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L3Harris Technologies, Inc. (LHX) CEO William Brown on Q3 2019 Results- Earnings Call Transcript

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Q3: 10-30-19 Earnings Summary

Press Release *10-Q* *Slides*

EPS of $2.58 beats by $0.19 | Revenue of $4.43B (182.59% Y/Y) beats by $0.9M

Earning Call Audio

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L3Harris Technologies, Inc. (NYSE:LHX) Q3 2019 Earnings Conference Call October 30, 2019 9:00 AM ET

Company Participants

Anurag Maheshwari - VP, IR

William Brown - CEO

Chris Kubasik - COO

Jay Malave - CFO

Conference Call Participants

Sheila Kahyaoglu - Jefferies

Carter Copeland - Melius Research

Noah Poponak - Goldman Sachs

David Strauss - Barclays

Richard Safran - Buckingham Research Group

Gautam Khanna - Cowen and Company

Robert Spingarn - Credit Suisse

Jon Raviv - Citi

Seth Seifman - JPMorgan

Michael Ciarmoli - SunTrust

George Shapiro - Shapiro Research

Peter Arment - Baird

Josh Sullivan - Seaport Global

Rajeev Lalwani - Morgan Stanley

Operator

Greetings and welcome to the L3Harris Technologies Third Quarter Calendar Year 2019 Earnings Call. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Anurag Maheshwari, Vice President, Investor Relations. Thank you. You may begin.

Anurag Maheshwari

Thank you, Michelle. Good morning, everyone, and welcome to our third quarter calendar year 2019 earnings call. On the call with me today is Bill Brown, CEO; Chris Kubasik, COO; and Jay Malave, CFO.

First a few words on forward-looking statements. Discussions today will include forward-looking statements of non-GAAP financial measures. Forward-looking statements involve assumptions, risks, and uncertainties that could cause actual results to differ materially from the statements. For more information, please see the press release, the presentation, and our SEC filings. A reconciliation of non-GAAP financial measures to comparable GAAP measures is included in the quarterly materials on the Investor Relations section of our website where a replay of this call also will be available.

To aid with year-over-year comparability following the L3-Harris merger, discussions also will be on a combined basis with prior results as well as year-to-date and first half 2019 result reflecting combined L3 and Harris historical operating results as if the businesses had been operating together during prior period under the four segment structure.

With that, Bill, I will turn it over to you.

William Brown

Great. Thank you, Anurag, and good morning, everyone.

Earlier today, we reported strong third quarter results with non-GAAP earnings per share of $2.58 up 26% on 10% revenue growth. Overall company margin increased 210 basis points to 17.4% and free cash flow more than doubled over Q3 of last year. These results extend our strong calendar 2019 performance with non-GAAP earnings per share with the first three quarters up 27% on 10% revenue growth and free cash flow up 73% to $1.6 billion.

Funded book-to-bill was 1.13 for the quarter and 1.10 year-to-date, driving funded backlog growth of 10% versus last year, and setting us up for a strong finish to the year. So we're off to a great start as a new combined company and we're executing well against our strategic priorities. I'll begin with an update on our progress on Slide 4, and then Chris and Jay will provide details on segment results and guidance.

First, we remain laser-focused on integration and capturing cost synergies, and we're tracking well toward achieving $80 million of gross in year savings and $200 million in gross run rate savings as we exit calendar 2019, both higher than previous expectations and giving us confidence in exceeding our $500 million target in calendar 2022.

In addition to cost synergy projects, we're also making good progress on our second priority of developing and institutionalizing a new enterprise-wide operational excellence program called E3. Building this muscle will be essential to driving near-term organic margin expansion and set us up to sustain the benefits of productivity well beyond the three-year integration period, including in program execution, R&D efficiency, and working capital management.

Third, we're building what we're calling a new performance culture as we pivot towards an operating company model, leveraging the power of the enterprise through shared services, shared resources, and shared best practices.

At the end of September, we held our first technology summit convening more than 200 top engineering leaders to cross-pollinate ideas, roll out our company-wide stage gate development process and detail our plan to manage R&D investments on a portfolio basis. We've also begun to institute enterprise-wide business metrics and a review cadence aimed at instilling greater rigor and accountability in our decision-making.

Fourth, we're investing smartly and aggressively in technology to grow revenue and increase share add content, and expand it to adjacencies. And while it's still early, I'm encouraged by our progress and recent success in capturing potential revenue synergies.

In just 120 days since the merger, we've already submitted 14 revenue synergy-type proposals primarily in electronic warfare and space sensing domains, with a potential lifetime value of about $3 billion. One proposal is for the U.S. Air Force F-16 electronic warfare modernization program, supporting a fleet-wide 15-year upgrade cycle .

Our offering combines proven EW capabilities from legacy Harris with an innovative digital signal receiver from L3 to provide the customer a high performing, low risk solution that we could not have created separately.

In September, we are one of two companies down selected for the initial development phase and if we ultimately prevail, we would double our addressable market and add the domestic F-16 fleet to our established international position.

From another bid, we were awarded an early study project for space sensing technologies that combines space optics and electronic solutions from legacy companies, with the potential to grow to over $250 million in value.

So a few encouraging early wins and a growing pipeline of opportunities, validating the strategic growth potential of the newly merged company. Our fifth priority is to maximize free cash flow with shareholder friendly capital deployment.

In the quarter, we generated $618 million in free cash flow up 123% over prior year through higher earnings, tight management of capital spending, and a two-day sequential improvement in working capital.

We've also improved the linearity of cash generation with about 70% of free cash flow guidance delivered in the first three quarters of the year compared to less than 50% for the same period last year.

And in the third quarter, we return $922 million to shareholders including $750 million in share repurchases which keep us on track to buyback $1.5 billion of shares in the second half of calendar 2019.

And finally, reshaping our portfolio to focus on high margin, high growth technology differentiated businesses where we can win and generate attractive returns. While this is an ongoing process, we've begun marketing several businesses that we've assessed as non-core. And our plan is to announce transactions as they occur and use the net proceeds to repurchase shares to offset dilution.

So in summary on the back of successful execution against our strategic priorities, strong third quarter performance and a solid backlog, we're increasing our second half guidance for non-GAAP earnings per share to $5.35 with revenue growth of 10% and free cash flow of approximately $1.35 billion, the higher end of the previous guidance range.

Now as we go into 2020 and assuming appropriations are enacted in line with the recent budget agreement, we continue to expect mid-single digit plus revenue growth and expanding margins off a higher 2019 base than we anticipated in S4, driving double digit cash and earnings per share growth.

So with that, let me turn it over to Chris to provide an update on operational and segment financial performance. Over to you, Chris.

Chris Kubasik

Okay. Thank you, Bill, and good morning, everyone.

We are performing very well right out of the gate due in large part to months of pre-merger work accomplished by the joint integration team. Expanding on Bill's comments, in addition to E3 and other enterprise-wide initiatives, we are also driving a common business development capture process.

We're incorporating best practices from across the company and we're focusing on a bottoms up effort to improve working capital performance. All of these enterprise-wide initiatives are gaining momentum and expected to contribute to our future growth, profitability and cash generation.

Let me now turn to operating results by segment. On Slide 5, Integrated Mission Systems revenue grew by 10% for the quarter and 11% calendar year-to-date from strength in ISR missionization and increased global demand for Wescam turret systems.

Orders were strong as we continue to solidify our position on big Safari programs, increase share on electro-optical, and enhance our unmanned maritime franchise. This resulted in a book-to-bill of 0.99 for the quarter and 1.11 year-to-date.

Segment operating income was up 24% and margin expanded 160 basis points to 13.8% for the quarter, resulting in a year-to-date margin of 12.7%. This solid performance was driven by increased volume, integration savings, pension income, and operational excellence, slightly offset by program mix.

In Space and Airborne Systems on Slide 6 revenue increased 20% for the quarter and was up 18% calendar year-to-date from increased content wins and a production ramp on long-term platforms, including F-35, F-18, and F-16.

In addition to sustained growth in classified space, as we expand into a full mission solution provider, order momentum was broad based, resulting in a book-to-bill of 1.05 for the quarter and 1.1 year-to-date. Segment operating income was up 38% and margins expanded 250 basis points to 19.4% for the quarter, resulting in a year-to-date margin of 18.6%.

This robust performance was driven by higher volume, operational efficiencies, and integration savings partially offset by higher investments in open systems architecture and advance space technology.

Moving to Slide 7, in communications systems, revenue growth was up 11% for the quarter and the year driven by solid growth in tactical communications and public safety. Tactical grew 19% with DoD up 33% on increased modernization revenue and international was up 9% from ongoing border security support in Eastern Europe and early adoption of the multi-channel radios in Western Europe.

Revenue was once again up double digits in PSPC as the business continue to gain share with utilities and state and local and federal agencies. Order momentum was even stronger with segment book-to-bill of 1.36 for the quarter and 1.09 year-to-date, as each sector is successfully executing on its strategy.

Tactical is ramping up modernization in DoD and international, broadband is maintaining incumbency on legacy platforms, Public Safety is increasing share in utilities, and Integrated Vision Systems received EMVGB test certification and made initial deliveries in August resulting in a significant follow-on order.

Additionally last week we achieved an important milestone on the SOCOM handheld program with the award of a full rate production order for $86 million following a successful field test in early August. Not only is this a significant step in the $390 million sole source program but the core architecture of the SOCOM handheld radio is also shared by the $250 million SOCOM manpack program.

The SOCOM handheld radio is also the foundational radio for the Army 2-channel and several international modernization programs. The investment in common architecture facilitates our customers desire for interoperability and future capability.

Segment operating income was up 18% and margin expanded 140 basis points to 22.7% for the quarter resulting in a year-to-date margin of 21.9%. The strong performance derived from higher volume and operational excellence more than offset the mix impact from the ramp and tactical radio modernization program.

Lastly on Slide 8 in Aviation Systems, we grew in defense while declining in commercial aviation for a net flat quarter in nine months. The decline in commercial aviation is the result of lower volume and Commercial Training Solutions as orders for full flight simulators continue to slip to the right.

We received 3 simulator awards in the first half and we're expecting 12 in the second half. And although our pipeline remains strong, due to uncertain timing of bookings, we have now lowered our award expectation to lower single digits for the second half which is reflected in our revised segment guidance.

Aside from simulators, order strength was good, resulting in a segment book-to-bill of 1.16 for the quarter and 1.05 year-to-date. Segment operating income was up 32% and margin expanded 330 basis points to 13.4% for the quarter, resulting in the year-to-date margin of 11.5%. This performance was driven by integration savings and improved operational performance primarily in our Traveling Wave Tubes business, partially offset by mix.

I'm very pleased with our first quarter at L3Harris with three of the four segments outperforming and more than making up for the shortfall in AS. Our customers remain supportive of the merger both domestically and internationally as we build a mission-focused, mission solution-focused company. And I'm increasingly encouraged by our company outlook.

With that, I'll turn it over to Jay.

Jay Malave

Thank you, Chris, and good morning, everyone.

Recapping third quarter results on Slide 9. Successful execution against our strategic priorities draw strong results for the quarter with revenue growing 10% and EPS increasing 26% or $0.54. Of this growth, $0.49 came from higher volume, solid program execution and integration synergies and $0.15 from pension and elimination of L3 intangibles, offset by a net transit headwind from taxes, share count and interest.

On the back of this performance, we are revising our outlook for the second half as noted on Slide 10. Starting with the top line, we are tightening second half revenue to be up approximately 10% at the midpoint of the previous range of 9.5% to 10.5% from strength in SAS and CS offsetting lower volume in AS.

Second half total company EBIT margin is expected to be 17.1% or 40 basis points improvement from the previous guidance of 16.7%, driven by higher cost synergies and pension income. This combined with lower interest tax expense results in a second half EPS expectation to approximately $5.35, up $0.35 from the prior midpoint of guidance to $4.95 to $5.05.

This EPS guidance also reflects $1.5 billion in share repurchase repurchases for the second half, bringing the second half share count to around 224 million shares. And effective tax rate to 17% versus our prior expectation of 18%.

In the second half, we expect to generate free cash flow of approximately $1.35 billion, at the high end of our prior range of $1.3 billion to $1.35 billion driven by increased earnings and a two to three day working capital reduction from June.

Capital expenditures are unchanged and expected to be $190 million or 2% of revenue. As noted on Slide 11, for the full year, revenue is expected to be up around 10% with EBIT margin of approximately 16.4% and EPS of about $10 per share. Full-year free cash flow is expected to be approximately $2.35 billion or about $420 million higher than last year for the combined company.

Turning to the EPS bridge on Slide 12, expected full-year EPS approximately $10 per share reflects a total increase of $2.08 and $1.74 from volume, operational improvements, and cost synergies, as well as $0.29 from the elimination of L3 intangibles and higher pension income, and $0.05 of net - $0.05 net of interest in taxes.

Switching to the segment outlook. In IMS, revenue guidance is unchanged at up approximately 10.5% for the second half driven by strength in airborne imaging systems and growth in ISR aircraft missionization. Segment operating margin is now expected to be approximately 13.3% versus previous guidance of 12.5% driven by higher cost synergies and pension income.

This implies full year segment revenue, up approximately 11.2% with operating margin of approximately 12.7%. SAS revenue is now expected to be up approximately 15.5% in the second half versus up 11.5% previously driven by stronger growth on long-term aircraft platforms in classified space. Segment operating margin is expected to be approximately 18.8%.

This implies full year segment revenue growth of approximately 16% with operating margin of approximately 18.5%. CS revenue is now expected to be up approximately 10% in the second half versus previous guidance of 9.5% resulting from better than expected modernization orders and DoD tactical.

Operating margin is now expected to be approximately 22.5% versus previous guidance of 22.1% driven by higher volume, cost synergies, and operational excellence. This implies full year segment revenue growth of approximately 10.8% with operating margin of approximately 22.1%.

Finally with AS, we are lowering revenue guidance for the business with second half revenue now expected to be up approximately 35 versus previous guidance of up 7% driven by slower simulator sales. At this guidance, we believe that we have sufficiently de-risk the uncertainty related to simulator sales.

Segment operating margin is unchanged at 14%. This implies full year segment revenue growth of approximately 2% with operating margin of about 12.3%. So in summary, an improved outlook reflecting a strong start for the combined company.

With that, I'll ask the operator to open the line up for questions.

Question-and-Answer Session

Operator

[Operator Instructions] And our first question comes from the line of Sheila Kahyaoglu with Jefferies. Please proceed with your question.

Sheila Kahyaoglu

Bill, in your prepared remarks, you mentioned 14 revenue synergy proposals that total about $3 billion in lifetime value. As you guys have combined the two portfolios, how do you think about the potential wins? How do they change the growth profile of the business over maybe in the coming year or two, and where are you seeing the most opportunity?

William Brown

So we have 14 proposals that are in. It's very early days but we're pretty encouraged, especially, given the fact that we've been down selected on two of them. So this is, I think, good news. So we talked about $3 billion in value, that's a lifetime value, so read that over the next 10-years.

I think the way these things will work, there's a bit of an incubation period, the studies or the small awards to receive upfront that eventually lead into bigger opportunities over time. So I think in 2020, probably minimal impact, getting to 2021 maybe a little bit more and I think it should ramp a bit beyond that.

So I went through the 14, but there's about 80 total ideas that we're tracking here. So hopefully we will see some of the good news coming over the next number of months. They broadly really come into mostly right now electronic warfare and space sensing domains, mostly relative to leveraging complimentary technologies. But it's an encouraging start and we hope to see more over time.

Operator

Our next question comes from the line of Carter Copeland with Melius Research. Please proceed with your question.

Carter Copeland

Just a couple of quick ones. One, I wondered if you could just give us some color on the slippage in the simulator sales? It just seems strange given all the talk about pilot training out there and I wondered if maybe that's particular customer behavior for one reason or another in the commercial realm, I just wondered if you talk a little bit about that?

And as a secondary one, I'm just kind of curious on the efforts on E3. How does that differ from what you were each individually trying to accomplish with HBX or L365, and what's unique to the opportunity set that you think you have together?

William Brown

So maybe Chris will take on the piece on the simulators. Let me here quickly on the E3 or the OpEx program. So both L3 and Harris had operational excellence programs. We called ours HBX, theirs was L365. And E3 really is a combination of the best across both programs. And the objective really, as I mentioned in my remarks, is to develop that operational excellence and muscle to go after labor reductions, go after supply chain savings, go after improving quality performance, on-time delivery, program execution. All of those things we need do to keep winning over time.

So we know that there’s going to be an organic margin expansion opportunity separate from cost synergies. It goes side by side with what we're doing on integration. But really over the next couple three years, they'll start to merge together. And what we want to make sure is we build that muscle so that once we get beyond integration, we continue to see that regular cost take out improving quality well beyond the integration period.

And that's really what we're trying to do. I think we're off to a great start. We've got core people working this. We have a new hire, driving us across the Company, doing a great job. And I think we're off to a really good start. So, I'll let Chris comment on the simulators.

Christopher Kubasik

As I said in my prepared remarks, we have three - in the first half of the year, we only had one in the third quarter. And while we have a lot of letters of intent signed and such. We've yet to secure those in the fourth quarter. And I think what we're really seeing is that the airlines and the training companies are slowing down their discretionary spend probably as a result of the pending issues with the MAX aircraft.

As you know, that's put financial pressures on the airlines themselves and there's still some uncertainty surrounding that. So we've actually - speaking of E3, we've had a lot of progress on the simulators. We've been able to reduce the cost and the cycle time of building them. We just now need to go ahead and sell them.

So still a good business, still optimistic. Just a little lumpy here in dealing with market trends somewhat outside our control.

William Brown

And Carter, just another comment here. The pipeline is pretty solid. It's just that the orders are lumpy and that the timing is difficult to predict. And so we thought it's prudent with one quarter left, to just push it to the right and take it out of the year or revisit that for 2020. But the pipeline is pretty solid.

Operator

Our next question comes from the line of Noah Poponak with Goldman Sachs. Please proceed with your question.

Noah Poponak

I was kind of hoping to just get your updated thoughts on where you think you can take the total operating margin of the business long-term, because you're going to exit the year at this kind of 17 or a little better than 17. And then the incremental cost synergies, you still have yet to achieve alone, get you, at least, 100 basis points if not more higher than that.

And then, Bill, you just spoke to continuing the drumbeat of operational improvement beyond the synergies. And each legacy business had a couple, sort of, temporarily depressed pieces that looked like they were going to improve. So, I mean, is this a 20% sustainable starting four to five years out, but then sustainable operating margin business?

William Brown

Look, we're very optimistic about what we've seen so far in the back half of the year as we raised our guidance on margins here in the second half. It's better than we thought. Some of this is coming from some pension good news. But the reality is, the team is coming together very well.

Chris and I had been working for a number of months here on integration. This goes back to from the time we signed and we knew we can get out of the gates quickly. We're getting out of the gates a little bit faster than we thought. So some of the ideas have been pull forward a little bit.

Exiting the year at $200 million run rate, at least, put us in something north of $20 million gross savings next year. So we will see margin expansion next year. I think it will continue to grow. We still have more gas in the tank, certainly, from integration savings.

Could it be the numbers you're suggesting? That's a little bit far out there. Our job is to keep driving it every day and every year. We'll see margin expansion next year. We'll see it again going into 2021 and probably 2022, just simply because of the tailwind behind us on integration savings.

A lot of it comes from growth and the mix of new customers and development programs. So we need to keep a close track on that. We'll keep watching our investment in business in BNP activity, as well as in IRAD, to fund some of the revenue growth ideas.

So, Noah, I think we'll keep updating you over time. But we are more encouraged today about margin expansion, I think, we started out.

Noah Poponak

If I could just follow-up really quickly on the aviation systems situation, I just want to - I think some people have the segment growth rates modeled somewhat level next year. And so any help you can provide on how the comparisons will shake out with the simulation in training piece? And then also, you have the C17 piece coming out, just in an effort to kind of get ahead of level setting everyone for the right order of magnitude change in that business next year would be helpful.

William Brown

So, yes, C17 drag will go away. But overall, we - my comments, I talked about mid-single digit plus. So just based on where we are at in the S4, L3 with the 5%, we're at 6.5%. So it's in that range and it's coming off of a much higher base in 2019, so about $0.5 billion above the S4. So we're still expecting good growth going into next year.

I think we'll see communication systems to be pretty good as more short cycle with CIMS and space business sort of in the middle, both doing pretty well. And we'll see Aviation systems probably being a little bit less than the other three part of some of the trends that Chris talked about will continue into next year.

I don't think I'll go into any more detail within the segment. But the reality, those are the major drivers at a pretty macro level across the four segments.

Operator

Our next question comes from the line of David Strauss with Barclays. Please proceed with your question.

David Strauss

Two-part question. First of all, on the margins, they are implied in the fourth quarter lower than what you did in Q3 despite having more in the way of synergies coming through. Can you just explain what exactly is going on there?

And then on the working capital side. Jay, it looks like you were relatively flat overall in terms of working capital in the quarter. Can you just maybe update us how you're thinking about this target, and I think longer-term target you have out there to reduce working capital days from 75 down to 50 to 60 days?

William Brown

So let me get the first one and I'll pass it on to Jay. So, yes, we do see really good performance in Q3. It steps down sequentially in Q4, still up year-over-year. And it's really coming from higher supplier cost synergies going from Q3 to Q4, offset by some additional investment. Quite a big chunk of investment coming in Q4 both in R&D as well as in BNP.

So there's a little bit of sloppiness here in our Q3, but we see good opportunities to invest, investing in some of the ideas that are coming out. We're really busy on BNP activity. And really it's just a measure of additional step up in investment in Q4 from Q3.

So let Jay hit the working capital.

Jay Malave

Just a quick on margins, David. We did 210 basis points in Q3. We're almost 200 basis points in Q4. So the expansion is fairly similar. We're just starting up a little bit of a lower base in Q4.

As far as working capital, we've got a couple of days that we achieved in the third quarter. As I mentioned, we'll be at flat to maybe a day in the fourth quarter over the longer term. We're still kind of holding on to the six, seven, eight days of reduction to get us to the $3 billion in 2022.

So really nothing has changed from our prior communication there. Obviously, the internal objective is to do better than that and that's what we continue to do and drive our working capital initiatives across our businesses in our sectors. But right now, we're just holding it to where we were before.

David Strauss

Okay.

William Brown

And I'll just chime in and say the working capital improvement really begins and ends with the operations and we have 1,200 program managers and we're pushing down specific goals and education at the program management level, in addition to the general managers and through the finance organization. So it's part of a top down, bottom up effort to focus on and improve working capital.

David Strauss

And Bill, just a quick follow up. The investments that you're talking about - it would look like from the margin guidance, these are mostly in IMS and SAS, is the right way to think about it?

William Brown

Yes. That would be - that's primarily the two places, yes, correct. A little bit in the CS, but mostly at the other two, right.

Operator

Our next question comes from the line of Richard Safran with Buckingham Research Group. Please proceed with your question.

Richard Safran

Another philosophical or strategic question to open up here, could you elaborate on your building a new performance culture and grow revenue remarks on Slide 4. Now you're constantly using the word innovation and its clear there's been a substantial benefit from innovation. But what works against that is size and I think you're all aware of the rule of thumb that a bigger company gets the less nimble and the less they are able to innovate. So you're say you're going to invest in innovation. But I thought you might discuss a bit more on how you're going to incentivize and foster innovation at a much bigger L3Harris?

William Brown

So Richard, that’s a good question and I won't be long winded on it, but this is fundamentally what Chris and I and the rest of the senior team are focusing quite a bit of time on.

It's just building the culture that we want to see in the organization. Going back eight years ago, Harris went from a holding company to an operating company. This is the path that Chris has been on. That is a clear statement of intent within the organization is moving towards an operating company.

That means more centralized coordination of the things I talked about in my remarks, shared services, resources, technology, talent across the organization to leverage the power of the enterprise. And there’s lots of things that spill off of that, that's driving a lot of change with the organization. That's fundamentally where we're heading. And I think that speaks to the culture we're trying to create.

That also flows into R&D and how we're thinking about R&D development. Again back to where Harris was a number of years ago, we're developing R&D plans by each segment very siloed. That's what L3 has been doing.

We're moving towards more of an integrated model where we're sharing ideas across the company. We had our technologists together at the end of September, started to share different ideas.

So how we remain innovative in agile, look, it comes through multiple dimensions. Part of it is structural in how we set up the organization with tools for us to be able to share ideas across the enterprise on things like cyber or AI or waveforms - capabilities that really embed across all that we do.

Part of it is in processes and going to a common stage gate process for developing programs, making sure there's good business cases, managing things on a portfolio so trading off investments across the organization.

And then a lot of it is going to come from just being - just culturally. And part of that is, Jay, Chris, and I being willing to step forward and invest ahead of the curve on innovation ahead of need.

We've been demonstrating a willingness to do that. And then of course you mentioned a part of it is the type of people we're selecting how we incentivize them. Look, Richard, it’s long-winded answer and I went a little longer than I wanted to but the reality, this is fundamental to how we're creating a different organization that we're calling L3Harris to remain agile, fast-moving, especially in the world we're in today with DoD where it's not just innovation or affordable innovation. It's affordable innovation now. It's moving quickly in delivering solutions and that's where I think we're geared toward.

Richard Safran

Just quickly here, Space and Airborne on the F-16 modernization program you were down selected for, because this is a potential revenue synergy and because it sounds like a pretty large opportunity here, just wondering if you could size that and give us a sense of timing.

William Brown

Yes. Look, it's going to take you know several years, a couple of years. So the final selection occurs. I mean the fact is we got in a little bit late, but we were one of two down selected for the program. In which, as you know, Harris, legacy Harris has the EW platform for international F-16s.

We are not on the domestic F-16 that opens up that market. We think over time that could be cumulatively something like a $1 billion, but depends on how many aircraft and the cost per shipset. But it's a pretty substantial opportunity. We're working at it pretty aggressively and we're encouraged by within just a few months being down selected to be one of the two.

Operator

Our next question comes from the line of Gautam Khanna with Cowen and Company. Please proceed with your question.

Gautam Khanna

A couple of questions. First, I was wondering can you give us any sense of the size of the divestments that you guys have identified.

William Brown

No. I don’t think we’re going to be prepared to do that today. What I'm very encouraged about is the fact that in a relatively short period of time, I think we've aligned across the management team and with the board on how we're thinking about the portfolio. We're moving quickly on a number of different businesses. We'll announce the transactions as we go forward, and as we do, then I'll size them for investors. But I think it would be premature to give you any sort of a target point.

Gautam Khanna

Secondly, just wondering, you guys are running the head of the cost targets. When will you formally address those again?

William Brown

Yes. We'll talk about that every earnings release, Scott. And I think it will probably give you a - as we get into 2020, an update on what the 2020 numbers are and given where we're tracking again exiting this year at $200 million gross run rate makes 2020 look pretty good and probably at that time we'll give you a sense as to the magnitude, the opportunities we're seeing longer term and if we were coming up above $500 million gross and if so, how much. So we'll probably shape that a little bit more early next year.

Gautam Khanna

And I was hoping you could also just walk through the legacy RF Tactical pipeline and what you're seeing there domestic, international, and kind of what your expectations for bookings are over the next 12 months? Thank you.

William Brown

Yes. So let me hit on that one pretty quickly. So on the tactical side, we're seeing the - for the second half for the legacy RF Tactical business up low double digits, which is still pretty, pretty good growth. It was mid-teens in the front of the year. So as we get through calendar 2019, the overall Tactical business will be up sort of low to mid-teens in that range,

DoD has been very, very strong this year. We started off in the mid-40s in the first half. They will be sort of in the mid-20s percent growth in the back half. So very good trajectory was up 33%, as Chris mentioned, in Q3 so very good numbers but we're starting to get into more tougher compares here as we get into the fourth quarter, which is why the year-over-year is not quite as good as it was in the past, but still very healthy we're seeing a great shift towards monetization, the base revenue and DoD has been relatively stable. Modernization is coming up pretty dramatically. It's up about 2.5 times over last year so it's moving quickly.

We're replacing some of the readiness spend that we saw last year. So overall, DoD looks pretty good. The pipeline is about $1.7 billion, that's pretty solid. On the international side, this year for calendar 2019, we'll be up low-single digits.

We are flat in the first half. We'll be up to around 3%, 4% in the back half of the year. Chris mentioned we're up 9% in the quarter so it was quite good. That will be down in Q4 but when you look at Q3 versus Q4 on a dollar magnitude, we'll be fairly similar in size.

We just had better linearity this year on our calendarization than we did last year. So all of that is really good trend. The pipeline is about $2.5 billion. It's right in line with where we were before. It's pretty resilient. This year, the story has been largely around Europe. Europe had a really good back half both Western and Eastern Europe but we also saw Middle East to be quite a bit. This year we saw Asia pretty nicely as well.

So, we're seeing I think generally good trends as we expected. Canada will be down. We knew Canada would be down a little bit so generally that's kind of where we're heading. But overall I think things are hanging in pretty well in both DoD and international for I think a very good year in Tactical.

Operator

Our next question comes from the line of Robert Spingarn with Credit Suisse. Please proceed with your question.

Robert Spingarn

I just wanted to, Jay, ask you about the free cash flow guidance and if the pension prefunding in Q3 is flattering your cash recoveries this year at all and therefore the driver of the boost of free cash flow guide? And then how do you plan to report cash recoveries going forward in other pension line items? Would you be giving us detail as per the industry just now that they seemed to be a little bit more material?

Jay Malave

Well, for this year in the cash, there's really no recoveries related to this pension funding. What's driving the improvement was just a little bit better earnings and just a little bit in terms of balance sheet position than what we were looking at before.

As far as going forward on there, I mean we could take a look at another disclosure you're looking for us to provide there. We can certainly take a look at that and give it to you. And I think going forward, I'm not entirely clear exactly what the go forward recovery is. And so I just have to get back to you on that Rob.

Robert Spingarn

And then just another question. On SAS growth, you called out classified space earlier in the call. Can you provide any detail on how quickly this area is growing either in percentage terms or versus the segment as a whole?

Jay Malave

Yes. Growing in line with the overall segment Rob, it's been very strong. It's been strong for multiple quarters. When we say classified space, so it's a space with a big S, meaning things in space. So there's meaning the domain. So a lot of what we do in that area is classified. It could be ground programs, it could be space programs. And what we're finding is really good growth trends in both areas in space with the capital S, as well as on ground domains. And really what's driving this is a shift.

Again, we've talked about this before from components to subsystems to full and end mission solutions. They started to move into various adjacent markets. So the trend has been very good. The funding has been very strong in this area and it's been growing sort of in line with the overall segment, so sort of mid-teens.

Operator

Our next question comes from the line of Jon Raviv with Citi. Please proceed with your question.

Jon Raviv

On the free cash flow finishing this year at the high end of the range, and then you also mentioned in your prepared remarks double-digit growth over the next couple of years. Just trying to piecing it out, gets us above $3.1 billion in 2022. So what are your thoughts on that $3 billion target in 2022? And when could we maybe revisit that and talk about potential some upside there?

William Brown

So Jon, thanks for the question. We’ll probably talk more about that, I would imagine next year, as we close this year out and settle down the balance sheets and get ourselves organized. We'll talk more about the longer-term goal. Right now we're still saying is $3 billion in calendar 2022. So we've had a good start. So we get the guidance here $2.35 billion for the year, getting to $3 is another $650 million over the next three years.

Broadly speaking, it's about a third each between earnings growth, the after tax cost synergies beyond the $50 million we're delivering this year, and then working capital, Jay mentioned six, seven days of working capital. It's still about $35 million a day. So that's generally the math and we’ll reassess where we happen to be, once we get a little more comfort in what's happening to cost synergies, what's going to happen with growth trajectory, and really as we start to see real traction on working capital, we had a good quarter.

We are down year-over-year on working capital by about 19 days, about 10 days is inventory. That's pretty good work. So to really accelerate $3 billion will require us to do a faster job on inventory take out. That just takes some time to go and do. Chris mentioned about some of the metrics being pushed down to the program manager, that's exactly right, is driving accountability for that deep in the organization across all of our facilities. So I think it's going to end about a lot on how quickly can we take our inventory, that's what we're working on.

Jon Raviv

And then you talked about investments a lot on this call, you talked about it a lot over the past months and quarters. Has investing calculus change at all if for instance the customer won't allow you higher return if you take on more risk? Are you investing ahead of need more often today than in the past perhaps and what could that mean for long term profitability?

William Brown

Well, I think, we're running just shy of 4% of revenue this year. That's what we've been guiding investors to on an overall basis. I think we'll still be in that range over the next couple of years. I think the mix of where those dollars happen to go will likely shift and move around as we move from running things locally to more as a portfolio.

We'll start to see shifts and spend between programs. You may see more shift towards revenue opportunities to backstop those. Only about 10% or so of our IRAD is in support of OTAs. I mean that's certainly been a trend but that's not going to be a big driver here. As I mentioned culturally, we have been willing to step up and invest ahead of the need and we're going to continue to be able to do that.

And our job is to drive operational excellence, drive cost synergies, and make sure that we can invest in great return programs for shareholders. And that's something that Chris and I and Jay in here looking each other, committed to go and do, Jon.

Operator

Our next question comes from the line of Seth Seifman with JPMorgan. Please proceed with your question.

Seth Seifman

I wanted to maybe ask the divestiture question in a different way. We shouldn’t think though the divestitures at all as being potentially standing in the way of the $3 billion cash flow target for 2022, correct?

William Brown

That's correct. That doesn't stand in the way. Each business we have or most of them that we're thinking about generating free cash. But we think with some of the levers we can pull, we'll be able to offset any cash loss from divestitures.

Seth Seifman

And then maybe as a quick follow up the DoD radios. In terms of the order flow and kind of what's needed from a fiscal 2020 budget. How does that shake out in terms of your visibility into your calendar/fiscal 2020 based on where are things down with the CR and the budget?

William Brown

No. I think we're assuming a CR through the balance of this year through December. If it gets deeper into 2020, it could have some impact on the DoD business, mainly because it's more of a short cycle business. But we've talked about this before. The visibility has become a lot better. We've got a good backlog. The order trends have been very good. At least, GFY 2020 budget is up again for tactical radios to about $1.1 billion from $900 million or so in GFY 2019. There's still some of unspent funds.

If you go out over the slide of the next five years, I think the number grows to $1.6 billion, $1.7 billion in that range. So there's a lot of momentum here still remaining in the tactical radio business. I think we're at the front end of the curve. And from the way we see it, there's funding support, there's program momentum, there is operational execution by our team up in Rochester. That still leaves us confidence that we have $1 billion business here in calendar 2022 in DoD tactical.

Operator

Thank you. Our next question comes from the line of Michael Ciarmoli with SunTrust. Please proceed with your question.

Michael Ciarmoli

Just to go back to the revenue synergies. I know you mentioned a couple of other programs. But can maybe talk a little bit more about some of the opportunities you might be seeing in some of the unmanned surface or subsurface areas. I know we've got - Navy has Project Overlord out there. And maybe additionally on the revenue synergies, I know it was already being bid on L3 stand-alone, but how does the future vertical lift program? Does the combination make that offering a bit stronger or are there some synergies there, is that a high priority program for you guys?

Chris Kubasik

Good morning, Michael. It's Chris. First on the on the maritime, you're absolutely right on the unmanned opportunities. We both have surface opportunities. The Overlord program is - as you called it, which I think was renamed Black Pearl. We submitted a proposal recently on the medium unmanned surface vehicle and we're going to team with another contractor on the large surface vehicle

On the undersea, we - legacy L3 had made some investments and those are actually progressing quite well. We've been able to get some smaller awards and demonstration. So we're feeling pretty good about the investments and the opportunities in the unmanned arena. And also, relative to synergies in maritime there are capabilities that legacy Harris had that we're now incorporating on new programs like frigate, where there's four different shipbuilders and we're on all four teams with more content than had we not done the merger.

And in future vertical lift, which is specifically the near-term is the FARA program. Our focus there is to be one of the two down-select for phase 2. We're teamed with another company who's the prime. They did the design, we did the modular open system architecture. And there is additional content from legacy Harris, mainly in the EW and avionics that we're able to pull together.

So the synergy is - we're very excited about the revenue synergies. Bill mentioned the 14, but again 120 days in I think that's more than any of us would have predicted. We have to go ahead and execute. We've got to go ahead and win these competitions. We're both very excited about where we are today.

Michael Ciarmoli

And then just if I may, can you sort of give a general state of the union here on the continuing resolution? Should we think or do you guys envision that there'll be any near-term impact to either revenues or bookings? Whether it doesn't look like this might get resolved by November 21 but if this drags on for three to six months, can you just maybe articulate if you expect any headwinds there?

Chris Kubasik

Well, as I mentioned, it was calibrated through calendar 2019 assuming this year-ago should be end of the year. So like you were expecting, that'll go beyond November 20 and go a little bit longer than that. It could go into early next year. I don't want to size it yet because we really just see when it actually gets enacted when the appropriation bills are enacted or hopefully that will happen by the end of this year. But we’ll have enough time as we get into January to assess where we're at

And as we guide on 2020, we’ll incorporate the latest thinking out of DC on budget and budget timing. But reality I think what's encouraging here, is there is a top line two-year agreement. There's a lot of alignment between House and Senate bills on funding areas. And as I look through that, we feel pretty good about the budget as they're starting to shape up.

And I'm optimistic that the overall budget will get approved, will get approved in a timely basis. A lot of pressure on that - of that to happen. So right now, it's not a concern for 2019. We'll revisit this early 2020.

Operator

Our next question comes from the line of George Shapiro with Shapiro Research. Please proceed with your question.

George Shapiro

Bill, just wondering that UTX have got to sell their accounts GTS business. I would think that would be pretty attractive for you, and I was wondering if you could comment on it.

William Brown

I won't. No, George. I'm not sure what UTX is going to do. I'm not really following in detail what's happening on the regulatory process so, I really can't comment on anything that they might have to divest. I really don't have any inside knowledge on that.

George Shapiro

And then, just one for Jay. The lowered operating cash flow guidance, is that just timing of all of the one-time items that caused that kind of a drop?

Jay Malave

Yes. That’s exactly right, George. And if you look at it, I think if you take a look at the deal-related costs, there were, on a cash basis, $300 million plus. The good news with that is that's pretty much fundamentally behind us. And so, it's not something that we'll have to worry about going forward. And what we'll have to tune up and to keep track of is the cost to implement the synergies, the integration costs going forward.

On a P&L basis, we're - we’ll be through the year about $250 million with $200 million left to go at the $450 million level, and kind of the timing of that on a P&L basis is about two-thirds, one-third. On a cash flow, a little bit slower. About $375 million dollars after tax there, and we'll be around you know $200-ish million, I guess, this year. And again, I would say probably 60/40 in terms of cash impact between 2020 and 2021 there.

Jay Malave

And just to add, if you're comparing it to the guide, George, we also pre-funded the pension of $320 million which is part of the operating cash flow.

George Shapiro

And one quick one if I might squeeze it in, you should benefit next year from the discount rate coming down for your - with pension income going up. Can you kind of just give us any benchmark as to how much it might change per every 25 basis point drop in DR or something along those lines?

Jay Malave

Yes, 25 basis points up or down about $10 million of P&L impact. The balance sheet impact is about $300 million on the liability.

Operator

Our next question comes from the line of Peter Arment with Baird. Please proceed with your question.

Peter Arment

A lot of questions already asked here. But I'll just ask a quick one here Bill, on all the investing and then just kind of highlighting, I think, these great revenue synergy proposals that have been put out. I guess, what are you hearing from the customer in terms of the feedback on your investing? Obviously, it sounds very encouraging. And then, anything about just share gains that you're going to be looking at?

William Brown

I'll jump in within and Chris can jump in as well and build on this. So Peter, look, first of all, we're very encouraged on the revenue synergies. Chris mentioned about being early in the process, and we are. So there's a lot more to do. We have to go and win some things. So it's all sort of good indications.

The feedback from the customers, I think, has been very good. But they've seen us do what we've been trying to do individually, and that's step up, invest in R&D, invest ahead of the need, be proactive in providing or offering solutions, being agile, moving things quickly.

So overall, the feedback has been very good. And I think the fact that these revenue synergies are moving like they're moving, is an indication of the trust and confidence that the customer community puts in this new company called L3Harris. So I'll let Chris may be build on that.

Christopher Kubasik

Yes, absolutely. I've put the customers in two buckets, the end users, the DoD. We've had meetings as recently as last month, and they're very supportive of the merger. They like the agility. They like the significant investments that we are making.

And, again, the mission solutions prime, the mission solutions provider, plays in very well with the strategies that our customer has. And whether it's older platforms with new capabilities or new platforms with better capabilities, it's really in the sweet spot of where the challenges are.

And, of course, we work collaboratively with a lot of other prime contractors. And again, those relationships are going well and our capabilities that we bring to like an F-35 are appreciated and noticed. And we work collaboratively to provide those capabilities.

So, pleasantly surprised with the feedback and we just have to continue to execute and deliver on-time quality products.

Operator

Our next question comes from the line of Josh Sullivan with Seaport Global. Please proceed with your question.

Josh Sullivan

Just a question on the classified budget exposure. I know you provided some color there on the space exposure. But what about the rest of the classified budget? How big of an opportunity is that outside of space? And then maybe, what percentage of the total portfolio at this point is coming from the classified budgets?

William Brown

By the time we come back to you on the piece of the portfolio. We knew where legacy Harris was. I think we the communize or definition, but it could be in the 20% range. The reality is, when you look at the combined military national intelligence budgets, it's north of $80 billion, $82 billion something like that.

So our piece of that assure that still is relatively small. I think lots of opportunities to grow into it. But more importantly, the places where that budget or those budgets are shifting are more in line with the direction that we've moved.

Clearly, there's been a shift towards resiliency in how you define that with space architecture. And I think we're ahead of the curve on that a little bit and we're enjoying some of the benefits of that.

I think it's - so I'd want to come back to you on what piece of our overall company is now. The classic part of it is definitional as well. So I think we'll come back and maybe have a different answer on that.

Josh Sullivan

And then just on the footprint consolidation efforts, where are you moving faster? Are there any hurdles popping up? And I'm not sure if you mentioned, but any metrics on square footage or the number of facilities maybe targeted for the end of the year?

William Brown

No, we didn't mention it. I mean, we - I think we've talked publicly that we have about 20 million square feet of space, just over 400 facilities. So we've obviously moved pretty quickly on a couple of different facilities, headquarters facility we've moved pretty quickly on a few others. There's a number of projects that are working itself through the process, we're evaluating each one in turn.

The bigger ideas, the ones that are going to move the needle are the ones where we actually do production. Those do take some time to really think through, to action, to put teams against, and we're right in the middle of that.

When we step back and we talk about sort of overall cost savings, we knew about half was coming from supply chain and facility rationalization. And the facility part was on the order of $30 million, $40 million, in that sort of overall magnitude. And we're making good progress. I think it's still early days of what will be a multiyear journey.

Operator

Our final question comes from the line of Rajeev Lalwani with Morgan Stanley. Please proceed with your question.

Rajeev Lalwani

Just a couple of quick ones on the international side. Bill, can you talk about the traction you've been gaining there post the deal given the expanded scale and size of the company? And maybe any color on the portion of revenues you think that could become as we look forward a couple of years?

William Brown

It's a good question. I'll start and maybe Chris can jump in here. So, Rajeev, good question. About 22% of our revenue today is coming out of the international. Again, we're still working to making sure we're harmonizing the definition of the international. So work in average around 22%.

We should expect that to come up over time. We're under penetrated internationally. Combined, we've got a great position in five or six different markets. And through that combined strength in those markets, we do believe we can provide better offerings.

It's something that we're working through and what the specific strategy is there. Chris is leading this with his team. But that should come up over time to sort of offset what might be a DoD flattening, if you will, in the next couple of years.

So, Chris, maybe jump in and say a couple of things on international.

Christopher Kubasik

Yes, absolutely. I've put in three buckets. We have three countries. We have a pretty big presence in Canada, U.K. and Australia, where we have engineers and business development actually delivering and building product in country and exporting out of those countries. And those three are looking very good. And we've had some combined synergies from both legacy companies with those three countries.

We have the distribution systems, the legacy Harris have in place that we're looking at some legacy L3 products going through those distributors. And then, of course, we have the business development footprint in about seven countries; mainly, Far East and Mid East. And we're very optimistic about the growth opportunities, again, bringing more capabilities to our customers.

And I agree, we're at 22% now and there is an upward trajectory over the next couple of years. And we'll give you more in future calls. But good opportunity and good progress so far.

Rajeev Lalwani

That's great. And then real quick on the tactical side. The DoD part of it has been incredibly strong. Is there any opportunity for the international side to maybe catch up to those sort of growth rates over time effectively on a lagged basis?

William Brown

Well, they're very different markets and they're driven by different factors. What you see in the U.S. is a shift towards modernization and upgrading legacy radios is well funded by government. So you've got different services moving at different rates, but you've got only a few services.

Internationally, we're in 100 different countries. So each one operates in different ways. But the reality of what we see is what's driving a lot of the growth right now is really coming from modernization and upgrading from what were a Falcon II to Falcon III and now Falcon IV radios, moving from single channel to two-channel radios, really lagging and following what we see happening in the U.S. domestic market.

So, typically, the way these things happen, you move from special operations in the U.S. with things like the two-channel radio, what Chris mentioned, the two-channel manpack we're developing, VHF radio. That trickles into regular army in the U.S. It trickles into international special operations. And that eventually trickles into regular forces on the international markets.

That’s sort of the trajectory here that we typically see and that gives us encouragement. We'll see continued growth into the future in international. I don't think it's going to be the sort of growth rates we've seen this year on DoD because they run at different paces. But I do think that that's the general trajectory and what backstops growth in the future international.

William Brown

So just to wrap up here, thank you very much for joining the call. The progress we've seen in our first 120-days has been terrific. And our leadership team, our employees remain focused on meeting customer expectations and delivering value to shareholders, while really executing extremely well in integration. I want to thank them for the hard work and for the dedication.

We feel good about our increased guidance as we enter the final innings of what has really been an exceptional year. And a relentless focus on our strategic priorities puts the Company in a strong position to continue to outperform next year and beyond. So, thank you again for joining us today.

Operator

Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation and have a wonderful day.