Keysight Technologies Second-Quarter 2015 Earnings Conference Call. Prepared Remarks

JASON KARY

Thank you and welcome everyone to Keysight's Second 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 very much, Jason, and hello everyone.

I will start by sharing four headlines regarding Keysight's Q2 results.

- First, our second quarter revenue of $740M was at the mid-point of our guidance, and non-GAAP earnings-per-share of 70 cents was at the high end of our guidance range. We executed well in our second quarter as an independent company, and this is the fifth quarter in a row that we have delivered financial results at or above expectations.

- Second, incoming orders declined versus a strong quarter last year.

- Third, in light of slower incoming orders, we have initiated programs in Q2 to reduce our cost structure by $25 million over the next 24 months.

- And Fourth, with the end of our IT support agreement with Agilent in Q2, we completed the final steps of our separation. With that last separation milestone behind us, our focus now is entirely on delivering value through growth and improving our operational efficiency as an independent company.

Now let's move to the specifics of our results.

Second quarter revenues of $740 million were flat over last year, up 3 percent on a core basis, and were at the mid-point of our guidance. Operating profit margin for the quarter was 20.3 percent. The business generated operating profit of $150 million and non-GAAP earnings of 70 cents per share.

From an end market perspective, total Aerospace Defense revenues declined 1 percent year-over-year with strength in the U.S. offset by weakness in the rest of the world. Stable budgets and on-going program technology investment drove Aerospace Defense spending in the U.S. from both direct government accounts and contractors.

Outside of the U.S. Aerospace Defense revenues were down. Europe and Russia remained weak, while Asia slowed on lighter spending in China.

Industrial, Computers, and Semiconductor revenues grew 2 percent year-over-year. Our broader general Industrial markets improved this quarter, while Computer and Semiconductor markets held up better than expected.

Communications revenues declined 3 percent year-over-year in Q2, driven by lower wireless manufacturing spending. As we expected, last year's strength in 4G base station and infrastructure manufacturing for China has moderated. In addition, capacity expansion for smartphone and for smart device manufacturing remains fairly limited.

We continued to see steady investment by device chipset and component customers. Wireless R&D revenues were steady this quarter and continued to track with our expectations of stable investment levels, especially from wireless chipset customers.

From a regional perspective, revenue growth was strong in the Americas and grew in all regions except for Asia Pacific excluding Japan. Americas grew 19 percent year-over-year driven by strength in Aerospace Defense and Industrial, Computers, and Semiconductor market segments.

Asia Pacific revenues, excluding Japan, declined 14 percent year-over-year versus a strong compare with declines in all market segments. Europe grew 4 percent on a core basis as strength in Computers and Semiconductor spending offset weaknesses in Russia. Japan rebounded strongly from a weak Q1 and grew 13 percent on a core basis with strength in wireless component spending.

While we are pleased with our financial results and execution this quarter, our incoming order rate was weaker than expected. Q2 orders of $697 million decreased 11 percent year-over-year, a decline of 8 percent on a core basis.

Russia accounted for two points of the overall order decline due to on-going sanctions and its economic situation. The balance of the decline was due to capacity-build orders placed by two large semiconductor and communications customers in our second quarter last year that did not repeat.

As we look to the remainder of the year, the weakness in Communications is partially being offset by strength in Aerospace Defense. There are positives and negatives across the Industrial, Computer, and Semiconductor end markets, and overall macroeconomic indicators remain mixed.

Accordingly, we initiated several programs that will provide $25 million in total in operational savings that not only offset the dis-synergies associated with our spin-off, but also will ensure that our investments are more focused on growth generation through R&D and sales efforts.

Coupling this focus with the discipline and strength of our operating model allows us to maintain our investment across the cycle and still deliver solid profitability and cash flow.

Therefore, we will continue to invest for the future in the three key areas that we have highlighted before: wireless communications, modular solutions, and software.

For instance, carrier aggregation is a key to increasing bandwidth and data rates to create better mobile communications experience for consumers. In Q2, Keysight and Spirent announced a partnership to offer the most advanced carrier acceptance solution available for testing maximum data throughput performance for LTE-Advanced carrier aggregation.

The solution was created by integrating our R&D one-box-tester platform—the UXM—into Spirent's new Carrier Acceptance and Conformance test solution.

Our modular business had another record revenue quarter, and continued to grow at high double-digit rates. We believe this trend will continue as we leverage state-of-the-art technology from our instrument solutions to deliver unparalleled combinations of measurement performance, speed, size, and cost of test for customers.

A good example of a Keysight solution incorporating multiple hardware and software elements is the 5G solution that we previewed at Mobile World Congress in Barcelona Spain, in March. The solution is for a complex task that is crucial in early-stage R&D to assess performance of proposed 5G network designs.

As I mentioned as one of the headlines for this call, we took the final steps in our separation from Agilent with the end of our IT support agreement. With this important milestone behind us, our focus is entirely on delivering value through innovative electronic design and test solutions, as well as improving our operational efficiency as an independent company.

I will now turn the call over to Neil to provide the details of Keysight's financial results and guidance for our third quarter.

Neil Dougherty
Thank you, Ron, and hello, everyone.

Before I review the details of our second quarter, please note that my comments refer to non-GAAP results. You can find reconciliations to the nearest GAAP figures on our investor relations website.

Turning to our results for Q2…
Second quarter revenue of $740 million was flat year-over-year, or up 3 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 Q2 of FY14.

Operating margin for the quarter was 20.3 percent, down 80 basis points versus the same period last year as a result of our incremental investment in R&D.

The regional breakdown of our revenue was in line with prior periods, with 38 percent of revenues coming from the Americas, 17 percent from Europe, and 45 percent from Asia.

On a core basis, revenue grew 19 percent in the Americas, 4 percent in Europe, and 13 percent in Japan. Asia excluding Japan declined 14 percent.

Lower revenue from Russia continued to be a drag on growth. Russia orders and revenue were both down significantly and we do not expect any improvement in the near term.

Moving to the income statement, currency movements had no material impact on our Q2 operating profit as the unfavorable impact on revenue was offset by favorability in expenses.

Gross margins improved 50 basis points versus last year on a similar revenue base due to a higher mix of revenue from R&D versus manufacturing applications and lower warranty expense. Expenses were well-controlled, and we continue to invest in R&D at a rate of 13 percent of revenue.

As mentioned, non-GAAP operating margins were just over 20 percent for the quarter at 20.3 percent of revenue. After applying our 17 percent non-GAAP tax rate, we generated non-GAAP net income of $120 million, or 70 cents per share.

Now turning to cash flow, in Q2 Keysight generated cash from operations of $68 million and invested $16 million in capital expenditures, resulting in $52 million of free cash flow. With cash and cash equivalents of $894 million and total debt of $1.1 billion, we finished the quarter in a net debt position of $205 million.

Moving to the results of our two operating segments...
Measurement Solutions generated revenue of $638 million with an operating margin of 20.7 percent in the second quarter. Segment revenue grew 3 percent on a core basis, while operating margin improved 20 basis points year-over-year.

The Customer Support and Services segment generated revenue of $102 million, a core increase of 3 percent. After adjusting for the impact of the March 2013 change to our standard warranty period from one to three years, segment revenue grew 11 percent. Second quarter operating margin for the Customer Support and Services segment was 17.7 percent, a sequential improvement of 400 basis points. We are already seeing the benefit of the incremental investments in technology and capacity that we began last quarter.

Now turning to our outlook for the third quarter…
You should note that Q2 and Q4 are typically stronger quarters for the business, while Q1 and Q3 are seasonally softer. Last year revenue did grow sequentially from Q2 to Q3 but that deviation from historical norms was a result of a weak first half and an increase in Aerospace and Defense spending post-sequestration. We expect to return to our typical seasonality this year and given our Q2 orders we are guiding revenues in the range of $635 to $675 million. This represents a core decline of 10 percent at the midpoint. We expect third quarter non-GAAP EPS to be in the range of 37 to 51 cents. Our guidance assumes exchange rates as of April 30th and a share count of 172 million shares.

Our revenue guidance does represent a lower point in our operating model; however, the flexibility of our cost structure will enable us to maintain Q3 operating margin in the mid-teens. In addition to the flexible spending reductions already made and which are fundamental to our operating model, we have also initiated programs to generate $25 million in structural savings over the next 24 months. These programs will improve our operational efficiency, and accelerate the transformation of our company. Two examples of structural actions we have taken include the announcement of a voluntary retirement program and the closure of our U.S. defined benefit plan to new entrants.

These cost reduction initiatives, in conjunction with our operating model discipline, will enable us to continue making the investments necessary for Keysight to return to market growth, while delivering strong profitability and cash flow across the cycle.

As a final note, we will be discussing our longer-term strategy and market outlook at our upcoming Investor Day, which is planned for September 1st in New York.

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

Ron's closing comments

Thank you all for joining our call. I am pleased that Keysight delivered another quarter of solid earnings. In addition, we initiated actions to reduce our cost structure by $25 million to adjust to the current dynamics of the industry, to deliver double-digit profits through the cycle, and to maintain our momentum in developing industry-leading solutions.

In closing, I remind you that—using our unique formula combining technology-leading hardware and software, and our global network of experts—we are committed to maintaining the discipline of our operating model, while investing to grow and deliver long-term value for shareholders.