Keysight Technologies Second Quarter 2018 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Second 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 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 Bank of America Merrill Lynch Global Technology Conference on June 6th in San Francisco, as well as the Stifel Cross Sector Insight Conference on June 12th in Boston and the Credit Suisse Semiconductor Supply Chain conference on June 14th, which is also in Boston. 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. Today, I'll focus my formal comments on three key headlines for the quarter.

- First, revenue grew to a record $999 million, which was well ahead of our guidance. We also achieved earnings of 83 cents per share, which was 2 cents above our guidance midpoint.
- Second, Keysight's core revenue and orders grew double-digits, and we achieved double-digit order and revenue growth in our Communications, Electronic Industrial and Services Solutions Groups as demand for Keysight's solutions in 5G, Automotive and Services continued.
- And third, we are raising our outlook for the year.

Let's now take a deeper look into our performance for the quarter. We achieved earnings of 83 cents per share and delivered strong order growth. Orders grew 23 percent in total, or 10 percent on a core basis. Broad-based demand across our markets, geographies and channels drove our third consecutive quarter of double-digit core order growth.

Q2 revenue grew 32 percent, or 18 percent on a core basis, to reach $999 million. Core revenue grew double-digits across all regions, including our emerging markets. Additionally, I'm pleased to report that the shipment disruption from the wildfires is now behind us. This was completed one quarter earlier than expected and without a single order cancellation.

During the quarter, we completed phase two of the Ixia integration. We have invested significant resources upgrading their systems and processes for long-term value creation. This included integration of all procurement, contract manufacturing, trade and logistics activities to leverage Keysight's scale. In addition, we consolidated 28 sites to drive operational alignment and cost savings and absorbed many management and administrative functions for efficiency. This was an enormous effort and stabilization took longer than expected, impacting ISG's Q2 results. Many of these integration issues are now resolved, and we will deliver the committed cost synergies in the current quarter.

Ixia's leadership in next-generation technologies is integral to our solutions and software strategy. Our acquisitions of both Ixia and Anite bring Keysight into the software layers of the design and test market. With our combined technology portfolios, we are able to deliver full end-to-end solutions across the total communications workflow. Our solution roadmap for the next several years is very exciting, especially as 5G provides new ways to connect people with their devices, cars and things. Our Communications Solution Group, or CSG, is making great contributions in the wireless portion of 5G, and ISG is addressing the network part of the ecosystem. We have had several significant wins for evolved packet core upgrades with major carriers. Major 5G network investments in the U.S. are expected to begin in the second half of the year as carriers introduce new services.

Moving to our markets, we continued to see increased investments in emerging technologies and overall healthy market dynamics. Our technology leadership, solutions and industry-focused approach to the market continues to advance our growth and footprint in key segments. Customers are increasingly looking to Keysight to solve their design challenges, and we are empowering them to bring their leading-edge innovations to market faster.

This quarter we saw particularly strong revenue growth in our Commercial Communications end-market, following Q1's record order performance. 5G-related R&D investment continues to increase across the wireless ecosystem, which includes networks, chipsets and devices. In Q2, we achieved strong double-digit 5G order growth. This was our tenth consecutive quarter of double or triple-digit order growth for our 5G solutions, which we believe confirms our early leadership position.

As another example of our leadership, in April we announced the industry's first 5G New Radio ready channel emulation solution, which has already been adopted by five major communications customers. This new solution, based on technology acquired from Anite, offers state of the art capability and enables customers to validate the end-to-end performance of their designs. Additionally, we delivered our first-to-market 5G millimeter-wave channel sounding solution to NTT Docomo, Japan's leading mobile operator.

Automotive and energy is another area where we continued to see strength in the quarter delivering our sixth consecutive quarter of double-digit order growth. The global race to deploy hybrid and electric vehicles, connected cars and autonomous driving capability as soon as practically possible is driving ongoing customer investments across a broad range of technologies. Investments for battery and electric drive train test are growing in strategic importance. Our ability to differentiate our solutions with the acquisition of Scienlab is proving to be a critical enabler to capturing this market opportunity.

General economic conditions in industrial electronics were strong in the quarter despite some modest slowing in semiconductor investment growth. We saw steady order growth for our general electronics measurement end-market, and improved demand in the education market in the U.S. and Europe. This market is an important avenue for building long-lasting relationships with future engineers.

In the aerospace, defense and government end-market, we delivered very healthy double-digit order growth for the third consecutive quarter and saw Q2 revenue increase by 27 percent driven by continued broad-based demand worldwide.

Moving beyond our end-markets, software and services are key components to our solution-centric go-to-market approach. Software is becoming a larger part of our portfolio and in the second quarter, orders for our software solutions grew double-digits organically. Our new PathWave software platform, which we introduced in January, is a foundational element of our strategy to deliver software-centric solutions to our customers around the world. We have already won our first orders for PathWave Analytics and are encouraged by the many deals we see in the funnel. Additionally, Q2 revenue for our Services segment grew 15 percent year-over-year to reach an all-time record. Our services expansion included growth in the managed services business with the introduction of PathWave Asset Advisor. This cloud-based software, has already been enabled at multiple large customers and is assisting them with proactive lifecycle management of their test equipment.

PathWave is a key part of Keysight's leading-edge technology strategy under the Keysight Leadership Model, or KLM. This model encompasses our guiding principles as a company, enables us to deliver greater value to customers, shareholders, and employees. KLM is centered around customer success and providing leading-edge technology, solutions and insights. We believe that staying true to this mission and the core values of KLM has and will continue to drive long-term business value.

Corporate social responsibility or CSR is one of these core values. Demonstrating our commitment to this endeavor, we released our CSR report in May. This report details the company's environmental, social, and governance initiatives worldwide. It also includes several company impact goals to help build a better planet, strengthen communities, and foster education. While corporate social responsibility has always been a part of Keysight's DNA, these measures provide a beacon to drive our efforts, measure our progress, and support stakeholder expectations. We look forward to sharing with you the success of this effort 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.

We delivered an exceptional topline quarter as we continued to execute onthe strong demand we see in core areas of our business. Given the impact to the quarterly seasonality of our revenue due to the disruption from the wildfire, I will comment today on both our second quarter and first-half results.

For the first half of 2018, we delivered 8 percent core revenue growth, a year-over-year core operating margin incremental above 40 percent, and 11 percent EPS growth overall.

In addition, first half orders grew 30 percent in total, or 13 percent on a core basis, enabling us to exit Q2 in a strong backlog position.

As expected, we saw a significant revenue ramp in Q2. We reported Q2 non-GAAP revenue of $999 million, which was well ahead of our guidance. This brought our revenue for the first half to $1.9 billion, up 25 percent year-over-year, which includes a 2-percentage point favorable impact from currency.

Looking at our operational results for Q2, we reported gross margin of 60.3 percent and operating expenses of $399 million resulting in operating margin of 20.4 percent. We reported net income of $158 million and 83 cents in earnings per share, on a weighted average diluted share count of 190 million shares.

Moving to the performance of our segments, as you may recall, our Communications Solutions Group, or CSG, was the business most impacted by the wildfire disruption. Total CSG revenue for the first half was $956 million, up 11 percent over last year, while delivering gross margin of 61.3 percent and operating margin of 19.3 percent. In Q2, CSG delivered revenue of $536 million, up 27 percent year-over-year, driven by 5G-related R&D spending across the wireless ecosystem, early investment in next-generation 400G and PAM-4 network test and strong 27 percent year-over-year growth in our aerospace, defense and government end market.

Our Electronic Industrial Solutions Group, or EISG, generated first half revenue of $458 million, up 11 percent from last year, gross margin of 60.3 percent and operating margin of 22.7 percent. Q2 EISG revenue was $255 million, up 16 percent year-over-year, driven by automotive & energy and general electronics measurement, while revenue for our semiconductor measurement solutions was in line with Q2 of last year.

As Ron mentioned, ISG, reported Q2 revenue of $90 million, gross margin of 75.8 percent and an 8.4 percent operating margin loss. We have resolved many of the integration issues and expect ISG will deliver solid profitability in the second half. In addition, our annualized cost synergies will ramp to the committed $40 million run rate in Q3.

Lastly, Services Solutions Group, or SSG, revenue grew 11 percent in the first half to reach $224 million, while delivering 40.5 percent gross margin and operating margin of 15.5 percent. Q2's record services revenue of $118 million grew 15 percent year-over-year and was driven by double-digit growth for calibration, remarketed solutions and repair.

Moving to the balance sheet and cash flow, we ended our second quarter with $784 million in cash and cash equivalents. We generated $111 million in cash flow from operations in the quarter, and $282 million on the half, as the significant Q1 timing-related reductions in working capital linked to the fire recovery began to balance out. In Q2, we invested $34 million in capital purchases, bringing our free cash flow for the quarter to $77 million, and $224 million for the first half, which represents 12 percent of revenue and 88 percent of adjusted net income.

As we outlined at our analyst day, our capital allocation priorities are to reinvest in our business to drive profitable organic growth, to de-lever following the acquisition of Ixia, and strike a balance between future M&A and return of capital.

Consistent with these priorities, in Q2, we repaid the final $260 million of the $540 million pre-payable debt that was put in place to fund the Ixia acquisition and we actively repurchased stock during the quarter under the $350 million share repurchase program we announced in March. During the quarter we repurchased approximately 770,000 shares at an average price of approximately $52 per share, for a total of $40 million.

Now, turning to our outlook and guidance …

We expect third quarter revenue to be in the range of $942 million to $972 million and Q3 earnings per share to be in the range of $0.72 to $0.82, based on a weighted diluted share count of approximately 190 million shares.

While we do not typically provide full year guidance, building on our positive momentum and our strong backlog position, we now expect to deliver full-year core revenue growth in the range of 7 to 8 percent, which is above our prior estimate of 5 to 7 percent, and we continue to expect to deliver a 40 percent core operating margin incremental 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?

OPERATOR – FINAL COMMENTS

Thank you. That concludes our question-and-answer session for today. I would like to turn the conference back to Jason Kary for any closing comments.

JASON KARY:

Thank you, Operator, and thank you all for joining us today. We look forward to seeing you at the upcoming conferences. Have a great day!