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HRS - Q3 2016 Harris Corp Earnings Call

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OVERVIEW:

Co. reported 3Q16 revenue of $1.91b and EPS of $1.45. Expects FY16 revenue on organic basis to be down about 7% and non-GAAP EPS to be approx. $5.70.

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PRESENTATION

Operator

Welcome to the Harris Corp's third-quarter 2016 earnings conference call.

(Operator Instructions)

I would now like to introduce your first speaker for today, Pamela Padgett, Vice President of Investor Relations. You have the floor.

Pamela Padgett - *Harris Corporation - VP of IR*

Good morning, everyone, and welcome to our third-quarter FY16 earnings call. I am Pamela Padgett and on the call today and is Bill Brown, Chairman & CEO; and Rahul Ghai, Senior Vice President and Chief Financial Officer. And first, before we get started, a few words on forward-looking statements.

Forward-looking statements made today involve assumptions, risks and uncertainties that could cause actual results to differ materially from those statements. For more information and a related discussion, please see the press release, the presentation and Harris' SEC filings.

In addition, a reconciliation of non-GAAP financial measures discussed today to comparable GAAP measures is included on the Investor Relations section of our website, which is www.harris.com, where a replay of this call will also available. And with that, Bill, I will turn it over to you.

Bill Brown - *Harris Corporation - Chairman and CEO*

Okay. Well, thank you, Pam and good morning everybody. Third quarter results were solid, with operational earnings benefiting from the continuing ramp in synergy savings. Total Company orders and revenue were sequentially higher and book-to-bill was a very strong 1.12, driven by Space and Intelligence Systems, Electronic Systems, and Critical Networks.

We delivered good bottom-line results despite the impact of lower tactical radio revenue from the Middle East, demonstrating that the added scale of the Exelis acquisition has broadened our business and is contributing to improved operating resiliency. Looking to the full year, and the now slower pace in the Middle East, together with a DoD tactical radio opportunity that has slipped into next year, we are adjusting our FY16 earnings per share guidance to about $5.70, the bottom end of the prior range on revenue of about $7.5 billion.

Rahul will provide more color in a minute but the only segment that's changing this Communication Systems where we're now expecting legacy tactical revenue to be down high single digits, with similar declines in both international and DoD. So let me start with a little color on what's driving the change. We started the year anticipating Harris legacy international, a flat to down even though we were coming off several years of strong expansion in international, including a record FY15.

But at the time, we had started to see some opportunities in the Middle East market stretch out a bit. The first half of the year played out about as we thought, with international revenue up 5%, including higher revenue from the Middle East as a result of strong FMS funding support. And while we were expecting a year-over-year back half decline in the Middle East, we anticipated sequential revenue growth.

But the combination of fiscal pressures and funding priorities, both in country and with the US government, as well as a slow FMS approval process, have shifted opportunities to the right. We believe the slow pace in the Middle East is temporary. Security issues and the need for more capable Tactical Communications are unchanged and the FMS funding support remains strong for the region, with additional money earmarked in the GFY17 President's Budget Request.

In the US Tactical market, while our book-to-bill was above 1 in the quarter, MUOS upgrade opportunities expected in FY16 are now unlikely to begin before the end of the year. While the MUOS capability is design into our new two-channel Manpack for the US Army. We've also adapted the Waveform so that it could be easily ported through a simple download into our 117G radios, 30,000 of which are currently fielded in DoD inventory.

We've demonstrated connectivity between our radio and the satellite. We are on track to receive NSA certification shortly and customers across several services are anxious to benefit from the mobility and higher bandwidth that the MUOS Constellation provides. This is a very real and compelling value proposition for our customers and funding for this opportunity has been earmarked in GFY16.

We anticipate this funding converting to an order for Harris before the end of September. So while FY16 is a bit softer than expected in Tactical Communications, our outlook is solid and our competitive position has never been stronger.

In the DoD, we've won or have a position on every major tactical radio contract awarded in the last five years. The mid-tier radio, MNVR won in 2013; the Rifleman Radio won last year; the SOCOM Two-Channel Handheld won earlier this year; and most recently, the very large HMS Manpack awarded in February.

These are all significant wins for Harris so let me update you on the latest developments. After more than four years of tenacious effort, the Army awarded Harris a 10-year, $12.7 billion IDIQ contract for the multi-channel Manpack radio, opening a market for Harris, which had previously been closed to competition.

Qualification and customer tests are starting soon and scheduled to wrap up by the end of our FY17 with the initial production delivery order award currently scheduled in early FY18. The $3.7 billion Rifleman Radio procurement is also progressing well. We've now completed both qualification and customer tests, receiving positive feedback on operational capabilities such as range and battery life.

And initial production delivery orders is expected in the second half of FY17. SOCOM's modernization is also moving forward and a protest of Harris' single award for the $390 million two-channel handheld radio program was recently resolved in our favor and work has begun. Product deliveries begin in the first half of FY18.

This radio features both communications and ISR capabilities and since SOCOM, has long been early adopter of cutting-edge technology that eventually find its way into the broader DoD and international militaries, it positions us well to compete on a number of other modernization programs.

The handheld is part of a broader modernization program that SOCOM is said could reach $900 million and include a new Manpack and a HF radio. The Manpack RFP is expected late this summer and contract award before the end of FY17 with the HF Radio following sometime thereafter.

On the international front, the pipeline remains about $2.9 billion and is diverse in terms of regions, countries and customers within a country. And while the near term velocity has slowed a bit in the Middle East, continued progress is being made elsewhere. In the last earnings call, we mentioned that a $600 million opportunity for Australia's phase 3 modernization had moved into the pipeline with an award expected by the end of FY17.

We've now been selected as the preferred supplier with a significantly broader scope, where Harris will now prime to deliver an integrated solution. This is a key part of our long-term growth strategy in international to expand our addressable market, leverage capabilities from across Harris and evolve from a radio supplier to now providing entire systems.

Turning to a few highlights in other areas of the Company, both Space and Intel, and Electronic Systems had strong orders, higher sequential and year-over-year organic revenue and book-to-bill greater than 1. Approximately 70% of Exelis' legacy business reside in these two segments and contributed to the positive sales and orders trend.

In Space and Intel, awards from classified customers totaled $329 million, with continued strong budget support for intelligence programs and the ongoing customer focus on space superiority and protection capabilities. On the commercial space side, there are signs of a recapitalization cycle and fleet expansions beginning and we recently received a $37 million order to provide an 18-meter unfurlable antenna reflector for the JCSAT-17 geostationary communications satellite. The prospects in our space antenna business are stronger today than they have been in the last decade.

Within Electronic Systems, we enjoyed another quarter of strong electronic warfare bookings including $88 million to supply electronic jammers for the F-18 aircraft, an excellent example of modernization opportunities on existing platforms with a very long tail. Electronic warfare is now on track in FY16 to double orders over the prior year and end the year with about $200 million higher backlog.

Strong free cash flow generation and deleveraging remain top priorities for Harris and at the end of the third quarter, year-to-date free cash flow stood at $425 million, supporting expectations for the year of $750 million. On April 8, we completed the sale of Aerostructures and used the cash proceeds to pay down debt. So less than a year after closing the Exelis acquisition, we've repaid $683 million of term loan debt, which is approximately one-third of the total debt we've committed to repaying over three years.

So now before turning the call over to Rahul Ghai, our new Chief Financial Officer, to cover the detailed financial results and guidance, I want to provide a brief introduction. As we already know, Rahul joined Harris in March of 2015 to lead the Finance Integration Team, and was named CFO in early February. By leading the Finance Integration Team over the last year, Rahul has been essential to our integration success and has provided a smooth and natural transition to CFO.

Rahul and I worked closely together for 5 of his 12 years at United Technologies and again over the past year, as we've integrated Exelis. I'm confident in Rahul's ability to lead the Harris finance organization and be a true business partner to me and to the rest of the Management team. So Rahul?

Rahul Ghai - *Harris Corporation - SVP and CFO*

Thank you, Bill, and good morning, everyone.

Before starting, I would like to remind you that our discussions today are on a non-GAAP basis. Now turning to third-quarter results and slide 3 in the presentation. EPS was $1.45, with acquisition savings supporting operating performance and benefiting from a lower-than-expected tax rate in the quarter.

Reported revenue was $1.91 billion compared to $1.19 billion in the prior year. On an organic basis, revenue was down 3%. Strong revenue growth in Space and Intelligence Systems and Electronic Systems was more than offset by lower revenue in IT services and International Tactical and both legacy Harris and Exelis. Sequentially, revenue was up 3.6% with higher revenue across three of our four segments, with the exception of Communication Systems, where revenue was less than 1 point lower than revenue in the second quarter.

EBIT margin for the Company headed strong at 16.4%, driven by excellent margin performance across all segments and reflecting continued focus on driving integration savings and lowering costs across the Company. Orders in the quarter were $2.1 billion, bringing year-to-date book-to-bill to 1.06 for the Company and was greater than 1 in each segment in the third quarter with the exception of Communication Systems.

Within Communication Systems, third quarter book-to-bill for Tactical Communications was 0.8 with legacy Harris business at 0.83. And in the supplemental pages of the presentation, we have included historical order and backlog detail for legacy Harris Tactical business. Public Safety book-to-bill was a bit disappointing at 0.5 and reflects that while the business is slowly improving, with revenue up 15% of the quarter, we're not beyond the choppiness.

In Space and Intelligence, orders trend continued in the classified area. In the Electronic Systems, orders were strong in electronic warfare and also in avionics, we already received $121 million and follow-on contracts for the F-35.

In Critical Networks, FAA funding was a significant driver and both CapRock Energy and Maritime reported book-to-bill of more than 1. For Harris overall, awards on track to achieve a book-to-bill of 1 or close to 1 for the year.

So turning to segment detail on slide 4 and comparisons to prior-year pro forma results, as Exelis and Harris were combined for all of FY15. Communication Systems third-quarter revenue was $485 million, and down 10%. Tactical Communications revenue was down 16% and Public Safety was up 15% compared to the prior year.

Higher tactical revenue in Europe and Central Asia was more than offset by lower revenue in Middle East for both Harris and Exelis legacy businesses and completion of Australia's phase 2 modernization programs. Operating income was $154 million and operating margin was a strong 31.8%.

Turning to Space and Intelligent System on slide 5. Third-quarter revenue was $489 million and up 7% compared to prior year, driven by higher revenue from a number of new classified programs including programs in Space Superiority. Operating income in the third quarter was $76 million and operating margin was 15.5%.

Following the close of the quarter, Harris was awarded $81 million in follow-on contracts, with $26 million order to sustain ground-based systems that support US missile warning, missile defense and space surveillance missions from the Air Force for the SENSOR Program.

Turning to Electronic Systems on slide 6. Third-quarter revenue was $393 million and up 6.2% compared to prior year. Higher revenue from the F-35 program and counter IED systems was partially offset by lower revenue from Commercial Broadband Satellite Program terminals. Operating income in the third quarter was $75 million and operating margin was excellent at 19.1%.

Just following the close of the quarter, we completed the sale of Aerostructures, which was part of the Exelis acquisition and reported within Electronic Systems. While not material to Harris we have included historical financial information of Aerostructures for FY15 and FY16 in the supplemental section of the presentation.

Turning to Critical Networks on slide 7. Third-quarter revenue was $551 million and down 10% compared to prior-year. Higher revenue from FAA's NextGen modernization programs was more than offset by lower revenue in IT services from the wind-down of two major programs and lower revenue in CapRock's energy market. Operating income in the third quarter was $59 million and operating margin was 10.7%.

So moving to slides 8 and 9. Total Company revenue guidance on an organic basis is revised from down 5% to 6% to down about 7%, driven by lower revenue in Communication Systems.

The impact of lower revenue is expected to be partially offset by cost savings across the Company and lower taxes. As a result, non-GAAP EPS is now expected to be approximately $5.70, the lower end of the previous guidance range.

In Communication Systems, we now expect revenue to be down between 8% to 9%, with Harris legacy tactical down high single digits. With lower volume for the year, operating margins is expected to be about 29.5%(corrected by company after the call) in the segment, which is at the lower end of the previous range.

In Electronic Systems, expectations remain unchanged with the exception of removing Aerostructures for the remainder of the year. With Aerostructures removed, revenue is revised to a range of down 3% to 4% and is in accordance with the previous organic expectations of down 2% to 3%. Operating margin is unchanged at 18% to 19%.

And in Space and Intelligence and Critical Networks, expectations remained unchanged. The expected tax rate for FY16 has been revised from 32.5% to 31% due to international tax settlements for prior years and from integration steps that have lowered state taxes.

Beyond FY16, we expect to benefit from lower state taxes and now permanent R&D tax credit. So let me turn it back to Bill for a few closing comments.

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, thank you, Rahul. A little less than a year ago, we closed on Exelis, a truly transformational acquisition for our Company. We're executing well on the integration and our results are benefiting from synergy capture. From day one of integration, we've been tracking a little ahead of schedule in reaching integration targets which is a great achievement from the team.

So as we maneuver through pockets of revenue softness, it's evident that the added scale of the Exelis acquisition has broadened our business and is contributing to improved operating resiliency. With less than a year into the acquisition, achieving our current expectation of about 11% earnings growth is a good outcome.

Looking ahead, we expect FY16's rising trend in earnings to continue until FY17, supported by higher synergy savings and other cost reduction acquisitions. In the meantime, we will continue to gain traction in our multi-year strategy to successfully integrate Exelis, lower costs and deliver accretion, shape our business portfolio, drive strong free cash flow and deleverage, all while still investing in technology and new product development to drive future growth.

And with that, I would like to ask the operator to open the lines for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Pete Skibitski, Drexel Hamilton.

Pete Skibitski - *Drexel Hamilton - Analyst*

Bill, on the Australia contract, it seems like one of the largest radio contracts you guys have won, as far as I remember. Is that through the protest period, I guess number one? And number two, how much of a growth driver can that be for you in FY17?

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, first off, we've been named the preferred supplier but haven't won the award yet. We expect the contract award to occur sometime late in our FY17 which means revenue from that opportunity extends into and begins in FY18 so it's still on the horizon.

We are very well positioned been officially notified by the Australian MoD that we're the preferred supplier is a very, very important step in the contract negotiation phase but we do expect that award to happen sometime in the late of our FY17. It's very big and we're very pleased with our progress there and again, it's a key part of our long-term strategy to grow from a radio supplier to now a systems supplier. We've talked about that for the last few years.

Pete Skibitski - *Drexel Hamilton - Analyst*

That's great. Is it fair to say that $2.9 billion international pipeline still includes Australia in it?

Bill Brown - *Harris Corporation - Chairman and CEO*

Yes, it does.

Pete Skibitski - *Drexel Hamilton - Analyst*

Okay, and just the last one. I know we're still a quarter out but directionally, in FY17, can you give us a sense of your outlook for communication, just given its importance?

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, the -- first of all, we're not going to provide today any guidance. We're not -- that -- we'll come to that in early August but I think when you talk about communications, you sound -- your question seems more directed towards the tactical side which, as we know, has been more of the important earnings driver. So we're not going to provide some guidance today.

But there's several things that are on our radar screen that we'd like to see happen in the near term that will help to shape some of the guidance we'll provide in early August. On the DoD side, both MUOS and the MNVR radio, the mid-tier radio, will together contribute to higher earnings, higher revenue in FY17.

MUOS, which did slip out of the quarters, we expect to receive certifications on that this summer. That is a certification. We've already demonstrated on-air performance for both voice and data. It's well supported; funds are allocated. And it's a very strong and compelling business case and we're very confident that, that's going to happen over the next several months.

On the mid-tier side, on the MNVR, that will be in the tens of millions of dollars. It's well supported in the President's Budget Request, as well as in the NDAA that just came out. The network assessment is going on as we speak. And we expect a production award towards the end of the government FY16, so around the September timeframe.

I think on the international side, which has become a bigger part of our business and it's a very large pipeline, we're looking at what's occurring in Eastern Europe and the Ukraine where we've been very, very strong in FY16. We need that to continue. We need to see the opportunities that we've seen very, very well in Iraq in FY16.

We expect that to continue at the same level as we see in 2016 and again, opportunities in Iraq, to us, as we speak today, seem to be well-supported. One of the opportunities in international that slipped out of FY16 into 2017 is in Iraq, but it's well-funded. We think that, that's going to happen in

2017. There's another country in the Middle East we can't name, where an opportunity did slip out and we expect that will happen in early 2017 as well.

And then finally, in Central Asia, meaning specifically, Afghanistan, we've had a very strong year this year. Opportunities there seem well-supported. We do expect Afghanistan and more broadly, Central Asia to be a strong contributor to revenue into next year.

Now outside of Tactical Communications, we have a broader -- outside of legacy tactical, we have a broader communications business including Exelis, the radio business from Exelis, which is mostly international. We've been tracking an opportunity in Saudi Arabia for quite some time. It's about $40 million, $50 million in size; it's for SINCGARS radios for vehicles. It's been hung up in the Saudi Royal Court for a number of months and we need that to break free as we get into 2017 as well. So maybe, Pete, just a little bit of shape and color around what we expect to going into next year.

Pete Skibitski - *Drexel Hamilton - Analyst*

Yes, I appreciate it very much. Thank you.

Operator

Gautam Khanna, Cowen and Company

Gautam Khanna - *Cowen and Company - Analyst*

So, to follow up on Pete's question, when we look at the absolute level of backlog at legacy Tactical, $419 million; it's a pretty low level. Obviously, that captures domestic and foreign. Why should we not be concerned about another down year in FY17 at tactical [Rav4]? Or are you willing to say directionally, it's going to be flat, up, down? What's your sense? Because a lot of what you talked about look like FY18 sales opportunities. How do we -- (multiple speakers)

Bill Brown - *Harris Corporation - Chairman and CEO*

Mostly, what I had talked (multiple speakers) -- yes, we won't -- we're not going to comment yet on 2017 in the shape up, down, flat at this point. We provided some additional information on the backlog in the document. I know some of the math that's some of the analysts have done on funded backlog. Where we're at to date, it is -- it's low; it's lowest it's been in some time.

As we look out over the next 12 months and how much is covered in backlog, it's not all that different from where we were about a year ago. But we do see a number of things that are materializing, both in the DoD as well as in the international side. Much of which we do expect over the course of next year and it's good to see a lot of the international opportunities backstopped by strong funding support within the US DoD and State Department funds.

Gautam Khanna - *Cowen and Company - Analyst*

Can you give us any color on the upcoming quarters? Do you expect to book-to-bill to be -- you are implying about $300 million of legacy Tactical or revenue in Q4. Do you anticipate that bookings will exceed that or come in below that? And how is it shaping in fiscal Q1? You mentioned MNVR might actually get an award in the September quarter. Are there any other items you can point to, to help us kind of calibrate to what we should expect in the next couple of quarters?

Bill Brown - *Harris Corporation - Chairman and CEO*

Gautam, over the course of the -- of Q4, we expect to end the year with funded backlog in Tactical, in line with Q3 or slightly up. So we do expect to see some decent awards in Q4 about that the level of revenue so we don't see another step-down in backlog at this point, but in line with where we're happen -- where we are in Q3. We're not anticipating or providing any guidance on Q1 in 2017 although we are watching very carefully the network assessment. The funding for MNVR is in the 2016 budget.

There is money allocated in the 2017 PBR; it seems to be protected in the NDAA that came out of HASC at about $20 million, $25 million. And we do anticipate a production award occurring in the September timeframe. That could drive revenue beyond that. It may not be in Q1 but we do think that, that's going to end up occurring as we get into 2017.

Gautam Khanna - *Cowen and Company - Analyst*

Okay, and last two, sorry. Australia is at still $600 million with the expanded scope in the pipeline?

Bill Brown - *Harris Corporation - Chairman and CEO*

Yes, the scope of our work hasn't changed from what we've been communicating before. And this has been in those discussions with the Australian MoD for several years. We've got a very strong group of partners with us. We have a very well-defined scope providing a broader system with radios and it's -- it remains about $600 million.

Gautam Khanna - *Cowen and Company - Analyst*

Last one and I'll turn it over. HMS manpack, when is the final down select to two?

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, we expect the customer test for the manpack to occur between January and May of 2017 and we expect the first delivery order within August of 2017 decision and delivering around October of 2017. That is our expectation; as we've said before, we see the manpack as a revenue driver in FY18 not in FY17.

Operator

Noah Poponak, Goldman Sachs.

Noah Poponak - *Goldman Sachs - Analyst*

So the MUOS slip, is it possible to quantify how much revenue that took out of the FY16 revenue outlook today?

Bill Brown - *Harris Corporation - Chairman and CEO*

It's in the tens of millions of dollars that slipped beyond Q4 into Q1, Q2. It's possible to receive the order late this quarter; it's more likely is in Q1 of our FY17. Over time, it's a pretty substantial opportunity. It's across a number of different services and we feel very, very good about the capability.

As I said in my prepared remarks, the business case on that is really very, very compelling. And we've demonstrated on air performance of the 117G with MUOS already and I think it's a great opportunity for us and we do -- we're confident it's going to go forward. It may not happen this quarter.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. I guess I'm sort of wondering more broadly, when I look at the revenue outlook reduction, especially in Comms Systems, kind of how much is that general softness across many areas; especially -- I guess, especially international versus the prior forecast as opposed to it being one or two or three bigger specific items that slipped into 2017?

Bill Brown - *Harris Corporation - Chairman and CEO*

Yes, it really comes into three specific opportunities. One is MUOS for -- on the DoD side which again, is tens of millions and dropped the guidance down to high single digits for the DoD side Tactical Radio in FY16. That did slip to the right, but we're very confident that's going to happen.

On the international side, we saw two opportunities slip to the right; one is in Iraq. It is -- it does have funding but we do expect that to be a first-half 2017 event, not in Q4 of 2016. And the other is an opportunity for another country in the Middle East which we can't name. The funding for that opportunity has been reprioritize but the customer is working with us on a number of other projects, which we believe will be funded in the first half of our FY17. So, it's relatively isolated to three different specific opportunities that generally just moved out of the quarter.

Noah Poponak - *Goldman Sachs - Analyst*

Okay, great. That's really helpful. On Slide 10, where you've given this historical data on Harris legacy tactical, you've broken out revenue by domestic and international. Can you tell us what orders were by domestic and international in the quarter?

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, we're going to stick with a splitting of the revenue for right now but I would say that the relative mix, Noah, of the ending backlog between international and DoD is reflective of the balance between international and DoD in the revenue base. So kind of on the order of two-thirds/one-third: international two-thirds; DoD, one-third.

Noah Poponak - *Goldman Sachs - Analyst*

And why not give those order numbers on that slide? Just competitively or --?

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, it's just something that we're not necessarily prepared to provide today. We'll give that some more thought over the next call that we have, Noah.

Noah Poponak - *Goldman Sachs - Analyst*

Okay. It would be helpful. And then what were -- specifically, what was the book-to-bill in the other segments where you've quantified it as being over 1? Can you tell us how far over 1 or specifically, what they were by segment? It sounds like they were pretty good.

Bill Brown - *Harris Corporation - Chairman and CEO*

Yes, we were at about in the Space and Intelligence business, just over 1.3. In the Electronic Systems business, we were at about 1.25, and in the CN business we were at 1.21.

Noah Poponak - *Goldman Sachs - Analyst*

Thank you.

Operator

Robert Stallard, Royal Bank of Canada.

Robert Stallard - *RBC Capital Markets - Analyst*

On the manpack award, some of your competitors have been talking about what they have to offer there. I was wondering if you could frame for us where you think Harris is positioned and why you think you're going to win?

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, we think we've got a very, very strong and compelling offering. We've been working on it for a number of years. We have a very strong, very high share today in the manpack market within the US DoD. And we've developed, I think, a very good radio in a very large factory where we've got tremendous scale.

That through the R&D investments, we're able to continue to bring features and functionality of the radio over time and use our scale to make sure we're competitive on the cost side, so we think we've got a very, very strong offering for the manpack.

Robert Stallard - *RBC Capital Markets - Analyst*

Okay, and then secondly, you highlighted the debt repayment year to date and you're about one-third of the way to your target. What do you think the profile of debt repayment will be going forward from here?

Rahul Ghai - *Harris Corporation - SVP and CFO*

Good morning. This is Rahul. So I think we had said that we will be about $2 billion in the first three years, so we are tracking to that. And in the first quarter of our FY17 or just after the first quarter FY17, we have about $250 million of debt repayment on one of the old Exelis notes that we will pre-pay. So I would say, between -- so maybe a little bit kind of the same fashion between 2017 and 2018 and we'll reevaluate as we get into FY17 if we need to alter that. But I would just spread that equally between 2017 and 2018 at this point. Maybe a little bit lower in 2017 and more in 2018.

Bill Brown - *Harris Corporation - Chairman and CEO*

What we said is there are also over the next three years, we'll bring our leverage down into the 1.5 range and we're tracking well towards that.

Robert Stallard - *RBC Capital Markets - Analyst*

Okay. And just a final one from me. I was wondering if you could size how large your Middle Eastern export sales are in the Communications division?

Bill Brown - *Harris Corporation - Chairman and CEO*

Middle East for us and broadly Middle East/North Africa is about 40%, 45% of our international Tactical business.

Operator

Howard Rubel from Jefferies.

Howard Rubel - *Jefferies & Co. - Analyst*

I wanted to address maybe a strategic question. You talk about continuing to optimize the business portfolio. Clearly, the sale of the Aerostructures business was spectacular outcome. But optimize means lots of different things. So could you elaborate on that, please?

Bill Brown - *Harris Corporation - Chairman and CEO*

Yes, we feel very good about where we ended on the Aerostructures business and completing the sale in early April. It's on top of what we did last year on the commercial healthcare business and before that, broadcast. So I think we've been pretty dispassionate, pretty aggressive in looking at what is in our portfolio; what strategically fits, what's a better value to Harris versus to an outside party.

We also look at the performance of the underlying business. That's actually an important factor, but Howard, as I step back, we are at the heart a technology-based Company, really in defense electronics, mission-critical communications. And we want to be in businesses where technology is a discriminator, adds some competitive advantage. We spent quite a bit on IRAD, more than 4%, it's well above our peers; 4% of our revenue.

We have about 40% of our population, our engineers are scientists, and we want to be in businesses where technology can allow us to win. And that's a key factor in how we evaluate the portfolio. We've been, again, aggressive in doing something with Aerostructures and we continue to look at what's in our base, our broader business, that we have today.

Howard Rubel - *Jefferies & Co. - Analyst*

That makes a lot of sense. And then just to build on that, can you talk -- we can see the cost synergies from Exelis. Can you talk about a little bit, of the sales synergies or where your -- where the organization is able to go-to-market with a package that can somehow accelerate some growth? You did -- just to finish on that, you did a nice job, I think, of outlining what you're doing in radios but the other markets are very large as well and important. Could you to talk to that?

Bill Brown - *Harris Corporation - Chairman and CEO*

Yes, our focus has been, Howard, really around the cost take-out and we've done, I think, a very good job. We get at it very, very quickly and we still feel good about hitting our run rate savings as we exit 2017, and at $140 million, $150 million net range, which is more aggressive than we thought.

We're closing about 15% of our floorspace and that's tracking very, very well. So that has been our number one focus. That's how we justified the acquisition, was really on cost take-out. On the revenue side, we've got our teams really focused on this.

Dana Mehnert, who's been over year at Harris for more than 30 years, and really built our Tactical Radio business into what it is today, has now taken on a role as Head of Global Business Development really with an eye towards -- how do we grow in major markets around the world, where the opportunities might be a little bit outside of the horizon or between businesses or might involve bringing together, strapping together some technology from Exelis with Harris?

And his focus is really on that and it crosses the gamut; it's across technology, across platforms, across geographies, or channels to market. In all of those things, we're starting to see some opportunities and as we get beyond this year and start to shape 2017, we'll talk a bit more about where they start -- where we're starting to see those opportunities come to fruition. What I'd rather do, is talk about the ones that we are actually achieving, as we achieve them as opposed to speculating about where they might be.

One last point on this, Howard, because I think this is very important and I want to make sure investors don't miss this. It's not just about applying common technologies, going after channels. The part of what we're doing in driving operational excellence and integration into -- across Exelis is improving program performance. This is very important. The best way to grow a business is performing well on what you're doing today.

And in the note that -- in Rahul's prepared remarks, he talked about the SENSOR program. The SENSOR program was being recompeted because the performance wasn't quite up to snuff with the Air Force and through a lot of work, the on-time delivery of that program has improved dramatically. And now we're starting to get awards back on SENSOR, and the competition has been canceled going to one of the pieces of SENSOR because of the improved performance. So I feel if we just keep focused on performance and executing very, very well that will help us grow our business into the future as well.

Howard Rubel - *Jefferies & Co. - Analyst*

And then one last item. You've got -- again, sort of focused on the top line a little bit. You've got an enormous amount of data that you provide to the FAA and some of that can be re-marketed and sold in a value-added manner. How far along are you with that?

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, our focus right now with the FAA is executing on NextGen programs and FAA today is probably our largest customer. We are on four or five NextGen programs and of course, we've got the FTI, the telecommunications infrastructure, that we are working on.

But through Exelis, they had the ADS-B network, more than 640 radio towers, operating very well. Long-term contract with the FAA, very strong position and they have unique access to data and that data can be used in other forms for other uses, including supporting the integration of UAVs into the North American air traffic control system. That is a key part of our strategy.

That's an opportunity that is likely beyond the next couple three-year planning horizon. But clearly, through both technology partnerships and legislation, all of which need to be worked on today to make sure we've got a strong position there over time. So Howard, that is an Important focus of ours and as we get clear around what our particular strategies there, we will share that more with investors. That's a little bit beyond the planning horizon.

Operator

Carter Copeland, Barclays.

Carter Copeland - *Barclays Capital - Analyst*

The -- maybe this horse isn't quite dead yet, so I will beat it again. But I want to talk tactical really quickly and I know you're not ready to provide 2017 guidance but you talked about several of these opportunities, which clearly, layer in later in next fiscal year and beyond. And you made a comment in your prepared remarks, in the closing remarks, about sort of short-term movements and revenue.

But when you look at that business on a long-term trend line basis, is it your expectation that, that trend line is upward sloping when we look out over the next two, three, five years because of all of the opportunities that we've been looking at and you've executed on in recent years?

Bill Brown - *Harris Corporation - Chairman and CEO*

I think it's a good question, Carter, and clearly on the DoD side, I think the answer is, yes. It's -- it is clearly on an upward slope and I think as I went into some detail on the programs we won on the DoD side, and the fact that even in the President's Budget they are well-supported in the DoD. They are well-supported.

The procurements are moving forward at a reasonable pace. I feel very confident that the DoD business will be a growth driver for us, certainly as we get into 2018 and beyond. 2017 is a little bit too soon to call. I do see it coming off the bottom in 2016 into 2017 but I think 2018 is really the growth year, and I think it really relates to the flow-in from some of these modernization programs where we're very, very well positioned including in SOCOM.

So the DoD, I think clearly is a growth driver. On the international side, we've seen fantastic growth over the last few years; we've seen a little bit of softness this year. The pipeline is still very robust. We are still well-positioned; competitively, we're very strong. When we're going out to compete, we win almost all the places that we are competing in around the world where we have a position.

I think the opportunity in Australia, where we've become the preferred supplier for a very large contract, which include systems and products, is an important part of our strategy because we need to increase the size of the addressable market we're going after in international, in order to continue to see growth in that international base over time. But I do see on the DoD side, yes; that, that will be a longer-term growth market for us.

Carter Copeland - *Barclays Capital - Analyst*

Okay, great. And on a couple of others. Just looking at the bookings trend and the revenue trend at CapRock; does that business look like it's bottomed now, from your perspective?

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, I think the good news, Carter, is that we haven't adjusted in our outlook for 2016. We haven't changed it based on what's going on in the CapRock business. The energy business is still under a lot of pressure and the oil prices have recovered a little bit but still way -- well down. A lot of the energy majors are reporting some pretty terrible numbers right now.

For the year, we still expect CapRock Energy to be down about 25%. We were down in the 20% range-ish in the first half; it will be worse than that, obviously, in the second half. As we get into Q4, we see the revenue in Q4 in CapRock Energy to be on the order of about $60 million in the quarter. So if you just annualize that, you're sort of around $240 million for the year as we exit FY16; and for perspective in FY16 overall, revenue of CapRock Energy was around $290 million.

So the math would imply that we'll see a little bit of another downturn on an annual basis in 2017 over 2016. 2016, again, is down about 25% from FY15. So we are seeing another step down as we get into next year but it's not different than what we described last time and built into our guidance for this year. I guess, as you saw the CN margins, we're down a little bit sequentially. We did lose money in energy in Q3 but we've done quite a bit of restructuring, as we laid out to investors back in February. And we do expect the energy business to come back to profitability in Q4 and be less of a profit driver as we get into FY17.

Carter Copeland - *Barclays Capital - Analyst*

When you say less of a profit driver, you (multiple speakers) the loss goes away?

Bill Brown - *Harris Corporation - Chairman and CEO*

Less of an impact on profit; yes, exactly. Yes.

Carter Copeland - *Barclays Capital - Analyst*

Okay and then one final one just for clarification. The increase in the synergies clearly benefits the fourth quarter this year. But does that imply any change to the run rate synergy target on Exelis that you laid out before or this is just faster capture?

Bill Brown - *Harris Corporation - Chairman and CEO*

It's faster capture. We still expect it to be at $140 million, $150 million net -- $140 million to $150 million net of what we give back to the government as we exit FY17. So it's really just a faster capture this year at $80 million, $85 million. We see next year, in-year FY17, integration savings or synergy savings in the $130 million to $135 million range, Carter, so that implies an extra $50 million in the in-year 2017 from 2016.

Operator

Seth Seifman, JPMorgan.

Seth Seifman - *JPMorgan - Analyst*

I apologize in advance for asking another 2017 question, but not in terms of numbers but just very broadly, outside of Communications, when we think about the DoD budget and investment account outlays, should be up pretty nicely in government FY17.

When we think about Space and Electronics, and let's say, Critical Networks, putting CapRock aside. With DoD investment account outlays growing nicely, is there any reason to expect that any of those segments won't grow?

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, we see very good trends through the year in our Space business as well as in the Electronic Systems business. It's kind of encouraging to be through the year here in Space and pretty good backlog growth, pretty good book-to-bill through the year; same thing on the Electronic Systems business.

It's good to see electronic warfare to be pretty strong returns out over the course of the year and ending a couple of hundred million dollars higher in backlog, at least that bodes well for not another step down as we get into 2017; but yes, the budget looks pretty good. There's still a long way to go between where we are today and appropriations bills.

But we feel pretty good about the overall outlook; the only cautionary points I would give is on CapRock. We do see, again, another step-down as we get into 2017, just based on where the exit rate happens to be. In our Mission Sustainment business, which was down this year in the 20%, 22%, 23% range, mainly because of a couple of big program roll-offs.

We've got some work to do there to make sure that we hold that business as we go into to next year. It's a very, very competitive landscape. We've got a third of that business; it's up for recompete as we go into next year, the Mission Sustainment Services business, and we've got to do a little work to make sure that we win on those recompetes. It's something that this management team is pretty well focused on today.

Seth Seifman - *JPMorgan - Analyst*

Thanks. Maybe as a follow up on cash flow, you maintain a free cash flow guidance for the year but the CapEx guidance came down. I was wondering if you can talk about the driver there. Was it basically that the uppers in the EPS guidance were kind of non-cash and -- versus the decline in the Communications revenue? And then, you've still got a pretty big jump in the CapEx in Q4 and what specifically is driving that?

Rahul Ghai - *Harris Corporation - SVP and CFO*

Yes, you're right. There's no change to our FY16 guidance on cash flow; the reduction in CapEx is basically offsetting the change in earnings. So that's where -- that's kind of the math we're doing. We still need to get some working capital improvement in the fourth quarter to get roughly a number but historically 50% of our cash flow for the year has come in the fourth quarter and this year we're expecting slightly less than that; so we feel good about that.

We have some projects going on, on -- and the timing of CapEx kind of differs from quarter to quarter and there's just variability within the quarter. So we have some projects going on that need some step up in CapEx but we've calculated that outlook for the year. And we think we will be close to the number that we've guided to.

Bill Brown - *Harris Corporation - Chairman and CEO*

We feel pretty good, Seth, about the progress we've made over the last several years, in just making ourselves little more capital efficient and it includes the approval thresholds in the Company. On a pro forma basis, a couple of years ago, the companies together would have been around $260 million, $270 million or in the range of 3% of sales and this year will be at about 2.3%. We still see some opportunities to continue to be a little more judicious on capital spending going forward. So, we feel pretty good about where we stand so far this year in capital.

Pamela Padgett - *Harris Corporation - VP of IR*

Operator, we will take one more question please.

Operator

Chris Quilty, Raymond James.

Chris Quilty - *Raymond James & Associates, Inc. - Analyst*

Bill, just to follow-up on Australia and your -- the focus on systems. Can you give us an idea of what you end up bundling in, in the system sale in addition to radios? And what kind of a revenue multiplier or I mean, does it increase the size of the potential order by 10% or 15% or double it?

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, it would include -- the radios would also include a lot of antenna systems. It's the battle management system, the software systems. There's a variety of other things that we package in to a systems offering to a customer. Every end market is going to be little bit different. We've had several hundred million dollar with a systems opportunity being booked and sold in other markets in the past. If I remember right on those markets, because I don't want to talk specifically about Australia, it's probably in the order of around maybe 2-to-1. So two parts of non-radios to one part radio; so in other words, about one-third of the opportunity would be radios with our balance, and the two-thirds would be other things you package around that.

Chris Quilty - *Raymond James & Associates, Inc. - Analyst*

And when you look at your opportunity pipeline down the road, broadly, what percent of those international opportunities might you convert to more of a systems versus a traditional radio sale?

Bill Brown - *Harris Corporation - Chairman and CEO*

It's a good question. It's something we've been working on for quite some time. In the US, the US military tends to do their own systems integration. They manage each of the suppliers and the components and then integrate it together and then test it through the -- what we are seeing today is these network evaluation -- at these NIEs. On the international side, more and more customers are moving towards buying an installed solution, integrated solution. And that's, I think, a good trend that's heading in our direction. We feel very good that the radio itself is very, very competitive and provides a key source of value and we think we broaden that and bring other partners on to our team. And in fact, that's exactly what we been able to do in Australia, some very important large global players are on the Harris team in Australia, providing components to us.

And what that does is it unite -- not just provide the radio but software and other components around that. It does continue to build more stickiness into that end customer coming back to Harris Corporation over time. So we feel very good about the trajectory we happen to be on, on the systems and integrations solutions side internationally.

Chris Quilty - *Raymond James & Associates, Inc. - Analyst*

And who would be your big competitors that are adopting the same approach?

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, I don't want to get into competitor because of the competitors have found their way onto our team in Australia and it's -- it really varies by market. But I would just say that we've got a line-up of very good suppliers, good partners with us in Australia and again, we go compete against different people in different markets.

Chris Quilty - *Raymond James & Associates, Inc. - Analyst*

Okay, and a clarification on the MUOS. Is that a one-time revenue opportunity on the software upgrade or is there any kind of tail?

Bill Brown - *Harris Corporation - Chairman and CEO*

Well, there's going to be a -- we've been investing quite a bit of IRAD into developing the ability to easily port this MUOS waveform into 117Gs. It sounds more simple in the way I explain it than it really was; it was quite a bit of magic to make this happen and not require any sort of firmware, hardware change-out for these radios, which I think is absolutely amazing -- amazing what the team has done.

And what we're now doing is working with our service partners to provide them software licenses that would allow them to, once they buy the license, to then download that software into their radios into the 117Gs. As that MUOS waveform is changed or advanced over time there may be opportunities for that to get re-advanced or other licenses or other opportunities, revenue opportunities, to occur but we see that over time, this is a pretty substantial opportunity. And I think as each service picks it up, we will drive some revenue event for us on MUOS.

Chris Quilty - *Raymond James & Associates, Inc. - Analyst*

Just a final follow-up question. You said the outlook on your reflector business is the best you've seen in 10 years and yet, last year was a pretty crappy year for commercial SATCOM orders and this year is not looking any better year to date. So is that primarily reflecting just a higher value for the type of and reflectors that you're developing or is it a market share gain?

Bill Brown - *Harris Corporation - Chairman and CEO*

Now, I think what we're seeing here is over the last five years, in our business, and we've got, as you know, a pretty high share of the hoop reflector or space reflector market. We've only sold two commercial reflectors; so far we have this JCSAT order for $37 million. We have four proposals out. We're 15 prospects in the pipeline and what's driving this, Chris, are new entrants. It's the increase in high throughput satellites. It's recapitalizations. It's a surge that is occurring in small sats relative to US government as well as the commercial sector.

We see that as a pretty good opportunity in the near to medium-term and it's both of the reflector side as well as SENSORS and payloads for these other small-size -- both again, commercial and US government. So I think we're on the front end of what appears to be a recap cycle and we feel it's a very important recent event. And again, with the prospects we see and the proposals we have out, we feel pretty good about this business, Chris.

Pamela Padgett - *Harris Corporation - VP of IR*

All right. Thank you, everyone, for joining us today.

Operator

Ladies and gentlemen, thank you again for your participation in today's conference. This now concludes the program and you may all disconnect your telephone lines at this time. Everyone, have a great day.
