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

JASON KARY

Thank you and welcome everyone to Keysight's Third 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.

To start, I have three headlines to share with you regarding Keysight's Q3 results and our recent acquisition.

First, despite challenging market conditions, Keysight delivered solid profit and cash flow. This was the sixth quarter in a row that we delivered financial results at or above the midpoint of our revenue and EPS guidance.

Second, our strategy to grow in wireless communications and software businesses took a major step forward this quarter when we announced the Anite acquisition and closed it two months ahead of schedule.

Third, our fiscal year 2015 guidance reflects our revenue and operating profit over-performance in Q3 and a slightly improved outlook for Q4.

Now, let's move to the specifics of Keysight's performance.

We had strong profit performance despite a challenging market environment.
Our operating discipline enabled us to perform better than expected in orders, revenue, and profit.

Q3 orders were down 5 percent primarily due to two factors:
Greater China and currency.

Core orders, without currency and acquisitions, were down 1 percent, largely due to weakness in Greater China. While this is not desirable, it is a noticeable improvement from the Q2 core order decline of 8 percent.

Q3 revenue, driven by weak orders in the previous quarter, was down 12 percent, or 9 percent on a core basis. As we anticipated this result, we used our flexible operating model to generate non-GAAP EPS of 55 cents, which was 11 cents above the midpoint of our guidance.
Neil will discuss the balance between flexible spending and one-time benefits for future modeling.

As this was the sixth quarter in a row that we delivered results above the midpoint of guidance, we feel very good about our operational capabilities as an independent company.

2. Strategically, our focus remains on addressing the customer needs of the faster growing market segments in electronic design and test.

Our first areas of focus that we outlined over one year ago are realizing solid gains: wireless communications, modular instrumentation and software solutions.

In fact, we accelerated our efforts in both wireless communications and software by announcing in Q3 our intention to acquire Anite. We closed the transaction just last week—two months ahead of schedule.

Anite is a leading supplier of test and measurement solutions to help customers develop software and optimize performance in the wireless communications market. This acquisition expands our solutions offering in wireless R&D design and test, specifically into the software layer for design and validation.

Coupling Keysight's expertise in helping customers design and test hardware, with Anite's leadership in helping the same customers design and test software, we can now provide customers with the most comprehensive wireless solutions for both the hardware and software layers.

Anite also has a Network Test business that brings innovative solutions that help deliver an outstanding experience for mobile users in the network. The Network Test business expands Keysight into an adjacent market and increases our overall served addressable market by about $500 million.

We are excited to have the talented Anite team join us as they bring a new set of skills, capabilities, and opportunities to Keysight.

Anite will provide 14-17 cent of accretion in FY16. It will also deliver at least 15 percent ROIC in year 5. In addition to Anite's contribution, we continue to make progress on our growth initiatives.

In wireless communications, we recently announced 5G collaborations with NTT DOCOMO in Japan and KT in South Korea, and we joined the "millimeter MAGIC" project, a European Commission 5G effort. These early 5G collaborations add to our growing list of engagements with market-making customers, consortia, and universities.

In modular, Keysight's PXI and AXIe modular business continues to generate very strong growth year-over-year driven by new products and our success in the wireless segment.

In summary, despite a down revenue quarter, Keysight delivered better profitability than expected in Q3, and we see a slightly improved outlook for Q4.

This contributes directly to our full-year guidance in which revenues are expected to be in the range of $2.84 to $2.88 billion and non-GAAP earnings per share are expected to be in the range of $2.38 to $2.52.

At this point, I will turn the call over to Neil to provide details of Keysight's financials.

Neil Dougherty

Thank you, Ron, and hello, everyone.

Keysight had solid profit performance in a quarter where seasonally softer revenue was compounded by the impact of our weak Q2 orders. The order picture improved in Q3, with orders down 1 percent on core basis versus a core decline of 8 percent last quarter. We actually saw core order growth in all regions with the exception of greater China and had a book-to-bill ratio above 1.

Third quarter revenues of $665 million were down 12 percent year-over-year, or down 9 percent on a core basis, which excludes the impact of currency and acquisitions.

The regional breakdown of revenue was in line with prior periods, with 37 percent of revenues coming from the Americas, 18 percent from Europe, and 45 percent from Asia.

On a core basis, revenue was down 11 percent in the Americas, down 5 percent in Europe, down 14 percent in Asia, excluding Japan, and up 14 percent in Japan.

China revenues were down double digits in Q3 versus a particularly strong compare.

Despite the softer top line, profit performance for the quarter was solid with Q3 operating margin of 18.6 percent. After applying our 17 percent non-GAAP tax rate, we generated non-GAAP net income of $94 million, or 55 cents per share.

We did benefit from $5 million in one-time items this quarter which improved our operating margin by 75 basis points and our EPS by 3 cents. Even after adjusting for these favorable benefits, our profit performance illustrates the strength and flexibility of our operating model.

Gross margins improved 110 basis points versus last year on much lower revenue. Among the drivers of this improvement was a higher mix of sales to R&D versus manufacturing customers and disciplined pricing management.

Expenses were well-controlled during the quarter as our flexible business model enabled us to manage our cost structure in response to business conditions.

Currency continued to provide a significant revenue headwind in the third quarter, reducing the topline by 4 percentage points. Despite this impact, exchange rate movements had no material impact on our Q3 earnings as the unfavorable impact on revenue was offset by a favorable impact on expenses.

Now turning to cash flow… In Q3 Keysight generated cash from operations of $135 million and had $35 million of capital expenditures. This resulted in $100 million of free cash flow. We finished Q3 with cash and cash equivalents of $1 billion and total debt of $1.1 billion, for a net debt position of approximately $100 million.

However, as Ron mentioned, after quarter end we closed the all cash acquisition of Anite for a purchase price of approximately $600million, materially reducing our cash balance.

Moving to the results of our two operating segments...

Measurement Solutions generated third quarter revenue of $564 million down 11 percent on a core basis, with an operating margin of 18.4 percent.

The Customer Support and Services segment generated revenue of $101 million, up 4 percent on a core basis with an operating margin of 19.4 percent.

Now turning to our outlook for the fourth quarter…

End markets appear to have stabilized and we expect Q4 to be seasonally stronger than Q3 in line with historical norms. Including the impact of the Anite acquisition, we expect Q4 revenues to be in the range of $735 to $775 million, and non-GAAP EPS to be in the range of 57 to 71 cents. At the mid-point, this reflects a core year-over-year revenue decline of 2 percent which excludes a 4 percentage point unfavorable impact from currency and 5 points of inorganic growth from the acquisition of Anite.

Now looking at our expectations for the full fiscal year….The midpoint of our Q4 guidance implies FY15 revenue of $2.86 billion which is flat on a core basis and FY15 non-GAAP earnings per share of $2.45.

In summary, our operating and profit performance in our first year as an independent company has been strong. We launched Keysight, completed the separation, and stabilized our operations. We accomplished all of this without disrupting our customer relationships, while generating strong profit, increasing our investments to drive future growth, and initiating our post separation optimization efforts.

Looking forward to FY16 we currently expect the electronic design and test market to grow at a rate of approximately 2 percent.

We are excited to have closed the acquisition of Anite as the addition of their product portfolio and the expansion of our markets supports our strategy to grow in wireless communications and software. We expect Anite to be accretive to our FY16 non-GAAP earnings by 14 to 17 cents and have already begun to implement our integration plan. This plan will result in $20 million of run-rate cost synergies by the end of year 2 and enable us to generate a 15 percent ROIC within 5-years.

It is important to note that Anite's revenue and profit are highly seasonal. In Anite's fiscal year ended April 30, 2015, 60 percent of their annual revenue and 77 percent of their annual profit was generated in their second half.

Keysight's business also follows a seasonal pattern, with our first and third quarters typically having lower revenue and our second and fourth quarters being seasonally stronger. As you look beyond the coming quarter recall that in addition to this revenue seasonality expenses are typically higher in our fiscal first quarter impacting Q1 profitability.

Finally, you will notice a new line item on our income statement this quarter, "other operating income and expense." We have determined that certain income and expense items, primarily rental income, are more appropriately classified within our operating results. We have therefore moved them from "other income and expense" to the new line "other operating income and expense." This is purely a reclassification and has no net impact on our business.

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

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

Ron's closing comments

Thank you everyone for joining our call.

While market conditions remain relatively soft, we have delivered to our operating model, as well as focused on transforming our company to grow.

We will continue to leverage our unique formula of technology-leading hardware and software and our large, global network of experts to create value for customers and shareholders.

In closing, I remind you that our inaugural Keysight Investor and Analyst Meeting is on September 1 in New York City.

We look forward to sharing more details of our long-term plan for value creation, and providing you a better understanding of Keysight's strengths and market opportunities.

I hope you can join us.