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

JASON KARY

Thank you, and welcome to Keysight's Fourth Quarter Earnings Conference Call for Fiscal Year 2015. With me today are Neil Dougherty, Keysight Senior Vice President and CFO, and Senior Vice Presidents, Guy Séné, and Mike Gasparian. Unfortunately, Ron Nersesian, Keysight President and CEO, is unable to join us today. He has hurt his back and is out of the office for a few days. Ron will be back on the call at the end of the first quarter. I will cover Ron's prepared remarks on his behalf today, and Neil, Mike and Guy will handle the Q&A.

As always, 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 "financial information". 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 me 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.

Now, let's turn to our results for the quarter and the year.

JASON KARY on behalf of RON NERSESIAN

Our strong Q4 performance contributed to a solid first year as an independent company. Beginning with four headlines.

- First, in Q4 we delivered strong profit in a soft market by leveraging the strength of Keysight's business model. This was the seventh consecutive quarter that we delivered financial results at or above the midpoint of our revenue and EPS guidance.
- Second, we demonstrated strong operational and strategic execution by closing two acquisitions and launching services as a fourth growth initiative for Keysight.
- Third, we announced a change in our company's organizational structure to focus on customer solutions and accelerate growth.
- Fourth, and now looking forward, we are holding to our 2% market growth expectation for 2016. However, recent macro data has tempered our expectations for the first half of the year.

It's been an exciting year and a good quarter so let's move to the specifics of Keysight's performance.

In Q4, we generated $756 million of revenue, just above the midpoint of our guidance, and delivered 71 cents EPS which was at the high end of our guidance range.

In line with our expectations, revenue for the quarter was down 1 percent year-over-year on an as reported and core basis, which excludes currency and acquisitions.

While we did see a strong seasonal rebound in our business from Q3, end market performance in Q4 was mixed. Communications grew 3 percent year-over-year with growth in wireless R&D, and the addition of Anite. That growth was offset by a decline in wireless manufacturing.

Aerospace Defense declined 5 percent versus a strong Q4 FY14 compare. As you may recall, last year Q4 FY14 was a high point for our Aerospace Defense business following the post sequestration recovery. In Q4, Industrial, Computer and Semiconductor declined 2 percent with growth in computer and semiconductor markets offset by a decline in industrial markets.

Regionally, Asia Pacific and Japan grew on a core basis, while Americas and Europe declined. Despite the recent headlines, China remained steady and grew 1 percent year-over-year.

Against this backdrop, Keysight built backlog for the second quarter in a row as core orders, excluding currency and acquisition, increased 1 percent and our book-to-bill ratio for the quarter was above 1.

In Q4 we also demonstrated strong operational and strategic execution by closing two acquisitions—Anite and Electroservices—and launching services as a fourth growth initiative.

The Anite integration efforts are going well and tracking to expectations. As we communicated at our Investor Day in September, the Anite business strengthens our wireless software design and test portfolio and expands our served addressable market with the addition of Network Test solutions.

Anite truly is a key component of Keysight's strategy to be first in 5G wireless solutions.

And in Q4 we made additional progress with our wireless initiative. Our wireless R&D business grew year-over-year, highlighted by orders for our market-leading 5G solutions. And we continue to gain traction through collaborations with industry consortiums, universities, and research institutes around the world—including our newest collaborations with China Southeast University and the University of Bristol in the U.K.

5G opportunities will materialize in the communications market over the next 5 to 10 years. Our customers will need new tools for 5G, which includes certain emerging IoT—or Internet of Things—applications, driven by faster data connections and electronic devices connecting everything from cars to appliances.

Turning to our services initiative, the second acquisition that we closed this quarter is Electroservices Enterprises Ltd, a U.K.-based company specializing in test equipment service and solutions. As a result of this acquisition, we have already won a large, multi-year multi-vendor service contract.

The Electroservices acquisition supports our newest initiative to grow Keysight services. Our focus on growing services through multi-vendor calibration and asset management builds upon a strong foundation and expands our overall market by $1 billion. In Q4, we saw solid revenue growth from the services business.

So let's look at how our other initiatives performed in Q4.

Expanding our modular solutions is another multi-year growth objective. In Q4, our modular business continued to perform very well. In fact, our modular PXI and AXIe orders topped $150 million for the year.

With greater than 60 percent year-over-year growth in fiscal year 2015, we believe Keysight is growing faster than our competitors in the modular segment of the market.

And finally, we continue to focus on expanding our software business. This was a record year for our Electronic Design Automation software platform. These software tools are used by two-thirds of the world's wireless designers and are playing a significant role in early 5G work around the world.

We are executing on a number of opportunities to grow our software business including growing recurring revenues through software subscriptions and services. Here too, Anite plays a strong role with their wireless R&D software solutions.

We continue to make good progress with all our initiatives as we transform our company to create more value for customers and shareholders.

With our on-going R&D investment and innovation, Keysight releases multiple new solutions each quarter that help our customers bring breakthrough electronic products to market faster and at a lower cost.

Here are three examples from Q4:

- The first is in software, where we introduced the latest version of our BenchVue platform. Among other capabilities, BenchVue allows design engineers to graphically automate measurements without the need for programming.

- The second is in modular, where we introduced the industry's highest performance PXI multiport vector network analyzer aimed at high-volume manufacturing of wireless components used in mobile phones and base stations.

- And, third, we also introduced the industry's first handheld 50 GHz combination analyzer that delivers laboratory-grade measurements for field testing of radar and satellite systems.

As you can see, we accomplished a lot in our first 12 months as an independent company. And we did it while meeting our financial commitments and keeping customer satisfaction at a high level.

Going into fiscal year 2016, Keysight will continue to focus on providing industry-leading services and solutions as no other electronic design and test company can.

To that end, this month we announced a new organizational design with expanded leadership to focus everything we do on our end markets and the development of complete customer solutions.

The organizational changes include the creation of a centralized Corporate Planning and Technology team, and a move to three customer-focused business groups – the Communications Solutions Group, the Industrial Solutions Group, and the Services Solutions Group.

These organizational changes are the next step in our evolution and are designed to focus our company, processes, and people directly on customers and the development of the solutions they need to succeed in their industries.

We are proud of our successes and the results that we have delivered in our first year as an independent company. We enter our second year with momentum, a focused strategy, and a team that is completely aligned to create value for customers and shareholders in FY16.

Now I will turn the call over to Neil to provide more details on our Q4 financial results, as well as our first-quarter guidance.

NEIL DOUGHERTY

Thank you, Jason, and hello, everyone.

As Jason mentioned, Q4 was a strong finish to our first fiscal year as a new company. Fourth quarter revenues of $756 million, that were just above the midpoint of our guidance, declined 1 percent year-over-year on both an “as reported” and core basis. Currency had a negative impact of 4 percentage points offset by 4 percentage points of growth from acquisitions.

Regionally, and on a core basis, revenue declined 6 percent in the Americas and 3 percent in Europe. Japan revenues improved 2 percent year-over-year while Asia excluding Japan grew 5 percent.

The regional mix of total revenues was consistent with prior periods, with 39 percent from the Americas, 18 percent from Europe, and 43 percent from Asia.

Gross margins increased 190 basis points year-over-year as our mix of R&D and software revenues improved. Expenses were well-managed, while we continued to invest in R&D programs in support of our growth initiatives.

Operating profit performance for the quarter was good with a Q4 operating margin of 20.7 percent. Non-GAAP net income after taxes was $122 million, or 71 cents per share, which was at the high end of guidance.

Shifting briefly to GAAP results, you will note that GAAP net income was significantly higher than usual this quarter due to a material deferred tax benefit recognized in Q4. This tax benefit resulted primarily from a ruling obtained from Singapore that allows us to amortize the value of the intellectual property acquired from Agilent in the separation.

In addition, this quarter we substantially completed the purchase price accounting and IFRS to GAAP accounting adjustments associated with the acquisition of Anite.

GAAP rules require us to revalue certain pre-acquisition revenue classified by Anite as deferred. Consistent with standard industry practice, we will include the amortization of pre-acquisition deferred revenue in our non-GAAP quarterly revenue reporting, which will better reflect our true business performance on a normalized basis.

Going forward, GAAP accounting will also require us to defer and amortize a larger portion of revenue than Anite had previously under IFRS accounting standards. While increasing the portion of our revenues that are recurring is a positive, this change will drive a revenue and corresponding profit reduction of approximately $12 million versus our prior expectations, all in the first half of FY16. For the year this adjustment moves our accretion expectations for Anite to the low end of the 14-17 cent range that we previously communicated. Given this adjustment, we are not expecting Anite to be accretive in Q1 2016.

Turning to full-year results...

Fiscal 2015 has been a highly successful first year for Keysight. We launched the company, completed the separation, and stabilized our operations. We have made significant organic and inorganic investments to drive future growth. We increased our investment in R&D to 13% of revenue and we completed the acquisition of Anite, significantly improving our competitive positioning in our wireless communications end markets.

In addition to these accomplishments Keysight generated strong financial results in fiscal 2015. Full-year revenues of $2.9 billion were flat on a core basis. Gross margins improved 80 basis points to 56.9% as we shifted the mix of our business to more R&D and software solutions. We exercised excellent discipline as we transitioned to operating as an independent company, which allowed us to generate 19.5 percent operating margin for the year. Non-GAAP net income after taxes was $432 million, or $2.52 per share.

Cash generation was also solid for the year with $376M of cash from operations. Capital expenditures for the year totaled $92 million, resulting in $284 million of free cash flow. We closed the year with cash and cash equivalents of $483 million and total debt of $1.1 billion.

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

Measurement Solutions generated fourth-quarter revenue of $653 million, down 3 percent on a core basis, with an operating margin of 21 percent. Full-year Measurement Solutions revenues were $2.5B, a decline of 1 percent on a core basis. Full-year operating margin was 19.8 percent.

The Customer Support and Services segment generated revenue of $103 million in Q4, up 8 percent on a core basis, with an operating margin of 19.5 percent. Full-year Customer Support and Services revenues were $401M, an increase of 4 percent on a core basis. Full-year operating margin was 17.9 percent.

Looking forward to fiscal 2016…

Several of the macro indicators that we monitor have weakened over the past quarter. The IMF reduced their 2016 forecast for global GDP, PMI data has fluctuated and China growth remains uncertain. While we still expect the broader Electronic Design and Test market to grow at approximately 2 percent this coming year, the softening of these macro indicators has tempered our expectations for the first half of the year.

A few items to note as you adjust your models for fiscal 2016, annual salary increases are effective December 1, 2015. Other "operating" income is projected to be $12 million. Interest expense for the year is projected to be $44 million. And lastly, we are assuming a diluted share count of 174 million shares by year-end.

Turning to our outlook and guidance for the first quarter…

We do expect Q1 to follow our typical seasonality with lower revenues in the range of $702 to $742 million, which at the mid-point reflects 3% growth or a core decline of 1%. As I've mentioned previously, expenses are also seasonally higher in our fiscal first quarter, which results in lower Q1 profitability. Given the combined effect of seasonally lower revenue and higher expenses, we expect first-quarter non-GAAP earnings per share to be in the range of 44 to 58 cents.

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

Jason Kary: Final Comments After Q&A:

On behalf of Ron, I want to thank everyone for joining our call.

Our strong Q4 performance contributed to a solid first year as an independent company for Keysight.

Our team's operational discipline drove excellent earnings results in Q4 and throughout the year, while we completed the separation and closed our first major acquisition in Anite.