



Keysight Technologies First Quarter 2016 Earnings Conference Call Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's First Quarter Earnings Conference Call for Fiscal Year 2016. 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 Mike Gasparian, Senior Vice President of the Communications Solutions Group, Gooi Soon Chai, Senior Vice President of the Industrial Solutions Group, John Page, Senior Vice President of the Services Solutions Group, and Guy Séné, Senior Vice President of Worldwide Sales.

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 thank you all for joining us. Keysight delivered strong first quarter results driven by our operational discipline. We continued to execute on our key initiatives as we transform our business and create value for our customers, partners and shareholders. We will focus today's discussion on three important headlines.

- First, our first quarter financial results were strong with earnings and revenue both above the midpoint of our guidance and we made solid progress on our four growth initiatives.
- Second, we remain committed to delivering solid profitability in line with our operating model despite macro headwinds. We are currently taking action to exercise the cost flexibility of the model to deliver high-teens operating margin in this environment. At the same time we are executing our strategy and making the R&D investments that should drive above market performance when markets stabilize.
- And third, consistent with our phased approach to return of capital, the board of directors has authorized a \$200 million share repurchase program. This action demonstrates our confidence in our ability to achieve above market growth in the long-term and our commitment to delivering shareholder value.

Now let's start with an overview of Keysight's first quarter performance.

In Q1, revenue grew 4 percent year-over-year and we delivered 55 cents in earnings per share, which was 4 cents above the midpoint of our guidance.

Revenue for the quarter grew to \$726 million, including revenue from our recent acquisitions. On a core basis, which excludes revenue from acquisitions and the impact of currency, revenue declined 1 percent, consistent with our expectations.

We continued to execute on our strategic growth initiatives and are building momentum in these areas with innovative solutions that help customers design leading edge technologies and bring their products to market faster.

First, in wireless, we are making solid progress on affirming Keysight as the market leader in 5G, including forming long-term strategic partnerships. In the first quarter, while off of a small base, orders for 5G solutions more than doubled year-over-year and grew over 50% sequentially as customers invest in early 5G research.

We continue to collaborate with consortiums working to establish worldwide 5G standards. We are the first company to offer a commercial 5G channel sounding solution. Our solution includes our channel sounding reference solution, instrumentation to measure and interpret how signals behave at high frequencies, and our industry leading SystemVue design and simulation software to develop and validate new designs.

We are proud to announce that in the first quarter a leading research center in China selected our 5G channel sounding solution as the foundation for their 5G channel modeling research. Our 5G channel sounding solution is now used in research centers in the U.K., Malaysia and China and has enabled us to secure several competitive wins. Early strategic relationships with research centers around the globe are critical to our 5G leadership in the longer term. We will showcase our 5G channel sounding solution along with our 5G beamforming and 802.11ad testing and design tools at Mobile World Congress, where I will be next week with the Keysight team.

Outside of 5G, we are gaining momentum with our newly introduced LTE-Advanced RF conformance solutions. This combined software and hardware solution offers best in class coverage for 3GPP industry standards and the flexibility for future technology evolutions. In the

first quarter two major chipset vendors, two leading carriers and a major test lab each selected our LTE-Advanced solution for testing complex radios with multiple bands and carriers.

Moving to our modular initiative, our PXI and AXIe modular products again delivered solid double-digit growth. New products and high-speed digital and optical solutions drove our modular growth this quarter. Introducing new modular solutions is a key component to expanding our share in this growing part of our market. In the quarter we introduced our first PXI reference solution for military, public safety and avionics radio test. Additionally, for the automotive market, we announced the Body and Safety Electronics reference solution that includes both instruments and software.

Moving to our software growth initiative, we continued to realize strong year-over-year revenue growth for our market leading design and simulation software solutions. As an example of our continued success with this platform, we were recently awarded a \$12 million multi-year software contract from a major wireless customer. Keysight's design and simulation software is used by two-thirds of the world's high-frequency designers.

You can see from the wireless and modular products I just mentioned that software solutions play an important role in our strategy to expand our business. Furthermore, the addition of Anite broadens our software portfolio. Our integration efforts are going well and tracking to expectations, and by leveraging the Keysight sales force we have identified additional opportunities to sell Anite solutions into our Aerospace and Defense market. We plan to meet many of our joint Anite and Keysight customers at Mobile World Congress where we will also showcase Anite's recently launched Virtual Drive Testing Toolset that was already selected by a major mobile operator in China to verify mobile device performance in high-speed train scenarios.

And lastly, looking at our services initiative, we continue to secure new business in North America and Europe with our multi-vendor calibration and asset management capabilities.

When adjusted to exclude the impact of the three-year warranty program and currency, our services revenue grew 11% year-over-year.

We are partnering with our customers to create value and help them manage assets and costs. For example, we recently worked with an Aerospace and Defense customer to measurably improve the use of their assets, reduce test time and increase yields -- all in an effort to reduce test design engineering and capital equipment expense. Our services plan included test system integration, test flow consulting and instrument and system level software functionality. And while we provided great value in helping this customer reduce their overall design expenses, their spending with Keysight more than tripled year-over-year.

Moving on to our markets, as we discussed in November, we expected macro factors to suppress first half market growth. While orders tracked to our expectations for the majority of the quarter, we saw a significant slowdown in January as weakening macro factors in the broader markets negatively impacted sentiment toward capital expense purchases. This effected order patterns across our end markets with the most notable pullback in Communications where our wireless supply chain customers paused spending following lowered estimates for wireless component and smartphone shipments. As a result, first quarter orders were down 2 percent year-over-year, and this is reflected in our second quarter guidance, which Neil will discuss in more detail.

While we expect to see continued market softness in the near term, we remain committed to delivering profit within our operating model range and at the same time investing in our growth initiatives. We believe Keysight is well positioned to grow when the market stabilizes and customers reaccelerate capital investments. The progress we made on our growth initiatives in the first quarter demonstrates that we are investing in the right areas and are creating value for our customers and partners by bringing leading edge solutions and services to market.

While strategic M&A remains our priority use of cash, the \$200 million share repurchase program we announced today reflects our confidence in our strategy and our ability to achieve above market growth in the long-term.

Now I will turn the call over to Neil to provide more details on our Q1 financial results, as well as our second-quarter guidance.

NEIL DOUGHERTY

Thank you, Ron, and hello, everyone. Today we reported first quarter total non-GAAP revenue of \$726 million that was above the midpoint of our guidance. On a year-over-year basis, this represents 4% growth. On a core basis, which excludes the impact of currency and acquisitions, revenue declined 1% year-over-year in line with our expectations. GAAP revenue for the quarter was \$721 million, which excludes certain accounting adjustments associated with revaluing pre-acquisition deferred revenue from Anite.

Looking at our topline performance by end market, communications revenue grew 8 percent year-over-year including revenue from Anite. Excluding Anite, Communications revenue decreased in the low double-digit range year-over-year as restructuring and consolidation activities impacted spending patterns and softness from customers in the smartphone supply chain outweighed growth in LTE-advanced and 5G technology.

Revenue from Aerospace Defense was \$171 million, a decline of \$3 million or 1 percent from last year's first quarter, which was the high point for 2015. Growth in the U.S. for our Aerospace and Defense solutions was offset by continued softness in Europe and Asia.

First quarter Industrial, Computer and Semiconductor revenue grew 3 percent driven by strong sales for our instrument and parametric test products and next generation processor testing.

Regionally, and on a core basis, revenue was flat in the Americas, up 1 percent in Europe and grew 16% in Japan. Revenue in Asia excluding Japan declined 7 percent.

The regional mix of total revenue was 38 percent from the Americas, 20 percent from Europe, and 42 percent from Asia.

Our first quarter operational results were strong with gross margin increasing to 56.6%, a 100 basis point improvement year-over-year as a result of a higher percentage of software and R&D revenue. Expenses were well-managed while we continued to invest in R&D programs in support of our growth initiatives. Operating expenses totaled \$282 million, including the first full quarter of Anite spending.

Operating margin was 17.8 percent, in line with the prior year. Our industry-leading margins result from our continued operational discipline and the proactive management of our cost structure across the cycle. Non-GAAP net income after taxes was \$95 million, or \$0.55 cents per share, which was above the midpoint of our guidance range.

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

Measurement Solutions generated first quarter revenue of \$631 million, an increase of 4 percent including revenue from Anite. Operating margin for Measurement Solutions was 18.3 percent.

The Customer Support and Services segment generated revenue of \$95 million in Q1, up 2 percent on a core basis, with an operating margin of 13.9 percent. As a reminder, the services business has a higher fixed cost structure when compared to our measurement solutions business. The Q1 cost structure also reflects the investments we are making in additional capacity to expand our multi-vendor calibration and asset management services.

Moving to the balance sheet and cash flow, we ended the quarter with \$572 million in cash and cash equivalents of which approximately 75% was located offshore. In the quarter we generated \$92 million in cash flow from operations. As I mentioned last quarter, cash flow is seasonally lower in Q1 due to the payout of variable compensation. In addition, we had higher capital purchases this quarter totaling \$34 million, which brought our free cash flow to \$58 million.

As Ron mentioned, our Board has authorized a share repurchase program of up to \$200 million. The new repurchase program goes into effect immediately and shares may be purchased from time to time. The program will be funded from current cash and future cash flows, and is consistent with our phased approach to return of capital. While we remain focused on identifying M&A opportunities that will help us achieve our growth objectives, this repurchase authorization reflects our confidence in our growth opportunities and strong cash flow generation.

Turning to our outlook and guidance for the second quarter...

Taking into account our order performance in the first quarter and the broader market sentiment, we expect Q2 non-GAAP revenue to be in the range of \$695 million to \$735 million, which at the mid-point reflects a 3 percent decline, or 9% on a core basis. With our on-going attention to cost management and the leverage and flexibility of our operating model we expect to deliver operating profit in the high-teens while continuing to invest in the growth areas of our business. Balancing these factors, we expect second-quarter non-GAAP earnings per share to be in the range of 48 to 62 cents and our weighted diluted share count to be approximately 173 million shares.

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

RON NERSESIAN: Final Comments After Q&A:

I want to thank everyone for joining our call and for your continued support. Thank you and good day.