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HRS - Q3 2014 Harris Earnings Conference Call

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OVERVIEW:

Co. announced 3Q14 revenues were up 5% from 3Q13, resulting in EPS of $1.27. Guidance was given for FY14 revenues to be down 2-3% from FY13, and EPS from continuing operations of $4.90-5.00.

CORPORATE PARTICIPANTS

Pamela Padgett *Harris Corporation - VP of IR*

Bill Brown *Harris Corporation - President & CEO*

Mick Lopez *Harris Corporation - SVP & CFO*

CONFERENCE CALL PARTICIPANTS

Lucy Guo *Cowen and Company - Analyst*

Yair Reiner *Oppenheimer & Co. - Analyst*

Carter Copeland *Barclays Capital - Analyst*

Chris Sands *JPMorgan - Analyst*

Josh Sullivan *Gleacher & Company - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Harris Corporation third-quarter 2014 earnings conference call.

(Operator Instructions)

As a reminder, today's call is being recorded. I would now like to turn the conference over to Pamela Padgett, Vice President of Investor Relations. Ma'am, you may begin.

Pamela Padgett - *Harris Corporation - VP of IR*

Thank you. Good morning everyone, and welcome to our third-quarter FY14 earnings call. I'm Pamela Padgett, and on the call today is Bill Brown, Chairman and CEO; and Mick Lopez, Senior Vice President and Chief Financial Officer.

Before we get started, a few words on forward-looking statements. In the course of this teleconference management may make forward-looking statements. Forward looking statements involve assumptions, risks, and uncertainties that could cause actual results to differ materially from those statements. For more information and a discussion of such assumptions, risks, and uncertainties, please see the press release and filings made by Harris to the SEC.

In addition, on this teleconference and the related presentation, we may discuss certain financial measures and information that are non-GAAP financial measures. A reconciliation to the comparable GAAP measures is included on the Investor Relations section of our website, which is www.harris.com.

A replay of this call will also be available on the Investor Relations section of our website. And with that, Bill, I'll turn it over to you.

Bill Brown - *Harris Corporation - President & CEO*

Okay. Well, thank you, Pam. And good morning, everybody. Third-quarter results were solid, with revenue and earnings per share above prior year, which was impacted by the triggering of sequestration. Government Communication Systems and international tactical radio within RF Communications had excellent revenue growth in the quarter, and both segments produced strong bottom-line performance.

Our strategy to lower cost while increasing R&D to drive growth in international expansion is serving us well in this constrained government budget environment, and was evident in this quarter's results. Company-funded R&D was up 10% in the quarter, and for the year is expected to be up high single digits, similar to last year's 8% increase. Total international revenue for the year for the Company was up 39% in the third quarter and up 15% year to date, and we're on track to increase international revenue for the Company from 26% in FY13 to around 29% this year.

Turning to Slides 3 and 4 of the presentation, revenue was up 5%, income from continuing operations was up 10%, and earnings per share was up13% to $1.27. Earnings per share included a $0.02 net benefit from out-of-period adjustments, and Mick will describe the impact by segment. It's also worth noting that the prior-year quarter benefited from a retroactive R&D tax credit of about $7 million.

Orders in the quarter were about $1.1 billion dollars and book to bill was 0.88. Year-to-date book-to-bill remained above 1, and we ended the quarter with strong funded backlog of $3.3 billion, down a bit from the previous quarter's $3.4 billion but up 4% year over year.

Strong international revenue growth drove revenue up 21% in Tactical Communications. International orders were up over the prior year, and included two significant orders of $82 million and $49 million from countries in Asia that are part of larger opportunities. And we continue to make progress in a lengthy procurement process for what are significant multi-year modernization opportunities in Iraq.

Our international tactical pipeline is healthy, and we've expanded a bit in the quarter to $2.3 billion from a previous $2.2 billion. The pipeline replenishing itself after the large orders we booked in our second and third quarters is encouraging, as it points to continuing underlying market strength.

It also reflects our strong competitive position, and the investments we've made over the last several years in feet on the ground and new product development, and those investments are bearing fruit with the recent launch of two new products for the international market, the wideband [HL] radio and the multi-band handheld radio, which achieved close to $100 million of revenue in the quarter.

In the US market, as expected, the tactical business continues to be soft as a result of DoD budget pressures. Modernization is a significant opportunity. The services are committed, and is progressing, although slower than hoped. While constrained, the US market is still substantial, and our 12- to 18-month opportunity pipeline remains stable at $1 billion, up a bit from $900 million last quarter.

Recent news on the Army's multi-billion dollar modernization effort has been mixed. As we talked about before, the Army's decision to change their procurement strategy to open competition and multi-vendor awards is a positive development for Harris, but it has caused a lengthy process of revising RFPs to reflect the new acquisition strategy and further delays for both the Manpack and Rifleman radio procurements.

With procurements delayed, funding has pushed out. The President's budget request reflect a one-year cut in JTRS funding in government FY15 to around $185 million, rebounding to the $400 million annual level in GFY16 to GFY19, pending the resolution of sequestration. The GFY15 funding cut is likely due to the significant carryover of unspent funds from prior years that's built up from procurement delays.

Earlier this month progress was made when Army finalized and awarded the $988 million multi-vendor IDIQ contract for SRW, or Soldier Radio Waveform Applique Systems. Our offering is for two different solutions, and with our SRW Appliques already proven and fielded with the Army, we feel confident about our ability to compete. Prior to contract award, Harris received a $4.3 million order from the Army in July of 2013, and to date has sold $10 million in appliques to the Army for earlier VCT fieldings.

Now I want to highlight a couple of new product milestones in the quarter. We received our first order from a DoD customer for the new RF340M Multi-channel Manpack, which was originally developed to compete in the Army's JTRS procurement.

This first order not only validates our solution, but its appeal to customers other than the Army. And we're seeing strong interest from customers in the international markets as well. Our Multi-channel Manpack is one-third smaller and lighter than the HNS program-of-record radio, and all of the waveforms are incorporated into the radio so the soldier doesn't need to carry add-on appliques to run a full set of waveforms.

We also designed expansion slots into the radio for accommodating a customer's unique mission requirements, such as specialized waveforms, ISR capabilities like data links and signal detection, or commercial SatCom access. And we're taking this same radio to the airborne tier, where we will have an equally capable and differentiated product. Another encouraging milestone on the JTRS front was receiving NSA certification on the RF330E wideband team radio which was developed for the upcoming Rifleman Radio Competition.

And I'll finally mention reaching an important product milestone for incorporating the powerful MUOS waveform into our radio, successfully passing the fourth consecutive test event. MUOS, or the Mobile User Objective System, is the DoD's next-generation military SatCom system, which I should mention also uses Harris reflectors and will deliver cellular-based service through tactical radios. We're not only embedding this critical capability into our new Multi-channel Manpack, but offering it as a separate software upgrade for existing Falcon III 117G wideband radios.

This creates a unique opportunity to add MUOS capability to potentially 30,000 fielded Harris radios to a simple and fast software upgrade. It provides the DoD with a cost effective and compelling solution for rapidly transitioning its inventory to MUOS-capable radios, and is an excellent way to maximize the use of the satellite infrastructure while awaiting JTRS procurements.

And our customers agree. During the quarter we received a $45 million order from a DoD customer who had current wideband radio requirements, but also wanted the added flexibility of a software upgrade pack for future enhancements, such as MUOS. This followed an initial order for $26 million that we received from this customer in May of last year.

Now turning to Government Communications, revenue was up 11%, and higher again this quarter and all three business areas of civil, national intelligence, and defense. Diversification and leveraging core technologies to address adjacencies with existing and new customers is providing resiliency in the current budget environment.

An excellent example of the success is the Aireon hosted payload program, which was a major revenue driver in the quarter, successfully completing critical milestone testing and beginning full-rate production. Under the original agreement, Harris is providing 81 ADS-B receiver payloads to be flown on Iridium NEXT to provide a satellite-based global aircraft tracking system, a capability separate from the main mission of a constellation.

But we've also added other customers, and so far have increased the number of payloads by almost 50% above the original contract with the potential to add more, significantly increasing the value of this program. This piggyback approach of using commercially-hosted payloads to support multiple missions, both government and commercial, is more cost effective and significantly shortens the time to mission compared to the historical model of building and launching separate exquisite satellite solutions for each and every mission requirement.

Harris is at the forefront of this new approach. The Aireon program is the largest implementation of a commercially-hosted satellite payload to date, leveraging our long and successful history of supplying space electronics and reflectors for government and commercial markets.

In Integrated Network Solutions, the segment continues to be less resilient in the current environment and posted a weaker than expected quarter. IT services, the profitable NMCI contract is winding down by the end of the fiscal year, and new awards have been slow to materialize.

In healthcare solutions we're implementing our new software platform at initial customer sites, and while we're making progress in proving out the technology, we need scale to reach profitability. In CapRock, the commercial business is progressing nicely and had good growth in the quarter, but was more than offset by government weakness. The bottom line is that we're not satisfied with the results in this segment and we're increasing our focus to improve performance.

Now before moving to the discussion of segment information, I'd like to take a moment and introduce our new Chief Financial Officer, Mick Lopez. Mick joined us in February, and he bring brings more than 30 years of experience across a number of different companies such as IBM, Cisco Systems, and Tyco.

He joined us from a company called Aricent, a global services company owned by KKR and their affiliates, where he was Chief Financial Officer. Mick has served in all the various finance functions in the US, as well as internationally in Brazil and Europe.

He is a seasoned global finance executive who brings a passion for developing talent and driving excellence in financial systems and processes. So with that introduction, I'll turn it over to Mick to comment on segment results and revised guidance for FY14. Mick?

Mick Lopez - *Harris Corporation - SVP & CFO*

Thank you Bill, and good morning to everyone. It's a real privilege to join the team at Harris. Moving to segment results on Slide 5. RF Communications orders were $405 million compared to $486 million in the prior year. Revenue was $457 million, up 9% from $4180 million last year.

In Tactical Communications, orders were $285 million compared to $297 million the prior year. Tactical revenue was $335 million, up 21% from $276 million last year. In international, revenue and orders were strong and higher than in the prior year. In the United States, both revenue and orders were weak but in line with our internal expectations.

Public safety orders were $120 million compared to $189 million in the prior year. Revenue was $122 million compared to a $142 million last year. The public safety market was weaker than expected.

Operating income for the RF Communications segment was $144 million, with a 31.4% operating margin. Excluding the out-of-period adjustment, operating margin was 30.8%. For the full year in RF Communications, we continue to expect flat revenue for the segment.

Tactical Communications revenue is up mid-single digit, which is slightly higher than previously expected on strength in international, but offset by weakness in public safety. We now expect operating margin to be in a range of 30.5% to 31%.

Let's turn now to Integrated Network solutions segment on Slide 6. Despite growth in the commercial side of the segment, both orders and revenues were down compared to the prior year as a result of continued government market weakness.

Revenue decreased 7% to $348 million, and was down across the segments in IT services, CapRock, and healthcare. Excluding the out-of-period adjustment, revenue would have been down 6%, with government more than offsetting a double-digit increase in commercial CapRock revenue. Segment operating income was $21 million and operating margin was 6.1%. Excluding the out-of-period adjustments, operating margin was 7.3%.

IT services orders included a $21 million follow-on order from the Canadian Department of National Defense for the CF-18 Avionics Optimized Weapon System Support Program. CapRock orders included $17 million from an international oil and gas drilling company.

At healthcare solutions, we introduced FusionFx, a vendor-neutral suite of software tools that brings together patient information across the entire continuum of care. FusionFx provides flexibility and scalability as health systems grow, merge, and consolidate. The solution is currently live in three customers covering 29 hospitals and has over 1,000 clinician and 40,000 patient users. For the full year, segment revenue is now expected to be down 8% to 9%, and operating margin in the range of 7% to 8%.

Moving to Slide 7, revenue in Government Communication segment was $477 million, increasing 11% from last year. Major revenue drivers included the Army's MET SatCom terminals, F-35, FAA's NextGen DataComm program, and the Aireon-hosted payload programs.

Operating income was $77 million compared with $67 million in the prior year, and operating margin was 16.2%. Excluding the out-of-period adjustment, operating margin was 15.2%.

Harris was awarded an eight-year single award IDIQ follow-on contract for $133 million for the US Navy's commercial broadband satellite program, bringing total potential program value to more than $250 million. Harris also received awards from classified customers totaling $59 million. For the full year, Government Communications revenue is now expected to be stronger than previously anticipated at about flat for the year, with an operating margin of about 15.5%.

Turning to Slide 8. Free cash flow was $120 million versus $185 million last year. Capital expenditures in the quarter were $55 million compared to $49 million in the prior year, due to continuing investment in our new facility at government communications and enterprise software upgrades at RF Communications. We expect that free cash flow for the year will be about equal to net income.

During the quarter we used $64 million in cash to repurchase about 897,000 shares, which brings year-to-date repurchases to $214 million. We continue to expect full-year repurchases of $300 million. Our effective tax rate for the quarter was 31.8%, and is now expected to be about 32.5% for the full year.

Let's move on to Slide 9. FY14 earnings-per-share guidance has been increased by $0.10 on the top and bottom end of the range to our new guidance of $4.90 to $5.00 per share. Revenue is now expected to decline 2% to 3% from last year. Back to you, Bill.

Bill Brown - *Harris Corporation - President & CEO*

Okay. Well, thank you, Mick. The core of our Company is provided mission-critical advanced communications that are differentiated through innovation and technology. This is reading through in our solid results this quarter and our expectations for the year.

Our commercial business model gives us a competitive advantage in the speed in which we develop and field new products with attractive margins. Our commitment to innovation will continue to bear fruit as the DoD adapts to operating under constrained budgets and relies more on industry to invest in new technologies that create affordable solutions that can be delivered quickly. And with that, I'd like to ask the operator to open the line for questions.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Lucy Guo, Cowen & Company.

Lucy Guo - *Cowen and Company - Analyst*

Good morning. This is Lucy Guo calling in for Gautam Khanna. So wanted to ask about your opportunities in the Middle East. You have talked about continuing the progress toward a multi-year for Falcon III radios and upgrades in Iraq, and then similarly Saudi is another area of opportunity. Do you have a better idea on the timing of these?

Bill Brown - *Harris Corporation - President & CEO*

Well, Lucy, first of all, thank you very much for the question. As I mentioned, the pipeline overall for international, I think you're referring specifically to the Tactical business, so let me just clarify that. The total pipeline is $2.3 billion. It was $2.2 billion last time. So it's still pretty good, and we've got about $900 million that are in the sort of final stages closure, proposal stage. So we're feeling pretty good about the advancement of opportunities through the pipeline.

To your point about the Middle East, where more than half of our pipeline is for the Middle East and Asia, and it really does relate to those issues I've talked about in the past; the security issues we do see the US pulling back from those markets. Iraq is a very big opportunity for us, and we've been working on this for a number of years.

We've got extremely good dealer in place there. It's probably one of the biggest multi-year opportunities that Harris and Tactical faces. We just yesterday were able to confirm that we received our very first order in the last couple of years in Iraq for $15 million. That is going to be booked in the coming days. We received confirmation last night. So that to me, Lucy, is good encouragement that these opportunities that we've been talking about for quite some time in Iraq are progressing, and we do see opportunities that are quite a bit larger than that in the near-term pipeline.

We continue to have very, very strong business with that country in Northern Africa that we've talked about before. The UAE is a very big opportunity for us, as is Saudi. We've booked a number of opportunities over the last year, year-and-a-half, and we see more coming down the path. And that's a little more than half of our total pipeline for international.

The other 25% or so is coalition countries that are deploying wideband. That's gaining some strength. We see continued about 50% of our pipeline in Latin America, Brazil, Colombia, Mexico remain the biggest opportunities in those marketplaces, but of course there's other opportunities really around the world that are a little bit smaller in nature. But clearly the biggest opportunity's in the Middle East, and I'm glad to be able to say that we've seen one come through the pipe late last night in Iraq. So thank you, Lucy.

Lucy Guo - *Cowen and Company - Analyst*

So as a follow-up, the SRW opportunity that you had booked an IDIQ contract on, how should we think about that going forward?

Bill Brown - *Harris Corporation - President & CEO*

I think we're very well-positioned. As I mentioned in my prepared remarks, we were one of two that have actually been selling SRW appliques to the Army. They've been tested. We have actually two solutions that were bid.

Of course, as you saw the press release, there's four companies that received IDIQ awards, but we feel very good, very well- positioned, and frankly we're encouraged about the size of the IDIQ $980 million total contract value, total possibility. And we're also encouraged by the fact that it is now finally out in the street and awarded, which means that there's some intention to place some orders against it, Lucy. So we're encouraged.

Lucy Guo - *Cowen and Company - Analyst*

Great. Thank you. I'll get back in the queue.

Bill Brown - *Harris Corporation - President & CEO*

Thank you.

Operator

Yair Reiner, Oppenheimer.

Yair Reiner - *Oppenheimer & Co. - Analyst*

Great, thank you. So congrats on the strong results in Tactical. Nice growth here year over year. If I look at the guidance implied for the fourth quarter, it suggests less of a sequential increase than you typically see.

Was there anything unusual about the third-quarter results to make the fourth-quarter compare more challenging this year? Is the seasonality in that business changing? Just need to give us some sense of kind of what's happening below the surface there.

Bill Brown - *Harris Corporation - President & CEO*

Yair, are you talking about revenue or operating margin?

Yair Reiner - *Oppenheimer & Co. - Analyst*

Revenue, but if you want to speak to operating margin, that would be helpful as well.

Bill Brown - *Harris Corporation - President & CEO*

Well, the revenue was up quite a bit in the quarter only because -- partly because of the easy compare. I think we acknowledged that in the prepared remarks. Last year in our third quarter, remember with sequestration being triggered, that caused some disruption in the business, but Tactical international was extremely strong in the quarter, and that was the big driver in our third quarter.

On the margin side, we did see very, very good margins over the course of the first three quarters of the year, sort of on average for RF Comm in the 31.5% range. Of course, Mick did mention that we had a modest out-of-period adjustment that did help us in Q3 in the tactic in the RF comp segment. We've been saying before, and I'll mention it again today, that we do see our R&D investments, sales and marketing investments, ramping quite a bit. It didn't ramp as much in Q3 as we had anticipated, but they certainly will ramp pretty steeply in Q4, primarily for these modernization opportunities in the Manpack and the MUOS development that we've been focused on and I mentioned in my prepared remarks.

So we do see a pretty substantial ramp in investment coming in Q4. Also we're a little impacted in the quarter by mix in the international side. So for the year we're still in that 30.5% to 31%. And we feel pretty good about where we happen to be. And I think if you look at the numbers closely, you'll see that we're going to be up sequentially in Q4 from Q3.

Yair Reiner - *Oppenheimer & Co. - Analyst*

Got it, okay. And then just another one on RF. In terms of the US pipeline, can you reconcile the comments on the one hand the terms of the pipeline being up a little bit quarter on quarter; on the other hand if you look at the five-year budget for the DoD, it looks like there are pretty significant cuts to the forecast in terms, not just of JTRS, but also for the MMGR radio?

Bill Brown - *Harris Corporation - President & CEO*

Yes. I would say, look first of all we're floating around $900 million to $1 billion, and frankly we're encouraged. It's stable. I wouldn't read too much into $900 million versus $1 billion. Of course you know that we get funding not just for those from those typical line items you see. At the high level it comes in lots of line items buried in budgets, including from some O&M accounts.

So I wouldn't -- yes, we're aware of some of the push-out of some of the bigger things that we've talked about in omni-modernization, but there's lots of line items that drive it. So we feel comfortable at about $1 billion of pipeline. We are seeing with the draw-down of activities in Iraq, drawn down, and Afghanistan drawing down that there are some reset opportunities that are now coming to bear.

There are some up modernization opportunities outside of the Army that are entering the pipeline. More than half of our pipeline itself is Air Force, Marine Corps, Silcomm modernization, and as we said before, they've standardized on the Falcon III technology. That still remains robust, and when you go into line-item detail, Silcomm funding remains pretty strong.

We only see about 10% of our total pipeline related to Army BCT modernization. We do see a lot of other Army programs unrelated to modernization in our pipeline. So overall about $1 billion, floating between $900 million and $1 billion, but again I'm encouraged that it's remaining about flat in the environment we happen to be in, Yair.

Yair Reiner - *Oppenheimer & Co. - Analyst*

Great, That's very helpful. Thank you.

Bill Brown - *Harris Corporation - President & CEO*

You bet.

Operator

Carter Copeland, Barclays.

Carter Copeland - *Barclays Capital - Analyst*

Hello. Good morning.

Bill Brown - *Harris Corporation - President & CEO*

Good morning, Carter.

Carter Copeland - *Barclays Capital - Analyst*

Just a clarification and a couple questions for you, Bill. The comment you made around the JTRS appropriations being down, yet the unspent funds, I think you implied providing a bit of support. Does that kind of point to flattish overall funding profile and award profile there, or is just too uncertain with the procurement delays you talked about before?

Bill Brown - *Harris Corporation - President & CEO*

No. Well, first of all, it's still very, very uncertain because in the President's budget it assumes sequestration is resolved, as you know, in GFY16. That's still a wildcard out there. We know that, we recognize that. If you look in his budget for 2016, all of the funding line items come back, snap back up, but we will see as the next year or two go by whether that's actually going to take place.

There is -- there are unspent funds in the JTRS procurement line items from prior years. Is that in that range of $300 million, plus or minus, and there's, I think, with a little bit more coming in GFY15 about $185 million, I think is what's in in the President's budget. We feel pretty good about the overall level of funding.

When we talk about our own profile here, we've said that the JTRS Army modernization opportunities won't be impacting our FY15. If anything, they're going to start to roll in in our FY16, and we've said that on our last call as well.

Carter Copeland - *Barclays Capital - Analyst*

Okay, great. And on the INS side, Mick, I wondered if you might help us clarify. With respect to that 6% adjusted decline in revenues, how did the pieces compare to that average in terms of above or below at IT services and healthcare and CapRock?

Mick Lopez - *Harris Corporation - SVP & CFO*

Let me give some clarification about the out-of-period adjustments. As we noted, there were two of them. Neither is significant for total Harris, and especially when netted out. And as we said, in total they provided only $0.02 of earnings per share.

For INS, the two were -- one was on post-employment benefits adjustment, and the other one negatively affected their revenues and cost. The one for post-employment benefits positively impacted ESA, which is the engineering sales and admin expenses for all the segments. And for INS, we had some of that, but we also had about a drop in the revenue and a small increase in charges for the cost, and that dropped their margin by 1.2%.

Bill Brown - *Harris Corporation - President & CEO*

Within INS, most of the positive benefit effected the IT services business, and most of the negative benefit was booked within the CapRock segment.

Carter Copeland - *Barclays Capital - Analyst*

Okay, but with respect to -- you highlighted the downward pressure on the government Satcom piece at CapRock. Was the CapRock piece the largest decliner in the quarter of the subgroups?

Bill Brown - *Harris Corporation - President & CEO*

I'm not sure I'm following the question, Carter,

Carter Copeland - *Barclays Capital - Analyst*

With respect to the total groups sales growth, I'm trying to figure out which one of the subgroups within there was the largest decliner. I'm just trying to put some numbers around the comments around the declines at each one of the businesses.

Bill Brown - *Harris Corporation - President & CEO*

Yes, I think -- the IT services business was down, as well as the government part of both CapRock and healthcare were both down, and they were down pretty substantially in the quarter, hits (inaudible) sort of in the 10% range, and the other two businesses down north of 20%. But what we're encouraged by was the growth on the commercial side of CapRock which was up in the quarter by 6% reported. When we adjust for this out-of-period adjustment that Mick mentioned that affected revenue as well, CapRock commercial was up about 12% in the quarter. So hopefully that hit the question.

Carter Copeland - *Barclays Capital - Analyst*

That's totally helps. Then with respect to the comment in healthcare that you made about scale. I mean, obviously you've been through quite a restructuring process there, and product rollout and whatnot. When you think about the scale you need to have to reach the kind of levels of profitability that you've outlined in the past, how does that compare to where you are today?

Bill Brown - *Harris Corporation - President & CEO*

Well, look. We have to grow the business. What I was encouraged about over the last three or four months is that the solution that we call FusionFx now, that the solution that's now installed and operating at three different customers, 29 hospitals, is stable, is performing well. Customers excited about it. There's more clinicians coming onto the system, more patients coming onto the system.

And I'm encouraged by this very complicated piece of software is stable. And that was our first hurdle to get over, was getting a piece of technology that worked, and I think we have something. Now what we have to do is, is find partners to help us grow and scale the business.

Harris is not -- does not have deep domain expertise in commercial healthcare. We don't have a robust channel that's built. And we're going to need some support, some partner help in growing our business. It will need to grow pretty substantially on the commercial side for us to reach profitability. But it's more important, not so much the size but the mix has to shift from installing system to converting to licensed revenue. And that will happen, Carter, as we bring on more customers and start to grow the business and scale the business.

Carter Copeland - *Barclays Capital - Analyst*

Great. Thank you for the color, Bill.

Bill Brown - *Harris Corporation - President & CEO*

You bet.

Operator

Joe Nadol, JPMorgan.

Chris Sands - *JPMorgan - Analyst*

Hello. Good morning, guys. It's actually Chris Sands on for Joe. Was hoping you could elaborate on the outlook for public safety? It was kind of down again sequentially in the quarter. You talked about your orders being up in the first half, but they wouldn't translate soon enough. When can we expect that to kind of turn?

Bill Brown - *Harris Corporation - President & CEO*

Well, look, as we talked about last time, in public safety the issues that we're seeing is both market and execution. I talked a lot about last time some of the sort of executional issues that we're seeing. Some of it is delayed rollouts of some systems; there's some customer issues that are associated with that.

Some of it is getting in early enough on large procurements so we can shape the RFPs. So we're adding sales and marketing resources. We're adding resources to improve our product offering. All of those things we're working on. We've got some of the leadership in place, we're augmenting our teams. But as I cautioned last time, these things will take time. They won't fix themselves over one or two quarters. It will take a little bit of time.

What we're also facing now today though, Chris, is a weaker environment. And that is a little bit worse than we expected last quarter, and I think as our peers and competitors in the space will report, we're all seeing a bit of weakness. Part of that may be some of the [re-competes] that happened a year and a half, two years ago, and the effect it had on the overall market. We are seeing municipal budgets be better, but it's not flowing through into an uptick yet in public safety communications. That will over time, but we're not seeing it at the moment.

It could be, and I think we have to believe, that the prospect and uncertainty around how LTE will allow it has to be having some impact on how customers are thinking about investments in LMR digital technology with the prospect of LTE down the path. So we don't know how this is all going to shake itself out.

We do see our Q4 being better than Q3, but I'm not going to call success in Q4, and we'll come back in late July when we give our Q4 report and our full-year fiscal report and give some guidance for next year. We'll have a lot more insight into what's happening in the market, our ability to compete, and what that might be for FY15.

But again, the market 's a little bit softer today than we at first expected. Longer term we know what's going to happen. We know the customers with analog systems will have to shift to digital. We know that LTE is going to come at some point in time and customers will shift again. That's going to be a growth driver for the Company, it's going to be a driver for the market itself, and we're investing to be prepared to be successful when those things happen.

Chris Sands - *JPMorgan - Analyst*

Great, thank you. And then just a follow-up, switching to government accounts, the margin was strong in the quarter, and do you think going forward is around 16% something you can sustain going into FY15, or if not, what are some of the moving pieces there?

Bill Brown - *Harris Corporation - President & CEO*

Wouldn't get too far ahead of yourself on 16%. I think we had a very strong quarter. Again it was 16.2%, but again keep in mind it was -- when you adjust for sort of the one-time, it was on the order of about 15.2%. So pretty much in line with where we've been year to date and what we're guiding to for the year. So again, we're still in that 15% to 15.5% range. The team in GCS continues to execute very, very well.

The awards fee certainly in the front half in the year were very, good. We see -- we continue to see margins in this 13% to 14% being sustainable over time in GCS. Keep in mind, as you know the market very, very well, as you roll on new programs, they tend to come in at lower margins, and over time as you work and you drive efficiencies, you can try to extend the margins is what we've seen. So it will depend upon the mix of new programs.

As we see, like the DCIS, the NBS programs in FAA roll in, they tend to come in at lower margins. And that's going to impact GCS over time. So I keep in my mind 13% to 14%, not 16%.

Chris Sands - *JPMorgan - Analyst*

Okay, great. Thank you, guys.

Bill Brown - *Harris Corporation - President & CEO*

You bet.

Pamela Padgett - *Harris Corporation - VP of IR*

Operator, we'll take one more question.

Operator

Josh Sullivan, Sterne Agee.

Josh Sullivan - *Gleacher & Company - Analyst*

Morning, Bill, Mick.

Bill Brown - *Harris Corporation - President & CEO*

Yes, good morning.

Josh Sullivan - *Gleacher & Company - Analyst*

Sorry about that. I'll just go back into that government operating margin question. You guys obviously did a lot of restructuring last year, and it's obviously having an impact here. But can you maybe give us an idea of the longevity of these actions, just given your fixed contract mix and these re-competes coming up? How should we think of timing-wise that rolling through?

Bill Brown - *Harris Corporation - President & CEO*

Look, clearly, 15%, 15.5% margins this year are positively impacted by some of the restructuring activities. It's impacted by some of the activities in driving operational excellence at GCS.

A lot of it is they just have been performing very, very well. They've got tremendous customer intimacy, and that, when you perform well, on time with that focus on the customer mission, what ends up happening is the award fees tend to be relatively strong, and that's in fact what's happened.

In operational excellence, when we provide guidance to investors in this area, we do it specifically knowing that some of what we say needs to go back to the customer when we have cost-plus type programs. Roughly half of GCS is fixed-price and roughly half is cost-plus. So a lot of what we see in restructuring and operational excellence programs does roll through and affect our ROS, and that is what you're seeing this year, in fact last year in the growth over the last couple of years.

Again, as we go out into next year, we'll provide guidance in late July on what we see to be the revenue and market environment, the ROS for GCS into FY15. But again, I keep in my mind in that 13% 14% range over time as opposed to the very strong performance we're seeing this year around 15.5%.

Josh Sullivan - *Gleacher & Company - Analyst*

Okay. And then just one last one on CapRock. On the government weakness, how much of that is related to just op tempo in Afghanistan versus, say, sequestration?

Bill Brown - *Harris Corporation - President & CEO*

It's some of that, but not the bulk of it. A lot of it has to do with a year or two ago there was a contract vehicle that was opened up and competed on with some of the satellite owners. And they won a contract vehicle and they are basically providing some bandwidth directly to the US government, which in the past went through, quote, unquote, brokers like our CapRock government business. So that is now going direct and it's impacting our business.

We're seeing some pricing pressure in our terrestrial business as well, which has been open to competition as well. And we're seeing some pressure on that side. There is some related to the draw-down, that's not the bulk of it.

Josh Sullivan - *Gleacher & Company - Analyst*

Great, thank you.

Bill Brown - *Harris Corporation - President & CEO*

You bet.

Pamela Padgett - *Harris Corporation - VP of IR*

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

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation. Have a wonderful day.
