Keysight Technologies First-Quarter 2015 Earnings Conference Call Prepared Remarks

JASON KARY

Thank you and welcome everyone to Keysight's First Quarter Earnings Conference Call for Fiscal Year 2015. With me are Ron Nersesian, Keysight President and CEO; and Neil Dougherty, Keysight Senior Vice President and CFO.

Joining in the Q&A after Neil's comments will be Guy Séné, Senior Vice President of Measurement Solutions and Worldwide Sales, and Mike Gasparian, Senior Vice President of Customer Support Services and Marketing.

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. We will also post a copy of the prepared remarks following this call.

Today's comments by Ron and Neil will refer to non-GAAP financial measures. 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.

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.

And now I'd like to turn the call over to Ron.

RON NERSESIAN

Thank you, Jason. And welcome everyone.

I will start by sharing four headlines regarding Keysight's Q1 results.

- First, revenue was above the mid-point of our guidance, operating margin was at the high-end of our guidance, and non-GAAP earnings-per-share was 56 cents. While this is our first time reporting quarterly results as an independent company, it is the fourth quarter in a row that we've delivered financial results above expectations.
- Second, we are further ahead on our stabilization plans than where we expected to be at this point.
- Third, we remain committed to creating shareholder value and to returning to market growth rates. We continue to focus intently on transforming our portfolio, and received several distinguished industry recognitions in Q1 for our modular PXI vector network analyzer family that is a proof point of our ability to innovate beyond current market offerings.
- And fourth, now that we have one quarter of results under our belt as an independent company and we have validated our models, we are changing from guiding operating margin to guiding non-GAAP earnings-per-share.

Let’s move to the specifics of our results.

Keysight Q1 revenues of $701 million increased 4 percent year-over-year, or 7 percent on a core basis, which excludes the impact of currency and acquisitions, and were $6 million above the mid-point of our guidance. First quarter orders of $691 million decreased 1 percent year-over-year, or grew 1 percent on a core basis. Keysight achieved strong profit margins that were above our guidance, generating operating profit of $120 million, an operating margin of 17.1 percent for the quarter, and non-GAAP earnings-of 56 cents per share.

Turning to our end market performance:

Total Aerospace Defense revenues increased 22 percent compared to Q1 of last year, when Aerospace Defense was down significantly due to delays in the U.S. budget approvals. This quarter Aerospace Defense revenues were driven by our strong backlog entering the quarter as spending from both U.S. direct government accounts and contractors continued with the current stable budget environment.

Aerospace Defense continued to be strong in Asia with growth in China. In Europe, Aerospace Defense revenues were soft due to general macroeconomic weakness and events in Russia, which we highlighted in prior quarters as potential risks to our outlook.

Industrial, Computers, and Semiconductor revenues decreased 6 percent year-over-year largely due to the expected slowdown in semiconductor end markets, after a very strong FY14. We also saw some slowing in our industrial business after a strong Q4.

Communications revenues grew 8 percent year-over-year in Q1, driven by both R&D and manufacturing with continued strength in infrastructure and the component supply chain for mobile devices. Wireless R&D business was steady in Q1, tracking with our expectation of stable investment levels. This overall growth was partially offset by continued weakness in smartphone, handset and tablet manufacturing test, which we've highlighted previously.

Turning to regional performance, Keysight revenues grew year-over-year in the Americas and Asia Pacific, excluding Japan, with declines in Europe and Japan. Americas grew 16 percent year-over-year driven by strength in Aerospace Defense. Asia Pacific, excluding Japan, grew 6 percent with growth driven primarily from Aerospace Defense and Communications. Europe was down 5 percent year-over-year, or 1 percent on a core basis. Japan was weak across all end markets this quarter, declining 15 percent year-over-year, or 5 percent on a core basis.

Our priorities continue to center on growing the business in order to create long-term shareholder value. We do this by focusing on higher growth opportunities in our markets—such as wireless communications, modular solutions, and software—while leveraging the strength of our business model.

As we have said in previous calls, this transformation will be a consistent, multi-year effort, yet you can see the progress we are making in our new introductions and industry recognition.

For example, in Q1, Keysight's first modular PXI vector network analyzer family won several prestigious industry awards, making it one of the most significant test and measurement products in 2014. Honors include:

- Product of the Year from Electronics Products magazine,
- Top Products of 2014 from Microwave and RF magazine
- and Hot 100 Products of 2014 from Electronic Design Network or EDN

Keysight modular products use state-of-the-art technology from our traditional box instrumentation to deliver unparalleled combination of measurement performance, speed, size, and cost of test for customers.

Also in Q1, we introduced new signal generators, signal analyzers, and network analyzers that exceed the performance of products in any form factor.

While we have been the technology leader in hardware for 75 years, in Q1, Keysight was recognized with the 2014 Global Frost & Sullivan Award for Market Leadership in Instrumentation Software for capturing the highest market share in the global instrumentation software market. We appreciate the recognition, yet we have more work to do and will continue to innovate to grow our software solutions from this strong foundation.

As I mentioned, we are on track with our separation, and I'm encouraged by how far we have come in a short amount of time since launching Keysight. In Q1, we continued rebranding our hardware and software products, and we closed our books in Q1 in our new and stable ERP environment.

That gives you a look into our results in Q1.

Now I will turn it over to Neil to provide the details of Keysight's financial results, and the details on the guidance for the next quarter.

NEIL DOUGHERTY

Thank you, Ron, and hello, everyone.

As Ron mentioned, Keysight is off to a strong start in its first quarter as a fully independent company.

Before I get into the details of our results, please note that my comments will refer to non-GAAP figures. In addition, we are now reporting results not only for Keysight in aggregate, but for our two operating segments, Measurement Solutions, and Customer Support and Services. The segmentation of our business remains consistent with our SEC reporting in both our Form 10 and our FY14 10K.

Now turning to our results…

First quarter revenues of $701 million were up 4 percent year-over-year, or 7 percent on a core basis, which excludes the impact of currency and acquisitions. The impact of acquisitions was immaterial, so currency accounted for the full 3 percentage point headwind versus Q1 of FY14. Keysight invested in R&D at a rate of 13 percent of revenue in the first quarter, which was in line with Q1 of FY14. Operating margin of 17.1 percent was down 50 basis points versus the same period last year as we began to see the impact of the separation related dis-synergies.

Both revenue and operating margin were above the midpoint of our guidance range. This is the fourth consecutive quarter that we have delivered in line with or better than guidance as we continue to demonstrate the strength and discipline of our operating model.

Taking a closer look at revenues, the regional revenue breakdown was largely consistent with prior periods, with 38 percent of revenues coming from the Americas, 19 percent from Europe, 33 percent from Asia excluding Japan, and 10 percent from Japan.

On a constant currency basis, regional revenue grew 16 percent in the Americas, declined 1 percent in Europe, declined 5 percent in Japan, and grew 7 percent in the rest of Asia.

Last quarter we noted Russia as a potential risk factor, and in Q1 we did see a material slowing of our incoming order rate due to on-going sanctions and the devaluation of the Ruble. We don't expect this situation to improve in the immediate future, and expect our business in this region to remain suppressed in Q2.

Moving to the income statement, I'll make a few comments about currency given the recent volatility in foreign exchange rates. While currency movements do impact the individual line items of our P&L, they typically have a minimal impact on our operating margin as a result of our geographic diversification and systematic hedging program. Even though approximately 75 percent of our sales are denominated in U.S. dollars, currency fluctuations did have the 3 percentage point unfavorable impact on Q1 revenue growth that I noted earlier. That impact however, was almost fully offset by the favorable impact of currency movements on costs and expenses. The result was that exchange rate fluctuations had no material net impact on our Q1 operating profit.

After applying our 17 percent Non-GAAP tax rate, Keysight generated Non-GAAP net income of $96 million, or 56 cents per share in our fiscal first quarter.

Now turning to cash flow, in Q1 Keysight generated cash from operations of $92 million, invested $15 million in capital expenditures, resulting in $77 million of free cash flow. We finished the quarter in a net debt position of $211 million.

Now let's move to the results for our two operating segments, starting with our Measurement Solutions Segment, which as a reminder, includes all of our hardware and software product solutions. In Q1, Measurement Solutions generated revenues of $606 million with an operating margin of 17.7 percent. Segment revenues grew 8 percent on a core basis while operating margins improved 50 basis points year-over-year.

Our second segment is Customer Support and Services, which includes our repair, calibration, and used equipment businesses. The Customer Support and Services segment generated revenues of $95 million which were flat on a core basis. However, after adjusting for the impact of the March 2013 change to our standard warranty period, from one year to three years, segment revenues increased 8 percent. First quarter operating margins for the Customer Support and Services segment were 13.7 percent, a decline of 630 basis points year-over-year. There were two main factors driving this decline in segment profitability. First, shared infrastructure costs shifted in Q1 from Measurement Solutions to Customer Support and Services based on the use of historic drivers. Second, we have made incremental investments in technology and capacity to drive services growth through a more complete product offering for large aerospace and defense customers.

Now turning to our guidance for the second quarter of FY 15, which assumes exchange rates as of Jan 31.

We expect Q2 revenues to be in the range of $720 million to $760 million, which after accounting for currency reflects 3 percent core year-over-year revenue growth at the midpoint. The slowdown in Russia is factored into our guidance and provides an additional 1-2 percentage point headwind to growth. Despite these topline impacts, we expect second quarter EPS to be in the range of 56 to 70 cents. Our EPS projection assumes no material earnings impact from currency and a share count of 171 million shares.

We remain confident in the strength of our operating model and maintain the same discipline that we have exercised over the past several years. With this discipline, we expect to deliver operating margins in the mid-teens in the troughs and better than 20 percent at the peaks, while making the investments necessary to drive growth for Keysight.

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