Keysight Technologies Third Quarter 2024 Earnings Conference Call

Prepared Remarks

JASON KARY

Thank you, and welcome everyone to Keysight's Third Quarter Earnings Conference Call for Fiscal Year 2024.

Joining me are Keysight's President and CEO, Satish Dhanasekaran, and our CFO, Neil Dougherty. In the Q&A session we will be joined by Chief Customer Officer, Mark Wallace.

The press release and information to supplement today's discussion are on our website at investor.keysight.com under financial information and quarterly reports. Today's comments will refer to non-GAAP financial measures. We will also make reference to "core" growth, which excludes the impact of currency movements and acquisitions or divestitures completed within the last twelve months. The most directly comparable GAAP financial metrics and reconciliations are on our website, and all comparisons are on a year-over-year basis unless otherwise noted.

We will make forward-looking statements about the financial performance of the company on today's call. These statements are subject to risks and uncertainties and are only valid as of today. We assume no obligation to update them and encourage you to review our recent SEC filings for a more complete view of these risks and other factors.

Lastly, management is scheduled to participate in upcoming investor conferences hosted by Jefferies, Deutsche Bank, Citi and Goldman Sachs.

And now I will turn the call over to Satish.

SATISH DHANASEKARAN

Good afternoon, everyone, and thank you for joining us today.

My comments will focus on three key headlines.

- First, Keysight executed well by delivering revenue and earnings above the high end of our guidance in market conditions that were stable and consistent with our expectations.
- Second, orders of $1.25 billion were slightly above our expectations, in line with the prior year, and growing low single digits sequentially. In a mixed demand environment, we continue to see stability and pockets of growth, particularly in commercial communications. The funnel of opportunities supports our outlook for second half orders to be above first half orders, followed by a more gradual recovery in 2025, barring any further macroeconomic degradation.
- Third, we remain confident in the strength of our business model, and are intently focused on value creation for both customers and shareholders. Our capital allocation priorities have not changed. First, we are strategically investing to deliver leading-edge capabilities as new technologies inflect – and to return the company to our long-term growth trajectory. Second, we are expanding our SAM and growth opportunities through disciplined M&A. And, third, we are committed to returning capital through share repurchases. In fact, we returned over $715 million, or 78 percent of free cash flow, over the past 4 quarters.

Now let's begin with a brief overview of Keysight's third quarter performance. Revenue of $1.2 billion and earnings per share of 1 dollar 57 cents were above our expectations. And for a second consecutive quarter, we saw relative stability in both orders and revenue.

Turning to our business segments…

CSG returned to order growth in Q3. While revenue declined 8% year-over-year, we saw some modest improvement sequentially. Commercial communications orders grew low double digits. Strong growth in wireline, driven by AI, more than offset the year-over-year decline in a sequentially stable wireless business.

Wireline orders grew for a third consecutive quarter driven by robust investment in the re-architecture of data center networks for 400G, 800G and terabit ethernet data rates, AI model training, and network performance. We are benefiting from the investments we've made to position Keysight ahead of this technology inflection. In R&D, we are enabling customers with our design and emulation solutions across the technology stack for key applications, including GPU servers, AI workload emulation, and performance benchmarking. In manufacturing, AI cluster and switching deployments drove capacity demand this quarter, and we secured key wins in GPU rack connectivity applications with market-leading customers. Keysight also collaborated with Cisco and Panduit to demonstrate interconnect technologies in AI Cluster networks to reduce power consumption. We are also actively engaged with customers in the Ultra Ethernet Consortium to define future network architectures for AI and high-performance workloads.

In wireless, demand has been stable over the past 3 quarters, albeit at a lower level on a year-over-year basis. While customer spending remains cautious, the breadth of our solutions portfolio is enabling us to capture ongoing R&D investment in non-terrestrial networks, Open Radio Access Network deployments, and release 18 of the 3GPP standard. Customers are also investing in scaling 5G and evaluating next-generation technologies. For example, at the recent IEEE International Conference on Communications, Keysight showcased early 6G technology together with Ericsson. Government incentives, particularly in the U.S., Europe and Japan, are driving the development of a robust ecosystem to commercialize Open Radio Access Networks. This quarter, Keysight's Open RAN solutions enabled state-of-the-art Open Testing and Integration Centers across the globe from Europe to North America to Asia.

Turning to aerospace, defense and government, revenue and orders were down year-over-year, but sequentially flat. The prolonged U.S. budget approval process has caused delays in the appropriation of funding for new projects, which we expect to filter through over the next few quarters. In the interim, spending on defense modernization remained steady, with healthy demand from U.S. primes and allied governments. Keysight recently expanded its engagement with the U.S. government through the Joint Cyber Defense Collaborative to enhance cybersecurity resiliency. In the quarter, we secured key wins with several U.S. and European primes for spectrum operation applications. We also expanded our Quantum footprint with a multi-hundred qubit application win with a key government customer.

Turning to the Electronic Industrial Solutions Group, revenue continued to normalize from a strong prior year, declining double digits as expected. Customer spending and market conditions remain muted, but we saw relative stability in orders and revenue on a sequential basis.

In semiconductor, revenue was down year-over-year versus an all-time high in Q3 last year. Orders increased low single digits, and were up strongly on a sequential basis. While certain segments of the market continue to work through excess inventory, higher performance requirements for AI workloads drove spending in advanced nodes, high-bandwidth memory, and silicon photonics technologies. The investments that we've made specific to these market opportunities resulted in increased demand from foundry and memory customers for our parametric wafer test solutions.

In automotive, orders and revenue declined double-digits. Lower auto manufacturing activity remains a headwind in the near-term. In new mobility, EV orders were lower as demand for some battery test and charging infrastructure investments were delayed, while AV orders grew mid-single digits on a sequential basis. The opportunities in R&D continue to grow as customer engagement in the transition to software-defined vehicles ramps. As an example, Riscure successfully completed the first Car Connectivity Consortium Digital Key Certification in conjunction with NXP. This certification strengthens trust in the security of next-generation vehicles. It also further expands Keysight's security evaluation offering for the automotive industry.

In general electronics, customer spending remains constrained, particularly in manufacturing, China, and the distribution channel. There were pockets of growth in digital health and advanced research, where orders grew low double-digits.

Software and services revenues are resilient and grew this quarter while accounting for 39% of total Keysight revenue. Annual recurring revenue from software and services also increased year-over-year and in Q3 accounted for roughly 29% of overall Keysight. Our Eggplant software test automation platform is expanding with multiple consecutive quarters of double-digit growth. We are also gaining early traction in sales channel leverage between ESI and Keysight to expand into select accounts and geographies. The collaboration resulted in a key win in the satellite communications space. Lastly, Keysight's design engineering software platform continues to grow. This quarter, we launched new releases for virtual prototyping and simulation capabilities, which address high-performance use cases across our communications, aerospace and defense, and automotive end markets.

In summary, the strength and differentiation of Keysight's business model is enabling us to outperform in a variety of economic conditions. We are well-positioned to capitalize on the technology inflections ahead of us, and remain laser-focused on value creation for both customers and shareholders.

With that, I will turn it over to Neil to discuss our financial performance and outlook.

NEIL DOUGHERTY

Thank you, Satish, and hello, everyone. Third quarter revenue of $1 billion 217 million was above the high end of our guidance range and down 12 percent, or 13 percent on a core basis. Orders of $1 billion 249 million were essentially flat, or down 1 percent on a core basis. Backlog at the end of the quarter grew $30 million to finish at $2.3 billion.

Looking at our operational results for Q3, we reported gross margin of 64 percent. Operating expenses of $484 million were up 1 percent year-over-year. Excluding acquisitions, SG&A expenses were down 7 percent reflecting our cost flexibility and actions taken to-date. Q3 operating margin was 24 percent, or 26 percent on a core basis. Year-to-date core operating margin is down only 400 basis points, continuing to outperform Keysight's downcycle model and demonstrating the financial resiliency of the business.

During the quarter, we amended our tax returns from 2020 onward to reflect an amortization deduction related to a prior-period corporate restructuring. This change reduces our effective non-GAAP tax rate from 17 percent to 14 percent, or 300 basis points, for fiscal year 2024 and going forward.

Turning to earnings, we achieved $275 million of net income and delivered earnings of 1 dollar 41 cents per share excluding the impact of the tax rate change. This tax change added an additional 16 cents to earnings per share, of which 11 cents relates to the first half of FY24 and 5 cents to Q3. All in, we finished the quarter at 1 dollar 57 cents in earnings per share. Our weighted average share count for the quarter was 175 million shares.

Moving to the performance of our segments, the Communications Solutions Group generated revenue of $847 million, down 8 percent on both a reported and core basis. Commercial communications revenue of $572 million declined 6 percent, while aerospace, defense, and government revenue of $275 million was down 10 percent. Altogether, CSG delivered gross margin of 67 percent, and operating margin of 26 percent.

The Electronic Industrial Solutions Group generated revenue of $370 million, down 20 percent, or 24 percent on a core basis. EISG reported gross margin of 58 percent, and operating margin of 20 percent, an increase of approximately 100 basis points versus the prior quarter on slightly lower revenue.

Moving to the balance sheet and cash flow, we ended the quarter with $1.6 billion in cash and cash equivalents, generating cash flow from operations of $255 million, and free cash flow of $222 million.

Share repurchases this quarter totaled 1.07 million shares, at an average price per share of approximately $140, for a total consideration of $150 million.

Now, turning to our outlook…

We expect to finish the year slightly better than anticipated, with fourth quarter revenue in the range of $1 billion 245 million to $1 billion 265 million, and Q4 earnings per share in the range of $1.53 to $1.59, based on a weighted diluted share count of approximately 174 million shares.

In closing, in an uncertain macro environment, we are executing on the dimensions that we control, capturing the current market opportunities, and positioning Keysight for success as markets recover.

With that, I will turn it back to Jason for the Q&A.