Keysight Technologies Third Quarter 2016 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Third 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, President of the Communications Solutions Group, John Page, 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. Following this conference call, we will post a copy of the prepared remarks to the website.

As a reminder and as we announced earlier this month, we have changed our reporting segments in order to align them with our end markets and management reporting structure. We are now reporting our operating results based on three segments: the Communications Solutions Group, the Electronic Industrial Solutions Group and the Services Solutions Group. The prior period results for these segments back to 2014 can also be found on our website.

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 on today's call. 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 would also note that we are scheduled to participate in the Citibank Global Technology conference in New York on September 7th and management is scheduled to present at the Deutsche Bank Technology conference in Las Vegas on September 13th. 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. We will focus today's discussion on three important headlines.

- First, we delivered strong third quarter results, which included growing revenue 8 percent, and achieving 20 percent operating margin and 15 percent earnings growth.
- Second, even though we continue to see headwinds in some markets, customers are accelerating investment in next-generation technologies.
- And third, we have made solid progress on our strategy to transform Keysight for growth. Given our targeted investments, including the acquisition of Anite, and the company focus on customer solutions, we believe we are capturing share in key next-gen markets. While it is still early, the strides we are making in the market today position us well for growth in the long-term.

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

We are pleased with our strong financial results and execution in the quarter. Revenue of $718 million grew 8 percent over last year while earnings per share of 63 cents increased 15 percent.

As we expected, the communications market remains soft. Additionally, macro uncertainty in Europe, which was further compounded by Brexit, impacted third quarter orders primarily in our aerospace, defense and government and electronic industrial end markets. We estimate that Europe was an approximate 3 percent headwind to our order growth for the quarter. Outside of Europe, we delivered order growth across all regions.

Even with these broader market dynamics, we are seeing customers increase investment in next-generation technologies such as 5G, optical networks for datacenters, leading-edge semiconductor processes and high-performance wireless-LAN chipsets. The mega-trend driving development of all of these technologies is the increasing reliance on electronic and digital communications and the growing number of connected devices from watches to cars.

First, let's take a look at 5G. It is clear that timelines and investments in 5G are accelerating. Carriers plan to launch 5G trials as early as 2017 with early deployment of 5G technologies in 2018. In order to help foster the development of 5G wireless networks in the U.S., the FCC has opened up nearly 11 GHz of higher-frequency spectrum. Additionally, the U.S. government has launched a $400 million initiative for advanced wireless research. The National Science Foundation will lead this new initiative and will use Keysight's solutions and services to test next-generation cellular and wireless LAN technologies.

As we have discussed before, our strategy to be first in 5G includes developing leading-edge technologies and solutions and engaging early with key partners. We are making solid progress on this initiative and 5G orders continue to outpace our expectations. Driving this growth is demand for our millimeter wave solutions, including over-the-air, channel sounding and massive MIMO solutions. In addition to our industry-leading 5G solutions, our early engagements with 5G innovators are contributing to our success. With over 25 collaborations to date, we added two new strategic partnerships this quarter: Datang from China and The National Applied Research laboratories in Taiwan.

Demonstrating our continued innovation in 5G and software solutions, we recently introduced the industry's first all-in-one signal optimizer software for designing 5G candidate waveforms. This solution enables R&D engineers to confidently validate their designs by simplifying the critical design tasks related to signal creation and analysis. Keysight is committed to advancing global 5G innovation. We have a strong new product roadmap that will enable us to gain share as the migration to 5G evolves.

Moving to high-speed optical networks for datacenters, the upgrade to 100 gigabit is just beginning and efforts to increase data speeds and reduce power are driving the need to measure signal quality and integrity. In the third quarter we secured several large deals with leaders throughout this supply chain -- including chip, network equipment and optical transceiver vendors. We are also seeing an increase in 400 gigabit activity. Our recently introduced modular solution for 400 gigabit addresses critical R&D and testing requirements and integrates both PAM-4 and NRZ signals on one testing platform. This unique level of integration and scalability will enable engineers to master the receiver test and design challenges for 400 gigabit datacenter interconnects.

In the semiconductor industry, the major foundries are in a race to shrink form factors and build faster, more energy-efficient components. This is driving increased investment in future semiconductor process technology and timelines have accelerated. As a result, we delivered strong double-digit order and revenue growth for our parametric test solutions in the third quarter.

These next-generation technologies represent long-term opportunities for Keysight and are important to achieving our growth objectives. The strategic actions we have taken are strengthening our market position and creating new business opportunities.

This included the acquisition of Anite that we completed one year ago. Anite significantly enhanced our wireless protocol capabilities and software portfolio, which are critical technologies as the industry migrates to 5G. Anite has achieved two consecutive quarters of double-digit order growth, despite headwinds in the communications market. Additionally, the acquisition has been accretive to both gross margin and earnings as we are executing seamlessly on the integration and are on-track to deliver the committed synergies.

Moving forward, we will continue to execute our strategy to transform our business for long-term growth with the objective of creating added value for both customers and shareholders.

Now I will turn the call over to Neil to provide more details on our Q3 financial results, as well as our fourth-quarter guidance.

NEIL DOUGHERTY

Thank you, Ron, and hello, everyone.

Today we reported third quarter revenue of $718 million, up 8 percent year over year, or up 2 percent on a core basis. Regionally, core revenue declined 8 percent in Europe and grew 3 percent in the Americas, 1 percent in Japan and 6 percent in Asia excluding Japan. The regional mix of total revenue was 37 percent in the Americas, 17 percent from Europe, and 46 percent from Asia. China, which represents 20 percent of our overall business, grew at a low double-digit rate in the third quarter.

Our third quarter operational results were strong with gross margin increasing to 58.7 percent, a year over year improvement of 210 basis points. Our improving gross margin continued to reflect a higher percentage of revenue from software and R&D solutions. Additionally, we realized a 70 basis point benefit from an adjustment to our warranty reserve liability as we have had lower than expected warranty claims. For the quarter operating expenses totaled $281 million, up 11 percent over last year primarily due to the addition of Anite. This resulted in third quarter operating margin of 19.5 percent, a year over year increase of 90 basis points. Net income increased 15 percent to $108 million or $0.63 cents per share, which was at the high end of our guidance range.

Moving to the performance of our segments:

Our Communications Solutions Group, or CSG, includes two primary end-markets. First is the commercial communications end market, which includes the mobile device and infrastructure supply chain, wireless network operators and datacenter and optical equipment manufacturers. Commercial communications revenue was $252 million in the third quarter, up 14 percent including revenue from Anite. As Ron mentioned, the market headwinds in the wireless supply chain that we highlighted earlier this year continued to offset the strong growth from 5G and next-generation datacenter technologies.

CSG also includes our aerospace, defense and government end markets, which generated revenue of $172 million in Q3, up 3 percent over the same quarter last year. Growth in this end market was driven by steady spending in the U.S., partially offset by softness in Europe and Asia.

This brought total CSG revenue for the quarter to $424 million, which is up 9 percent year-over-year or flat on a core basis. CSG reported gross margin of 61.7 percent. Expenses increased year-over-year with the acquisition of Anite, bringing operating margin to 18.1 percent, compared with 18.4 percent in the third quarter of last year.

Moving to our Electronic Industrial Solutions Group, or EISG, this group provides design and measurement solutions across a broad set of electronic industrial end markets including: automotive, energy, consumer electronics, education, and semiconductor.

EISG generated third quarter revenue of $191 million, up 9 percent over last year or 7 percent on a core basis. The growth in EISG was driven by strong sales for our parametric semiconductor measurement solutions, partially offset by weakness in Europe. With the strong topline performance, EISG gross margin improved 340 basis points to 60.7 percent and operating margin improved 460 basis points to 23.1 percent.

Lastly, in our third segment, the Services Solutions Group, or SSG, we generated revenue of $103 million in Q3, a 2 percent year-over-year increase or flat on a core basis. Excluding the impact of the three-year warranty program, revenue for this segment grew 6 percent. Growth was driven by our multi-vendor calibration services and a rebound in used equipment sales. SSG reported operating margin of 18.7 percent, up 750 basis points over the prior quarter. The significant sequential improvement in operating margin was largely driven by the higher topline.

Moving to the balance sheet and cash flow, we ended the quarter with $664 million in cash and cash equivalents. In the quarter we generated $68 million in cash flow from operations, reflecting our typical seasonality as well as higher working capital balances driven largely by timing factors within the quarter. Capital purchases totaled $14 million, bringing our free cash flow to $54 million, or 8 percent of revenue. We do expect Q4 cash flow to improve in line with our historical seasonality.

In the third quarter, we repurchased approximately 707,000 shares of common stock at an average price of $28.20 per share for a total consideration of $20 million. This brings our total shares repurchased to date to approximately 2.3 million for a total consideration of $62 million, or 31 percent of our $200 million authorization. We will continue to opportunistically deploy capital under this repurchase program, even as we work to identify M&A opportunities that will help us achieve our growth objectives.

Overall, we are very pleased with our operational performance and execution as a company. Our operating model has the ability to deliver strong profitability under a variety of end-market conditions, which sets us apart from others in our industry. We remain committed to executing our strategy to transform Keysight for long-term growth and create value for our shareholders.

Turning to our outlook and guidance for the fourth quarter…

As Ron noted, while we are seeing increased investment in the development of next-generation technologies, we continue to see headwinds in the broader communications market. Additionally, orders in the third quarter were impacted by macro uncertainty in Europe and we are incorporating this into our market outlook. We currently expect Q4 revenue to be in the range of $715 million to $755 million, which at the mid-point reflects a year-over-year decline of 3 percent, or 4 percent on a core basis. Note that as we have now passed the one-year anniversary of the Anite acquisition, the difference between total and core revenue growth in the fourth quarter will be entirely due to currency. We expect fourth-quarter non-GAAP earnings per share to be in the range of 57 to 71 cents, or 64 cents at the mid-point, based on a weighted diluted share count of approximately 172 million shares. At the mid-point, this would bring our non-GAAP earnings per share for FY16 to $2.43 on revenue of $2.9 billion.

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.