

Keysight Technologies Second Quarter 2019 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Second Quarter Earnings Conference Call for Fiscal Year 2019.

Joining me are Ron Nersesian, Keysight President and CEO; and Neil Dougherty, Keysight Senior Vice President and CFO. Joining us in the Q&A session will be Mark Wallace, Senior Vice President of Worldwide Sales, and Satish Dhanasekaran, President of the Communications Solutions Group.

You can find the press release and information to supplement today's discussion on our website at investor.keysight.com. While there, please click on the link for quarterly reports under the financial

information tab. There you will find an investor presentation along with Keysight's segment results. Following this conference call, we will post a copy of the prepared remarks to the website.

Today's comments by Ron and Neil will refer to non-GAAP financial measures. We will also make references to "core" growth, which excludes the impact of currency movements and acquisitions or divestitures completed within the last twelve months. You will find the most directly comparable GAAP financial metrics and reconciliations on our website.

We will make forward-looking statements about the financial performance of the company on today's call. These statements are subject to risks and uncertainties and are only valid as of today. The company assumes no obligation to update them. Please review the

company's recent SEC filings for a more complete picture of our risks and other factors.

Lastly, I would note that management is scheduled to present at upcoming investor conferences in June hosted by Baird, BAML and Stifel. We hope to see many of you there.

And now I will turn the call over to Ron.

RON NERSESIAN

Thank you, Jason, and thank you all for joining us. Keysight delivered an outstanding second quarter with both record revenue and earnings exceeding the high-end of our guidance and very strong free cash flow. Our continued focus on our winning strategy and commitment to

operational excellence under the Keysight Leadership Model are delivering strong results for the company.

Today, I'll focus my formal comments on four key headlines for the quarter.

- First, Keysight delivered another record quarter and exceptional results. Revenue was well above our guidance and grew 9 percent, or 12 percent on a core basis, to surpass \$1 billion dollars for the fourth consecutive quarter and to reach a new high. We also achieved record gross margin, record operating margin and record earnings. We grew earnings 47 percent to reach \$1.22 per share, which was well above our guidance. And, we generated strong free cash flow of \$192 million.
- Second, we are complying with the recently announced United States Department of Commerce export control regulations with

regard to China and Huawei. Outside of China, we continue to see broad-based momentum across multiple end markets. Customers continue to make R&D investments in next-generation technologies, which helped fuel growth in Q2, and we expect will drive Keysight's growth to between 7 and 8 percent for fiscal 2019.

- Third, we are significantly ahead of our plan on the margin expansion and earnings objectives that we outlined last year at our Investor Day. We now expect that we will achieve the gross margin and EPS targets outlined for FY21 in this year fiscal 2019. This is two years ahead of plan. We remain focused on operational excellence as defined by our Keysight Leadership Model or KLM. This discipline is driving margin expansion and translating into strong earnings growth and cash flow, as

demonstrated by our results, and provide model durability even as macro conditions change.

- And fourth, as we announced today in our earnings release, Keysight's board of directors has authorized a new share repurchase program for up to \$500 million of common stock. The new repurchase program is effective immediately and replaces the previously authorized \$350 million program of which \$160 million remained. The expanded repurchase authorization demonstrates our confidence in Keysight's business and our continued commitment to return capital to our shareholders.

Now let's take a deeper look into our performance for the second quarter. We achieved \$1.22 per share in earnings, which was 23 cents above the high-end of our guidance. We delivered 47 percent earnings

growth for the quarter and 60 percent earnings growth in the first half of the year.

We also delivered strong order growth. Orders grew 14 percent in total and 16 percent on a core basis to exceed \$1 billion. As a reminder, our core metrics exclude the impact of currency movements and revenue from acquisitions or divestitures completed within the last twelve months.

Revenue grew 9 percent, or 12 percent on a core basis, to reach 1 billion 93 million dollars, a new record for Keysight. This represents our fourth consecutive quarter of delivering over \$1 billion in both orders and revenue.

Our strategy to consistently invest in leading-edge technologies in areas of the market undergoing multi-year transformations, while also focusing on operational discipline, is delivering top and bottom-line

results. Over the past ten quarters, we have generated growth across multiple dimensions of the business as a result of our targeted investments. Expanding our portfolio of software solutions to help customers accelerate their designs is a key component of our strategic vision.

During the quarter, revenue for our software solutions continued to grow double-digits and faster than our overall growth rate. Our innovations in software provide Keysight with a very strong competitive advantage, which we believe will continue to benefit the company for many years ahead. Increased software sales and our focus on R&D solutions and operational excellence are all helping us generate a higher corporate gross margin. We have improved our gross margin by over 500 basis points in the first half of 2019 when compared to the same period just three years ago. And, we are ahead of schedule on our margin expansion plan for this year.

Moving to our markets, we continued to see customers across the board invest in the R&D of next-generation technologies, which fueled our growth in Q2.

In 5G, we achieved another record quarter of record orders. The entire mobile communications ecosystem is now investing in solutions to support the early ramp of commercial 5G networks and devices. Our first-to-market innovations and engagement with leading-edge market makers across the wireless R&D ecosystem continue to strengthen our position in this fast-growing market. We had a great showing again at Mobile World Congress this past quarter. Our solutions enabled over fifteen industry-leading customers to demonstrate their innovations at the show, which highlights the greater role we are playing. We continued to build on our 5G collaborations with many industry leaders. This quarter, we continued our partnership with Qualcomm to

establish the industry's first 5G New Radio connection in Frequency Division Duplexing mode.

While we have been diligently investing and innovating with our 5G customers and partners for a number of years, the industry is still in the very early stages of realizing the transformative potential of 5G technology. Commercialization of 5G networks around the world will usher in a new era of bandwidth and high-speed connectivity, with a massive improvement in many network attributes, such as, data rates, coverage and reliability. Achieving this multifaceted improvement requires transformation of the entire communications stack, end-to-end.

Keysight is uniquely positioned to address the entire network transformation from wireless to wired to the cloud. Our solutions

cover the entire communications workflow in both the physical and upper layers of the network.

As 5G drives investment end-to-end, we are also seeing customers invest in the internet infrastructure R&D in advance of 5G. In Q2 we captured R&D investment in next-generation electrical and optical test for speeds of 400G and beyond, including key new design wins with several network and data center customers. Our leadership position in 400G at the physical layer creates valuable opportunities at the protocol layers, where customers' R&D investments follow over time. The industry-leading 400 gigabit Ethernet solutions delivered by our Ixia Solutions Group address these opportunities.

The automotive and energy market is another area where we continue to make great strides. In Q2, we continued to see strong R&D investments in autonomous driving, electric and hybrid electric vehicles

and connectivity, even as sales for manufacturing-oriented solutions slowed during the quarter. Auto manufacturers and suppliers continue to invest in critical new capabilities for their future designs and our customer engagements at Tier-1 accounts are deepening.

We also saw a similar dynamic in the semiconductor market this quarter, where we saw solid revenue growth for our parametric test solutions. This growth was supported by early strategic investment in next-generation 5 nanometer process technology despite the expected softness in this market that we have seen for the past couple of quarters and continue to expect in the near-term.

Looking ahead, we believe we are well-positioned to continue to build on our strengths, expand our leadership and take advantage of our opportunities we see in the market. We have a differentiated portfolio of solutions across a diverse and broad set of end markets.

We continue to closely monitor the trade situation with China and the macro environment. As reflected in our Q3 revenue guidance, we are not immune to these events; however, next-generation R&D investment has remained strong and we have deep engagements with industry-leading customers around the globe. Our strategy to focus on bringing solutions to market that help customers accelerate innovation sets Keysight apart from the competition and is driving our success.

In summary, we delivered an outstanding second quarter. In addition to achieving strong revenue growth, with our commitment to operational excellence, we are driving strong earnings growth and cash flow, while investing in key areas of the business. We will continue to focus our investments to foster innovation, create value for our customers and outgrow the market.

Now I will turn it over to Neil to discuss our financial performance and outlook in more detail.

NEIL DOUGHERTY

Thank you, Ron, and hello, everyone. Before I get started, I will note that all comparisons are on a year-over-year basis unless specifically noted otherwise.

As Ron mentioned, we delivered another strong quarter as we continued to execute on the demand we see in core areas of our business, while maintaining focus on operational excellence.

For the second quarter of 2019, we delivered non-GAAP revenue of 1 billion 93 million dollars, which was well above the high end of our guidance range, and grew 12 percent on a core basis. This brings our

revenue growth for the first half of the year to 13 percent, or 15 percent core growth.

Our better than expected Q2 results were driven by continued strong demand especially in 5G, where we have a leading position, as well as superior execution by the entire Keysight team. I will also highlight that in Q2, orders for services grew double-digits. Services demand was broad-based and we saw good adoption of our new support offerings such as Keysight Care.

Total Keysight orders exceeded revenue once again this quarter. We delivered \$1 billion 121 million dollars in orders in Q2. Orders were up 14 percent in total, and 16 percent on a core basis.

Looking at our operational results for Q2, we reported record gross margin of 64 percent. This represents our second consecutive quarter of delivering record gross margin. As Ron mentioned, our growing

contribution of software revenue is helping increase our overall gross margin profile to a new level.

We also delivered record operating margin and earnings. We achieved 25 percent operating margin and net income of \$233 million. On a per share basis, we delivered \$1.22 cents in earnings, which was well above the high-end of our guidance. Our weighted average share count for the quarter was 191 million shares.

Our Communications Solutions Group generated total revenue of \$676 million, up 8 percent, while delivering record gross margin of 63.4 percent and operating margin of 28 percent. In Q2, Commercial Communications delivered double-digit order growth and revenue of \$431 million, driven by increased 5G R&D demand across the wireless ecosystem and growth in data center related next-generation 400 gigabit Ethernet and higher digital test. In our Commercial

Communications end market, the strong software content in our solutions is enabling our improved gross margin performance.

Aerospace, defense and government generated revenue of \$245 million, a core decline of 1 percent on a high year-over-year compare.

During the quarter, we saw steady spending in the U.S., which was offset by softness in some international markets. However, we have a very healthy overall funnel for this end-market.

EISG generated second quarter revenue of \$299 million, up 6 percent, driven by strength in automotive, general electronics and next-generation parametric test. EISG reported record gross margin of 61.3 percent and operating margin of 26 percent.

ISG reported Q2 revenue of \$118 million, up 32 percent over last year's soft compare of \$90 million. ISG sales were driven by strong application and security sales along with large visibility renewals, which

are recognized ratably over the course of the year. ISG reported gross margin of 71.5 percent and 3 percent operating margin, which does not include the full benefit of the approximately \$50 million in annualized cost synergies we generated from the transaction, of which about 70 percent are being realized within CSG and EISG.

Moving to the balance sheet and cash flow, we ended our second quarter with \$1.3 billion in cash and cash equivalents and reported cash flow from operations of \$221 million and free cash flow of \$192 million, or 18 percent of revenue. This brings our free cash flow for the first half of the year to \$401 million, or 19 percent of revenue, and 98 percent of non-GAAP net income.

Under our prior share repurchase authorization, during the quarter we acquired approximately 344,000 shares on the open market, at an average price of \$87.21, for a total consideration of \$30 million. As Ron mentioned, yesterday Keysight's board of directors authorized a new

share repurchase program for up to \$500 million of common stock. The new repurchase program is effective immediately and replaces the previously authorized \$350 million program of which \$160 million was remaining.

Before moving to our outlook, I would like to make a few comments regarding the recently announced United States Department of Commerce export control regulations. These regulations directly impact one of our larger customers in China that contributed approximately 2.5 percent of revenue in the second half of FY18. Our business with this customer, and other leading 5G customers, has continued to expand driven by the acceleration of 5G timelines and the strength and breadth of our 5G solutions. As a result, this customer represented almost 5 percent of Keysight revenue in the first half of 2019, of which we believe roughly 2 percent was pulled forward due to the US/China trade situation. The new trade restrictions will create a headwind to revenue growth starting in Q3. Despite this headwind, we

expect to deliver between 7 and 8 percent revenue growth for the year along with strong profitability.

Now, turning to our outlook and guidance ...

We expect third quarter 2019 revenue to be in the range of 1 billion 20 million to 1 billion 60 million dollars. We expect Q3 earnings per share to be in the range of ninety-seven cents to one dollar five cents, based on a weighted diluted share count of approximately 191 million shares.

With that, I will now turn it back to Jason for the Q&A.

JASON KARY:

Thank you, Neil. Operator, will you please give the instructions for the Q&A?