KEYSIGHT TECHNOLOGIES

Keysight Technologies Fourth Quarter 2016 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Fourth 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, Gooi Soon Chai, President of the Electronic Industrial Solutions Group, John Page, President of the Services Solutions Group, and Mark Wallace, 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.

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 Credit Suisse Technology conference in Scottsdale on December 1st and the Barclays Global Technology conference in San Francisco on December 7th. 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 key topics.

- First, we delivered a strong fourth quarter, with revenue at the high end of our guidance, achieved earnings of 64 cents per share and generated $124 million in free cash flow.
- Second, customers continue to increase investment in next-generation technologies and Keysight continues to innovate and expand its leadership in these important areas of the market.
- And third, during fiscal year 2016, the team executed well on its strategy to transform and position the company for growth and we made measurable progress on our key growth initiatives.

Let's begin with a brief overview of Keysight's fourth quarter performance. We are pleased with our results and execution in the quarter. We achieved earnings of 64 cents per share, generated $124 million in free cash flow or 17 percent of revenue, and delivered $751 million in revenue, which was at the high-end of our guidance. Additionally, orders grew 3 percent year-over-year to reach $806 million, which is the highest level we have seen in the past four years. Neil will provide you with further detail on our fourth quarter financial results in a few minutes.

Moving to our markets, overall, the dynamic we saw in the quarter remained relatively consistent with our expectations. We continue to see softness in the broader communications market and in certain regions within Europe, while investments in the development of next generation technologies continued to grow. More specifically, we saw increased investment in the areas of 5G, wireless LAN, high-speed optical networks for datacenters, automotive, alternative energy, and leading-edge semiconductor process technologies.

In 5G, major players continue to accelerate development and timelines around the globe and we generated strong growth for our 5G solutions in the fourth quarter. To highlight the growing momentum around 5G, I would like to note several recent industry announcements:

- NTT announced plans to begin its 5G trials in Japan as early as May 2017;
- Just last week, Korea Telecom declared that it aims to be the first to commercialize 5G in 2019, which is one year ahead of its previously stated plans;
- China Mobile has deployed a wideband Massive MIMO site on its network in Shanghai; and
- Verizon announced it is moving forward with its plans for 5G pilots beginning in 2017.

Utilizing spectrum at very high frequencies is a key tenet behind 5G as mobile providers look for ways to cope with expanding amounts of mobile traffic, proliferation of connected devices and the internet of things, as well as to improve its overall customer experience. For decades, engineers in a variety of industries have counted on Keysight for easier access to accurate, repeatable measurements at even higher frequencies and wider bandwidths. Today, we are the industry's leading innovator in the commercialization of tools for millimeter-wave simulation, test and analysis. In October, we extended our leadership with an industry-leading breakthrough in spectrum and signal analysis at millimeter-wave frequencies. Our new signal analyzer is the first to provide continuous frequency coverage from 3 Hz up to 110 GHz and spans across access, fronthaul and backhaul 5G applications in an integrated solution. These tools can also be used for satellite communication and automotive radar applications.

Moving to high-speed optical networks for datacenters, deployment of 100 Gig optical technologies throughout the datacenter and efforts to reduce power are driving the need to measure signal quality and integrity. In the fourth quarter, we continued to win deals and see strong demand for our optical and high-speed digital test products and growing interest in 400 Gig development. Our customers in this market include chip, network equipment, optical transceiver vendors and hyperscale datacenter operators. At the European optical show in September, Keysight showcased new and enhanced solutions to help R&D engineers master their 400 Gig designs by making validation easier and speeding up the testing of components and systems.

In the automotive market, the electronic content of cars continues to increase with numerous traditional car manufacturers accelerating their investments in electrified vehicles and autonomous driving. Areas of investment and development include powertrain electrification, battery technology, the connected car and radar technology. These activities are still in the R&D stage and are expected to be long-term growth trends for this market. Keysight recently demonstrated more than fifty automotive design and test solutions across various technology domains including radar, wireless, millimeter wave, high-speed digital, and power and energy. We are leveraging our decades-deep expertise in testing radar technologies for aerospace and defense applications, to launch products that address the specific needs for the emerging autonomous driving market. We recently introduced a new radar target simulator to help automotive electronic manufacturers confidently simulate various realistic scenarios.

Moving to our full year performance, the Keysight team executed well on its multi-year strategy to transform and position the company as a solutions leader in key next-generations technologies. As a reminder, our ultimate goal is to drive above-market growth in the long-term and create value for customers and shareholders. In fiscal 2016, we achieved 3 percent order growth and 2 percent revenue growth, as we navigated a challenging market environment and executed on our strategy. We remain committed to our key growth initiatives and made measurable progress:

- First, in wireless, our focus on positioning Keysight as the market leader in 5G is delivering results. With our technical breadth and expertise and strategic engagement with customers and partners around the globe, Keysight continues to have leading-edge solutions for 5G applications available when needed, even as development schedules accelerate. Throughout the year orders for our 5G solutions surpassed expectations resulting in triple digit growth.
- Second, in modular, we achieved double-digit order and revenue growth for our PXI and AXI modular business for the year. We introduced several new solutions for a variety of market applications and we received the Frost & Sullivan's 2016 growth excellence leadership award in recognition of our strong momentum in PXI-based instrumentation.
- Third, in software, we also delivered double digit order and revenue growth, led by our acquisition of Anite and high single-digit growth for our market leading design and simulation software solutions. As a part of our longer-term strategy to expand our software innovation activities, earlier this year we announced a software design center in conjunction with the Georgia Institute of Technology in Atlanta and our staffing plan there is ahead of schedule.
- And lastly, in Services, while revenue was flat on a reported basis for the year, we generated 9 percent order growth for the year. Multi-vendor calibration services showed strong success with Aerospace and Defense customers. This is a key target market for Keysight and we believe we have gained share.

Overall, we are pleased with our execution in fiscal year 2016. The strategic actions we have taken are strengthening our market position and creating new business opportunities.

Investing in innovation regardless of short-term market challenges is a critical element to our future success as a company. In fiscal 2016 we increased our R&D investments by 11 percent, while delivering industry-leading non-GAAP operating margin of 19 percent. We believe our investments are delivering above-market results as we exit the fourth quarter. Our accomplishments speak to the focus, discipline and commitment of the Keysight team to transform our company for growth and to create value for our customers and shareholders.

Moving forward, we will continue to innovate, invest for long-term growth and expand our leadership. We are building on the momentum we achieved in 2016 with a robust pipeline of new services and solutions that have been identified by our industry teams working closely with leading-edge customers. While we expect continued headwinds in some of our markets, we believe we are well positioned to deliver above-market results.

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, Ron, and hello, everyone.

Today we reported fourth quarter revenue of $751 million, compared with $756 million in the same period last year. On a core basis, which excludes the impact of currency and acquisitions, revenue decreased 2 percent. Regionally, core revenue declined 7 percent in Europe, 1 percent in the Americas, 11 percent in Japan and increased 1 percent in Asia excluding Japan. In China, we achieved our third consecutive quarter of double-digit growth, driven by strength in optical and semiconductor process solutions.

Looking at our operational results, gross margin was 57.5 percent, a year-over-year decrease of 50 basis points due to product mix. For the quarter operating expenses totaled $290 million, up 2.7 percent over last year and reflected higher sales costs given our strong order performance in the quarter. This resulted in fourth quarter operating margin of 18.9 percent, compared with 20.7 percent last year. We reported net income of $110 million or $0.64 cents per share, which was at the midpoint 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 that reported revenue of $254 million, up 3 percent compared with last year's fourth quarter driven by growth from 5G and next-generation datacenter technologies, offset by continued softness in the broader communications ecosystem.

CSG also includes our aerospace, defense and government end markets, which generated revenue of $188 million in Q4, compared with $206 million in the same quarter last year, reflecting ongoing weakness in Russia and China.

This brought total CSG revenue for the quarter to $442 million, a 2 percent year-over-year decrease or 4 percent on a core basis. CSG reported gross margin of 60.3 percent and operating margin of 17.1 percent.

Our Electronic Industrial Solutions Group, or EISG, generated fourth quarter revenue of $201 million, up 1 percent from last year or down 2 percent on a core basis, driven by ongoing weakness for general electronics solutions, particularly in Europe, which was partially offset by strong growth for leading-edge semiconductor process technologies and automotive applications. EISG reported gross margin of 59.6 percent and operating margin of 23.3 percent.

Lastly, the Services Solutions Group, or SSG, generated record revenue of $108 million in Q4, a 5 percent year-over-year increase, or 3 percent on a core basis. Revenue growth for SSG was driven by an increase in sales for our remarketed solutions. Excluding the impact of three-year warranty program, revenue for this segment grew 8 percent. SSG reported gross margin of 42.2 percent and operating margin of 18.1 percent.

As Ron highlighted, overall, we are pleased with our performance and execution as a company for the 2016 fiscal year. We achieved 3 percent order growth and 2 percent revenue growth as we navigated a challenging market environment and remained focused on the growth areas of our markets. Revenue for the year totaled $2.9 billion and gross margin improved 80 basis points to 57.7 percent. To fuel innovation and strengthen our market position in strategic areas, we continued to invest in research and development, which grew by 11 percent. At the same time, we remained within our operating model, delivering 18.6 percent operating margin and reporting non-GAAP net income after taxes of $419 million, or $2.43 per share.

Moving to the balance sheet and cash flow, we ended our fiscal year 2016 with $783 million in cash and cash equivalents, up $300 million when compared with $483 million at the end of fiscal 2015. We generated $416 million in cash flow from operations for the year and consistent with our plan, we invested $91 million in capital purchases. This brings our free cash flow for the year to $325 million or 11 percent of revenue, an improvement of 120 basis points compared to last year.

As we are entering fiscal year 2017, please note a few items for modeling purposes. Annual salary increases are effective December 1, 2016. Additionally, as we mentioned last year, cash flow is seasonally lower in Q1 due to the payout of variable compensation. Other "operating" income is projected to be $15 million in FY17. Interest expense for the year is projected to be $46 million. Pension and benefit expense for the year is projected to increase by approximately $20 million, while cash contributions to our global pension plans are expected to be inline with 2016. And lastly, we are committed to continue to opportunistically deploy capital through our share repurchase authorization but are assuming a base-case diluted share count of 175 million shares at year-end.

We remain committed to investing in the key growth areas of our markets to drive the long-term growth of our business, while at the same time staying consistent with our operating model. As a reminder, our operating model is structured to deliver high-teens operating margin at current revenue levels.

Turning to our outlook and guidance for the first quarter…

As Ron noted, we are encouraged by the strong order growth we saw in the fourth quarter, and while we are seeing increased investment in the development of next-generation technologies, we continue to expect headwinds in the broader communications market. Balancing these factors, we currently expect Q1 revenue to be in the range of $706 million to $746 million, with the mid-point inline with the first quarter of last year, or on a core basis, representing a decline of 1 percent, with the difference entirely due to currency. We expect first-quarter non-GAAP earnings per share to be in the range of 49 to 63 cents, or 56 cents at the mid-point, based on a weighted diluted share count of approximately 173 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.