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# EDITED TRANSCRIPT

LLL.N - Q4 2018 L3 Technologies Inc Earnings Call

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## OVERVIEW:

Co. reported 4Q18 sales of \$2.771b and adjusted diluted EPS from continuing operations of \$3.10. Expects 2019 sales to be at \$10.75b range and 1Q19 sales to be about \$2.5b.



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## CORPORATE PARTICIPANTS

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## CONFERENCE CALL PARTICIPANTS

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## PRESENTATION

### Operator

Good afternoon, and welcome to the L3 Technologies Fourth Quarter and Full Year Conference Call. (Operator Instructions) Please note, this event is being recorded. I would now like to turn the conference over to John Kim, Vice President of Investor Relations. Please go ahead.

**John H. Kim** - L3 Technologies, Inc. - VP of Investor Relations & Analytics

Thank you, and good afternoon. I'd like to welcome everyone to our Fourth Quarter 2018 Earnings Conference Call. With me today are Chris Kubasik, our Chairman, CEO and President; and Ralph D'Ambrosio, our Senior Vice President and CFO. After their formal remarks, management will be available to take your questions.

Please note that during the call, management will reiterate forward-looking statements that were made in the press release issued this morning. Please refer to the press release as well as the company's SEC filings for a more detailed description of factors that may cause actual results to differ materially from those anticipated. Please also note that this call is simultaneously broadcast over the Internet. I would now like to turn the call over to Chris.

### Christopher E. Kubasik - CEO & President

Thank you, John, and good afternoon, everyone. As you saw this morning, our fourth quarter capped off a very strong year, highlighted by sales growth, operating income growth, record free cash flow and a solid book-to-bill ratio of 1.06. We are seeing improvements in the business from the various changes we made in leadership, organizational alignment and processes. These changes contributed to a 50 basis point improvement in margin for the quarter, however, overall margin improvement for the year fell short of my expectations. As we've been discussing, performance in our Traveling Wave Tube business was the primary driver of the shortfall, which I will discuss in more detail later.

For the full year, we grew sales 7%, over our initial guidance of 4% last January, and also grew segment operating income 7%. We exceeded our free cash flow guidance, delivering \$935 million for the year. In addition, our strong funded orders growth resulted in a book-to-bill of 1.13 for the year and \$9.7 billion of backlog at year-end.

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A year ago, we laid out our plan for our multiyear L3 3.0 transformation with a focus on integration, collaboration and innovation. We also put forth a strategy to move up the value chain to become a mission solutions prime. We began the year with a strategic review and made the decision to sell our Vertex services business. Even though it was 15% of our sales, we believed the asset was not a strategic fit with our technology focus and vision for L3's future. The divestiture closed in June of last year for a sales price of \$540 million in cash.

During the third quarter, we realigned the businesses from 4 to 3 segments based on their technologies and capabilities in order to more effectively collaborate and compete. And in the fourth quarter, we announced our merger of equals with Harris to accelerate our transformation and increase our scale to compete.

2018 marked the first year of our transformational journey as we laid the foundation for a more integrated L3. We have been successful attracting additional talent, energizing the workforce and building common systems and processes. Leadership remains an important aspect in driving change, so it was a key priority of mine to roll out a leadership excellence expectation model across the enterprise. As previously discussed, we made several changes at the board level and within the company. We added new leadership in senior functional areas, including corporate human resources, global business development and engineering. In addition, we changed out 2 of the 4 segment presidents during 2018. Across the enterprise, over 70 Vice Presidents exited the business last year. We replaced them equally with external hires and internal promotions, all bringing energy and new ideas.

We took significant strides to energize our employees and to build a culture of respect and collaboration. We renewed our focus on our enterprise vision, mission and core values, and the employee survey was one of the many new initiatives to leverage feedback and heighten employee engagement to make L3 a more attractive place to work. We received many recognitions for our commitment to diversity in 2018, including rankings in America's Best Employer for Diversity by Forbes, Top 50 Employer by Woman Engineer Magazine and a Top Veteran-Friendly Company by US Veterans Magazine.

We began our journey making investments that will improve operations and profitability. We centralized and consolidated IT functions, leveraging the latest cloud technology. We standardized and simplified HR policies and benefits to create more consistency throughout the company. On the labor front, we successfully negotiated multiple labor agreements without work stoppage or other disruption. And our annual incentive compensation metrics were modified to promote organic growth, which contributed to achieving our highest sales growth in 10 years.

We consolidated to a single CRM system and improved our business development processes to better align our capabilities and to enable greater collaboration. This will allow us to pursue larger mission solutions prime growth opportunities.

We also booked \$11.6 billion of funded orders for the year, positioning us for continued growth in 2019. Obviously, the pending merger with Harris adds uncertainty to the workforce, but our employees and leaders remain focused on what is most important, delivering reliable products to our customers on time and on budget. The leadership team has accelerated its communications activities through videos, emails and dedicated employee websites to keep all our employees better informed on what lies ahead. Overall, there is genuine excitement about the L3-Harris combination in the workforce, and I share that excitement as well.

The fruits of these and many other improvements are now becoming visible, most notably, through our reaffirmation of the plan to achieve 12% margin in 2019. Through L365, better alignment of your businesses and functional consolidation, we are streamlining the organization and removing cost. We are making progress on many fronts, including indirect procurement, IT consolidation and engineering redesigns to remove product costs and improve cycle time. These and many other activities that began in 2018, in addition to the new initiatives in 2019, are expected to drive cost savings this year.

On the growth side, our segment leaders recently presented their long-term order outlook, which leverages the investments we've made in technologies, processes and business development talent. We are seeing evidence of many pursuits, where we are bundling our capabilities to go after and win larger integrated systems. We're bidding more opportunities as a prime, and we're expanding the dollar value of those opportunities. The Canadian Surface Combatant is such an example.

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Plans are becoming more ambitious as we are well-positioned for continued sales growth by leveraging common technology and delivering more disruptive innovation to customers.

International sales grew 8% in 2018, and there are many opportunities emerging in the Middle East that will continue to support that growth. In fact, I'll be going over to the region in March to continue to build relationships and reaffirm our commitment.

All in all, I'm excited about the progress we made last year and encouraged that the spirit of integration, collaboration and innovation is taking hold firmly in our culture.

Now I would like to review our segment performance. Both the ISRS and Electronic Systems segments delivered strong year-over-year financial performance in orders, sales and segment income. However, this was partially offset by weakness in the sector within the communications and network systems segment.

As you may recall in August, we formed the ISR Systems segment by combining the legacy aerospace and sensors businesses in order to strengthen leadership, increase profitability and provide customers with more integrated ISR solutions. As expected, we are seeing positive results from this change.

The ISR segment grew sales 14% in the quarter, while improving margins. For the year, orders were up 19%, sales were up 11% and margins up 140 basis points, with growth led by ISR aircraft recapitalization and fleet expansion, more night vision equipment and EO/IR turrets. Margins improved due to segment consolidation, better contract performance and L365 savings. An important highlight of the quarter was the capture of the \$450 million Army Shadow UAV ID/IQ award for EO/IR equipment. This win solidifies L3's position in an important unmanned platform and opens opportunities for future international business. We expect strong sales momentum and margin improvement to continue in 2019.

Our Electronic segment delivered 11% sales growth with slightly lower margins in the quarter. For the full year, funded orders increased 20%, sales were up 11%, and margins improved 70 basis points. Growth was balanced across our military and commercial aviation businesses and led by precision munitions, airport security equipment and pilot training. Sales growth in 2019 will be more modest due to the C-17 loss announced in June, which accounted for \$100 million in sales in 2018. Margin expansion will also continue throughout the year.

Our Communications and Network Systems segment experienced headwinds, with sales down 3% and margins down 100 basis points due to charges related to our TWT businesses in the quarter. For the full year, funded orders were up 9%, sales down 2% and margins contracted 240 basis points. The softness in sales was due to lower shipments in our UAV business and network communications. We expect sales in communications to start growing again in 2019, based on customer demand and our unique capability in secured assured communications, electronic warfare, manned-unmanned teaming, and maritime sensors and systems. These are large and growing markets that we are now addressing with focused R&D and business development efforts.

A particular highlight during the quarter was the award of the Navy's next-generation jammer, an example of leveraging our differentiated and disruptive technology. This demonstration of an existing technology award puts us in position to pursue much larger opportunities in providing full-spectrum dominance in the convergence of electronic warfare and communications.

Communication margins should rebound in 2019 due to better overhead absorption and return to more normalized operations in the Traveling Wave Tube business. We are beginning the year by collapsing our 5 sectors into 3 to reduce indirect costs and to better align capabilities, such as our maritime sector, which will be under a single leader to develop strategies for both cost and revenue synergies.

Let me outline our recovery plan for the TWT business, which was the main source for our margin shortfall in 2018. As a reminder, we appointed a new segment president in September, and subsequently, we upgraded the management team by appointing a new sector president, divisional

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president, along with new operations and supply change leaders on-site. The new team conducted a thorough review in November and December, and are now executing on a recovery plan, which has several key elements.

We are improving technical documentation and migrating to a new business system that provides increased visibility into program and operational performance. We are increasing employee training to accelerate adoption of new tools and systems, and we are implementing a series of L365 initiatives to improve the efficiency of our operations.

As we implement these corrective actions, we are taking steps this quarter to rightsize the business, specifically, we are eliminating consultants and contract labor and reducing the total staff an estimated 12%, commencing with voluntary reductions, and then with an involuntary reduction in-force if necessary. In parallel, we have eliminated the past practice of advanced funding material, which resulted in an inventory charge this past quarter, and we are no longer signing long-term supply agreements with fixed pricing.

Lastly, we've met with our top 10 customers and top 10 suppliers to align our respective schedules and identify further opportunities for improvement across our supply chain. While essential to our success going forward, these largely nonrecurring corrective actions had a significant cumulative impact on fourth quarter performance. Looking forward on a positive note, TWT orders and sales remain strong, driven by rising demand from our military customers.

With the new plan in place, I have increased the reporting cadence to ensure the successful execution of the plan. Sean Stackley and I were on-site earlier this month to review our progress and to talk to the new leadership team, and I'm certain we have the right team, processes and oversight in place to drive improvement this year.

Turning to our corporate-wide guidance for 2019. We expect sales growth of 5% and are reiterating our margin guidance of 12%. All 3 segments will grow sales and improve margins in 2019. Margin expansion will be driven by productivity improvement savings, elimination of nonrecurring charges in our Traveling Wave Tube business and higher pension income, each contributing about 40 basis points to margin improvement.

Now I will turn it over to Ralph to go over our 2018 financial performance and 2019 outlook in more detail, and then I'll make a few comments on the status of our merger with Harris, before taking questions. Ralph?

### **Ralph G. D'Ambrosio** - L3 Technologies, Inc. - Senior VP & CFO

Thanks, Chris. I'll review some details about the fourth quarter results and our initial 2019 guidance. Reviewing the 2018 fourth quarter, we had solid financial results with strong growth in orders, sales, segment operating income and adjusted EPS. Favorable tax items boosted EPS. We also generated record quarterly free cash flow.

As Chris commented, we missed our 2018 margin guidance of 11.2% by 40 basis points because of continued losses at the TWT business in the Communications and Network Systems segment. Our segment operating margin for 2018 was unchanged from 2017 at 10.8%, and that was after increasing IRAD by \$40 million. And our 16% orders growth for 2018 shows that the higher R&D investment is paying off. The TWT losses, which increased from earlier in 2018, were \$45 million for the fourth quarter and primarily relate to continued delays in returning to normal manufacturing yields. They included \$25 million for estimated contract cost overruns, \$10 million of overhead absorption losses and \$10 million of inventory charges. The TWT losses were \$74 million for the full year 2018.

Our poor performance in the TWT business has obscured the significant progress we made across L3 to improve cost efficiency, productivity and profitability this year. Without the TWT losses, segment operating margin for the fourth quarter would've been 12.5% instead of 10.9%, and for 2018, 11.5% instead of 10.8%. The TW business is beginning to turn the corner. We reset its contract estimates and inventories in the fourth quarter, and Chris outlined the recovery plan and actions that we're taking. So we expect incremental improvement as we progress through 2019. However, we have taken a conservative position for it in our 2019 guidance, and I'll cover that in a few minutes.

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Now getting to some details about the 2018 fourth quarter. Adjusted diluted EPS from continuing operations was \$3.10. Fourth quarter sales increased 8% to \$2.77 billion and organic growth was 7.1%, driven by solid growth in all of our customer end markets. Segment sales were strong at ISR and electronics, with each growing 14% and 11%, partially offset by Communications, which declined 3%. Encouragingly, for the Communication Systems segment, we do not expect the 2018 sales headwinds on UAVs to continue in 2019.

Fourth quarter segment operating margin increased 50 basis points to 10.9%. ISR Systems' margin increased 180 basis points to 10.4%, in line with our full year estimate. Electronics margin declined 20 basis points to 13.6%, due to lower profitability at Security & Detection Systems, primarily related to sales mix. And in Communications, margin decreased 100 basis points to 9.1% as a result of the TWT losses. Our fourth quarter tax rate of 6.3% was lower than expected, primarily because we completed 2 income tax audits with favorable outcomes and they reduced the 2018 tax rate to 10.4%. Free cash flow was very robust at \$664 million for the fourth quarter, resulting in full year free cash flow of \$935 million. During 2018, and specifically during the fourth quarter, we made progress in reducing our working capital days, and they declined by 2 to 78 from the end of 2017. And that was after a significant increase in aircraft deposits related to new aircraft recap and fleet expansion contracts in ISR Systems.

Now moving to our initial 2019 financial guidance, we expect sales of \$10.75 billion, growing 5% over 2018. We expect segment sales to grow 7% for ISR, 3% for Electronics, and 4% for Communications. As Chris mentioned, last year C-17 training systems contract loss is lowering the growth rate for Electronics by about 380 basis points. Communications is returning to growth in 2019, primarily due to a rebound in UAV production volume in both our enabled power systems and photonic masts for the Virginia class submarine.

We expect consolidated operating margin to increase 120 basis points to 12%, and combined with our sales growth, we expect operating income to grow 17% this year versus 2018. The 3 main drivers of our 2019 margin expansion are: first, 40 basis points from lower pension expense, primarily due to the soft freeze, which we implemented effective January 1; second, 40 basis points from a combination of L365 productivity and cost savings, including business integration actions, net of planned incremental growth investments; and third, another 40 basis points due to lower TWT losses. With respect to the TWT business, the division's 2019 plan has a modest profit, but in order to derisk this exposure, our guidance does not assume that it will be profitable for all of 2019. We estimate 2019 segment midpoint margins at 11.2% for ISR; 11.1% for Communications; and 14.4% for Electronics, with the segments expanding margin 110, 190 and 70 basis points, respectively, over 2018.

Below the operating income line, we estimate interest expense of \$155 million for the year and interest in other income of \$30 million. We are not providing EPS guidance given our impending merger with Harris. We expect to generate free cash flow of \$1.045 billion for 2019, increasing 12% over 2018, with a cash conversion rate of about 115%. Our cash balance was \$1.066 billion at December 31, and regarding capital allocation, we expect another modest increase in our cash dividend and no debt repayments for 2019. As you know, given the impending merger with Harris, we suspended share purchases until the merger is completed. Consequently we'll see some share creep in our diluted shares outstanding [per] the merger closing date.

Looking at the 2019 first quarter, we expect sales of about \$2.5 billion with growth between 5% and 6%, operating margin in the low 11% range expanding 50 to 70 basis points, and free cash flow of between minus \$50 million and slightly positive.

Finally, to conclude my financial review, we had solid growth in 2018 across all the financial performance metrics, except for operating margin, which was flat. L3 is growing at a healthy pace and becoming more efficient and productive. For 2019, we expect to grow orders, sales, operating income and cash flow and to also increase operating margin to 12%.

Thank you, and I'll now turn it back to Chris.

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### Christopher E. Kubasik - CEO & President

Thanks, Ralph. I started the year in Florida, meeting with Bill and working with the IMO, the Integration Management Office. Integration planning is going very well. Bill and I have been in constant contact over the last several months and have cultivated a strong working relationship. We have met with each other's direct reports and visited many of the key operating sites. As we learn more about each other and our businesses, we're finding that we have a lot in common. Bill and I have discussed our operating philosophy, and we are aligned on how we want to run the company. We want to build 1 unified L3-Harris culture, focused on working collaboratively to deliver mission-critical solutions to our customers at the right time, with the right technology, at the right price.

Finally, on the regulatory front, as many of you have heard on the Harris call this morning, everything is moving along as expected and we are working closely with all the government agencies on the review process. With the temporary resolution of the government shutdown, we continue to expect the merger to close midyear.

In closing, 2018 was a truly exciting year for the company, culminating in the announced merger with Harris. We believe L3-Harris is a unique transformational story, with our cost synergies and capital efficiency savings, driving significant value creation. It's a true merger of equals and we also view it as a merger of strength: two companies that are both on the upswing with rising sales, operating income and backlog coming together to leverage complementary technologies and greater scale. Gary, let's now open the line for questions.

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) The first question comes from Sheila Kahyaoglu with Jefferies.

### Sheila Karin Kahyaoglu - Jefferies LLC, Research Division - Equity Analyst

So Chris, you mentioned you're moving up the value chain in terms of some larger opportunities that you're pursuing. You announced a partnership with [Vera -- for Vera] in the quarter. Can you maybe talk about some of these opportunities? What this opportunity set looks like? And how it jives with Harris' more mission systems approach.

### Christopher E. Kubasik - CEO & President

Thank you, Sheila. I think we're aligned on being a mission solution prime, both individually and on a combined basis. During 2018, we had one major recompetes, which was the F-16 STP for training, which we were successful in winning. As we look forward in our portfolio of opportunities for the coming year or years, we have a lot of interest in our night vision equipment. There's numerous classified opportunities. We have C-130 AMP. We have the Canadian Surface Combatant, which you've heard me talk about in the past. We're actually on the Lockheed Martin team, and Lockheed Martin was actually selected and is in process of being -- negotiating with the customer, so that could be close to \$1 billion opportunity there in and of itself. Clearly, International ISR is of great interest. We're seeing a lot on commercial pilot training due to the shortages. The TSA has a backlog that it needs to relieve relative to the airport security and we're working closely with them on a next-generation checkpoint. And internationally, we have opportunities. Again, teams with Lockheed on the SEA 1000 and SEA 5000, similar to our CSC opportunity. So there's a handful of things that are near-term that we're excited about and, I think, aligned with our strategy as L3 and then the new strategy as a combined company going forward.

### Sheila Karin Kahyaoglu - Jefferies LLC, Research Division - Equity Analyst

And then, just on the revenue deceleration, how does that jive, you grew 7% in 2018, and you're forecasting 5% in 2019?



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### Christopher E. Kubasik - CEO & President

Yes. Go ahead, Ralph.

### Ralph G. D'Ambrosio - L3 Technologies, Inc. - Senior VP & CFO

Sheila, so the way that we positioned our guidance for sales for 2019 is similar to what we've done the last couple of years. And if you look at our experience in 2017 and in 2018, comparing our initial sales guidance to the final actual, in each of those 2 years, we did about \$300 million better in sales. So based upon the strong orders that we had in 2018, and our very healthy backlog, we have potential to perform in a similar fashion on the top line in 2019. So we'd like to think that our guidance is conservative on the top line.

### Christopher E. Kubasik - CEO & President

Yes. Thanks, Sheila, and that guidance that we gave is in fact, in all cases, better than what we had in the preliminary S-4 filing, so it's an increase relative to what we have previously disclosed.

### Operator

The next question comes from Robert Spingarn with Crédit Suisse.

### Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst

Just a couple things. Ralph, if we clean up the '18 margin and take out not only that TWT but anything else that's really nonrecurring, are you implying that, that would be about 11.2%? And then, the cost savings in '19 and the lower pension gets you to the 12%?

### Ralph G. D'Ambrosio - L3 Technologies, Inc. - Senior VP & CFO

Yes. So I said that if you look at our 2018 margins and take away or exclude the TWT losses, the consolidated margin would have been 11.5%. We're not assuming those losses go entirely away in 2019 because it makes sense to be conservative on that. But there are 3 elements that would drive the margin expansion. Chris touched upon it, and I also underscored them. We're going to have lower pension expense, which is 40 bps; the various L365 productivity and cost saving initiatives that we're undertaking, plus the business restructuring and integration actions we've taken in the last couple of years is going to generate another 40 bps, and that's after increasing IRAD this year to keep in line with what it was last year in terms of a sales percentage. And also, after making certain increases in employee compensation, which makes sense given the competitive environment for talent today. And then, lastly, as I said, we're definitely -- we're going to have -- we're going to do better in TWT in 2019, and hopefully, the way we've positioned the guidance turns out to be conservative in that regard.

### Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst

Okay. So on that note, I would ask you and Chris, are there any items in the 2019 plan that could go awry sort of the way the TWT did? And what are they? And really as part and parcel to that, why didn't you derisk this TWT thing back in Q3? Was it just not visible? It sounds like it already half of...



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### Christopher E. Kubasik - CEO & President

Yes, I'll take that one on, Rob. To answer your first question, we feel very confident in our 2019 guidance and our path to 12%. Hopefully, the explanation made sense, and I think we're being conservative by only assuming 40 basis points improvement relative to that \$74 million just on that one item for the TWT. Now we talked throughout the year about the risk and the problems we were having. Obviously, if we knew about it, we would have disclosed it. I talked about the personnel changes that we made, some of the leading indicators on deliveries and supply chain raised issues that we did a deep dive in the December time frame when we tried up the EACs based on the performance, the learning curves not coming down the learning curves at the rate we would've wanted to, the poor yields that referenced to the inventory and then the overall absorption problem by having lower sales than anticipated due to the inability to deliver the product, all kind of came down on us at once and resulted in the charges that we referenced. So obviously, disappointing. We knew the risk was there. And honestly, the amount of it ultimately was higher than we had expected, and we were disappointed in that. But more importantly, I think we've acknowledged it. We've taken a corrective action, and we're going to make sure it won't happen again in '19. And the other businesses seem to be performing well and risks are identified, opportunities are identified, and I'm highly confident in the '19 guidance.

### Robert Michael Spingarn - Crédit Suisse AG, Research Division - Aerospace and Defense Analyst

Okay. So what you're basically saying, you don't really have any yellows that could go red that you see right now?

### Christopher E. Kubasik - CEO & President

Well, we have 75 divisions, as you know, and 17 sectors, but I think we've got a great team, and we have the ability to identify risks and mitigate them, as we always have. So I think we'll be fine.

### Operator

The next question comes from Cai Von Rumohr with Cowen and Company.

### Cai Von Rumohr - Cowen and Company, LLC, Research Division - MD and Senior Research Analyst

So Chris, you guys won this enhanced night vision goggles, and you won the first contract, and the big one was supposed to come next and the key potential competitor was going to be Harris. What's the status of that program? And is that a potential impediment? How do you deal with the fact that you're the 2 leaders for that one competition?

### Christopher E. Kubasik - CEO & President

Yes. Your memory is correct on the enhanced night vision goggles. We were awarded that contract for just over 13,000 units. It contributed maybe about \$10 million of revenue this year, and ramps up just under \$119 million and then over \$100 million in the subsequent years for a total of \$391 million by the end of 2021. There will be additional competitions, as you mentioned, for up to 90,000 for the Army and 25,000 for the Marines. We feel very comfortable with what our position is. Everything is tracking relative to the development and production so far. And I think, earlier this morning, if you were listening, if you didn't, Bill Brown on Harris mentioned that they're exploring potential divestiture of their night vision business. There will be other competitors, I'm sure. Two or 3 other companies come to mind. Not sure I'm going to name them, but there are at least 4 people that I think are very interested in this opportunity, and I expect a good competition, and I'm confident in our team and our approach.

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**Cai Von Rumohr** - Cowen and Company, LLC, Research Division - MD and Senior Research Analyst

Got it. And then, the Traveling Wave Tubes, you moved from Northern California to Southern California. Is part of the problem that maybe you had some skilled folks up in the prior location that didn't come back? And so is the ability to get enough people with the correct skills, is that part of the issue? And is that behind you?

**Christopher E. Kubasik - CEO & President**

Yes, that was absolutely part of the issue. We've been able to hire additional people. The training took longer than expected, and the ability to build these TWT is very -- a little bit more art than science, so there was some ramp-up. I believe we have that behind us. This whole situation goes back several years, maybe 5 or 6 years, where everybody anticipated the commercial space market was going to be a high growth market. I think we all thought that. There was inventory bought in advance, as I mentioned. There were long-term supply agreements signed with aggressive learning curves. The market never materialized and then we decided to shut down and consolidate these 2 businesses, which I still believe is, in hindsight, the absolute right decision. There were 3 things that -- I have a list of about 30 lessons learned that our team and I have agreed we will keep in our forefront as we move forward. But the 3 large ones, in my opinion, was the simultaneous decision by the sector to put in a new ERP and business system with the move. I think that was clearly a mistake, and in hindsight, we should have moved before we put in the system or vice versa. And then, we had a very aggressive schedule. We were quite excited that we were offered over \$60 million for the land and building, which I'll admit, I looked at as a way to fund the restructuring or the move. The downside was we had to get out by December of '17, and I think the second lesson would have been maybe if we took a little more time planning and thinking through every aspect, but maybe the cash enticed us to go faster than we should have in hindsight, and probably should have had some outside expertise. I think our team did a good job laying out the plan, but given the complexity of the move and the fact that it was really one of our first major integrations at L3, I probably would have got outside help. So the culmination of those 3 things over the last 5 to 6 years hit us. But you've got to have the people and the talent, and I think as we all know, Northern California and Southern California might as well be 2 different states when it comes to moving and living. So those are my thoughts. I don't know, Ralph, anything you want to add?

**Ralph G. D'Ambrosio** - L3 Technologies, Inc. - Senior VP & CFO

I think you covered it all, Chris.

**Operator**

The next question comes from Jon Raviv with Citi.

**Jonathan Phaff Raviv** - Citigroup Inc, Research Division - VP

Kind of bigger picture than TWT but also somewhat related, Chris. How does integration either hamper or perhaps help or accelerate the opportunities to not only fix TWT but to drive some of the other efficiencies that you're trying to get out of the rest of your 70-plus segments?

**Christopher E. Kubasik - CEO & President**

Jon, a great question, and I think this really goes back to a year ago when I started having this conversation when I took over with all of you, and of course, internally, we started the discussion more in the latter half of 2017. And it really revolves, in my opinion, around the operating model, and we've been characterized and I believe more of a holding company operating model, and that's just not at the corporate level but even at the segment and to a lesser degree, the sectors. And I've talked about the last 13 months, the need to transform into an operating company. And when I first met with Bill in early '18, we talked a lot about the journey he had taken Harris on and the challenges and the opportunities that they went through 6, 7 years ago as they started their journey to transition from a holding company to an operating company. And as I look at the results, they're quite impressive, and that's what's been exciting, I think, for both of us, as we look at the potential for the new company. So I look at it as

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truly a great opportunity. I mean, I've talked about the employee surveys that we've done and the desire by the workforce to be more integrated and understand the greater capabilities of L3. We're looking at some of these wins that we've been getting when we work together collaboratively. They're larger, they're prime positions, they're much more exciting. So it was a multiple step process, as I tried to lay out in my prepared comments. First and foremost, getting everything aligned based on capabilities and technologies, we've never done that, and that brings a lot of synergies, both on the top line and the bottom line. So I view it as an opportunity. I think the IMO is doing a great job, about 50 people combined down there every week, Bill and I have weekly calls. I see the decisions that are being recommended and made. Really excited about the day 1 opportunity and the potential. I can go on much longer with the answer if you like, but I view it as a huge opportunity.

**Jonathan Phaff Raviv** - Citigroup Inc, Research Division - VP

Got it. That's very helpful, Chris. And just as a follow-up, the cash flow weakness we saw in 3Q, how much of that, or has all of that been recovered? I believe it was some NVG delivery delays and bizjet purchases.

**Christopher E. Kubasik** - CEO & President

I think we had a great fourth quarter. I'm not sure I want to -- [like] over \$600 million in each of the quarters, but that was a very stressful fourth quarter. But a lot of that caught up and with \$935 million for the year, I think we're in good shape and we're optimistic to have over \$1 billion of free cash flow for 2019 for the first time in a long time. So quite exciting.

**Operator**

The next question comes from David Strauss with Barclays.

**David Egon Strauss** - Barclays Bank PLC, Research Division - Research Analyst

I wanted to actually follow up on that point, Chris. I think, at the beginning of the year, you were looking at working capital being like a \$60 million drag for the year, and it ended up being something like \$180 million for the year. So can you maybe just -- I know it improved in the fourth quarter, but maybe go into a little bit more detail on why the working capital drag was much larger than what you anticipated at the beginning of the year and kind of how that plays out in 2019?

**Ralph G. D'Ambrosio** - L3 Technologies, Inc. - Senior VP & CFO

David, it's Ralph. I'll take that question. So it's a few items. Number one, we grew -- we ended up growing our sales by about \$300 million more than we initially planned and guided for. So there's a significant amount of working capital related to those additional \$300 million in sales. Part of it included the new work that we won in ISR Systems on aircraft recap and fleet expansion on a variety of ISR aircraft. And as I said earlier, and Chris discussed it previously, we need to go out and procure green aircraft, and then, that we subsequently missionize and ultimately sustain for our customers. So our working capital included about \$60 million of net investment in 2018 that was not in the original plan for those aircraft deposits. And then, additionally, we talked about some of night vision sales into the Middle East being delayed. Consequently, we had to carry some more inventory and receivables on those which slipped into 2019. And then, when we refinancing of our debt in May, the timing of the interest payments on the old debt and the new debt worked out such that we ended up paying about \$20 million more of interest in 2018 than was originally planned. So those are the major drivers. That said, we still made some marked improvement in our working capital. I said it was 2 days after those items, and we expect to make some additional days improvements in 2019, which are embedded in our free cash flow guidance.

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### Christopher E. Kubasik - CEO & President

Yes, and David, as we negotiate some of these international opportunities, there's always a tradeoff, as you would expect, on all the variables in the contract, from the cash flows, to the profitability, to the schedule. And I think, going forward, we're going to have a little more focus on working capital and cash. I think you know the synergies and the opportunity that we've laid out of \$3 billion on the new company in 3 years, a very conservative, take out of 6 to 7 days, \$35 million a day, contributing to our working capital improvement. And in all honesty, late last year in '17, early '18, we spent a lot of time with the board talking about our strategy and what we wanted to do, and I alluded to the fact that we changed our incentive to focus on organic growth in addition to cash and earnings, and I'm pretty confident you get what you measure and you measure what you pay people for. So the decision there was to get to organic growth, given the fact we have divested over \$1.5 billion of our revenue, and we have declined from a peak of \$16 billion down to the \$9 billion. So to seize these opportunities to change this, renew the focus and I'm sure it's something Bill and I will be talking about and laying out for the new company. But good question, and hopefully that explained the roll-forward.

### David Egon Strauss - Barclays Bank PLC, Research Division - Research Analyst

That's great. I also wanted to ask you about -- so you commented that the revenue guidance for this year is a little bit better than what you had in S-4. Could you just talk about the forecast in the S-4 beyond 2019? It looks like about 5% revenue growth and margins eventually getting up to that 13% level, but I think a little further out than what most of us had anticipated.

### Christopher E. Kubasik - CEO & President

Yes, I mean, it's a 5-year plan. We did have -- we had 6% growth for '19 and they go on to 5% thereafter, but we overachieved in '18, so we level lined it at 5%, which is mid-single digits, I think, is achievable. We do have the operating margins ramping up, as you said, from 12% in '19, I think we have about 30 basis points each and every year and then capping out at 13% in 2023 per the S-4. Clearly, what we'll be doing better than that is our goal and our objective. Clearly, with the merger, we've talked about the obvious objectives for the new company. A lot of this does include -- these are net of the investments you need to make to realize a lot of these savings, and that's the exciting part about the merger. I mean Ralph was going down the trail of putting in our shared service organization in late '18, early '19, it would have been a \$30 million investment. In a simple example here, to put in the financial shared service with a \$30 million payback in year 2 or 3. So you have those types of pressures that cause the margins not to be as quick as you would like, but that was our 5-year plan. I think it was conservative, but that's what we're sticking with for now, and I think the new company will do much better on a combined basis, especially with the \$500 million of cost synergies we've talked about publicly and are highly confident in achieving.

### Operator

The next question comes from Carter Copeland with Melius Research.

### Carter Copeland - Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense

Chris, I wonder if I could just get really specific as they were a couple of qualifiers in the language on the TWT on largely nonrecurring corrective actions and returning to normal yields. I just sort of -- as I listened to the description when you talked about improving the technical documentation and yields and whatnot, it sounds like the -- post move, whatever it was that moved, you just couldn't manufacture it the way you could before. And so, I guess, to be specific, have you guys identified the root cause of what was driving that? And how do you prevent something particular like that happening again, as you think about future integration activities and consolidation efforts? I just -- I wonder if you could be specific about what it was that you discovered?

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### Christopher E. Kubasik - CEO & President

Yes, I think that's a great question. And yes, we think we have identified it. We have the documentation in San Carlos. We videotaped the people doing the assembly. We used that to train the new people. I have the utmost confidence that the training of both how to use the new system, and I think it was as much a system problem as it was a manufacturing problem. And if you can't get timely, accurate data out of your ERP system, which we weren't able to do, it drives all sorts of production problems. You're not getting signals that you need to go ahead and order material from your supply chain if your system is not appropriately updated and the data is not clean. So a lot of what we were looking at relative to the production problems was not having the material on hand because it wasn't ordered, because the system didn't tell you that you needed it, those things are being worked and have been identified and we have workarounds as we're going ahead in continuing to automate that process. I mean, relative to future opportunities to go ahead and consolidate and integrate, we have teams looking at that. I think there's huge opportunities, in my opinion, to how we can do that. I mean, today, in the course of the last year, we reduced 6 sites organically, just within L3. But that's out of 256 leased facilities. I mean, we have 256 leased facilities totaling 12.6 million square feet. So we're down 100,000 square feet compared to a year ago. We only own 29 facilities, which is still a fair amount, at just under 5 million square feet, and we're down 300,000 square feet. Truth is, there's probably no more complicated business process, tooling to move than Traveling Wave Tube line, and fortunately, that was the first one we bit off. And as I tried to lay out in the prior question, it was pretty much a perfect storm relative to all the things that could have gone wrong. And we have 12 key metrics that we're measuring each and every day, getting updates every 2 weeks, these deal with assembly yields, testing results. And just through the month of January, we've started to see some improvements. So I hope that's a little more specificity, but...

### Carter Copeland - Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense

No, I appreciate it. And does the -- I mean, you're driving ERP commonality across a lot of different places, does that drive a feedback loop to make sure that doesn't introduce any challenge elsewhere?

### Christopher E. Kubasik - CEO & President

Yes. That -- in my already long answer about transforming from a holding company to an operating company, there's several aspects to it. One of it is the centralization of IT, and that was something we took on in '18 and we were able to migrate everybody by the end of the year, reporting to our CIO, all several hundred of our IT execs and support staff. So we now have the ability to do centers of excellence and have experts in the different applications and software. We have a corporate-wide strategy on when to invest and how to migrate to have great security, to have more common systems, and then to allow and work collaboratively to do these implementations. Historically, these were done in isolation, and that was the model. Had we been more of an operating company, more centralized, more functionalized is the word I use, these things have a greater chance of success. So we have way too many ERP systems, closer to 90, than we would want to admit, but that's something that the IMO is always looking at and figuring out a migration plan, how best to optimize our systems and get the value that we can get out of this merger.

### Operator

The next question comes from Peter Arment with Baird.

### Peter J. Arment - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Chris, maybe you could just give us an update on it sounds like things are tracking very well with the Harris merger, but what are the next steps or the next milestones regarding any regulatory or customer approvals that we need to hear?

### Christopher E. Kubasik - CEO & President

Yes. Peter, things are going really well. I mean, even maybe better than expected. I mean, the milestones that will get visibility to the outside world, there probably really aren't many, other than maybe the S-4, right? The S-4 will be reviewed, approved and go effective. That will allow us to

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schedule the shareholder meetings. So you'll see that happen probably in the months ahead. The HSR DOJ approval, the long pole in the tent, we had the second request January 10, which we publicly disclosed, that process now with the government's open, will continue to gain momentum. The international approvals, we don't see any issues there. We're having discussions both with the EU and the U.K., depending on the Brexit scenario. And we remain confident in the middle of 2019. So I think the S-4 going effective will be something everybody will see. Behind the scenes, like I said, we have the 50 people who I couldn't be more proud of, of both teams just working incredibly hard, and coming up with the best of the best. Like I said, we call it a merger of strength. We don't care if it's legacy Harris, legacy L3, we want to build a great company. Bill and I are completely aligned on that, best systems, best people, best process. And the moment this deal closes, we're going to have 1 company, we're going to have 1 board, we're going to have 1 management team. And I think that's going to really put us in position to create a lot of value for our shareholders and our customers both, so I can't wait until we get to that point, but several months off, obviously.

**Peter J. Arment** - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

And if I could just squeeze in a quick one on. And could you just give us a little bit color on any kind of book-to-bill expectations by segments for the year? I know you had a really strong year with \$11.6 billion for 2018. What are your expectations around some of the order flows for the business?

**Christopher E. Kubasik - CEO & President**

Yes. Thank you. And Ralph, you want to throw out some numbers here?

**Ralph G. D'Ambrosio** - L3 Technologies, Inc. - Senior VP & CFO

Sure. We're expecting a positive book-to-bill-ratio for all 3 segments. And on a consolidated basis, we expect the book-to-bill ratio to be in the high single-digit range and close to that in every segment. So another year of strong bookings is what we expect in 2019.

**Christopher E. Kubasik - CEO & President**

Yes. As I was looking at the CRM system the other day and I mentioned our long-term or our 3-year orders outlook, it is over a period of time, but that would suggest a 10% CAGR in the quarters based on what the team presented for that 3-year plan. Obviously, these programs need to continue. We have to win them and such. And we have a pipeline with a number so big. I'm reluctant to say it, so I won't. But I feel good about the progress we've made on the business development front. And clearly, to support this type of mid-single-digit growth going forward, the book-to-bill will be well above 1 and arguably close to the 1.10.

**Operator**

And the last question will come from Seth Seifman with JPMorgan.

**Seth Michael Seifman** - JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst

Just one quick one. You pointed out, and we can see in the results, the strong results in ISR Systems. And you've talked about the aircraft that you're purchasing there. I mean, a slowdown in that business has kind of weighed on the ISR Systems for a while. Where do you see the demand coming back? Is it broad-based? Is it concentrated in specific geographies? And kind of how durable do you think it is? Are we at the beginning of a cycle of ISR upgrades that can fuel growth longer term?

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### Christopher E. Kubasik - CEO & President

Yes. Well, Seth, a great, great question. Clearly, we believe it's broad-based. I think part of our success is the fact that we're platform-agnostic. I think we do a great job listening to our customer. They've been migrating to more business jets. Internationally, I think there's some absolute great opportunities. In fact, we've had some wins abroad. We generally don't disclose the countries, but there are tens of aircraft in the ISR fund going forward. We talked historically about Compass Call that has a potential for 10 aircraft. I think they have 3 in backlog already. And even the Missile Defense Agency with their HALO aircraft, are opportunities. So you look at the threat, you look at the national security strategy, and globally, there is a need for ISR. Otherwise, the mission doesn't really work. So I'd say we're in a good position, maybe in the beginning of a long up cycle. And the team's performing well. And the combination of aero and ISR is really paying off, even more quickly than I had anticipated. So I think it was a good move. All right. So yes, thank you.

So let me just wrap up, and obviously, thank you all for joining the call today. It's a little later than we normally do it, but Bill and I thought it was important that we both go on the same day so you can hear us and see our results. And again, to my team and then to Bill's team, could not be more proud of the working relationship and the progress that we're making, and look forward to speaking to everybody again in April after our first quarter. Have a great day. Thank you.

### Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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