything is tracking.

Operator

The next question is from the line of Peter Arment with Baird.

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

Chris, the TDL acquisition seems like it's a really great fit, as you kind of highlighted that you had 2 kind of capabilities. Maybe you could just talk a little bit about if you see like a big product upgrade cycle or with that road map or what kind of opportunity it is for L3?

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

Yes. Thanks, Peter. Now look, we've talked about Link 16 being on 20,000 platforms, and that really gives us the ability to upgrade and modernize. So when I mentioned the IRAD we're spending on the Advanced Data Tactical Link, that's an obvious fit.

One of the things we focused on in the negotiation, this was a carve-out. So that's a little unique as to what do we buy, what we don't buy. And we really wanted to get access to a relatively small piece of the business, which was the Link 16 to space and Link 16 and ViaSats on the SDA transport. Later this year will be a launch. We will have the first-ever Link 16 capability in space. And I think, again, that's kind of the hidden jewel in this thing. There's going to be Link 16 in space. The connectivity from space to air is a game changer to focus on resiliency.

So relative to revenue synergies, we're very excited about the potential here with ViaSat. So the upgrade is going to happen. We're investing in new products. We also have the existing production that's going well. So I think we're going to look back on this one. It's going to look pretty successful and pretty straightforward and off to a good start. So hopefully, that helps.

Operator

Our final question comes from Richard Safran with Seaport Research Partners.

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

Chris, from the last year, I'm going to try two because I think they're quick. So your letter indicate you're getting compensated for inflation on new contracts. I was just wondering on existing fixed price contracts, is the government allowing you any adjustments based on higher unforeseen costs? And if so, would that be the upside to your guide?

Second question is Chris, just given your knowledge on -- I asked this of your competitors. It seems to be just a general view that, as we move into a deficit reduction, defense is going to be the bill payer. I was kind of curious about, though, your view of sentiment on the Hill and for continued defense spending and funding modernization.

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

Yes. Thanks, Rich. On the first one, we have not received any compensation for inflation on fixed price contracts nor have we asked for any. Similar to COVID expenses and others, we just absorbed it as part of the business. I just kind of feel like we survived these 3 years, and everything is looking much better on the upside. Obviously, if we got money, that would be upside. But as of now, we're just moving forward and focused on the new contracts. If something changes or if the DoD encourages us to bring forward a claim of some sort, we'll do it. But there have to be clear documentation. It's not as easy as you would think to prove that.

On the deficit reduction, it's something we're all watching. I referenced in the letter. And we're excited to actually have a defense budget to start our fiscal year. So a shout-out to everybody in the Lame-duck session for getting that done. And it's a big deal for us and a big deal for the industry and probably even a bigger deal for the Department of Defense. So I think that's the type of thing that gives us confidence in the future.

I mean one thing is for certain. It's really hard to predict how that's going to kind of play out. I'm really not in the camp that thinks DoD is going to be the bill payer. I know there's some rhetoric around that. People say things to get different leadership positions in Congress. But when you look at the threats out there, it's just hard to justify flattening or reducing the defense budget, and it's a dangerous world.

And that comes back to these acquisitions and looking what's going to matter at the end of the day and what the future fight is, and it's situational awareness with ISR, it's resilient comms, and it's munitions. So I like where we are relative to those positions, Rich.

So I think with that, we'll wrap up. So I appreciate everybody calling in. I'm a big believer in momentum, and I feel like we have the beginning of some momentum with 2 consecutive quarters of growth, some acquisitions. I don't know if you can hear it in my voice and Michelle's, but we're really excited about the future and what the potential brings. And I know the initial feedback from the ViaSat employees has been all positive and the Aerojet Rocketdyne employees. And we've actually heard from many of the former Aerojet Rocketdyne employees who are also excited about the transaction.

So we're going to focus on the closing, get this deal done. And once it's closed, we're looking forward to connecting with any former Aerojet Rocketdyne employees and welcome them back if they're passionate about the mission. So I think it's going to be an exciting couple of years.

But before I sign off, I wanted to recognize and thank Dana Mehnert for his 38 years of service. As you know, Dana announced his retirement in Q4 and is assisting with a smooth transition. So we appreciate that, Dana, and wish him all the best in his future endeavors. And I want to turn it over to Michelle real quick.

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

So thank you, everyone, for joining the call today and for your continued interest in our company. Before we disconnect, I just want to take a minute. As many of you know, this will be Rajeev's last earnings call with us. And I want to thank you, Rajeev, for your contributions in our Investor Relations function, overall L3Harris and for me, personally, for my transition over the last year. We all wish you the very best in this next adventure. So thank you.

Operator

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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