Keysight Technologies First Quarter 2018 Earnings Conference Call

Prepared Remarks

**JASON KARY**

Thank you, and welcome everyone to Keysight's First 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, who is calling in from Barcelona where he has been for Mobile World Congress this week.

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.

Lastly, I would also note that we are hosting our investor day on March 6th at the New York Stock Exchange and we look forward to seeing 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 first quarter with both revenue and earnings exceeding our guidance and we are pleased with our performance and growing leadership position in the market. I'll focus my formal comments on three key headlines for the quarter.

- First, 2018 is off to a great start and we delivered a strong quarter across the board. Our better-than-expected results this quarter were driven by robust order growth as well as the strength of our execution.
- Second, customers are increasing their R&D investments in next-generation technologies and we have continued to build momentum across multiple end markets, contributing to four consecutive quarters of accelerating order growth.
- And third, Keysight's transformation strategy is delivering results. With our strong performance in the first quarter, we are raising our guidance for the first half of the year. Additionally, our order

growth and backlog expansion over the past several quarters has established a strong foundation to drive revenue and earnings growth in 2018.

Let's take a deeper look into our performance for the quarter. We achieved earnings of 51 cents per share, which was 15 cents above the midpoint of our guidance and exceeded the high-end of our guidance range. We delivered outstanding order growth this quarter. Orders grew 39 percent in total, or 16 percent on a core basis, to reach a new first quarter record. Q1 revenue increased by 18 percent to reach $856 million, which was also above our guidance.

Our better-than-expected results were driven by our strong order growth and execution - including our ability to recover from the Northern California wildfires faster than expected. With the team's diligence, focus and hard work, our Santa Rosa production capacity is running above the pre-fire levels. We still have work to do in order to fully recover, but bringing production back to pre-fire levels at this site was essential, especially as customer demand for our solutions continued to grow.

At the same time as we were working to recover from the wildfires in Santa Rosa, we achieved another major operational milestone in the quarter by completing the integration of Ixia's people, systems and processes. This was a significant undertaking and now we are able to book, build, ship and invoice Ixia sales on Keysight's ERP.  We completed this integration in nine months, once again through the strong execution of our team.  This milestone is a key enabler in realizing the committed Ixia cost synergies, and we remain on track to deliver $40 million in annual run-rate savings beginning in Q3 of this year.

When I look back on everything we accomplished in the quarter, I continue to be proud of and inspired by the team's tremendous efforts and resiliency.  The team was tested, rose above the challenges and delivered.  We believe our execution during the quarter is even more impressive when considering the magnitude of the circumstances. In addition to supporting our employees through a terrible tragedy, we achieved above-market order growth, recovered production capability faster than planned and completed the integration of Ixia into Keysight's ERP.  Once again, we thank each and every member of the Keysight worldwide team for their commitment and diligence.

Moving to our markets, we continued to see increased investments in emerging technologies and overall healthy dynamics.  Our strategic areas of focus, including our first-to-market position in leading-edge technologies and our solution-centric portfolio, are helping fuel our momentum, resulting in above-market growth as customers increase their development activities and investments.  The first quarter was our fourth consecutive quarter of accelerating core order growth and second consecutive quarter of double-digit core order growth.  Order demand was broad-based and balanced across our markets, geographies and channels.  We saw particularly strong order growth in our Commercial Communications end-market, with orders reaching the highest level since forming Keysight.

Overall, we are seeing excellent adoption of our solutions in key segments of the market that are undergoing technology transformations such as 5G, next-generation Wi-Fi, electronic warfare, and high-value automotive.

In 5G, we are seeing growing R&D investment across networks, chipsets and devices.  Winning in 5G is a cornerstone to our strategy to transform Keysight for growth.  With targeted investments, early partnerships with key industry innovators around the globe and ground-breaking first-to-market solutions, we have established a strong leadership position in 5G. Our 5G performance in the quarter was exceptional with R&D communications orders growing to a new record. In December, we brought together key industry players to advance 5G innovation and demonstrate our 5G New Radio network emulation solution within days of publication of the first 5G new radio specifications. We continue to further advance our 5G solutions with the goal of enabling industry first innovation. At Mobile World Congress this week, we are proud to have enabled multiple industry-leading customers to showcase their 5G readiness with Keysight solutions.

Automotive electronics and communications is another exciting area where we are seeing growth as technology advancements transform the market. During the quarter, R&D investment at major automotive OEMs and Tier 1 suppliers was robust across a broad set of electronics applications, including wireless connectivity and power solutions. With our continued focus on developing our solutions portfolio for this evolving market, Keysight has achieved double-digit order growth with our automotive and energy solutions for five consecutive quarters.

In the aerospace and defense end-market, electronic warfare and defending against malicious actors looking to take advantage of security gaps in electronic communications continue to grow in importance. Keysight provides the industry's most advanced electronic warfare and radar testing solutions and has been a long-standing leader in this market. For the second quarter in a row aerospace and defense orders grew approximately 20 percent, although versus a soft compare. Over the long-term, we remain confident in our outlook and market position in this market; however, in the near term, we expect the timing of U.S. orders to be weighted toward the end of the fiscal year given the delayed budget approvals over the past several months.

Moving beyond our end-markets, software is a key component of our solution-centric go-to-market approach and strategy to transform Keysight. Our long history of innovation and leadership gives Keysight critical insights into measurement needs, resulting in software that helps customers accelerate innovation and bring their products to market faster. Software is becoming a larger part of our portfolio and in the first quarter, orders for our software solutions grew double-digits organically. Further expanding our software offerings, in January we unveiled PathWave, the industry's first software platform that integrates simulation, design and test workflows across the entire product development lifecycle, from early concept through manufacturing and deployment. This disruptive innovation bridges the gaps between development points that were once discrete and is an important milestone on our multi-year journey to expand our software capabilities and solutions.

In summary, we are very pleased with our execution and results in the first quarter. We are well-aligned with growing market trends where customers are investing in next-generation electronic technologies. And our first-to-market advantage and solution-centric model is differentiating Keysight in the marketplace. With our accelerating order growth, expanding backlog and strong operational execution, we are poised to drive revenue and earnings growth in 2018. We have an exciting line up for you at our investor day and look forward to sharing more with you next week on March 6th. At this point, I would like to turn this over to Neil.

**NEIL DOUGHERTY**

Thank you, Ron, and hello, everyone.

As Ron discussed, we delivered a very good quarter even as we managed through several events that included accelerating customer demand, recovering from the wildfires and completing the integration of Ixia into Keysight's ERP. Needless to say, the past three months were extremely busy for Keysight.

I would like to start today by discussing orders as given the ongoing production recovery, orders are the best indicator of the underlying business strength. In Q1, we delivered strong 39 percent order growth, with core orders growing 16 percent. This was our fourth consecutive quarter of accelerating core order growth. Ramping capacity to meet this high level of demand can be complicated in and of itself, and it is even more challenging when production and shipments are impacted by unforeseen circumstances like the Northern California wildfires. As Ron mentioned, we were pleased with our ability to recover faster than expected, and production capacity is now above pre-fire levels. It is worth noting that we have not had a single customer order cancellation as a result of the fire, and we have grown our backlog by $226 million over the past two quarters. We have made solid progress, but still have a lot of work to do to increase our shipment levels and clear our growing backlog, which was over $1 billion at quarter-end.

Moving to revenue, as we discussed last quarter, we expected the disruption from the wildfires to impact the seasonality of revenue and, therefore, focused our guidance on the first half of 2018. As predicted, seasonality was difficult to forecast as we finished the first quarter with non-GAAP revenue of $856 million, up 18 percent with a 2-percentage point favorable impact from currency. While Q1 revenue was significantly above our expectations, it was still down 2 percent year-over-year on a core basis. We expect a significant revenue ramp in Q2 as the production recovery continues.

Looking at our operational results for Q1, we reported gross margin of 60.1 percent and operating expenses of $383 million resulting in operating margin of 15.4 percent. We reported net income of $97 million and $0.51 cents in earnings per share, which was 8 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, was the business most impacted by the wildfire disruption.  CSG includes two primary end markets, Commercial Communications and Aerospace, Defense and Government.  In the commercial communications end market, orders grew at a strong double-digit rate as the underlying business remains strong, while in contrast, revenue of $245 million, was down 4 percent year-over-year, as we worked to re-ramp production.  Order growth was driven by 5G R&D spending across the wireless ecosystem and early investment in next-generation 400G and PAM-4 network test.

As Ron mentioned, aerospace, defense and government orders grew approximately 20 percent, however, this end-market generated revenue of $175 million in Q1, compared with $180 million in the same quarter last year.

Total CSG revenue for the quarter was $420 million with 60.9 percent gross margin and 14.0 percent operating margin.

Our Electronic Industrial Solutions Group, or EISG, generated first quarter revenue of $203 million, up 6 percent from last year.  Growth was led by automotive & energy and semiconductor measurement solutions, offset by a slight decline in general electronics measurement. EISG reported gross margin of 59.0 percent and operating margin of 18.5 percent.

Our Ixia Solutions Group, or ISG, generated revenue of $127 million, gross margin of 75.6 percent and operating margin of 14.5 percent. Gross margin in this business was unfavorably impacted by a one-time inventory clean-up tied to the ERP integration and cut-over. ISG revenue was above our expectations for the quarter as they saw an increase in shipments for their high-speed 400G Ethernet test solutions, and overall, support renewals reached a new record.

Lastly, Services Solutions Group, or SSG, revenue grew 6 percent year-over-year to reach $106 million. Revenue growth for SSG was driven by an increase in sales of remarketed solutions and calibration with overall regional strength in the Americas and Asia-Pacific. SSG reported gross margin of 40.3 percent and operating margin of 15.6 percent.

Moving to the balance sheet and cash flow, we ended our first quarter with $980 million in cash and cash equivalents and generated $171 million in cash flow from operations. Our operational cash flows were strengthened by significant timing-related reductions in working capital linked to the fire recovery, which we expect to balance out during the remainder of the first half. In Q1, we invested $24 million in capital purchases, bringing our free cash flow for the quarter to $147 million, or 18 percent of revenue, which was atypical for the first quarter and, again, will even out over the half.

Before we move to guidance, I will provide an overview of the impact of U.S. tax reform on our business. We expect the lower U.S. corporate tax rate and shift to a modified territorial tax system to lower our overall tax rate and provide much greater access to our global cash generation. While some provisions of the new legislation are subject to interpretation, which may change over the coming months and impact our initial estimates, we now expect our non-GAAP tax rate will drop 200 basis points to 15 percent beginning this quarter.

The new U.S. tax law includes a deemed repatriation on existing offshore cash balances and historic foreign earnings. We currently estimate that this provision will result in Keysight paying cash taxes totaling $95 million over an eight-year period while providing a one-time U.S. cash influx of greater than $500 million.

We are currently exploring different strategies to best optimize our balance sheet and we are committed to acting in the best interests of our shareholders and maximizing shareholder value over the long term.

**Now, turning to our outlook and guidance …**

Balancing our strong order growth, the current market dynamics, our better-than-expected Q1 results and the continued recovery from the wildfires, we are raising our guidance for the first half of the year. We now expect first half revenue in the range of $1,805 million to $1,835 million and first half earnings per share in the range of $1.27 to $1.37. At the midpoint, our first half guidance represents 4 percent core revenue growth, a greater than 40 percent year-over-year core operating margin incremental and 10 percent EPS growth. The midpoint of our first half guidance implies Q2 non-GAAP revenue of $964 million and second quarter non-GAAP earnings per share of 81 cents, based on a weighted diluted share count of approximately 190 million shares. Building on our positive momentum, we are pleased to raise our guidance for the first half, and as a result of our strong backlog position, we are now expecting full-year core revenue growth in the range of 5 to 7 percent.

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 day next week. Have a great day.