Keysight Technologies Second Quarter 2016 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Second 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.

I will also note that management is scheduled to present at the JP Morgan TMT conference on May 24th in Boston, the Stifel Technology conference on June 6th in San Francisco, and the

Credit Suisse Semiconductor Supply Chain conference on June 15th in Boston. We hope to see many of you there.

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 second quarter earnings as we continued to navigate a challenging market and execute on our key initiatives to transform our business. We will focus today's discussion on three important headlines.

- First, our second quarter financial results were strong with earnings and revenue at the high-end of our guidance.
- Second, we continued to make progress on our growth initiatives and we are pleased with the momentum we are gaining in these areas.
- And third, consistent with our strategy to opportunistically return capital, we repurchased $42 million in common stock under the $200 million repurchase authorization we announced in February. This action is reflective of the confidence we have in our ability to achieve above market growth in the long-term.

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

In Q2, we delivered 61 cents in earnings per share, which was at the high-end of our guidance range. Revenue for the quarter was $735 million, representing a decline of 1 percent. On a core basis, which excludes revenue from acquisitions and the impact of currency, revenue declined 7 percent, primarily driven by the slowdown in wireless communications. As we expected, the market and spending environment continued to be soft, however, we are pleased with our execution in the quarter. We delivered revenue and EPS at the top-end of our guidance range and achieved order growth on a core basis.

We continue to make measurable progress on our strategic initiatives to transform our business and position the company for growth. Our momentum in these areas continues to build.

First, in wireless, we continued to expand our leadership in 5G. While off a small base, orders for our 5G solutions continued to accelerate and more than doubled over last year. Growth was primarily driven by investment in millimeter wave development and modeling software.

This past quarter 5G development was the headline at Mobile World Congress. At the event in February we demonstrated unique capabilities such as our 5G channel sounding solution, which engineers use to evaluate how effectively a signal will travel between a base station and a cell phone in a real-world environment. We also showcased a system for massive MIMO 5G beamforming calibration, as well as new design and test tools for 802.11ad.

We also recently announced that we have joined China Mobile's newly formed 5G Innovation Center. Strategic relationships such as these are critical to our 5G leadership. We first engaged with China Mobile on their 5G research starting back in 2014. In this new collaboration, we are working with China Mobile and other industry partners to promote 5G innovation and provide new 5G design and test solutions and support for the whole 5G ecosystem. This also includes solutions for channel measurement and modeling and massive MIMO over-the-air testing. We are actively involved with leading standards bodies and industry leaders in Asia, Europe and the U.S as they begin the first phases of 5G standards development.

5G research is starting to move into early development, with major carriers announcing trials ahead of standards being adopted. The use of spectrum well above 6 GHz is one of several areas of investigation under the 5G umbrella. As frequencies move higher, the engineering challenges become increasingly complex. While 5G research at these frequencies is emerging, higher frequencies have in fact been supported by Keysight's commercial and aerospace defense solutions for decades. In addition to higher carrier frequencies, the higher data rates associated with 5G require wider frequency bands around the carriers, and these in turn require test equipment with wider analysis bandwidths. To meet these needs, in February Keysight introduced the industry's first 50 GHz signal analyzer integrated with 1 GHz of analysis bandwidth.

Moving to our modular initiative, our PXI and AXIe modular solutions again delivered solid double-digit order and revenue growth with particular strength in aerospace defense and optical applications for 100 Gigabit manufacturing. Additionally, we are seeing momentum in wireless LAN as our router & network access customers are performing more rigorous testing on their high-performance wireless LAN chipsets. We have a strong position in this market and we further advanced our footprint in the second quarter by winning new modular solution business with a leading network equipment vendor.

Moving on to our software growth initiative, we realized strong year-over-year revenue growth driven by Anite and our market leading design and simulation solutions. Our integration of Anite remains on track, as we are beginning to realize topline synergies by leveraging the Keysight sales channel. As an example, we won a multimillion-dollar Anite solutions deal with a leading Keysight customer in the U.S.. Additionally, we are building momentum with our recently launched Anite Virtual Drive Testing Solution that verifies mobile device performance in high-speed train scenarios.

As we have discussed previously, software solutions play an important role in our strategy to transform our business. We are committed to investing in this area and broadening our software portfolio. To accelerate these efforts and foster innovation, I am excited to announce that we are creating a new software development center with the Georgia Institute of Technology in Atlanta. Georgia Tech has one of the best and largest engineering programs in the country. Its graduates bring with them skills and capabilities that will be a great asset to Keysight in developing next-generation technologies and solutions.

And lastly, looking at our services initiative, we delivered solid double-digit order growth in the second quarter. This was driven by ongoing success with our multi-vendor calibration services, new business in Europe and the U.S., along with follow-on deals with several large Aerospace Defense customers. Our calibration and service capabilities can be an important factor in winning new design and test solutions business, especially as customers look for ways to assure system uptime. Our Services Solutions Group and sales team recently joined forces to win a multimillion-dollar competitive modular opportunity. This customer needed a modular solution that delivered superior performance and on-site services for uptime assurance in their high-volume manufacturing environment.

Moving on to our markets. In line with our expectations and as we discussed in February, macro factors continued to impact market growth. The most notable pullback continued to be in Communications area where wireless supply chain customers in North America and Asia paused spending due to lower component and smartphone shipments. Outside of Communications, we delivered solid mid-single-digit core order growth with strength in the Aerospace and Defense and Industrial markets.

While the communications market outlook remains soft, our performance across other end markets was steady, and we are very pleased with the execution and leadership amidst this challenging backdrop. Additionally, with our continued commitment to operational excellence and to maintain strong profitability through the cycle, we delivered 18.3 percent operating margin in the quarter and generated $89 million in free cash flow. Consistent with our strategy to opportunistically deploy capital, we repurchased $42 million in stock. This action reflects the confidence we have in our ability to achieve above market growth when the market stabilizes and customers across our markets reaccelerate capital investments. Our continued progress on our growth initiatives 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.

Now I will turn the call over to Neil to provide more details on our Q2 financial results, as well as our third-quarter guidance.

NEIL DOUGHERTY

Thank you, Ron, and hello, everyone.

Today we reported second quarter non-GAAP revenue of $735 million, at the top-end of our guidance range of $695 million to $735 million. On a year-over-year basis, this represents an approximate 1 percent decline, or a 7 percent decline on a core basis.

Looking at our topline performance by end market, communications revenue was $252 million and grew 2 percent year-over-year including revenue from Anite. Excluding Anite, Communications revenue decreased as the market dynamics we highlighted last quarter continued, which included softness in the smartphone supply chain and restructuring and consolidation among some of our largest customers. These headwinds offset growth from 5G technologies, as well as strength in data center business that was driven by optical 100 gigabit manufacturing.

Revenue from Aerospace Defense was $160 million, up approximately 3 percent from last year's second quarter. Growth in Asia and steady U.S. spending for our Aerospace and Defense solutions contributed to the uplift in revenue.

Second quarter Industrial, Computer and Semiconductor revenue was $323 million, a 4 percent decrease year-over-year, reflecting the challenging spending environment.

Regionally, and on a core basis, revenue declined 14 percent in the Americas, 4 percent in Europe and 10 percent in Japan. Revenue in Asia excluding Japan was flat compared with last year.

The regional mix of total revenue was 35 percent from the Americas, 19 percent from Europe, and 46 percent from Asia.

Our second quarter operational results were strong with gross margin increasing to 57.8 percent, a 70 basis point improvement year-over-year, largely a result of a higher percentage of revenue from software and R&D solutions. Expenses were well-managed while we continued to invest in R&D programs in support of our growth initiatives, and on a dollar basis, R&D expenses were in line with Q1. Operating expenses totaled $290 million for the quarter, up 8 percent over last year primarily due to the addition of Anite. This resulted in second quarter operating margin of 18.3 percent, compared with 20.9 percent in the prior year. On a sequential basis, operating margin improved 50 basis points as we continued to proactively manage our cost structure. Non-GAAP net income after taxes was $106 million, or $0.61 cents per share, which was at the high end of our guidance range.

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

Measurement Solutions generated second quarter revenue of $639 million, inline with last year, including revenue from Anite. Gross margin improved 130 basis points to reach 60.6 percent as a result of increased revenue from software and R&D solutions. Expenses increased year-over-year with the acquisition of Anite, bringing our operating margin for Measurement Solutions to 19.5 percent, compared with 21.3 percent in the second quarter of last year.

The Customer Support and Services segment generated revenue of $96 million in Q2, a 5 percent year-over-year decrease, or 6 percent on a core basis. Excluding the impact of the three-year warranty program, revenue for this segment grew 1 percent. We reported an operating margin of 11.2 percent for our CSS segment. As a reminder, the services business has a higher fixed cost structure when compared to our measurement solutions business and we have been making investments in additional capacity to expand our multi-vendor calibration and asset management services. We are confident these investments will help support our growth, and the profitability of the Services segment over the cycle will be consistent with the overall business.

Moving to the balance sheet and cash flow, we ended the quarter with $620 million in cash and cash equivalents. In the quarter we generated $117 million in cash flow from operations. Capital purchases this quarter totaled $28 million, bringing our free cash flow to $89 million, or 12 percent of revenue.

Under the $200 million share repurchase authorization that we announced in February, we repurchased $42 million of our common stock, or 20 percent of the authorization. We repurchased 1.58 million shares in the open market at an average weighted cost of $26.27 per share. We will continue to opportunistically deploy capital under this repurchase program, as well as look to identify M&A opportunities that will help us achieve our growth objectives.

Stepping back from the details of the quarter, we are pleased with our operational discipline as a company and with the ability of our operating model to deliver strong profitability under a variety of end-market conditions. We continue to optimize all aspects of our business model, including pricing, sales strategies, cost management and efficiency gains. For example, the costs associated with the Software Development Center in Georgia will be managed within our existing cost envelope as we make tradeoffs in other areas. In addition to our operational discipline, we remain focused on executing our strategy, which includes continued investment in our growth initiatives, targeted M&A and market expansion opportunities, to ensure increasing value creation both in the short and long-term.

Turning to our outlook and guidance for the third quarter…

While we are seeing stabilization in some areas of our end markets, the communications market remains quite weak and macro indicators remain uncertain. In light of these market conditions and the traditional seasonality in our business, we remain cautious in our outlook for the third quarter. We expect Q3 non-GAAP revenue to be in the range of $697 million to $737 million, which at the mid-point reflects 8 percent growth year-over-year, or 2 percent on a core basis. In the third quarter 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 third-quarter non-GAAP earnings per share to be in the range of 50 to 64 cents based on a weighted diluted share count of approximately 172 million shares.

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

JASON KARY:

Thank you, Operator, and thank you all for joining us today. We look forward to seeing you at the upcoming investor conferences that I mentioned at the top of the call. Have a great day.