Keysight Technologies Third Quarter 2017 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Third 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 us in the Q&A session will be Satish Dhanasekaran, 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 Citi Technology Conference on September 6th in New York City and the Deutsche Bank Technology Conference in Las Vegas on September 12th.

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 strong third-quarter results. In total, we achieved 24 percent order growth, 20 percent revenue growth, and core order growth accelerated to 8 percent and we delivered 4 percent core revenue growth. We generated 19 percent operating margin and EPS of 61 cents, which was 3 cents above the midpoint of our guidance.
- Second, as we have progressed through the year, we have continued to execute and build momentum in our key growth areas across multiple end-markets. Our success this year demonstrates that our strategy is working and we are pleased with our results.
- And third, while we have been in business for decades, it is still early days for Keysight and for the technology trends where we are focused. We are just getting started and are excited by our future opportunities.

Let's begin with a review of Keysight's third-quarter performance. Overall, it was a very strong quarter for Keysight. In our markets we continued to see increased investments in emerging technologies. Our strategy to partner with customers early and bring full solutions to market that enable customers to accelerate and automate their designs is delivering results, including increased order growth and a strong funnel of opportunities. As a team, we couldn't be more pleased with the momentum we are building in the market with both new and existing customers developing leading-edge technologies such as 5G, next-generation wireless, high-speed datacenters, and automotive & energy. In total, we delivered 24 percent order growth, or 8 percent on a core basis.

Our investments to bring new solutions to market, our relentless focus on the growth areas like 5G, and our go-to-market approach are fueling our growth. As a result, we are gaining momentum with key players in the industry, our business is growing as customers increase their investments in R&D, and we believe we are outpacing our competitors.

In short, our strategy is working. Keysight is well-aligned with emerging market trends and the needs of our customers. Our continued execution has led to strong year-to-date results and solid progress in our key growth areas. For the nine-month period, we delivered 5 percent core revenue growth and 9 percent core order growth when excluding our aerospace and defense end-market, where we have a solid competitive position but overall market spending has been lower when compared to last year. For the year-to-date period, we have achieved double-digit order growth for our software solutions and high-double-digit growth for our 5G solutions. We have maintained our R&D investment level, achieved 19 percent operating margin, and generated solid cash flow.

Even though Keysight has been in business for decades, we are just getting started. We have an incredible bench of talent throughout the organization, a clearly defined vision, and amazing technology. We are leveraging these strengths to create value for our customers and design our future as a company. Keysight is at the heart of innovation processes in many dynamic end-markets. We have a solid foundation to drive continued growth across multiple evolving technology trends, which are in the early days. Today, I will highlight the trends we see in 5G, IoT, Automotive & energy, and high-speed datacenters

In 5G, we invested early, and have established a leading position, and we continue to win business across the communications ecosystem. In the quarter, orders for our 5G solutions more than doubled year-over-year.

5G cellular networks will explore uncharted territory in frequency coverage, data rates, number of simultaneous users, spectral efficiency, and reduced latency. Before the standards are even established, 5G innovators need to simulate, design and test in dimensions they have never dealt with before. Leveraging our expertise in high-frequency and millimeter wave technologies, Keysight has partnered with key industry innovators around the globe, and introduced several industry-first solutions, including our new simulation software that provides Verizon and 3GPP standards 5G link-level validation of 5G base stations and handset designs.

IoT is also driving growth for Keysight across several of our end-markets including wireless, general consumer electronics, and automotive and energy. IoT encompasses a broad range of applications from billions of IoT devices to connected cars, connected grids, and even the connected you. Keysight has a broad portfolio of solutions to help designers fast-track IoT innovation and optimize designs for critical performance attributes, including power consumption, RF performance, interoperability, and conformance testing.

In our automotive and energy end-market, we see growing development activities driven by increasing demand for electric and hybrid cars, as well as, the increasing electronic content in vehicles, radar technologies for autonomous driving, and high-power devices and applications. Autonomous driving will need multiple sensors, high-power computing and artificial intelligence. Additionally, infrastructure will need to support real-time information flow. The number of connected cars is estimated to grow to 100 million by 2021, up from just 10 million shipped in 2015. Keysight has achieved double-digit order growth with our automotive and energy solutions for three consecutive quarters. The electronic content in vehicles is rapidly increasing, driving customer investments in manufacturing capacity for the latest generation of capability and R&D investments for next-generation features.

All the data traffic created at the edge of the network from the growing number of connected devices and higher speeds requires upgrades across the network, deeper visibility into network operations and greater levels of security. All areas where Ixia has leading technology. While the network test and visibility market dynamics this year have been mixed, we are pleased with our competitive position and progress. In Network Test, our NEM customers have curbed their development investments in speeds up to 100G as they plan and prepare for 400G. While this has decreased demand for 100G and predecessor technologies, we are confident in our 400G technology and believe we are well-positioned as spending increases. In the quarter, we achieved strong growth among service provider customers with our visibility and application and security solutions, while we saw continued soft spending with Enterprise accounts in the U.S.

While the topline didn't meet our expectations primarily due to temporary market softness, ISG delivered solid gross margin and operating profit. Additionally, our integration efforts are well on their way, and we are pleased with our progress. Our ability to combine our technologies and bring complete end-to-end solutions to market enables us to further expand the technology gap between Keysight and the competition. We have already begun partnering on end-to-end development of next-generation technologies and currently have six joint projects under development. We recently introduced our first joint end-to-end solution, well ahead of our planned timeline. Our new Cellular and Wi-Fi emulation system is the industry's first test platform to cover a complete cellular and Wi-Fi system, enabling simultaneous signaling tests over the protocol stack from physical transmission to data traffic transmission. With this new solution, customers can view the performance of the complete protocol stack with the end-to-end performance verification needed for emerging and demanding applications such as IoT, connected car and 5G.

In summary, we are very pleased with our third-quarter performance and continued progress in building multiple avenues of growth across a diverse set of end markets. We are executing on our strategy to create value for our customers and shareholders by building on our heritage, partnering with customers early to create new opportunities, and driving growth across multiple avenues of emerging technology trends. Additionally, we have expanded the value that Keysight brings to the market. To deliver the next world-changing innovation, our customers need help with more than just test and measurement of physical devices. With more complicated and integrated functionality, electronic devices are vulnerable to faults at any point in the technology stack. We need to verify the quality, performance, compliance and security of products at every layer--from Layer 1 to Layer 7--as well as how they integrate into live networks. Through our acquisition of Ixia, Keysight helps customers gain insight into how products are functioning at every layer. We believe we are poised to continue to drive growth as customers increase R&D investments and deploy next-generation technologies. We look forward to sharing our progress with you along the way.

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

NEIL DOUGHERTY

Thank you, Ron, and hello, everyone.

Today we reported third-quarter GAAP revenue of $832 million, and non-GAAP revenue of $863 million, which excludes the impact of the acquisition-related fair value adjustments 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 4 percent year-over-year and was ahead of our guidance of 2 percent core growth. Growth was driven across all geographies. Regionally, core revenue grew 1 percent in the Americas, 8 percent in Europe, 2 percent in Japan, and 6 percent in Asia excluding Japan.

Looking at our operational results, gross margin was 60.9 percent, a year-over-year increase of 220 basis points driven by the addition of Ixia.

Operating expenses totaled $362 million, compared with $281 million in the same period last year reflecting a full quarter of Ixia expenses and increased sales investment. This resulted in third-quarter operating margin of 19.0 percent, which was down 50 basis points when compared with 19.5 percent last year.

We reported a GAAP net loss of $18 million or a loss of $0.10 per share, which includes a $134 million unfavorable impact from the amortization of acquisition-related assets related to Ixia. On a non-GAAP basis, we delivered net income of $115 million, up 7 percent over last year, and $0.61 cents in earnings per share. We ended the quarter with a weighted average diluted share count of 188 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 $254 million, compared to $252 million in the prior year third quarter. Growth in wireless was partially offset by softer spending in infrastructure.

CSG also includes our aerospace, defense and government end markets, which generated revenue of $164 million in Q3, compared with $172 million in the same quarter last year, reflecting softer spending in the U.S. due to the budget approval delays we saw earlier this year. While ADG orders have stabilized and we expect spending in the U.S. to strengthen in Q4, 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 $418 million, compared with $424 million in the same quarter last year. CSG reported gross margin of 61.2 percent and operating margin of 15.7 percent.

Our Electronic Industrial Solutions Group, or EISG, generated third quarter revenue of $218 million, up 14 percent from the same quarter last year. General Electronics, Semiconductor measurement solutions and automotive and energy solutions all posted double-digit growth. As we noted last quarter, we have had several quarters of robust growth in semiconductor measurement solutions and we expect this to moderate somewhat as we move into our fiscal fourth quarter and first quarter of next fiscal year. EISG reported gross margin of 61.1 percent and operating margin of 25.3 percent.

Our Ixia solutions group generated revenue of $120 million, gross margin of 77.0 percent and an operating margin of 19.9 percent. As Ron mentioned, we are well on our way with our integration efforts and are on track with our cost synergy timeline. We 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 third quarter revenue of $107 million, a 4 percent year-over-year increase. SSG reported gross margin of 41.8 percent and operating margin of 18.1 percent.

Moving to the balance sheet and cash flow, we ended our third quarter with $873 million in cash and cash equivalents. Cash flow from operations in the quarter was $98 million. Capital purchases were $21 million in the quarter resulting in free cash flow of $77 million. In addition, we paid down $240 million of debt related to the Ixia acquisition this quarter.

Turning to our outlook and guidance for the fourth quarter…
Our current outlook for the fourth quarter reflects our very healthy 8 percent core order growth rate in Q3 and strong backlog as we enter into the fourth quarter. As Ron mentioned, partnering with customers early and delivering full solutions is a cornerstone of our go-to-market strategy. As a result, we are seeing a higher mix of solution sales within our business, which have a longer order-to-revenue conversion cycle when compared with our historical product-centric approach to the market and we have accounted for this in our Q4 outlook.

We currently expect Q4 non-GAAP revenue to be in the range of $875 million to $905 million, representing 3 percent core growth at the midpoint. We expect fourth quarter non-GAAP earnings per share to be in the range of 59 to 69 cents, or 64 cents at the mid-point, based on a weighted diluted share count of approximately 189 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!