



Keysight Technologies Third Quarter 2019 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Third Quarter Earnings Conference Call for Fiscal Year 2019.

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 and 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.

Lastly, I would note that management is scheduled to present at upcoming investor conferences in September hosted by Citi and Deutsche Bank. We hope to see many of you there.

And now I will turn the call over to Ron.

RON NERSESIAN

Thank you, Jason, and thank you all for joining us. Keysight delivered another outstanding quarter. Our differentiated strategy, relentless focus on execution and commitment to operational discipline continue to generate strong financial results.

I will focus my formal comments on three key headlines for the quarter.

- First, Keysight delivered another strong quarter with both revenue and earnings exceeding the high end of our guidance. Record third quarter revenue grew 8 percent year-over-year, or 9 percent on a core basis. Our differentiated solutions, software and services continue to fuel our growth across a broad portfolio of customers. And equally important, our strong culture of execution and commitment to operational excellence continues to drive our record performance on the bottom line. This quarter, we achieved record operating margin of 25 percent, and earnings of \$1.25 per share and earnings growth of 41 percent. We also generated record free cash flow of \$244 million.
- Second, we continue to see customers make R&D investments in certain next-generation technologies, such as 5G, across multiple end-markets. However, our macro environment concerns remain, and we continue to anticipate headwinds resulting from trade tensions with China. Despite these dynamics, given our broad portfolio of customers and solutions, we believe we are in a strong position to drive above market growth even in times of economic uncertainty.

- Third, given our continued success in the market and strong performance in Q3, we are raising our revenue and earnings outlook for the year. We now expect revenue growth between 9 and 10 percent, and earnings growth between 40 and 42 percent for the full fiscal year.

Now let's take a deeper look into our performance for the third quarter. We achieved \$1.25 per share in earnings, which was 24 cents above the midpoint and 20 cents above the high end of our guidance. This represents our sixth consecutive quarter of double-digit earnings growth, and earnings growing 41 percent for the quarter and 52 percent year-to-date.

Revenue grew 8 percent year-over-year, or 9 percent on a core basis, to surpass \$1 billion dollars and reach a new third quarter record for Keysight. This brings our year-to-date revenue growth to 13 percent on a core basis.

We also delivered strong order growth. Orders grew 10 percent, both in total and on a core basis, to exceed \$1 billion dollars for the fifth consecutive quarter. As a reminder, our core metrics exclude the impact of currency movements and revenue from acquisitions or divestitures completed within the last 12 months.

Software orders grew double digits in the quarter. Our portfolio of solutions, comprised of leading software, hardware and services capabilities, is at the core of our competitive differentiation, and further strengthens Keysight as a strategic partner to customers. Building on our commitment to help customers accelerate their innovations through software, Keysight recently collaborated with Nokia to launch the Open Test Automation Project, which we refer to as OpenTap. This new collaboration provides an open-source, scalable architecture for automated solutions and enables innovation in new technologies and increased development efficiency. Customers can also extend their OpenTAP capabilities through additional commercial offerings in our PathWave lineup.

Our ability to expand our software capabilities across the total communications workflow through acquisitions has generated strong returns for Keysight. This began with the acquisition of Anite in 2015, which was a key enabler of our 5G platform. Our expansion into the software layers of test with Anite has resulted in significant share gains in the 5G market. As we move forward, we see increased opportunities to make greater contributions to our customers' workflow. To that end, we are pleased to announce the acquisition of Prisma Telecom Testing. Based in Milan, Italy, Prisma has deep software expertise and a decades-long track record of delivering network equipment manufacturing solutions. This acquisition further enhances our ability to deliver leading end-to-end solutions across the entire communications ecosystem.

Moving to our markets, Commercial Communications drove considerable upside in the quarter with double-digit order and revenue growth. This growth was driven by another exceptional quarter of 5G orders, where we believe we have strong technology leadership over the competition. Keysight's success is a result of first-to-market innovations and engagement with leading-edge market makers across the wireless R&D ecosystem. We are proud of the many industry breakthroughs that are a result of these collaborations. For example, in July we announced that our efforts with many industry leaders have resulted in the industry's first Global Certification Forum validation of 5G test cases. This achievement, combined with our ongoing collaboration with key operators, accelerates 5G deployments globally.

Looking ahead, we expect the Commercial Communications market will continue to benefit from increasing demand driven by the complete redesign of communications systems for higher speeds and new use cases. Keysight is at the forefront with solutions designed to accelerate these innovations. In addition to R&D strength, our new modular products are doing very well in selective customer production workflows.

Moving to automotive, we continue to engage with customers in the automotive electronics market for new powertrain electrification technologies and advanced electronic systems. With our acquisition of ScienLab in 2017, we have considerably extended our leadership in this market by integrating our technologies and expanding across Tier-1 customers.

Automotive is an area where we continue to invest and innovate. We recently launched Keysight's Automotive Cybersecurity Test Portfolio, which delivers hardware, software and services that address the growing concern of cyber-attacks on connected vehicles. Utilizing security solutions developed by our Ixia Solutions Group, Keysight is delivering extensive security validations of the 4G/5G radio access network infrastructure that connects vehicles, and the backend data centers that manage business operations. Additionally, network visibility solutions deliver an enhanced infrastructure that improves the efficiency of security toolsets in production networks.

With the combined technology portfolios of Keysight, Anite, Ixia as well as Prisma, we are delivering solutions across the entire communications workflow from end-to-end and up and down the stack. Beginning in Q1, we are taking the combination one-step further by integrating ISG within our Communications Solutions Group. We believe this will create improved go-to-market and product development alignment to foster growth across the ecosystem as 5G moves from the deployment phase to commercialization. 5G deployments pose complex challenges across devices, base stations and core networks on an accelerated timeline.

Keysight is uniquely positioned to offer solutions end-to-end for all these challenges. This organizational alignment will further enhance our ability to accelerate innovation in 5G. Additionally, we see future opportunities to expand our footprint within enterprises deploying dedicated networks, as our network visibility solutions provide increased actionable insight and security for mission critical applications running on these networks.

In summary, Keysight has expanded its technology leadership with a diverse portfolio, while strengthening our competitive position in fast-growing, high-margin target markets. And our leadership position has delivered strong financial results. 2019 will be our fifth consecutive year of outstanding execution and operational excellence since launching Keysight. At the midpoint of our Q4 guidance we will deliver FY19 revenues of 4 billion 280 million dollars and 4 dollars 57 cents in EPS. This represents a compounded annual growth rate of 11 percent for revenue and 16 percent for EPS since our first year as a public company in FY15. Most importantly, Keysight has achieved a leadership position across growing addressable markets and is well-positioned for continued share gains.

Lastly, our commitment to excellence is deep in our DNA and extends beyond our financial performance. On that note, I'm proud to report on our achievements in corporate social responsibility. We released our 2018 Corporate Social Responsibility Report in May outlining Keysight's accomplishments in this space, including key impact results in natural resource conservation, supporting next-generation technologists through education processes and programs, and strengthening local communities. Our continued efforts are often recognized in the industry, most recently with Keysight's inclusion in several CSR-focused indices.

I'd like to congratulate all Keysight employees for their dedication to the company's success over the past five years, while upholding our global business framework of ethical, environmentally sustainable and socially responsible operations.

Now I will 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-over-year basis unless specifically noted otherwise.

As Ron mentioned, we delivered another strong quarter as we continued to execute on the demand we see in core areas of our business, while maintaining focus on operational excellence and superior execution.

For the third quarter of 2019, we delivered non-GAAP revenue of 1 billion 88 million dollars, which was well above the high end of our guidance range and grew 9 percent on a core basis. Our better than expected Q3 revenue results were driven primarily by continued strong demand in areas where we have a leading position in the market, such as 5G. This brings our total revenue growth for the first nine months of the year to 11 percent, or 13 percent core growth.

Total Keysight orders exceeded revenue once again this quarter. We delivered 1 billion 110 million dollars in orders in Q3. Orders were up 10 percent in total and on a core basis. I will also highlight that

in Q3, orders for services again grew double-digits on broad-based demand and good adoption of our new support offerings, such as Keysight Care.

Looking at our operational results for Q3, we reported strong gross margin of 63 percent. Our notable gross margin performance and continued strong operational discipline led to another quarter of record operating margin and earnings. We achieved 25 percent operating margin and net income of \$239 million. On a per share basis, we delivered \$1.25 cents in earnings, which was well above the high-end of our guidance. Our weighted average share count for the quarter was 191 million shares.

Our Communications Solutions Group generated record revenue of \$683 million, up 13 percent, while delivering gross margin of 63 percent and record operating margin of 28 percent.

In Q3, Commercial Communications delivered double-digit order growth and revenue of \$440 million, driven by broad strength across the wireless ecosystem as increased 5G R&D investment continued.

Aerospace, defense and government generated revenue of \$243 million, an increase of 2 percent on a core basis. During the quarter, we continued to see steady spending in the U.S., which was offset by softness in some international markets. Order growth for this end-market was high single-digits, and we have a strong overall funnel building into Q4.

EISG generated third quarter revenue of \$295 million, up 3 percent, driven by strength in next-gen automotive and general electronics. As expected, this growth was offset by lower capital investments by our semiconductor customers. This quarter we saw strength in the broad portfolio of products that serve our general electronics end-market. EISG reported record gross margin of 62 percent and record operating margin of 28 percent.

ISG reported Q3 revenue of \$110 million, a 7 percent decline over last year. The decline in ISG revenue reflects ongoing softness in the network test market, whereas network visibility solutions generated high single-digit growth driven by enterprise sales in the U.S. and Asia. ISG reported gross margin of 72 percent and 1 percent operating margin. As Ron mentioned, in Q1, we will implement a change in our organizational structure to align ISG with our Commercial Communications end-market, including global sales. At that time, we will report ISG results combined with our Communications Solutions Group, which will provide solutions across the entire communications ecosystem, both end-to-end and up and down the stack.

Moving to the balance sheet and cash flow, we ended our third quarter with \$1.4 billion in cash and cash equivalents and reported cash flow from operations of \$274 million and record free

cash flow of \$244 million. Free cash flow for the quarter was 22 percent of revenue and 102 percent of non-GAAP net profit.

Under our share repurchase authorization, during the quarter we acquired approximately 760,000 shares on the open market, at an average price of \$78.92, for a total consideration of \$60 million.

Before moving to our outlook, I would like to make a few comments regarding the United States Department of Commerce export control regulations that impact one of our larger customers in China. As I'm sure you can appreciate, the current regulatory environment remains a fluid situation. On our last conference call, we said that we expect these trade restrictions to be a headwind to revenue growth in the second half of this year and the first half of 2020. To date, we have been able to ship some products to this customer within the current legal regulations. As a result, we expect to see a slightly smaller headwind in Q4 than previously anticipated. Due to on-going trade concerns, we continue to expect a 3 to 4-point headwind in the first half of 2020 related to this customer.

Now, turning to our outlook and guidance ...

We expect fourth quarter 2019 revenue to be in the range of 1 billion 80 million to 1 billion 100 million dollars. This brings our revenue growth range for the year to 9 to 10 percent, which is above our prior outlook of 7 to 8 percent.

We expect Q4 earnings per share to be in the range of 1 dollar fourteen cents to 1 dollar twenty cents, based on a weighted diluted share count of approximately 191 million shares. The midpoint of our earnings guidance implies 41 percent earnings growth for the full year.

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?