

Keysight Technologies Second Quarter 2020 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Second Quarter Earnings Conference Call for Fiscal Year 2020.

Joining me are Ron Nersesian, Keysight's Chairman, 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 participate in upcoming virtual investor conferences in June hosted by Baird, Bank of America and Stifel.

And now I will turn the call over to Ron.

RON NERSESIAN

Thank you, Jason, and thank you all for joining us. First and foremost, we hope you are all staying safe and well, and our thoughts are with everyone affected by the coronavirus pandemic. The world has faced unprecedented challenges over the past several months, and I would like to thank all of our employees for their continued dedication and commitment to Keysight, our customers and our partners. Our execution and results this quarter underscore the power of our balance sheet, our business model and our Keysight Leadership Model which drives our unique, high-performance culture, and guides our company to continuously deliver greater value to customers, shareholders and employees.

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

- First, the health and safety of our employees is our top priority. After acting quickly to temporarily close most of our global locations in mid-March and implement risk mitigation measures in response to the pandemic, we are now re-opening sites and our production capacity is ramping rapidly.
- Second, despite the mandatory government shutdown of our production facilities and resulting supply disruption impact on Q2 revenue, Keysight delivered steady orders, strong operating margin and record free cash flow. Our results demonstrated the exceptional resilience of our business and the durability of our financial operating model.
- And third, despite the near-term uncertainty, we are confident in our differentiated market leadership position, the strength of our operating model and the long-term secular growth trends across our diverse set of end markets.

Turning to the dynamics that impacted second quarter results, demand was steady across markets in February. As the impact of the pandemic expanded beyond China in early March, we responded quickly to limit the spread of the coronavirus and mitigate the risks to employees, customers and suppliers, while also responding to local government directives. On March 18th we issued a press release to announce the temporary closure of most locations around the world, including our production and order fulfillment facilities, which were fully closed for two weeks in March and had limited activity in April.

We also took the necessary steps to deliver on our customer commitments, particularly those that provide essential services, and support the communities in which we operate around the world. Working with local governments and health officials to implement health and safety measures at all of our locations, we are pleased to announce that we are re-opening sites worldwide. Despite ongoing broader industry supply chain challenges, we are ramping our Keysight production and services operations and expect to be back to 100% capacity by the end of the third quarter.

Now let's take a deeper look into our financial results.

Order growth was positive through March, followed by a decline in April to finish the quarter down only 3% compared to last year's record second quarter. While we don't typically comment on calendar quarter performance, given the dynamic nature of the situation it's worth noting that Keysight's orders and revenue both grew mid-single digits in the January through March timeframe.

Despite lower-than-expected revenue as a result of supply chain disruptions, the resilience of Keysight's business model was exceptional and our flexible cost structure performed as expected. As a result of our immediate actions to reduce costs and preserve liquidity, we delivered operating margin of 19 percent, record free cash flow of \$275 million, and a record cash balance of \$1.8 billion.

Our second quarter revenue declined 18 percent year-over-year as both segments of the business were impacted by the limited manufacturing capacity. However, we continue to see steady demand across several end markets with on-going investment in next-generation technologies such as 5G, 400G, and advanced semiconductor node processes. Other markets, such as general electronics and automotive, are expected to be more challenged in the near-term.

In commercial communications, our ongoing 5G order momentum resulted in a new record. Our end-to-end solutions portfolio continues to gain strong global customer adoption and is enabling the commercial 5G launches underway. We are further solidifying our global leadership position

across both the wireless and wired 5G ecosystem through close collaborations with market leaders, leadership in standards, and first-to-market 5G design and test solutions.

This quarter we introduced Keysight's new 5G Core Network Test Solution called LoadCore. The 5G core testing software simulates complex real-world subscriber models. This enables mobile operators and network equipment manufacturers to qualify performance and reliability of voice and data transferred over 5G networks. This solution leverages from the Ixia and Prisma acquisitions to deliver testing capability needed by our customers.

We also announced a collaboration with Rakuten, an operator in Japan, to enable their 5G deployments using our solutions for test, validation and optimization of devices and networks. Keysight's comprehensive solutions portfolio, spanning the entire ecosystem, is a key differentiator in the market.

In aerospace defense and government, order growth was driven by strong demand in the U.S., which was partially offset by lower international investment. Our solutions for electromagnetic spectrum operations, radar, space and satellite continue to benefit from a favorable U.S. spending environment and on-going investments in technology modernization.

Despite the substantial challenges in the automotive sector, next-generation electric and autonomous vehicle technology is a strategic priority for our customers. Keysight continues to invest in first-to-market solutions and remains highly engaged with key market players. For example, we recently announced the use of our Scienlab Battery Test Solution in the BMW Group's new Battery Cell Competence Center in Germany.

Foundry customers are continuing to prioritize investment in advanced process node technologies and incremental infrastructure. This resulted in revenue growth for our semiconductor measurement solutions, where we had less supply chain disruption.

Software and services continue to contribute to the differentiation of our solutions and recurring revenue base. While growing above the company average over time, they are strengthening the

durability and diversity of our business model. In Q2 the combination of both software and services represented approximately 35% of revenue.

Turning back to the current COVID-19 pandemic, we are committed to supporting our customers and our communities through this challenge. For our customers, we launched the Innovate Anywhere program to enable IT teams to support remote users, ensuring VPN performance and security. We also implemented various health and safety measures at our facilities to ensure all safeguards are met before production and other operations resumed. For our communities, we are contributing to relief efforts globally through monetary and supply donations. These include donations of personal protective equipment to local hospitals, and government agencies providing support to children, families and the most vulnerable. We are also making direct financial contributions to local community and global non-profit organizations.

Before turning the call over to Neil, I'll close with a few key points. Keysight is a market leader in large, diverse and growing end markets, and serves a diversified, global base of over 32,000 customers across multiple industries. The challenges of this pandemic are unprecedented, and I'm proud of how our team has responded. Our execution demonstrates the durability of our business and the resilience of our business model with 19% operating margin and solid cash flow even with a Q2 revenue impact. We continue our significant investment in R&D and remain focused on first-to-market solutions. Our sales teams remain highly engaged with our customers, and we continue to execute our strategy for long-term, above-market growth. While we expect ongoing COVID-19 demand and supply chain headwinds over the next few quarters, our long-term secular market growth trends and the strength of our operating model remain intact. We expect to come through this challenge stronger than ever.

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.

Keysight delivered a solid quarter thanks to strong execution in a challenging environment. While supply chain disruptions dampened our revenue performance during the second half of the quarter, our results demonstrated the resiliency of our operating model and durable cash generation. We responded quickly with proactive measures to reduce costs and preserve liquidity, while supporting our customers and advancing key projects.

For the second quarter of 2020, we delivered revenue of \$895 million, down 18 percent on a reported and core basis, due to our site closures and supply chain disruptions that started in mid-March and continued through the end of the quarter.

Orders of \$1.1 billion were down 3 percent on a reported and core basis. As Ron mentioned, we continue to see steady demand and investment across multiple end markets, particularly for our next-generation communications solutions.

Turning to our operational results for Q2, we reported gross margin of 63 percent with improved mix and lower spending partially offsetting the impact of lower revenue. The flexibility of our cost structure resulted in lower variable compensation and a reduction in outsourced manufacturing costs. This, combined with other specific actions, such as a temporary hiring freeze and reductions in discretionary spending, enabled our flexible operating model to perform as expected, resulting in 19 percent operating margin for the quarter.

Net income in the second quarter was \$148 million. On a per share basis, we delivered \$0.78 cents in earnings. Our weighted average share count for the quarter was 189 million shares.

Regarding the performance of our segments, in light of the broad supply chain disruption, CSG and EISG expense management and margin performance were exceptional. CSG operating margin was 18%, while EISG delivered 24% operating margin. On the demand side, general electronics, education and automotive were weak, while investment continued in 5G, aerospace/defense and other leading-edge technology solutions.

Moving to the balance sheet and cash flow, we ended our second quarter with a record \$1.8 billion in cash and cash equivalents, with \$450 million of additional liquidity available under our undrawn revolving credit facility.

We reported cash flow from operations of \$298 million and record free cash flow of \$275 million, or 31 percent of revenue. The strength of our cash generation reflects the power of our financial operating model, which incorporates a flexible cost structure and includes a financial playbook that is designed to preserve margins and cash generation during challenging times.

Under our share repurchase authorization, we acquired approximately 1.3 million shares on the open market in the first half of the quarter at an average price of \$91.14 for a total consideration of \$120 million. Our YTD repurchases are sufficient to achieve our objective of being anti-dilutive for the full year and to exit the year at 190 million shares. While we are focused on optimizing liquidity, given our strong operating model and cash generation, our capital allocation priorities remain unchanged.

Now, turning to our outlook and guidance ...

While we are not quite back to full capacity, our production operations and those of our suppliers have been ramping since mid-April. We expect to make continued progress in Q3 and, as a result, expect third-quarter revenue, operating margin and earnings to be in line with, or better than, Q2. These expectations are based on our order funnel, a strong backlog position, and assume limited incremental supply chain constraints or disruption from additional shutdowns or a second wave of the pandemic. While maintaining our R&D investments for future growth, we will continue to focus on profitability and leverage the flexibility of our operating model to manage expenses.

In closing, the near-term situation is obviously challenging, but we remain focused on our long-term strategy of enabling our customer's success through first-to-market, leading-edge solutions. Once the COVID-19 situation stabilizes, the durability of our business model, cash generation, strong balance sheet, and market leadership position, give us confidence in our long-term financial targets that we shared with you at our Investor Day in early March; specifically, sustainable long-

term core revenue growth of 4 to 6 percent, operating margin of 26 to 27 percent, and EPS growth of at least 10 percent over the long term.

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