Keysight Technologies Third Quarter 2018 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Third Quarter Earnings Conference Call for Fiscal Year 2018.

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 Mark Wallace, Senior Vice President of Worldwide Sales, and Satish Dhanasekaran, President of the Communications Solutions Group.

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. We will also make references to “core” growth, which excludes the impact of currency movements as well as revenue from acquisitions or divestitures completed within the last twelve months. 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 Global Technology conference on September 5th in New York, and the Deutsche Bank Technology conference on September 12th in Las Vegas. 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 delivered an outstanding third quarter with both revenue and earnings far exceeding the high-end of our guidance.

Today, I'll focus my formal comments on three key headlines for the quarter.

- First, revenue grew 17 percent, or 15 percent on a core basis, to reach a record $1 billion. We achieved this growth while also delivering 45 percent year-over-year EPS growth, which is a new record for Keysight.
- Second, customers continued to make strong R&D investments in next-generation technologies and we continue to achieve differentiation and momentum across multiple end markets with our solutions. Keysight's orders also grew to over $1 billion and both core revenue and orders grew double-digits for the second consecutive quarter.
- And third, we are raising our core outlook for the year. We now expect 2018 core revenue growth to be approximately 11 percent, which is an increase from our prior estimate of 7 to 8 percent.

Let's now take a deeper look into our performance for the quarter. We achieved earnings of 89 cents per share, which was 12 cents above the midpoint and 7 cents above the high-end of our guidance. This represents 45 percent year-over-year earnings growth.

We also delivered outstanding order growth for this quarter and reached a new Q3 record. Orders grew 15 percent in total to surpass $1 billion. On a core basis, which excludes currency as well as acquisitions or divestitures completed within the last twelve months, orders grew 12 percent. This is our fourth consecutive quarter of double-digit core order growth and the second quarter out of the last four with orders above $1 billion. Our continued strong order growth has translated into record revenue results. Q3 revenue grew 17 percent, or 15 percent on a core basis, to also surpass $1 billion. Broad-based demand and investments in emerging technologies drove double-digit order growth for our solutions in Commercial Communications, Aerospace, Defense and Government, Automotive & Energy, Semiconductor and Services.

Our technology leadership, solutions, and industry-focused approach continues to advance our footprint in key end-markets undergoing technology transformations. We are seeing excellent adoption of our solutions within marquee Keysight customers. Additionally, we are adding new customers at a rapid rate. In total, we have added close to 2,000 new direct customers so far this year.

This quarter we saw very strong 23 percent revenue growth in our Commercial Communications end-market. Broad 5G-related R&D investment continues to increase across the wireless ecosystem, which includes chipsets, devices, networks and infrastructure. Our early engagement with the market leaders and our advanced portfolio of 5G R&D solutions continue to strengthen Keysight's leadership position in 5G. In Q3, this translated to triple-digit 5G order growth.

We have the broadest array of 5G solutions on the market today and continue to see strength globally for our 5G program. We are engaged with lead operators around the world, such as NTT Docomo, in their 5G deployment process. This quarter our Ixia Solutions Group, along with our Nemo solutions team from the Anite acquisition, secured key design wins for leading-edge RAN and core network solutions for 5G, which is just another example of our differentiated portfolio of solutions.

Speaking of Ixia, we were pleased with Ixia's improved revenue performance after our extensive integration activities last quarter. We are continuing to make good progress in optimizing the business and we have a healthy pipeline of opportunities. Ixia is also seeing increased 400G activity. Our recently announced AresOne high-density 400G Ethernet test solution won Best of Show at Interop Tokyo, and is gaining strong interest from customers.

Automotive and energy is another area where we continued to see strength in the quarter, delivering our seventh consecutive quarter of double-digit order growth in Q3. Demand was driven by broad strength across all regions, expansion within our top customers, and wins with new accounts in the quarter. Major automotive OEMs and tier-1 suppliers continued to aggressively invest across a broad set of automotive electronics applications. This is driving growth for both R&D applications and the associated solutions supporting high-value manufacturing test.

In the aerospace, defense and government end-market, we delivered double-digit order growth for the fourth consecutive quarter and increased revenue by 22 percent. In the quarter, we saw strong worldwide demand across the aerospace and defense supply chain including space, satellite, radar and electronic warfare applications. Looking forward, in this end-market we are seeing some headwinds in China from growing trade tensions, but expect them to be offset by growing demand in the rest of the world. In the U.S., the defense budget for 2019 was passed last week. We expect to benefit from the year-over-year budget stability, as well as the significant increases in U.S. spending for research, development, test and evaluation.

Across our end-markets, software and services are key components to the value creation we deliver to customers. In the third quarter, revenue for our software solutions grew double-digits. We continue to see increased demand in next-generation technology design as the complexity of that design increases and design cycles accelerate. Our long-term strategy to drive growth in services is also yielding results. Services orders grew double-digits and revenue grew 9 percent year-over-year driven by calibration, remarketed solutions and repair.

Customer success and providing leading-edge technology, solutions and insights is at the core of Keysight's Leadership Model, or KLM. The growth we have achieved over the past several quarters would not have been possible without our commitment to innovation and the continued targeted investments we have made over the past several years. We have significantly strengthened our technology leadership in key areas of the market undergoing multi-year transformations and growth trends. We will continue to focus our investments in these key growth areas to drive innovation, create even more value for our customers and outgrow the market.

Lastly, we have an amazing team at Keysight and I thank them for their commitment to both our company and our customers. Attracting and fostering and retaining top talent across the globe, as well as creating a culture of diversity and inclusion, will be contributing factors to our future success. Demonstrating KLM in action this quarter, I would highlight the Career Comeback program we have in Malaysia, where our largest manufacturing facility is located along with a sizable R&D center. I'm proud to say that through this program, we have a growing number of mothers who have returned to the workforce, bringing their expertise to the company in various areas including electrical engineering, software development, human resources, and supply chain.

We look forward to sharing with you the success of the Keysight Leadership Model in the quarters and years to come.

I will now to turn it over to Neil to discuss our financial performance and outlook in more detail.

NEIL DOUGHERTY

Thank you, Ron, and hello, everyone. Before I get started, I will note that all comparisons are on a year-overyear basis unless specifically noted otherwise.

As Ron mentioned, we delivered an exceptional quarter as we continued to execute on the strong demand we see in core areas of our business. Additionally, our continued focus, execution and commitment to operational discipline is delivering record results for Keysight.

For the third quarter of 2018, we delivered record non-GAAP revenue of $1 billion, which was well above of our guidance of $942 million to $972 million.

In Q3, we also delivered $1 billion in orders, which were up 15 percent, with core orders growing 12 percent, enabling us to exit the quarter in a solid backlog position.

Looking at our operational results for Q3, we reported gross margin of 61.2 percent and operating expenses of $402 million, resulting in operating margin of 21.3 percent, which is the highest level in Keysight's history. We also achieved record net income of $170 million and delivered 89 cents in earnings per share, which was up 45 percent. Our weighted average diluted share count for the quarter was 191 million shares.

Moving to the performance of our segments, our Communications Solutions Group, or CSG, generated total revenue of $515 million, up 23 percent, while delivering gross margin of 61.7 percent and operating margin of 22.2 percent. In Q3, Commercial Communications delivered revenue of $314 million, up 23 percent, driven by increased 5G R&D demand across the wireless ecosystem and growth in data center next-generation 400G and high-speed digital test. Aerospace, defense and government grew 22 percent and generated revenue of $201 million.

As Ron mentioned, aerospace defense and government growth was robust with strong demand across the aerospace defense supply chain including space, satellite, radar and electronic warfare applications.

Our Electronic Industrial Solutions Group, or EISG, generated third quarter revenue of $258 million, up 19 percent, driven by strength across all of its markets; automotive & energy, semiconductor and general electronics. EISG reported gross margin of 63.1 percent and operating margin of 28.5 percent.

Our Ixia Solutions Group, or ISG, reported Q3 revenue of $119 million, gross margin of 75.6 percent and operating margin of 8.1 percent. We were pleased with ISG's improved revenue performance after our extensive integration activities last quarter. We continue to focus on optimizing processes in several key areas and are confident in our ability to grow the business and increase profitability.

Lastly, Services Solutions Group, or SSG, revenue grew 9 percent in Q3 to reach $116 million, while delivering 40.1 percent gross margin and operating margin of 15.0 percent. Q3's services revenue was driven by growth for calibration, remarketed solutions and repair.

Moving to the balance sheet and cash flow, we ended our third quarter with $742 million in cash and cash equivalents and reported cash flow from operations of $38 million and free cash flow of negative $2 million. This includes accelerated funding for our U.S. pension plan in the amount of $85 million in order to secure tax deductibility at the current corporate rate prior to the new tax legislation taking effect. Excluding this accelerated payment, free cash flow was $83 million, which represents 8 percent of revenue.

Under our existing share repurchase authorization, during the quarter we acquired approximately 668,000 shares on the open market, at an average price of $59.81 for a total consideration of $40 million.

Before moving to our guidance, I would like to make a few additional comments about the potential impact on our business from the trade tensions between the U.S. and China. We currently estimate that the expense impact from the announced tariffs is still relatively immaterial. We are also closely monitoring the potential impact of these tensions on our aerospace and defense business in China, which we currently estimate at $10 to $15 million per quarter. As Ron mentioned, we believe this will be offset by the strong demand trends we see in the rest of world aerospace and defense market.

Now, turning to our outlook and guidance …

We expect fourth quarter revenue to be in the range of 1 billion to 1 billion 20 million dollars and Q4 earnings per share to be in the range of 85 to 91 cents, based on a weighted diluted share count of approximately 191 million shares.

At the midpoint, this brings our earnings growth for 2018 to 23 percent, and total revenue growth to approximately 19 percent, or 11 percent on a core basis, which is an increase from our prior estimate of 7 to 8 percent. Additionally, for the year, we expect to deliver a year-over-year core operating margin incremental at or above our 40 percent target. With that, I will now turn it back to Jason for the Q&A.

JASON KARY:

Thank you, Neil. Operator, will you please give the instructions for the Q&A?