



Keysight Technologies Third Quarter 2020 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Third 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 the management team is scheduled to participate in upcoming virtual investor conferences in September hosted by Jefferies, Citibank and Deutsche Bank.

And now I will turn the call over to Ron.

RON NERSESIAN

Thank you, Jason, and thank you all for joining us. Keysight delivered stronger-than-expected third quarter results, demonstrating the exceptional resilience of our business for the second quarter in a row, despite ongoing macro challenges. I am proud of how the Keysight team rapidly adapted to a new operating environment, while delivering on our commitments to our customers, partners, and shareholders.

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

- First, we delivered stronger-than-expected third quarter results with solid gross margin and record operating margin. Our differentiated solutions drove steady demand through the quarter, and our operational execution was exceptional as we ramped production capacity to nearly 100% by quarter-end.
- Second, despite the ongoing pandemic uncertainty, we remain confident in our differentiated leadership position and the long-term secular growth trends driving our markets. The past two quarters have demonstrated the resilience of the Keysight Leadership Model, which we believe provides a durable competitive advantage for the long-term.
- And third, despite near-term macro disruption, we expect to achieve year-over-year revenue and earnings growth in the fourth quarter.

Now, let's take a deeper look into our financial results and the market dynamics within the quarter. Despite the challenging macro environment, demand for Keysight's differentiated solutions was steady through the quarter. Orders declined 4 percent year-over-year and 2 percent sequentially, in line with our typical Q2 to Q3 seasonality. Revenue declined 7 percent year-over-year, while increasing 13 percent sequentially. The durability of our financial operating model and flexibility of our cost structure was again exceptional as we delivered third quarter gross margin of 64 percent, record operating margin of 26 percent, and free cash flow of \$151 million.

In commercial communications, we continue to see the global adoption of Keysight's 5G platform. Our end-to-end solutions for the 5G lifecycle across both the wired and wireless domain, AND from R&D to high-value manufacturing, are enabling the ecosystem to scale from product development to deployments.

5G commercialization is progressing and on track to add an estimated 190 million subscribers in 2020. Device design and development investments continued to be strong, driven by the large scale ramps in Asia. As 5G deployment expands and ongoing innovations gain customer interest, we see continued strength in R&D. With several test house announcements this quarter, Keysight's leadership is further solidified as our 5G test platforms are now being used by all leading test houses worldwide. Keysight's first-to-market 5G design and test solutions are also helping to accelerate and enable the virtualization of the Radio Access Network, and the rapid adoption of the Open Radio Access Network technologies.

We also saw strong demand for our high-speed digital and optical solutions driven by 400G manufacturing expansion and an uptick in R&D investment in 800G. Keysight is well-positioned to capitalize on commercial rollouts and mainstream deployments. Our comprehensive platform provides end-to-end solutions that enable customer innovation throughout the entire 5G lifecycle.

In aerospace defense and government, orders were strong in the U.S., offset by lower investment in Europe and, to a lesser extent, in Asia. We continue to see strong demand for our electromagnetic spectrum threat simulation platform, as well as solutions for radar, space, satellite, and 5G. In addition, we continue to enable our customers' initiatives to increase their electronics supply chain capacity and reliability in the U.S., which we believe is a multi-year opportunity.

In the automotive sector, macro-driven weakness persists; however, the fundamental drivers for long-term investment in electric and autonomous vehicle technologies continue to be a strategic industry priority. As the industry adapts to tremendous change and multiple technology disruptions, Keysight is investing in first-to-market solutions and remains firmly engaged with key market players. We recently announced a multi-year collaboration with IPG Automotive and Nordsys, to jointly develop a new modular test platform for autonomous drive emulation. This will accelerate the validation of advanced driver-assistance systems and functions for autonomous driving.

Strategic investment in next-generation semiconductor process technology remains a priority for our customers. Demand is being driven by 5G smartphone processors, high-speed networking, and high-performance data center applications to serve the work-from-home economy. This trend resulted in double-digit year-over-year order growth for our semiconductor measurement solutions.

Software and services again delivered solid revenue growth this quarter. Our software-centric solutions strategy is providing strong value to our customers. Services and support, such as KeysightCare, continue to expand to higher value-added consulting and optimization offerings. At greater than 30 percent of total revenue, our growing mix of software and services is contributing to the durability of our business model, while increasing recurring revenue and improving gross margins.

With the bulk of the 5G opportunity ahead of us and mmWave commercialization still in its early days, we recently launched the PathWave Design 2021 Software Suite. This advanced software accelerates 5G design, simulation, and verification workflows with an integrated solution that ensures design performance, improves accuracy, and speeds time-to-market. In the manufacturing arena, Keysight continues to collaborate with leading 5G infrastructure customers on new cloud-based PathWave manufacturing solutions.

We continue to increase our solution differentiation with strategic acquisitions, expanding into the application layer, and growing our addressable market. We recently acquired Eggplant, an industry leading software test automation platform provider. Eggplant's differentiated technology uses artificial intelligence and analytics to automate test creation and test execution. With this acquisition, Keysight is now the only company that can provide test capability from the physical layer through the application layer and extending to the user experience, or UX. Eggplant's customers span a wide range of sectors, overlapping Keysight's existing customer base while expanding software test opportunities into new end-markets.

Looking back at the past two quarters, our performance exemplifies the core values of the Keysight Leadership Model on multiple fronts. We demonstrated operational excellence and the durability of our financial operating model. KLM also extends beyond financial accountability and aligns with our foundational pillars of Corporate Social Responsibility. We released our latest annual CSR Report in May. We are proud to have surpassed our social impact goals in community and education, while making progress on our governance and environmental goals, including climate change. Lastly, as a result of recent events, we are taking further actions to expand our inclusion and diversity programs to advance racial equality. For example, we are working with academic institutions, including historically Black colleges and universities, to reinforce our diversity recruiting strategy. We are committed to accelerating racial equality and will do our part to make a difference.

To wrap up my comments, Keysight's execution this quarter is a reflection of our values and our commitment to customers to deliver first-to-market solutions for their businesses and technology challenges. I couldn't be prouder of the Keysight team. They have risen to the occasion in a challenging environment, and continue to execute on customer commitments – while, at the same time, upholding the values that make Keysight a diverse, inclusive work environment with a culture of innovation, ownership, passion, and respect. 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. Note that all comparisons are on a year-over-year basis unless specifically noted otherwise.

Keysight delivered a solid quarter thanks to steady demand and strong execution. Despite a challenging economic environment and supply chain disruption, our financial and operational performance demonstrated the durability of our operating model as we reported record operating margin and solid cash flow. This performance also proved, for the second quarter in a row, the effectiveness of our financial playbook, which is designed to preserve margins and cash generation during challenging times.

For the third quarter of 2020, we delivered revenue of \$1 billion 11 million, down 7 percent on a reported and core basis. Our team executed well in ramping production capacity and managing supply constraints, which resulted in stronger-than-expected sequential revenue growth of 13 percent.

Orders of \$1 billion 67 million were down 4 percent on a reported and core basis and were steady through the quarter in aggregate.

Regionally, demand accelerated in Asia and began to stabilize in the US, while Europe lagged as the pandemic continues to hamper their economic recovery.

Turning to our operational results for Q3, we reported gross margin of 64 percent, with improved mix and lower discretionary spending offsetting the impact of lower revenue. Expenses were well-managed as we benefited from our flexible cost structure and the specific actions that we initiated last quarter. The combination of strong gross margin performance and expense discipline resulted in record operating margin of 26 percent.

Net income in the third quarter was \$226 million. On a per share basis, we delivered 1 dollar 19 cents in earnings on a weighted average share count for the quarter of 190 million shares.

Regarding the performance of our segments, we saw continued strength in 5G investments, both in R&D and in manufacturing, as well as next-generation semiconductor node technologies, which drove double-digit order growth across both markets respectively. This strength was offset by weaker spending in legacy communications, automotive, general electronics, and international aerospace, defense and government markets. Exceptional execution and expense discipline resulted in CSG operating margin of 26 percent, and EISG operating margin of 27 percent.

Moving to the balance sheet and cash flow, we ended our third quarter with \$1.7 billion in cash and cash equivalents, with \$450 million of additional liquidity available under our undrawn revolving credit facility. Our quarter-end cash balance reflects the impact of the \$319 million net of cash acquisition of Eggplant. We reported cash flow from operations of \$183 million and free cash flow of \$151 million. We did not repurchase any shares during the quarter.

Turning to our outlook and guidance ...

As Ron mentioned, we expect to make continued progress in Q4, and as a result, we expect fourth quarter revenue to be in the range of 1 billion 170 million to 1 billion 190 million dollars, and Q4 earnings per share to be in the range of 1 dollar 42 cents to 1 dollar 48 cents, based on a weighted average share count of 190 million shares. At the midpoint, this represents 5 percent year-over-year revenue growth and 9 percent year-over-year earnings growth. These expectations assume limited incremental supply chain constraints or disruption from additional shutdowns or a second wave of the pandemic.

While the near-term remains challenging, the long-term secular growth trends in our markets remain intact. We continue to invest in R&D and focus on our long-term strategy of enabling customer success through first-to-market, leading-edge solutions. As I mentioned last quarter, the durability of our business model, steady cash generation, strong balance sheet, and market leadership give us confidence in our long-term core revenue growth target of 4-6 percent, and operating margin target of 26 to 27 percent.

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

JASON KARY:

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