KEYSIGHT TECHNOLOGIES

Keysight Technologies Second Quarter 2017 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Second Quarter Earnings Conference Call for Fiscal Year 2017. Joining 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, Bethany Mayer, President of the Ixia 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 management is scheduled to present at the Credit Suisse Semiconductor Supply Chain conference on June 13th in Boston.

And now I'd like to turn the call over to Ron.

RON NERSESIAN

Thank you, Jason, and thank you all for joining us. As I am traveling internationally today, I will keep my formal comments brief and focus the discussion on three topics.

- First, we achieved a strong second quarter that was substantially ahead of our expectations and we are pleased with our execution and results. In total, we delivered 6 percent order growth, 3 percent revenue growth, 19 percent operating margin and 5 percent earnings growth.
- Second, we continued to build momentum within our key growth areas. We achieved record orders for 5G including a significant win with Qualcomm as announced in a press release this morning. We also had record orders for our modular and automotive and energy solutions. We believe our continued progress demonstrates that our strategy is working and our transformation is well underway.
- And third, we closed the acquisition of Ixia in April, which was ahead of our expected timeline as we efficiently obtained financing and cleared all necessary regulatory approvals. We are thrilled to officially have the Ixia team on-board and now focus our joint-efforts on the integration, innovation and increased value creation.

Let's begin with a review of Keysight's second quarter performance. In addition to our strong total results that I just referenced, Keysight excluding Ixia, delivered 4 percent organic order growth, 2 percent core revenue growth, 20 percent operating margin and 64 cents in EPS. Taking a deeper look into our bottom-line performance, excluding Ixia and the associated interest expense and share dilution from the acquisition financing, we delivered 67 cents in earnings per share, a 10 percent improvement over Q2 of last year.

The dynamics in our end-markets remained relatively consistent with last quarter as customers continued to focus their investment on next-generation technologies. In our aerospace, defense and government end-market, funding in the U.S. partially recovered off its soft Q1 to bring orders in line with last year.

In the growth segments of our markets, we continued to build solid momentum and finished the second quarter stronger than we had expected. Our growth was driven by continued investments in next-generation technologies including 5G, IoT, high-speed datacenters, the electric car, autonomous driving and next-generation process technologies.

Our focus on bringing solutions to market that help customers accelerate their next-generation designs across the communications ecosystem is allowing us to drive multiple avenues of growth across these trends. To demonstrate our progress in capitalizing on these evolving trends, I will share with you a few highlights in the quarter that we find particularly exciting:

- First, orders for our 5G solutions doubled over Q2 of last year to reach a new record and we secured a significant 5G win with Qualcomm for our industry-first 5G protocol design solution that we just launched this quarter. This solution enables developers the ability to seamlessly prototype designs as they migrate from pre-5G to 5G New Radio and addresses protocol layer design, an area of the market where we did not participate in 4G. With our targeted efforts in 5G and our leadership in high-frequency technologies and solutions, we believe we have established a leading position in the 5G marketplace, and are on a solid path toward our goal of being first in 5G.
- Second, in high-speed datacenters, we saw an increase in development activities for 400 Gig, PAM-4 and silicon photonics technologies, which drove demand for our recently introduced 64 Gbaud bit error rate tester developed for electrical and optical PAM-4 transmitters and receivers. Ixia has also taken a leadership

role in 400 Gig innovation. Earlier this year at OFC, Ixia demonstrated line rate 400 Gig Ethernet with PAM4 electrical lanes. Ixia is the first and only player in the market with this solution in the latest double density form factor. This first-to-market solution underlines why Ixia is the leader in the network test market, and delivers continued proof of their technology leadership over the competition.

- Third, in the automotive and energy market, we delivered a record quarter with strong revenue growth across all regions as the automotive ecosystem continued to grow at a healthy rate and Tier-1 suppliers expanded their design capacity. The rapid electrification of vehicles and the move to autonomous-driving is shifting this industry from mechanics to our areas of strength in wireless communications, radar and smart battery development. We are gaining strong momentum with leading customers in this evolving industry and growing ecosystem. Notably, in the second quarter, we added ten key new customers. Our expanding customer base in this end-market includes top-tier automotive makers, as well as specialized automotive electronic module producers, chipset vendors, and energy component and battery producers.

- And lastly, we achieved another quarter of strong growth in next-generation processing technologies, where we have a leading position in parametric test. In the back-half of the quarter, new investments in the build-out of capacity in China drove higher-than expected demand, which contributed to the upside in our second quarter results. Our leadership in this end-market coupled with our record performance in automotive and energy, resulted in 14 percent year-over-year revenue growth for our EISG segment.

In summary, we are very pleased with our second-quarter performance and continued steady progress in building multiple avenues of growth across a diverse set of end markets where customers are investing in next-generation digital and electronic technologies. We are confident that we have the right strategy in place, it is working and our transformation is well underway. Our strong innovation and solutions portfolio uniquely positions us for growth as these long-term trends continue to evolve and customers invest in next-generation technologies. It is undeniable that the digital landscape is transforming and will continue to influence the way we communicate, drive, shop and even obtain medical care in the years to come. Whether it is for high-speed datacenters, next generation mobile networks, radar, electronic warfare, automobiles, or medical devices, Keysight's solutions go where the electronic signal goes, from design simulation, to prototype validation, to production test, to optimization in the network.

Now, with the acquisition of Ixia, which we closed in April, we have broadened our reach within and beyond these growth trends and the communications development lifecycle. Keysight's reach now includes digital packetized data, applications, visibility and network security, as well as electrical signals. We are excited to add Ixia's deep bench of talent to the Keysight team, which will continue to be led by Bethany Mayer. Our integration efforts are off to a great start and we look forward to partnering on end-to-end development of next-generation technologies. Together, we will expand our number of touch points within long-term technology trends and key customers, and accelerate our growth.

With that, I will turn the call over to Neil for a detailed review of our financial performance and third-quarter outlook.

NEIL DOUGHERTY

Thank you, Ron, and hello, everyone.

Today we reported second quarter GAAP revenue of $753 million, which includes 13 days of revenue from Ixia, and non-GAAP revenue of $758 million, which excludes the impact of the acquisition-related fair value adjustment to Ixia's deferred revenue balance. Core revenue, which excludes the impact of currency and revenue from acquisitions completed within the last twelve months, grew 2 percent year-over-year and was ahead of our updated guidance range. Regionally, core revenue declined 1 percent in the Americas, 3 percent in Europe, and 5 percent in Japan, while in Asia excluding Japan core revenue grew 10 percent.

Looking at our operational results, gross margin was 59.0 percent, a year-over-year increase of 120 basis points driven by favorable product mix with a higher contribution of software and EISG solutions.

Operating expenses totaled $300 million, a $10 million increase over the same period last year reflecting Ixia expenses for the partial-period. Excluding Ixia, year-over-year operating expenses were flat, demonstrating our on-going operating model discipline. This resulted in second quarter operating margin of 19.4 percent, up 110 basis points when compared with 18.3 percent last year. We reported net income of $114 million or $0.64 cents per share. Excluding Ixia and the associated interest expense and share dilution from the acquisition financing, which was not in our guidance, we delivered net income of $116 million or $0.67 cents per share, which represents approximately 10 percent earnings growth versus the second quarter of fiscal year 2016. We ended the quarter with a weighted average diluted share count of 179 million shares.

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 $256 million, compared to $257 million in the prior year second quarter. Growth from 5G and next-generation datacenter technologies was offset by soft spending in wireless 4G.

CSG also includes our aerospace, defense and government end markets, which generated revenue of $168 million in Q2, compared with $189 million in the same quarter last year. As we mentioned on our last quarterly call, our aerospace, defense and government end-market was impacted in Q1 by soft spending in the U.S. due to delayed budget approvals. A federal budget with increased funding for defense was approved by Congress in late April and we did see a partial recovery in Q2 order results, however, it is difficult to predict exactly when the flow of funding will return to a steady state in this end-market. Over the long term we remain bullish on both our market position in aerospace and defense and the prospect for increased defense spending in the U.S.

Total CSG revenue for the quarter was $424 million, compared with $446 million in the same quarter last year. CSG reported gross margin of 61.3 percent and operating margin of 17.6 percent.

Our Electronic Industrial Solutions Group, or EISG, generated second quarter revenue of $220 million, up 14 percent from the same quarter last year and a record high. Semiconductor measurement solutions and automotive and energy solutions both posted strong growth, which was partially offset by a decline in the broader general electronics market. As we noted last quarter, we have had several quarters of very strong growth in semiconductor measurement solutions and we expect this to moderate somewhat as we move through the remainder of the fiscal year. EISG reported record gross margin of 61.8 percent and operating margin of 26.1 percent.

Following the completion of the acquisition of Ixia on April 18th, we created a new operating segment named the Ixia Solutions Group, or ISG. The reported second quarter results for ISG cover the 13-day period between the closing of the acquisition and the end of our fiscal quarter. During this time, ISG generated revenue of $12 million, gross margin of 77.1 percent and an operating loss of $2 million. While Ixia was not required to and did not perform a hard close of its first quarter, which ended on March 31st, I'll provide some color on their order performance for that period. Ixia orders of $128 million, were in line with expectations and up 4 percent year-over-year. Orders for Ixia's visibility solutions grew 18 percent year-over-year and were 28 percent of total orders. Ixia's test solutions order performance was in line with the prior year's first quarter, but contained a higher-mix of service and subscription orders, which are recognized as revenue over time. Please note that we do not intend to provide Ixia's order performance on a go-forward basis, but will be reporting their financial results as a separate operating segment. As Ron mentioned, our integration efforts are off to a great start, and as our integration plan has solidified, we are able to update our cost synergy timeline. We now expect to achieve annualized run-rate cost synergies of $40 million by Q3 of next fiscal year and remain committed to delivering the full $60 million of cost synergies over time.

Moving to the Services Solutions Group, SSG generated second quarter revenue of $102 million, a 6 percent year-over-year increase. Revenue growth for SSG was driven by an increase in sales for our remarketed solutions and calibration services. SSG reported gross margin of 40.9 percent and operating margin of 16.2 percent.

Moving to the balance sheet and cash flow, we ended our second quarter with $983 million in cash and cash equivalents. Cash flow from operations in the quarter was $49 million, which included $60 million in acquisition-related operating cash utilization. Capital purchases were $17 million in the quarter resulting in free cash flow of $32 million.

We ended the quarter with $2.2 billion in long term debt, up $1.1 billion from the prior quarter, which we used to fund the Ixia acquisition along with equity raised in the quarter. We were able to take advantage of strong credit markets and issued $700 million in senior unsecured fixed-rate notes, with a coupon of 4.6 percent. On the equity side, we raised $444 million in net proceeds by issuing approximately 13.1 million common shares priced at $35.00 per share, which includes the overallotment.

Before moving to guidance, we would like to discuss a few modeling items. First, we will continue to report revenue on a GAAP and Non-GAAP basis, with the difference being the impact of the fair value adjustment to the acquired deferred revenue balance from Ixia. Based on preliminary purchase price accounting, the net deferred revenue balance inherited from Ixia is $44 million, reflecting an approximate adjustment of 70 percent. Second, we currently expect interest expense to be approximately $24 million per quarter. Third, regarding our go forward tax rate, we are in the early stages of planning how best to bring Ixia and Keysight together from a tax perspective but for the immediate future we are continuing to model a 17 percent non-GAAP tax rate on Keysight's profits and a 30 percent non-GAAP tax rate on Ixia profits, which yields a combined rate of approximately 19 percent. And lastly, we expect our weighted diluted share count exiting fiscal year 2017 to be approximately 188 million shares.

Turning to our outlook and guidance for the third quarter…
We currently expect Q3 non-GAAP revenue to be in the range of $840 million to $880 million, representing 2 percent core growth at the

midpoint. We expect third-quarter non-GAAP earnings per share to be in the range of 51 to 65 cents, or 58 cents in the mid-point, based on a weighted diluted share count of approximately 188 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!