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Keysight Technologies, Inc. (KEYS) CEO Ron Nersesian on Q3 2019 Results - Earnings Call Transcript

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FQ3: 08-21-19 Earnings Summary

Press Release *10-Q* *Slides*

EPS of $1.25 beats by $0.23 | Revenue of $1.09B (7.94% Y/Y) beats by $43.12M

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Keysight Technologies, Inc. (NYSE:KEYS) Q3 2019 Earnings Conference Call August 21, 2019 4:30 PM ET

Company Participants

Jason Kary - Vice President, Treasurer and Investor Relations

Ron Nersesian - President and Chief Executive Officer

Neil Dougherty - Senior Vice President and Chief Financial Officer

Mark Wallace - Senior Vice President, Worldwide Sales

Satish Dhanasekaran - President, Communications Solutions Group

Conference Call Participants

John Marchetti - Stifel

Tim Long - Barclays

John Pitzer - Credit Suisse

Brandon Couillard - Jefferies

Adam Thalhimer - Thompson Davis

Jim Suva - Citigroup

Richard Eastman - Robert Baird

Brian Yun - Deutsche Bank

Operator

Good day, ladies and gentlemen, and welcome to the Keysight Technologies Fiscal Third Quarter 2019 Earnings Conference Call. My name is Rob and I will be your lead operator today. After the presentation, we will conduct a question-and-answer session. [Operator Instructions] Please note that this call is being recorded today, Wednesday, August 21, 2019 at 1:30 p.m. Pacific Time.

I would now like to hand the conference over to Jason Kary, Vice President, Treasurer and Investor Relations. Please go ahead, Mr. Kary.

Jason Kary

Thank you, and welcome everyone to Keysight's third quarter earnings conference call for fiscal year 2019. Joining me are Ron Nersesian, Keysight President and CEO; and Neil Dougherty, Keysight Senior Vice President and CFO. Joining us in the Q&A session will be Mark Wallace, Senior Vice President of Worldwide Sales; and Satish Dhanasekaran, President of the Communications Solutions Group.

You can find the press release and information to support today's discussion on our website at investor.keysight.com. While there, please click on the link for quarterly reports under the financial information tab. There you will find an investor presentation along with Keysight's segment results. Following this conference call, we will post a copy of the prepared remarks to the website.

Today's comments by Ron and Neil will refer to non-GAAP financial measures. We will also make references to “core” growth, which excludes the impact of currency movements and acquisitions or divestitures completed within the last 12 months. You will find the most directly comparable GAAP financial metrics and reconciliations on our website.

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

Lastly, I would note that management is scheduled to present at upcoming investor conferences in September hosted by Citi and Deutsche Bank. We hope to see many of you there.

And now, I will turn the call over to Ron.

Ron Nersesian

Thank you, Jason, and thank you all for joining us. Keysight delivered another outstanding quarter. Our differentiated strategy, relentless focus on execution, and commitment to operational discipline continue to generate strong financial results. I will focus my formal comments on three key headlines for the quarter.

First, Keysight delivered another strong quarter with both revenue and earnings exceeding the high-end of our guidance. Record third quarter revenue grew 8% year-over-year, or 9% on a core basis. Our differentiated solutions, software and services continue to fuel our growth across a broad portfolio of customers.

And equally important, our strong culture of execution and commitment to operational excellence continues to drive our record performance on the bottom line. This quarter, we achieved record operating margin of 25%, and earnings of $1.25 per share and earnings growth of 41%. We also generated record free cash flow of $244 million.

Second, we continue to see customers make R&D investments in certain next-generation technologies, such as 5G, across multiple end-markets. However, our macro environment concerns remain, and we continue to anticipate headwinds resulting from trade tensions with China. Despite these dynamics, given our broad portfolio of customers and solutions, we believe we are in a strong position to drive above market growth even in times of economic uncertainty.

Third, given our continued success in the market and strong performance in Q3, we are raising our revenue and earnings outlook for the year. We now expect revenue growth between 9% and 10%, and earnings growth between 40% and 42% for the full fiscal year.

Now let's take a deeper look into our performance for the third quarter. We achieved $1.25 per share in earnings, which was $0.24 above the midpoint and $0.20 above the high-end of our guidance. This represents our sixth consecutive quarter of double-digit earnings growth, and earnings growing 41% for the quarter and 52% year-to-date.

Revenue grew 8% year-over-year, or 9% on a core basis, to surpass $1 billion and reach a new third quarter record for Keysight. This brings our year-to-date revenue growth to 13% on a core basis. We also delivered strong order growth. Orders grew 10%, both in total and on a core basis, to exceed $1 billion for the fifth consecutive quarter. As a reminder, our core metrics exclude the impact of currency movements and revenue from acquisitions or divestitures completed within the last 12 months.

Software orders grew double digits in the quarter. Our portfolio of solutions, comprised of leading software, hardware, and services capabilities, is at the core of our competitive differentiation, and further strengthens Keysight as a strategic partner to customers. Building on our commitment to help customers accelerate their innovations through software, Keysight recently collaborated with Nokia to launch the Open Test Automation Project, which we refer to as OpenTap.

This new collaboration provides an open-source, scalable architecture for automated test solutions and enables innovation in new technologies and increased development efficiency. Customers can also extend their OpenTAP capabilities through additional commercial offerings in our PathWave lineup.

Our ability to expand our software capabilities across the total communications workflow through acquisitions has generated strong returns for Keysight. This began with the acquisition of Anite in 2015, which was a key enabler of our 5G platform. Our expansion into the software layers of test with Anite has resulted in significant share gains in the 5G market. As we move forward, we see increased opportunities to make greater contributions to our customers' workflow.

To that end, we are pleased to announce the acquisition of Prisma Telecom Testing. Based in Milan, Italy, Prisma has deep software expertise and a decades-long track record of delivering network equipment manufacturer solutions. This acquisition further enhances our ability to deliver leading edge end-to-end solutions across the entire communications ecosystem.

Moving to our markets, Commercial Communications drove considerable upside in the quarter with double-digit order and revenue growth. This growth was driven by another exceptional quarter of 5G orders, where we believe we have strong technology leadership over the competition. Keysight's 5G success is a result of our first-to-market innovations and engagement with leading-edge market makers across the wireless R&D ecosystem.

We are proud of the many industry breakthroughs that are a result of these collaborations. For example, in July we announced that our efforts with many industry leaders have resulted in the industry's first Global Certification Forum validation of 5G test cases. This achievement, combined with our ongoing collaboration with key operators, accelerates 5G deployments globally.

Looking ahead, we expect the Commercial Communications market will continue to benefit from increasing demand, driven by the complete redesign of communications systems for higher speeds and new use cases. Keysight is at the forefront with solutions designed to accelerate these innovations. In addition to R&D strength, our new modular products are doing very well in selective customer production workflows.

Moving to automotive, we continue to engage with customers in the automotive electronics market for new powertrain electrification technologies and advanced electronic systems. With our acquisition of ScienLab in 2017, we have considerably extended our leadership in this market by integrating our technologies and expanding across Tier-1 customers. Automotive is an area where we continue to invest and innovate.

We recently launched Keysight's Automotive Cybersecurity Test Portfolio, which delivers hardware, software and services that address the growing concern of cyber-attacks on connected vehicles. Utilizing security solutions developed by our Ixia Solutions Group, Keysight is delivering extensive security validations of the 4G and 5G radio access network infrastructure that connects vehicles, and the backend data centers that manage business operations.

Additionally, network visibility solutions deliver an enhanced infrastructure that improves the efficiency of security toolsets in production networks. With the combined technology portfolios of Keysight, Anite, Ixia, as well as Prisma, we are delivering solutions across the entire communications workflow from end-to-end and up and down the stack.

Beginning in Q1, we are taking the combination one-step further by integrating ISG within our Communications Solutions Group. We believe this will create improved go-to-market and product development alignment to foster growth across the ecosystem as 5G moves from the deployment phase to commercialization. 5G deployments pose complex challenges across devices, base stations and core networks on an accelerated timeframe.

Keysight is uniquely positioned to offer solutions end-to-end for all these challenges. This organizational alignment will further enhance our ability to accelerate innovation in 5G. Additionally, we see future opportunities to expand our footprint within enterprises deploying dedicated networks, as our network visibility solutions provide increased actionable insight and security for mission critical applications running on these networks.

In summary, Keysight has expanded its technology leadership with a diverse portfolio, while strengthening our competitive position in fast-growing, high-margin target markets. And our leadership position has delivered strong financial results. 2019 will be our fifth consecutive year of outstanding execution and operational excellence since launching Keysight.

At the midpoint of our Q4 guidance, we will deliver FY 2019 revenues of [$4.280 billion] and $4.57 in EPS. This represents a compounded annual growth rate of 11% for revenue and 16% for EPS since our first year as a public company in FY 2015. Most importantly, Keysight has achieved a leadership position across growing addressable markets and is well-positioned for continued share gains.

Lastly, our commitment to excellence is deep and our DNA and extends beyond our financial performance. On that note, I'm proud to report our achievements in corporate social responsibility. We released our 2018 Corporate Social Responsibility Report in May outlining Keysight's accomplishments in this space, including key impact results in natural resource conservation, supporting next-generation technologists through the education processes and programs, and strengthening local communities.

Our continued efforts are often recognized in the industry, most recently with Keysight's inclusion in several CSR-focused indices. I'd like to congratulate all Keysight employees for their dedication to the company's success over the past five years, while upholding our global business framework of ethical, environmentally sustainable, and socially responsible operations.

Now, I will turn it over to Neil to discuss our financial performance and the outlook in more detail.

Neil Dougherty

Thank you, Ron, and hello, everyone. Before I get started, I will note that all comparisons are

on a year-over-year basis unless specifically noted otherwise. As Ron mentioned, we delivered another strong quarter as we continue to execute on the demand, we see in core areas of our business, while maintaining focus on operational excellence and superior execution.

For the third quarter of 2019, we delivered non-GAAP revenue of $1.088 billion, which was well above the high-end of our guidance range and grew 9% on a core basis. Our better than expected Q3 revenue results were driven primarily by continued strong demand in areas where we have a leading position in the market, such as 5G. This brings our total revenue growth for the first nine months of the year to 11%, or 13% core growth.

Total Keysight orders exceeded revenue once again this quarter. We delivered $1.110 billion in orders in Q3. Orders were up 10% in total and on a core basis. I will also highlight that in Q3, orders for services again grew double-digits on broad-based demand and good adoption of our new support offerings, such as Keysight Care.

Looking at our operational results for Q3, we reported strong gross margin of 63%. Our notable gross margin performance and continued strong operational discipline led to another quarter of record operating margin and earnings. We achieved 25% operating margin and net income of $239 million. On a per share basis, we delivered $1.25 in earnings, which was well above the high-end of our guidance. Our weighted average share count for the quarter was 191 million shares.

Our Communications Solutions Group generated record revenue of $683 million, up 13%, while delivering gross margin of 63% and record operating margin of 28%. In Q3, Commercial Communications delivered double-digit order growth and revenue of $440 million, driven by broad strength across the wireless ecosystem as increased 5G investment continued.

Aerospace, defense and government generated revenue of $243 million, an increase of 2% on a core basis. During the quarter, we continued to see steady spending in the U.S., which was offset by softness in some international markets. Order growth for this end-market was high single-digits, and we have a strong overall funnel building into Q4. EISG generated third quarter revenue of $295 million, up 3%, driven by strength in next-gen automotive and general electronics.

As expected, this growth was offset by lower capital investments by our semiconductor customers. This quarter we saw strength in the broad portfolio of products that serve our general electronics end-market. EISG reported record gross margin of 62% and record operating margin of 28%. ISG reported Q3 revenue of $110 million, a 7% decline over last year. The decline in ISG revenue reflects ongoing softness in the network test market, whereas network visibility solutions generated high single-digit growth, driven by enterprise sales in the U.S. and Asia.

ISG reported gross margin of 72% and 1% operating margin. As Ron mentioned, in Q1, we will implement a change to our organizational structures to align ISG with our Commercial Communications end-market, including global sales. At that time, we will report ISG results combined with our Communications Solutions Group, which will provide solutions across the entire communications ecosystem, both end-to-end and up and down the stack.

Moving to the balance sheet and cash flow, we ended our third quarter with $1.4 billion in cash and cash equivalents and reported cash flow from operations of $274 million and record free cash flow of $244 million. Free cash flow for the quarter was 22% of revenue and 102% of non-GAAP net profit. Under our share repurchase authorization, during the quarter, we acquired approximately 760,000 shares on the open market, at an average price of $78.92, for a total consideration of $60 million.

Before moving to our outlook, I would like to make a few comments regarding the United States Department of Commerce export control regulations that impact one of our large customers in China. As I'm sure you can appreciate, the current regulatory environment remains a fluid situation.

On our last conference call, we said that we expect these trade restrictions to be a headwind to revenue growth in the second half of this year and the first half of 2020. To date, we have been able to ship some products to this customer within the current legal regulations.

As a result, we expect to see a slightly smaller headwind in Q4 than previously anticipated. Due to on-going trade concerns, we continue to expect a 3 to 4-point headwind in the first half of 2020 related to this customer.

Now, turning to our outlook and guidance. We expect fourth quarter 2019 revenue to be in the range of $1.080 billion to $1.100 billion. This brings our revenue growth range for the year to 9% to 10%, which is above our prior outlook of 7% to 8%. We expect Q4 earnings per share to be in the range of $1.14 to $1.20, based on a weighted diluted share count of approximately 191 million shares. The midpoint of our earnings guidance implies 41% earnings growth for the full-year.

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

Jason Kary

Thank you, Neil. Rob, will you please give the instructions for the Q&A?

Question-and-Answer Session

Operator

[Operator Instructions] And you first question comes from the line of John Marchetti from Stifel. Your line is open.

John Marchetti

Thanks very much. Good evening guys. Just real quick on the upside in the quarter itself. I think on the last call you talked about the Huawei or the expectation of Huawei, being about a $25 million hit in the quarter. Just curious where that stands now. I know you said that in the guidance it is still a little less than you had thought, but how much of soft of that 25 million actually came through in the quarter? And as you have been going through some of your processes there and looking at what you can ship, how does that stand now in terms of what you are shipping today, versus maybe what you were shipping at least from a product perspective earlier in the year?

Ron Nersesian

Yes, John. So, it's a couple of comments. So, first of all, as it relates to Q3, we ended up shipping about a little, you know approximately $10 million more to Huawei than we had originally drawn up when we were issuing the guidance three months ago. I think as we look forward, as we mentioned in our prepared remarks, we do see a muting, if you will, of the risk in Q4 because we are able to ship a portion of our portfolio into Huawei. And so that impact is more muted than we had originally anticipated and we've reflected that in the guidance that we've provided to you for the fourth quarter.

I think as we look forward, as we've mentioned, Huawei has historically been a 3% customer, approximately a 3% customer for us. They were significantly larger than that in the first half of last year and with 2020 hindsight, it's pretty clear that they were buying ahead in anticipation of trade tensions. I think – so they'll need to work through whatever incremental inventory they've built up. And so, I think as we look to next year, we would expect Huawei to be maybe a 1% or a 2% customer for us, therefore, resulting into 3-point to 4-point headwind for us in the first half of next year.

John Marchetti

Thank you. And then maybe just as a follow-up. Shifting gears, a little bit to the European market. That was certainly a little bit of a drag this quarter. Just curious if you can share some color there about what areas seem to be weaker? Is it just a sense that the general economic outlook there has deteriorated? Or is there something more to it than that? And does that become a greater concern for you as we get further into this calendar year and into early next?

Mark Wallace

Yes, John. This is Mark Wallace. I'll take that question. So, we had mixed results in Europe. During the quarter, we saw growth in 5G, as we did in every single region across the world. We saw a growth in automotive. We saw growth in education and in the general broad customer base, including research.

The two areas we saw some softness that offset it was in semiconductor, which we had a pretty tough compare to this time last year, to Q3 of last year due to some acceleration of business with one of our customers there, and we saw some general softness in aerospace, defense. So, I would say it's a mixed set of markets that we experienced during the quarter as opposed to anything broader.

John Marchetti

Thank you very much.

Operator

Your next question comes from the line of Tim Long from Barclays. Your line is open.

Tim Long

Thank you. Just two questions if I could. First, on the 5G side, I'm not sure if you gave the order number. Just curious if you can just update us on competition. Obviously, it continues to be a really strong performer for you. Just wondering what you think will happen when that segment gets a little more competitive? And then secondly, if you could just touch on Ixia. I understand the – moving it around closer to the Commercial Communications Group. Maybe if you could just touch on a little bit why there hasn't really been the same type of pull-through that we would have expected with those two businesses? And how mechanically, that you think that will change and help the Ixia Group in the next year or so? Thank you.

Satish Dhanasekaran

Yes. I'll just take the first question. This is Satish. With regard to 5G, so we continue to have strong momentum in 5G this quarter yet again and our strength is pretty broad as Mark Wallace referenced. And it's really a reflection of our portfolio, which is intended to be broad and applicable to the entire ecosystem end-to-end and across all the regions where we saw customers adopt our solutions.

A particular driver that if I may highlight amongst everything is, the GSA reported that well over 100 devices have been announced for 5G most recently through the year and the number of subscribers who will have access to 5G-ready devices next year would be north of $60 million to $70 million. That's a pretty big number. And we saw that reflected in some of the R&D spend that was coming from the Tier 1 and Tier 2 players in the smartphone space. So, it continues to be strong and our differentiation holds and because of our lead in the 5G standards, we continue to do well.

Ron Nersesian

Tim, this is Ron, and I'll take the second question and then pass it over to Mark Wallace. So, with regards to ISG, there are two different businesses there. One is network visibility and the second is network test. Network test sits right in the communications workflow and is very much connected to what happens in CSG. Network visibility is a little bit further down the line and therefore is able to get going without the integration directly. So, in network visibility, we had 9% revenue growth and we had 17% revenue growth year-to-date.

So, we feel that we've integrated that business, stabilized that business, and we have turned that around and that is growing and doing well. The network test business, which is in a tough market right now really needs to play out in our next phase of our original vision. Our original vision was to provide solutions across the total communications ecosystem end-to-end and up and down the stack. And this next step in our evolution where we're combining it with the rest of CXG is something that myself and others had envisioned right from the start. And the reason is two-fold.

One is product synergy and then in the product synergy area, for instance, they have introduced a 400-gig solution for AresONE, and we use part of the stack that was developed in Ixia network test in our BERTs are bit error rate testers. And there is much more opportunities on the product synergy area as we go forward. The second area is the sales synergy. I'll let Mark talk to that. But the key reason is, by pulling this together, we're finding more and more areas to drive product synergy and therefore, revenue synergy.

Mark Wallace

Yes. And Tim, this is Mark. I'll just add to what Ron just said. This product synergy is going to be amplified by the changes that we're making to reorganization and sales, which is a continuation of the transformation that we've been doing for the last three years, further scaling our footprint across all of our global markets. Leveraging these really deep account relationships and access that we've built over years and decades into some of the same customer base. And then, as Ron has mentioned and we've talked about before, really enabling us to bring the complete set of end-to-end solutions to our customers. So, I think this really ties it all together.

Ron Nersesian

And I'll just add one other comment that you may be wondering about. We had talked about at an earlier Investor Day of doubling our sales force from approximately 500 people to a 1,000. We are right on track with that. And that does not include the additional people that will move over from the Ixia sales force. So, that will be incremental of about 100 people on top of that.

Tim Long

Okay. Thank you very much.

Ron Nersesian

Thank you, Tim.

Operator

And your next question comes from the line of John Pitzer from Credit Suisse. Your line is open.

John Pitzer

Yes. Good afternoon, Ron and Neil. Congratulations on the solid results. Ron, you guys have done a good job sort of quantifying the direct impact from Huawei. I'm wondering if you can talk a little bit about maybe an indirect impact that might happen. Are you seeing any changes in deployment schedules in 5G in China because of this? And when you think about the direct impact of Huawei, is this a temporary loss of business? Or do we have to worry that they might look for other potential non-U.S. suppliers to substitute you?

Ron Nersesian

Well, on your first question, yes, it is impacting 5G in China. It is accelerating our growth in that area. Our order growth was very, very strong in China in the quarter. And again, with the races on where countries are competing for 5G growth, and we saw that also in China. So, we're very pleased with the overall results in that area.

John Pitzer

And then guys maybe as my follow-up, maybe for Neil. Neil, just a little bit of nitpicking. But just when you look at the forward guidance, you're guiding revenue kind of flattish, EPS down a little bit. Just given how well you guys have done operationally on both in gross and operating margins, can you just help me square the circle little bit as to what's happening maybe either with mix and period cost that would drive EPS down a little bit on flattish revenues?

Neil Dougherty

Yes, we do have some seasonally higher expenses that we're expecting here in the coming quarter that we think will impact profitability a little bit this quarter. Obviously, we've, over the long term talked about an operating model, which delivers a 40% incremental on revenue growth and we've been over the past couple of quarters really exceeding that by a very, very large degree.

So, we have some pent-up demand for expenses and some seasonality around year-end sales commissions and other things that will impact our profitability in the fourth quarter. But we're comfortable with the long term, and we're pleased that we were able to raise both our revenue and earnings estimates this quarter.

Ron Nersesian

And John, just getting back to the second half of your question, I believe you asked about whether or not in China, there were other competitors that may gain from the trade wars. We don't see that obviously for other U.S. competitors. But for competitors out of Germany and out of Japan, they can get, let's just say a more consideration, but we're very comfortable with our overall differentiation, which will enable us to drive our growth throughout the world.

John Pitzer

Perfect. Thanks, guys. That's very helpful.

Ron Nersesian

Thank you.

Operator

And your next question comes from the line of Brandon Couillard from Jefferies. Your line is open.

Brandon Couillard

Hi. Thanks. Good afternoon.

Ron Nersesian

Good afternoon.

Brandon Couillard

Ron, a question for you is, when you sort of looking out to fiscal 2020, to the extent you're willing, sort of given the Huawei loss and tougher comps kind of uncertain macro environment, would you still expect to be able to deliver top line growth organically above your 4% to 5% long-term range? Any color you can help us out with this, as we sort of build our models for next year?

Ron Nersesian

I'm going to let Neil take this. Obviously, we only guide one quarter out, but Neil will be able to give you a little bit of color.

Neil Dougherty

Yes. Obviously, Brandon, it's a little bit of a difficult question, given some of the macro uncertainty that exists today. I think what we would focus on is that we're very confident in the strength and differentiation that exists in our portfolio and we're very confident in our ability to outgrow the market and our competitors regardless of what set of economic circumstances take place. I think we still see strong secular trends in some of these big growth areas. As we talked about, the 5G ramp is accelerating and China is kind of leading that today, but we expect other countries will soon follow.

Auto is the other one that obviously where we would see – expect to see a little bit of an arms race going on, as folks across the globe will look to get out with the EV and increased levels of autonomous vehicles out into the marketplace. We'd also expect aerospace defense to have a good year next year. So, as you know, we operate in a diverse set of end markets, both from a market standpoint, from a geographical standpoint, with the broadest portfolio in the industry, which is very well-positioned and so we're pretty confident going into next year.

John Pitzer

Thanks. And then just one follow up on the Prisma acquisition. Can you quantify the revenue base for that asset? Kind of what your pipeline looks like for other deals right now and exactly what whole Prisma feels that in terms of capabilities that you didn't have in-house already? Thanks.

Ron Nersesian

Thanks. Why don't I take the first part of that and I'll let Satish talk? It's a small acquisition. It's substantially less than 2% of company revenue. We have a strong – as always, we have a strong funnel development process, but I think we set a high bar in terms of the types of assets that we're looking to bring into Keysight in the types of returns that we – that we like to grapple. We're always looking to reinvest, to drive growth and value expansion for our investors.

Satish Dhanasekaran

Yes. Thank you. As you know, a big part of our success and expansion in 5G has been in the software layers of test where we have made this a strategic priority. And we've made some acquisitions of Anite and continue to invest for the position we have. We believe we have a leadership position here. But having said that, as 5G evolves, we see opportunities in new areas, like with RAN disaggregating and virtualization, and other areas where our collaboration with customers has been very close. And as you saw from the press release that we had with Nokia as an example.

To continue to build on this trend, we're always looking for great talent, teams with credibility, and Prisma Telecom Testing has had over two decades of experience, specifically focused on helping base station designers overcome the software layers challenges. And it's a great team and a great add, and while the revenue today is a smaller fraction of Keysight, I know it will add and strengthen our 5G platform and build on the runway we currently have.

Ron Nersesian

And Brandon, this is Ron. A good way to think about Prisma is very similar to Anite, where it has capability to help us move forward in the software layers to leverage our overall 5G and communication solutions. And as far as utilization of our cash with regards to other M&A, as you can see, we're generating very strong free cash flow. We have $1.4 billion of cash right now.

But if you take a look at our return on invested capital over the last 12 months, it's been roughly 26%. So, we have a high threshold. As Neil had mentioned, as far as our utilization of cash and we're going to make sure that anything we buy will always generate an ROIC above our WACC. And we've done about nine acquisitions and eight of them are in really good shape. And one of them we've got about halfway there.

Brandon Couillard

Very good. Thank you.

Operator

And your next question comes from the line of Adam Thalhimer from Thompson Davis. Your line is open.

Adam Thalhimer

Hi. Good afternoon, guys. Congrats on a great quarter.

Ron Nersesian

Thanks, Adam.

Adam Thalhimer

I also wanted to ask about fiscal 2020 and particularly on the margin front. Just curious if there's any reason the margins that you put up in Q2, Q3, and then you're guiding to for Q4, I mean, are those sustainable for next year? Maybe you can just walk us through puts and takes there.

Neil Dougherty

Yes. I mean, I'd focus – start on the gross margin line. We did talk about in the second quarter having some really favorable mix that kind of drove that to be rounding to 64%. I think we're comfortable in the 63% range as we look out over foreseeable horizon. Moving down through the P&L, continue to see a tremendous amount of demand for research and development activities coming from our customers. So, if anything I see upward pressure on the R&D line, particularly relative to the past couple of quarters, right.

We're running close to 16% year-to-date, but we're close to the 15% for the last two quarters and so. You could see that trending back up toward 16% next year, given some of the demand that we see in the marketplace. But overall, we feel like we're very well positioned and are pleased with both the profit and cash flow that we've been generating.

Adam Thalhimer

Okay. And then just a second question for me. In 5G, feels like we're still awfully early in kind of development stage of 5G, is that correct? Or how are you guys viewing that at this point?

Ron Nersesian

We are early. And 5G development continues for a while even if after manufacturing starts. We also mentioned that we do have some manufacturing solutions, but we're very selective there. We're only going to go after opportunities that give us very good returns. But we see a decade long evolution, at least in this 5G market and we're very happy with where we're at. I'll let Satish also make a couple of comments.

Satish Dhanasekaran

Yes, we agree. I think with 5G, obviously, the first used case is the enhanced mobile broadband of the smartphone used case and that's playing out. And even there, we're still very early days, with the first device is just being announced. So, that will play out over next few years. And then we believe with Release 16, a new use case is coming online, the runway is there. And obviously, for Keysight having being with all the leading vendors, very early on in their design phase, continues to give us the strategic advantage.

The other point I want to highlight is we've always believed in this thesis and we've talked about it, that 5G because of the technology changes, the presence and upgrade cycle for testing – design and testing, you can start to see that in our numbers and you're starting to hear that on other conference calls as well.

Adam Thalhimer

That's great. Okay. Thanks a lot.

Ron Nersesian

Thank you.

Operator

Your next question comes from the line of Jim Suva from Citigroup. Your line is open.

Jim Suva

Thank you very much. And I will ask both my questions at the same time, so you can sort out about answering the order of them. But on 5G, I believe a previous person asked, what was the order rate for 5G. And I can't remember if you actually said the percent, or if you just kind of talked in generalities. And with the 5G orders versus 4G orders, since a lot of hardware can be upgradable via software, base stations can be upgraded that are 4G into 5G via software, is it the same true about a tester? Can a tester be upgraded from 4G to 5G, or needs a completely new tester? So, just kind of a little bit more on the 5G orders and testers.

And then my second question is on the acquisition you mentioned. Can you explain exactly kind of what they do and how magnitude wise, they fit into your sales outlook for this year? Are they meaningfully contributing in sales this year? And what about a full run rate, and why this acquisition should make sense, as compared to say, Ixia, which has had some challenges?

Satish Dhanasekaran

Okay. Well, thank you. I think the first thing is our – our 5G momentum continues, as we have said before. Our commercial communications, you can look at the – the segment growth rates have been double digit as Ron has mentioned. And we continue to do well across the – across the entire ecosystem in 5G and it's still very early days. With regard to the upgrade question that you had, for most of the test tools that we are talking about, 5G represents a complete change, higher frequencies, wider bandwidth, which means the physical equipment is different.

And then even in the protocol stack, the diversity between the non-stand-alone and stand-alone that we talked about also represents a pretty big opportunity for us, not only for a test equipment replacement, but also a continuous software mix changes and you'll start to see our – that reflected in our margin profile as software becomes a bigger part of our business. So, that's the other piece. With regard to Prisma, we're very pleased with the acquisition because we have been engaging very closely with a number of the base stations and small cell equipment designers, especially in the software layers of test and Prisma brings the expertise and the installed base with that customer set that allows us to build on the strength of our 5G platform. And I'll let Neil make some comments on the materiality of Prisma.

Neil Dougherty

Let me do that. So Prisma, as I said is substantially less than 2% of revenue, think of it as closer to 1%. We're obviously baking into our forecast that level of revenue. So, it's a relatively small impact. It's a profitable business. But we're excited for what they bring both in terms of the talent of the people that we brought onboard and being able to bring on a technology that's additive to our 5G portfolio.

Mark Wallace

And Jim, this is Mark. I just want to add one thing to the 5G discussion. And that is that we're seeing a strong demand and growth for our services. As a part of this business and overall, we saw double-digit order growth in services in Q3. And if you think about the expansive nature of these solutions and the complexity associated with them, we're selling more and more professional services. And now that we're into the second and soon to be the third year of deploying some of these network equipment emulation solutions, I'm really excited to see some of the opportunities grow for us to sell continuing services to help our customers to be successful.

Jim Suva

Thank you. That's all very useful, and your additional commentary was greatly appreciated. Thank you.

Ron Nersesian

Thanks, Jim.

Operator

And your next question comes from the line of Richard Eastman from Robert Baird. Your line is open.

Richard Eastman

Yes. Good afternoon. And thank you for the questions and very nice quarter.

Ron Nersesian

Thank you.

Richard Eastman

Ron, could we just speak for just a second or two, we're talking about Huawei and trying to get our arms around the situation kind of going forward, what has changed here? Is the fact that we're able to ship more. Is this part of the licensing process, or is this a definitional adjustment as to what's characterized to be affected by the restricted list? Because again, the Commerce Department just put out 44 new Huawei entities that were just added to the restricted list. And I'm trying to maybe figure out a little bit of what's changed here on a go-forward basis, because you seem to be including Huawei orders in your order growth rate. So, presumably, there is an assumption that you'll be able to ship those in 12 months. Good luck there, but...

Ron Nersesian

Sure. I'll just say this. With regard to understanding what products we can ship and where they are, that was a moving target and it changed a couple of times. And we've sorted that out and we're very confident in what – not only what we did do, but in what we believe we can do if the regulations stay as they are. The new list that was just put out mentioning new entities, we've also looked at that and that's also in our guidance. So, I'll let Mark talk about that.

Mark Wallace

Yes, Rick. It's a fluid situation. It's changing, as you just pointed out, most recently in the last few days. So, we're focusing on this. We're complying fully with all of the export regulations. And as we pointed out in following those, we were able to ship some products and some more products than we originally had thought when we guided Q3. But I don't want to lose sight of the broader China situation. We have a very strong and broad business in China. And it's a very important market for us.

The prior headwinds beyond the export control issues with semiconductor and some of the RPL customers that we've been talking about for a year now, they still remain and yet we had very strong double-digit order growth in the quarter in 5G, in automotive, in aerospace defense, in the broad industries, in semiconductor. And so, we've got a very strong position there. Matter of fact, when you exclude Huawei during Q3, we still deliver double-digit order growth for the quarter. So, yes, Huawei is built into our assumptions. We're looking at it very closely, but there is a broader story there that's very strong.

Richard Eastman

Can I just – just a follow-up on that particular point. Have you started shipping infrastructure, kind of manufacturing test? You are kind of moving down that to the value chain there from R&D, which obviously is probably held up, but have you started shipping any manufacturing – infrastructure manufacturing test equipment?

Satish Dhanasekaran

Yes. For – in the broader sense, it is still very early days for manufacturing at the 5G ecosystem level, but our solutions have gained a good penetration with all the major players.

Ron Nersesian

The volume is not high. It's more or less prototype lines and an early start. So, we haven't come close to near the curve there of what we expect to see.

Richard Eastman

And then just the last question. A follow-up for Neil. Around the CSG business, the margins have just been fantastic year-to-date, both gross and operating margin. The incrementals coming in, might just well be 100%. Is that the influence of software in CSG? In other words, somewhat sustainable at these levels going forward?

Neil Dougherty

Yes. We definitely are seeing as part of our 5G portfolio a significantly higher software content than in prior generations. You took the words out of my mouth. If you're going to point to a single driver, that is the biggest driver of the margin improvement. You coupled that with the fact that we have a highly differentiated portfolio and an early lead to see the advantage of being a first mover in the marketplace, but certainly, that the software – the software component or the software portion of 5G is higher. And we do believe this is sustainable over time.

Richard Eastman

Okay. Great. Thank you, guys.

Ron Nersesian

And I'll just add that our software growth, we don't report this all the time, was well over 20%.

Richard Eastman

Okay. Fantastic. Thank you.

Ron Nersesian

Thank you.

Operator

Your next question comes from the line of Brian Yun from Deutsche Bank. Your line is open.

Brian Yun

Hi guys. Great quarter. My question is on your China business. Can you expand on sort of your competitive moat in the region, as well as give us an update on domestic or global competitors? Are you seeing any increasing competitive efforts from peers, especially given sort of ongoing macro trade concerns?

Mark Wallace

Yes, Brian. This is Mark. I'll take that. So, there's a lot of competitors in China, and we are continuing to focus on delivering value as we've just been speaking about. So, when it comes to the highly differentiated solutions and our global connection across these ecosystems, we have a very clear differentiation. So, I think we're winning a lot of that business. There is some lower-end commoditized business, including some companies that are based in China, that we're seeing an increased activity level as you might imagine because of the trade situation. And with the ongoing growth of all the industries that we've talked about in China, there is always going to be competition.

We take that competition very seriously. But we're going to continue to focus on our strengths and differentiating at being first to market with the products that we're bringing to our customers. And then globally, it's kind of hard to tell. It's hard to speak to that in a general sense. But I think, again, what we're doing today with our focus on solutions and being first to our – first to market with customer solutions is a differentiator that we're driving across all the regions and we continue to be very successful.

Brian Yun

Okay. Great. Thanks.

Operator

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

Jason Kary

Alright. Very good. Thank you, Rob. And we thank you all for your time and joining us today. We look forward to seeing you at the upcoming conferences. And that concludes our call. So, thank you and have a great day.

Operator

This concludes our conference call. You may now disconnect.