Keysight Technologies Fourth Quarter 2017 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Fourth 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, Mark Pierpoint, Acting 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 Barclay's Global Technology, Media and Telecommunications 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 an outstanding fourth quarter across the board. In total, orders grew 27 percent year-over-year to reach a record of over $1 billion, with core orders increasing 11 percent. We achieved 20 percent revenue growth and generated 20 percent operating margin and EPS of 71 cents, which was 7 cents above the midpoint of our guidance and 2 cents above the high-end.
- Second, our continued focus and commitment throughout the year generated strong results. We have continued to build momentum in key growth areas across multiple end markets, contributing to three consecutive quarters of accelerating core order growth.
- And third, our success this year demonstrates that our strategy is delivering results, we are well aligned with the needs of our customers and we have a strong foundation to drive growth and earnings in 2018 and beyond.

Let's begin with a review of Keysight's very strong fourth-quarter performance. We achieved earnings of 71 cents per share, exceeding the high-end of our guidance. We grew orders by 27 percent to surpass one billion dollars, a new record for Keysight, and grew revenue by 20 percent or 3 percent on a core basis. We are very pleased with our fourth quarter performance and execution, resulting in an outstanding close to a transformative year for Keysight.

Beyond the numbers, we believe our execution in the fourth quarter is even more meaningful when considering the unimaginable challenges our team faced with the Santa Rosa wildfires in October. Personally, I am proud of how the Keysight team came together to help the community and each other to navigate through this challenging time, as well as deliver a strong quarter. I'm inspired by their resiliency, acts of courage and generosity. I'd like to thank each and every member of the Keysight worldwide team for their unwavering support, as well as thank all of our partners, customers and investors.

Our Santa Rosa headquarters did incur some damage and was temporarily closed as it was in a mandatory evacuation zone, which did have an impact on our operations. Neil will discuss the specifics shortly, but I would highlight that Keysight is a global company with global operations and our business performance worldwide remains strong.

Our record fourth quarter resulted in a strong finish to the fiscal year with total order growth of 15 percent or 7 percent core growth, and total revenue growth of 11 percent, or 2 percent core. With our strong 2017 order performance, we are exiting the year with a strong backlog and a solid foundation to build upon as we move into 2018.

As we look at our markets we continue to see increased investments in emerging technologies and overall healthy dynamics. Our strong results throughout the year demonstrate that our strategy is driving growth. We have focused on partnering with customers early and bringing full solutions to market that enable them to validate and accelerate their designs. As a result, we are building momentum in key segments of the market that are undergoing technology transformations such as 5G, next-generation Wi-Fi, electronic warfare, high-speed datacenters, and automotive & energy. We are seeing excellent adoption of our solutions, including software. Orders for our software solutions grew in the high-single-digits for the year to reach over $450 million, excluding Ixia.

Keysight is at the heart of innovation processes in many dynamic end markets. Today, I will highlight the trends we see in 5G, auto and energy, as well as aerospace and defense.

5G networks and devices will explore uncharted territory in frequency coverage, data rates, number of simultaneous users, spectral efficiency, and reduced latency. This will allow providers to introduce new and potentially game-changing business models. Our early engagement with leading market makers and solutions-based go-to-market strategy have advanced Keysight to a leadership position. Orders for our 5G solutions grew to a new record in Q4, and we delivered high double-digit growth for the year. This is an area where we continue to invest in our partnerships and solutions in order to strengthen our position as the marketplace develops. We have teamed up with multiple industry leaders to successfully demonstrate industry-first achievements that are important milestones towards making 5G commercialization a reality. By leveraging our core strengths and our acquisitions of Anite and AT4 Wireless, we have developed ground-breaking solutions and established a leadership position in 5G.

Auto and energy is another key area where we are building momentum as technology advancements transform the market. Keysight has achieved double-digit order growth with our automotive and energy solutions for four consecutive quarters. There are several trends driving development activities across multiple dimensions at once in this end-market, including the increasing electronic content in vehicles, electric and hybrid powered cars, and radar technologies for autonomous driving. Autonomous driving in itself encompasses a spectrum of technologies. At one end, there are driver-assist features that include lane-centering, parallel parking and collision avoidance. At the most advanced end, there is the next-generation vehicle with full self-driving capabilities, which will need multiple sensors, high-power computing, artificial intelligence and communications infrastructure to support real-time information flow. With this broad development landscape, we believe we will see continued R&D investments in auto and energy for many years to come. Accordingly, we are intensifying our focus in this key growth area and investing to expand our presence. We introduced over 70 new solutions for the auto and energy market since October of last year. Just last month, we opened an automotive solutions center in the Detroit area that features an electronic test and measurement lab, a training facility and a fully-equipped vehicle test bay, which complements our automotive solutions centers in Germany, Silicon Valley and other strategic locations. Additionally, we recently expanded our Auto and Energy solutions offerings with our acquisition of ScienLab, which is based in Germany and serves a Tier-1 customer base. This acquisition strategically expands our global footprint and solutions portfolio, allowing end-to-end solutions for hybrid and electric vehicles and battery test solutions.

In the aerospace and defense end-market, electronic warfare and defending against malicious actors looking to take advantage of security gaps in electronic and digital communications are growing in importance. Aerospace and defense technologies need to keep advancing in order to stay ahead of commercially available technology evolutions, and this is driving innovation across multiple dimensions. For example, in communications, new break-through frequency domains need to be explored. Additionally, aerospace and defense needs to be on the cutting edge of software defined radios, future generations of satellite communications, and private mobile ad hoc networks. Keysight provides the industry's most advanced electronic warfare and radar testing solutions and has been a long-standing leader in this market. While delayed budget approvals in the U.S. impacted our aerospace and defense growth in the first three quarters of 2017, we exited the year with strong Q4 aerospace defense orders, growing

20 percent year-over-year. The timing of annual budget approvals is always a concern; however, over the long term, we remain bullish on both our market position in aerospace and defense and the prospect for increasing U.S. defense spending.

In closing, our clear vision, continued focus and commitment led to our strong results for the quarter and year. We have consistently delivered on our commitments and are very pleased with our steady progress to transform and position Keysight for growth. We are executing on our strategy to create value for our customers and shareholders and driving growth across multiple avenues of emerging technology trends. This year we continued to increase investments in R&D, while expanding our technology portfolio and markets inorganically with several acquisitions. We believe these investments are already delivering results and we are well-aligned with growing market trends where customers are investing in next-generation digital and electronic technologies. We are poised to continue to drive growth and earnings as these long-term trends evolve, and 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 our outlook.

NEIL DOUGHERTY

Thank you, Ron, and hello, everyone.

Today we reported fourth-quarter GAAP revenue of $878 million, and non-GAAP revenue of $902 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 3 percent year-over-year and core orders grew 11 percent.

Regionally, order growth was strong across all geographies, whereas, core revenue declined 3 percent in the Americas, and grew 6 percent in Europe, 11 percent in Japan, and 7 percent in the rest of Asia.

Looking at our operational results, gross margin was 61.9 percent, a year-over-year increase of 440 basis points driven by favorable core product mix and the addition of Ixia.

For the quarter operating expenses totaled $377 million, compared with $290 million in the same period last year reflecting the addition of Ixia and ongoing R&D and sales investments. This resulted in fourth quarter operating margin of 20.1 percent, up from 18.9 percent last year.

We reported net income of $135 million, up 22 percent over last year, and $0.71 cents in earnings per share, which was 2 cents above the high-end of our guidance range. We ended the quarter with a weighted average diluted share count of 189 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 $280 million, up 10 percent compared with last year's fourth quarter driven by R&D solutions for new technologies including 5G, 4.9G/LTE Advanced and Wi-Fi test.

CSG also includes our aerospace, defense and government end markets, which generated revenue of $182 million in Q4, compared with $188 million in the same quarter last year.

Total CSG revenue for the quarter was $462 million, or 4 percent growth with 62.9 percent gross margin and 21.3 percent operating margin.

Our Electronic Industrial Solutions Group, or EISG, generated fourth quarter revenue of $206 million, up 3 percent from last year. Automotive & Energy led the growth followed closely by General Electronics Measurement. EISG reported gross margin of 61.3 percent and operating margin of 21.8 percent.

Our Ixia solutions group generated revenue of $124 million, gross margin of 76.2 percent and an operating margin of 16.4 percent. ISG revenue was above the level implied in our guidance for the quarter. ISG saw solid demand for its high-speed Ethernet test solutions, including 400 Gig, and strong orders for its security and applications solutions. Additionally, visibility sales to its service provider customers were strong, offset by softness in enterprise accounts.

Lastly, the Services Solutions Group, or SSG, revenue grew 2 percent year-over-year to reach $110 million. Revenue growth for SSG was driven by an increase in sales for both calibration and remarketed solutions. This brings our SSG revenue for the year to $419 million, up 4 percent over last year. In the fourth quarter, SSG reported gross margin of 42.6 percent and operating margin of 16.3 percent.

As Ron highlighted, overall, we are pleased with our performance and execution as a company for the 2017 fiscal year. Revenue for the year totaled $3.2 billion and gross margin improved 230 basis points to 60.0 percent. To fuel innovation and strengthen our market position in strategic areas, we continued to invest in R&D, and made several acquisitions. At the same time, we remained within our operating model, delivering 19.1 percent operating margin and reporting non-GAAP net income after taxes of $462 million, or $2.53 per share.

Moving to the balance sheet and cash flow, we ended our fiscal year 2017 with $818 million in cash and cash equivalents, compared with and $873 million last quarter. Our quarter-end cash balance reflects, a $40 million pay down of our term loan, $60 million net of cash used for the acquisition of ScienLab and a $68 million payment for a Malaysian tax liability, which we continue to actively dispute. We generated $64 million in cash flow from operations in the fourth quarter, and invested $18 million in capital purchases. This brings our free cash flow for the quarter to $46 million.

Turning to our outlook and guidance …

We are encouraged by the healthy market dynamics, strong order growth and increased backlog we saw in the fourth quarter, as well as, our strong funnel of future opportunities. However, as Ron noted, Keysight was impacted by the Northern California wildfires. Our headquarters was under mandatory evacuation for more than three weeks and while direct fire damage to our core facilities was limited, especially when compared to the immediate surrounding area, our buildings did experience some smoke and other fire-related environmental impacts. Since re-gaining access to our site, our focus has been on returning manufacturing to full production.

Over the intermediate term we expect the fire to have no net impact on our business results, but the disruption will impact the seasonality of revenue in the next few quarters. For this reason, we are taking the unusual step of focusing our guidance on the first half of FY18. For the first half of the year we currently expect non-GAAP revenue to be approximately $1.775 billion with non-GAAP earnings per share of $1.29, based on a weighted diluted share count of approximately 190 million shares and a non-GAAP tax rate of 17 percent. As we look at the expected seasonality within the half, we currently expect first quarter non-GAAP revenue to be in the range of $780 million to $820 million with non-GAAP EPS in the range of 29 to 43 cents. Assuming Q1 performance is at the midpoint, the balance of $975 million of revenue and 93 cents of EPS, will land in Q2 to reach our guidance for the first half of non-GAAP revenue of $1.775 billion and non-GAAP earnings per share of $1.29.

As Ron mentioned in his opening remarks, we have built a strong foundation and remain confident in our ability to drive revenue and earnings growth in 2018, while continuing to create value for our customers.

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.