Keysight Technologies First Quarter 2017 Earnings Conference Call

Prepared Remarks

**JASON KARY**

Thank you, and welcome everyone to Keysight's First Quarter Earnings Conference Call for Fiscal Year 2017. 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.

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 four key topics.

- First, we delivered a strong first quarter. We achieved earnings of 57 cents per share, above the mid-point of our guidance and revenue of $726 million, at the mid-point of our guidance.
- Second, in the aerospace and defense end market, we saw funding delays in the U.S., which impacted orders and revenue in the quarter. While we expect to see headwinds in this end-market for the next few quarters, we are confident in our longer-term opportunities for growth when the funding resumes.
- Third, outside of aerospace and defense, we achieved double-digit organic order growth driven by continued momentum in next generation technologies. Our growth on multiple fronts of several emerging trends, gives us confidence that our strategy is working and Keysight's transformation is well under-way.
- And fourth, we are further accelerating the execution of our strategy and transformation with the proposed acquisition of Ixia, which we announced two weeks ago.

Let's begin with a brief overview of Keysight's first quarter performance. We are pleased with our results in execution in the quarter. We delivered $726 million in revenue, at the mid-point of our guidance, and achieved earnings of 57 cents per share, above the midpoint of our guidance. We achieved 2 percent order growth despite unexpected aerospace and defense funding delays in the U.S. While we remain cautious on the timing of the funding for the next few quarters, we are very confident in our leadership position including a number of recent program wins.

Excluding Aerospace and Defense, orders grew 11 percent year-over-year organically. Our growth was driven by the continuation of the trends we have discussed in previous quarters including: 5G, IoT, high-speed datacenters, wireless LAN and the electric car. We are still in the very early stages of these emerging technologies and believe Keysight is best positioned to help these industries move forward. Our focus on bringing solutions to market that helps customers accelerate their next-generation designs across the communications ecosystem is allowing us to drive multiple avenues of growth across these trends. We are pleased with our momentum and believe the Keysight transformation for growth is well under-way.

In 5G, our growth continues to track ahead of expectations. Our collaborations with major universities and research centers around the globe are fully under-way. In December, Keysight and the University of California San Diego demonstrated a bidirectional 60 GHz link for 5G applications and achieved gigabit-per-second speeds at previously unachieved ranges. The demonstration included advances in millimeter-wave technology that provide critical proof of concepts for 5G, including the fixed-broadband use case at the center of many pre-standardization efforts.

The 5G ecosystem is broadening beyond universities and research institutions to chipset players, device developers and mobile operators. While 5G standards have yet to be established, full design and development efforts are driving material R&D investments as large device makers retool their labs for millimeter wave commercialization and high-speed digital interfaces. Millimeter wave applications at higher-frequencies can deliver far more throughput and speed but 5G is about more than just consumer applications such as streaming mobile video. Pervasive, ultra-reliable and low latency over-the air-communications are also critical tenets of 5G. This is to support large IoT deployments and machine-to-machine communications as more and more devices become smarter, automated and connected including trucks, cars, smart-homes, and medical devices.

Given our deep heritage and leadership in RF, microwave, and millimeter wave design and test, our increased focus on software solutions that enable rapid prototyping, and the broad range of solutions we have available today, Keysight is well positioned to lead the market as these next-generation technologies evolve and converge. In recognition of our leadership position in IoT, Frost & Sullivan recently awarded Keysight with the 2016 global test and measurement for IoT company of the year award.

Keysight has a broad portfolio of solutions to help designers fast-track IoT deployment and many 5G applications. Later this month at Mobile World Congress, we will showcase many of our solutions that help designers transform their ideas into reality—from simulation to prototype, to manufacturing and optimization. In order to demonstrate the breadth of our portfolio, I would like to share with you just a few of the solutions we plan to showcase at Mobile World congress.

- First, our narrow band IoT testing solution.  This industry first solution helps designers accelerate the deployment of IoT technology and optimize designs for critical performance attributes, including power consumption, RF performance, interoperability, and conformance test cases.
- Second, Keysight's 5G front-haul monitoring solution that brings next-level capabilities to mobile operators and a real-time dashboard.
- Third, our 5G Wideband Real-Time Beamforming Reference Solution that empowers researchers to quickly and accurately test analog, digital and hybrid beamforming systems, including the transmission of massive MIMO with beamforming technology.
- Fourth, our new 802.11ax solution that supports up to 8x8 MIMO and drives greater test efficiency, enabling R&D engineers the ability to quickly validate their new devices and drive greater test and manufacturing efficiency.
- And lastly, our virtual drive testing toolset from our Anite team, which is an automated field-to-lab test solution that replicates drive test conditions, and now is extended to help cost effectively verify wireless connectivity in the connected car.

All the data traffic created at the network edge from higher speeds and the growing number of connected devices requires upgrades across the network, including data centers.  In the first quarter, we continued to see strong growth from our optical and high-speed 100 Gig digital test solutions along with initial 400 Gig investments.  We also launched new products targeted at the data center including a high-performance bit error rate tester for electrical and optical PAM-4 transmitters and receivers, and this month, we launched a new sampling oscilloscope solution for 100 gigabit per second PAM-4 signals.

Whether it is for high-speed datacenters, next generation mobile networks, radar, avionics, automobiles, or medical devices, Keysight's solutions go where the electronic signal goes, from design simulation, to prototype validation, to manufacturing test, to optimization in the network.

And now, with the proposed acquisition of Ixia we are broadening our reach within and beyond the communications development lifecycle. Our reach will include electrical signals, as well as, packetized data, applications and network security.  This acquisition also creates a new powerful innovation engine and end-to-end partner for the development of next generation technologies and optimizing and securing networks; expanding our number of touch points with long-term technology trends and accelerating our transformation for growth.

Keysight's wireless leadership, combined with Ixia's leadership in network test and visibility, will allow us to address the entire communications and networking sphere and move Keysight into network operations. Ixia is a pioneer and true innovator in testing IP networks. The company has consistently been first to market in leading-edge technologies, including high-speed Ethernet up to 400 Gig.

Our complementary technologies and world-class talent, together with our increased scale, will create new opportunities for growth and market penetration that will enable us to lead in our served markets.

This acquisition is 100 percent complementary to Keysight, and is in direct alignment with our growth initiatives, including expanding our portfolio of software-centric solutions. Ixia's solutions have significant software content as evidenced by the fact that 90 percent of their R&D

engineering staff are software engineers, and results in the company's very high gross margin profile.

In closing, we believe our strategy to align the company with the growth segments of our markets is working. We have invested in the right areas of the market at the right time and we continue to execute on our strategy. We still have lots of work ahead to complete our transformation but we are excited to see the initial results from our continued commitment and execution. Our strong innovation and solutions portfolio position us well for growth as these long-term trends continue to evolve and customers increase the development of Next-Gen technologies. With the acquisition of Ixia, we are further accelerating our transformation for growth, and creating a powerful innovation engine and end-to-end partner for the development of next generation technologies and optimizing and securing networks.

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 revenue of $726 million, which was at the midpoint of our guidance and in line with the same period last year. On a core basis, which excludes the impact of currency and acquisitions, revenue was flat year-over-year. Regionally, core revenue declined 5 percent in the Americas, increased 4 percent in Europe, and increased 3 percent in Asia excluding Japan. Core revenue was flat in Japan.

Looking at our operational results, gross margin was 57.5 percent, a year-over-year increase of 90 basis points. For the quarter operating expenses totaled $289 million, up 2.3 percent over last year. This resulted in first quarter operating margin of 17.7 percent, compared with 17.8 percent last year. We reported net income of $98 million or $0.57 cents per share, which was above the midpoint of our guidance range and 2 cents above the first quarter of FY16.

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 2 percent compared with last year's first quarter, driven by growth from 5G and next-generation datacenter technologies, offset by continued cautious spending across the wireless device value chain.

CSG also includes our aerospace, defense and government end markets, which generated revenue of $180 million in Q1, compared with $191 million in the same quarter last year. As Ron mentioned, delayed funding in the U.S. impacted first quarter revenue and orders. As expected, we continued to see a stable but lower level of spending in our aerospace and defense business in Russia and China. In total, aerospace and defense orders declined by approximately 20 percent over the first quarter of last year. We expect to see continued headwinds for at least the next two quarters as even after new budgets are approved, spending will take time to resume.

This brought total CSG revenue for the quarter to $434 million, compared with $440 million in the same quarter last year. CSG reported gross margin of 60.5 percent and operating margin of 16.7 percent.

Our Electronic Industrial Solutions Group, or EISG, generated first quarter revenue of $192 million, compared with $191 million in the same quarter last year.  Growth in Semiconductor Measurement Solutions was offset by a decline in General Electronics Measurement. Automotive & Energy solutions were flat year-over-year.  As you know, we've had three quarters of very strong growth in Semiconductor Measurement but we expect this to moderate in the back half of the fiscal year.  EISG reported gross margin of 59.9 percent and operating margin of 21.7 percent.

Lastly, the Services Solutions Group, or SSG, generated first quarter revenue of $100 million, a 5 percent year-over-year increase.  Revenue growth for SSG was driven by an increase in sales for our calibration and remarketed solutions.  SSG reported gross margin of 39.4 percent and operating margin of 14.4 percent.

As Ron highlighted, overall, we are pleased with our performance and execution as a company for the first quarter.  We delivered revenue at the mid-point of our guidance despite some challenging market dynamics and we had solid improvement in the targeted growth areas of our markets.  Our total order growth was 2 percent, or 11 percent when excluding Aerospace and Defense.  We remained within our operating model, delivering 17.7 percent operating margin and reported non-GAAP net income after taxes of $98 million, or $0.57 per share.

Moving to the balance sheet and cash flow, we ended our first quarter with $896 million in cash and cash equivalents, up $113 million when compared with the $783 million at our fiscal year-end in October. We generated $102 million in cash flow from operations in the quarter and we invested $16 million in capital purchases.  This brings our free cash flow for the quarter to $86 million or 12 percent of revenue, an improvement of over 380 basis points compared to last year.

Before we move to guidance, we would like to remind you of certain modeling items we discussed on the last quarterly earnings call.  For FY17, other operating income is projected to be $15 million inline with last year but pension and benefit expense is increasing by approximately $20 million versus FY16.

Annual salary increases became effective December 1, 2016, which means that Q1 reflected a partial impact and the April quarter will reflect the salary increases for the full quarter.  Additionally, we are investing in incremental field resources and have restructured our sales compensation plan with a higher variable component to drive engagement. We are investing consistently in the key growth areas of our markets to drive the long-term growth of our business, while staying within the operating model we have laid out in the past. As a reminder, our operating model delivers 40 percent incremental operating profit when we achieve 4 percent revenue growth or above.

**Turning to our outlook and guidance for the second quarter…**
Balancing the dynamics we see in the market, we currently expect Q2 revenue to be in the range of $720 million to $760 million, representing 1 percent growth at the midpoint on both a core and reported basis. We expect second-quarter non-GAAP earnings per share to be in the range of 54 to 68 cents, or 61 cents at the mid-point, based on a weighted diluted share count of approximately 174 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. Have a great day.