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EDITED TRANSCRIPT

HRS - Q2 2017 Harris Corp Earnings Call

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OVERVIEW:

HRS reported 2Q17 revenues of $1.7b. Expects FY17 revenues to be $5.76-5.88b, GAAP EPS to be $5.21-5.41, and non-GAAP EPS to be $5.40-5.60.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Harris Corporation's second-quarter 2017 earnings 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 be begin.

Pamela Padgett - *Harris Corporation - VP of IR*

Thank you. Good morning, everyone, and welcome to our second-quarter FY17 earnings call. I'm Pamela Padgett. On the call today is Bill Brown, Chairman and CEO; and Rahul Ghai, Senior Vice President and Chief Financial Officer.

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

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

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Bill Brown - *Harris Corporation - President & CEO*

Thank you, Pam. And good morning, everyone. Earlier today we reported solid second-quarter results as we continued to execute well on our strategy to shape our portfolio, deploy capital in a balanced and shareholder friendly way, drive operational excellence including strong execution on Exelis integration, and position the Company for long-term growth through sustained investment in high-return R&D.

Last week we achieved a major milestone with the announced sale of IT services, following closely on the heels of completing the sale of CapRock in early January. The divestitures of these two businesses, with combined revenue of $1.4 billion, together with the acquisition of Exelis in mid-2015, and the sale of aerostructures, commercial healthcare, and broadcast completely reshapes the Company, and sharpens our focus on core franchises where technology provides differentiation.

The new Harris has a more simplified business model, with a streamlined portfolio of higher-growth, higher-margin businesses. These actions, when combined with the significant R&D investments we have made over the last five years to support our key franchises, position our Company for growth at a time when government budgets are bottoming and beginning to trend up.

The divestitures also provide more than $1 billion in net proceeds that we'll use to support our capital allocation goals, about 40% for share repurchases, 60% towards deleveraging, and prefunding the pension. $435 million of sale proceeds will be used to buy back shares, which, when added to the $150 million we committed to at the beginning of the year, plus an incremental $115 million provided by free cash flow, raises total FY17 share buyback to now $700 million, the largest single-year share repurchase action in our Company's history. And since the buyback will fully exhaust the remaining share authorization of $584 million, the Board added a new $1 billion authorization, demonstrating confidence in future free cash flow, in our balanced and shareholder friendly approach to capital allocation.

$225 million of sale proceeds has been used to reduce debt, supporting the deleveraging goals we set when we acquired Exelis. With this payment already made, we have now repaid $1.3 billion against the commitment of $2 billion of debt reduction by FY18. And $400 million of sale proceeds will be used for pension prefunding, which fully funds the pension on an IRS basis and eliminates, at least for the next few years, the mandatory annual contributions currently running at almost $200 million.

With the divestitures of CapRock and services, we will now operate the Company with three segments and eliminate the Critical Networks organizational structure. The air traffic management business will now operate as part of the Electronics Systems segment, with no changes to Communications Systems, or Space and Intell. The restructuring actions we are taking will significantly reduce stranded costs. And by closing the transaction and implementing essentially all of these actions before the end of FY17, we expect to limit the FY18 dilutive impact of the divestitures to about $0.10 to $0.15.

Before Rahul walks you through the divestiture details intended to simplify what are clearly a lot of moving parts, we'll first touch on 2Q results. Keep in mind that 2Q compares have CapRock removed from current and prior year. It is not until the third quarter that IT services is reported in discontinued operations. Second-quarter non-GAAP EPS was $1.42, with operating income up slightly and operating margin expanding 50 basis points, to 17.6% and higher in each segment. For total Company EPS, the improved operating performance was offset by a higher tax rate. Revenue was $1.7 billion, down 2% on an organic basis.

We posted solid revenue growth of 6% in Electronics Systems, 5% in Space and Intell, and 2% in Critical Networks. Communications Systems revenue was down 16%, with higher DoD tactical radio sales more than offset by significantly lower international.

Total Company book to bill was 0.83 in the second quarter and just over 1 in the first half. Legacy tactical orders were strong in the second quarter, with a book to bill of 1.1, and backlog rising again this quarter, now up 22% fiscal year to date. Higher backlog was driven by international, partly offset by relatively weak US orders.

Europe remains particularly strong, coming off of a record FY16 and trending toward another record year, driven by countries in eastern Europe modernizing in the face of regional instability. And in 2Q, orders included a $75 million order from a country in eastern Europe, with several significant opportunities expected to book in the second half.

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In the Middle East, a region that's still relatively constrained, we were encouraged by several significant orders, including from two countries that slipped from the back half of last year, $16 million from an unnamed country and $19 million from Iraq. Following the close of the quarter, we booked a $56 million order from a country in northern Africa as part of a multi-year, multi-phase modernization program.

A key strategy for our Company, even while faced with constrained government budgets, has been to invest our own R&D dollars to innovate and develop new products to expand our core franchises and drive future growth. And in 2Q, we see evidence of this winning strategy, from tactical modernizations progressing, to an expanded footprint in space superiority, to early successes in rebuilding the electronic warfare franchise.

In tactical, we continue to invest in new product development to support both US and international modernizations that are expected to drive renewed tactical growth in FY18. Army and SOCOM modernizations continue to progress. And we shipped about $5 million in HMS Manpack customer test units last month, and expect a first delivery order decision in the August time frame, with shipments beginning in the fall.

For SOCOM, development and testing of the two-channel handheld continues to progress. And we will submit our proposal this week for the two-channel Manpack, with an award still on track for the summer, with deliveries beginning at the end of calendar 2018. With the Army and SOCOM, as well as countries like Australia, interested in the new two-channel Manpack and handheld products, our ability to scale investments and leverage technology platforms is driving R&D efficiency and resulting in core technology being shared across multiple products for US and coalition partners.

Another recent investment has been in our newly developed wide-band HF radio, which delivers data up to 10 times faster and is 20% smaller and lighter than prior generations. Harris has long been number one in HF radio technology. And the changing threat environment and greater concern over SATCOM deniability has increased customer interest in HF radios as an alternative for beyond line-of-sight transmission of classified images, maps, and other large data files. Already released for the international market, the radio just received NSA type 1 certification and is on track for US government release in mid-calendar 2017. Given the favorable response from customers, we currently expect an incremental annual revenue stream in the low tens of millions, boosting our base business across the services.

In Space and Intell, our classified businesses continue to be key revenue growth areas again in the second quarter. That positive trend was also reflected in new wins, including follow-on contracts of $53 million and $29 million for space asset protection and situation awareness capabilities. And following the quarter close, we received an $80 million classified contract in what we can describe as a ground-based adjacency that has the potential to become a new franchise area for the Company.

Our recent awards reflect continued success in leveraging technology investment to broaden our reach and move from providing components, to subsystems, into now full mission solutions. Over the years, we've leveraged expertise and technology from government markets to grow in commercial space where a recapitalization and fleet expansion cycle is currently underway. In the back half of 2016, we were awarded two unfurlable antennas. And we commented that prospects were stronger than they have ever been in almost a decade. In this quarter we were awarded another two reflectors. And we are pursuing another 10 opportunities, with expected awards over the next few years. So, prospects remain positive.

In Electronics Systems, electronic warfare continued to be a growth driver. Over the last 18 months, we have had excellent success in rebuilding the electronic warfare franchise, winning modernizations on legacy platforms with long tails, and building a strong backlog. While EW growth has been primarily US based, we had two new international wins in the quarter -- $91 million for EW pods for Moroccan F-16s, and $22 million on the IDECM program to upgrade electronic counter measure capability on Australian F-18s.

Longer term, we are investing in next-generation technology to pursue new platforms by marrying Harris front-end, state-of-the-art phased-array antenna technology with Exelis back-end processing. In both Electronics Systems, and Space and Intell, bidding and proposal activity remains very high, and our opportunity pipeline continues to grow, giving more confidence in growth in 2018 and beyond. And with that, let me now turn the call over to Rahul to walk through 2Q financial results, divestiture details, and guidance. Rahul?

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Rahul Ghai - *Harris Corporation - SVP & CFO*

Thank you, Bill, and good morning, everyone. One additional reminder -- discussions today are on a non-GAAP basis and exclude Exelis integration cost. And, as Bill just mentioned, second-quarter results exclude CapRock but include IT services.

Turning now to segment detail on slide 5. Communication Systems segment revenue was $413 million, down 16% compared to prior year. Tactical communications was down 19%, with higher DoD tactical radio sales more than offset by significantly lower international revenue in both legacy Harris and [single] product line. Public safety revenue was down 5%. Backlog in the legacy tactical business is up $26 million in the quarter, driven by orders from international customers.

Operating income was $121 million, compared with $138 million in the prior year, due to lower volume. Operating margins trended higher from integration savings as a result of the closure of the Fort Wayne factory. Following the close of the quarter, Harris was awarded a five-year, $403 million single award ID/IQ contract from US Defense Logistics Agency to provide tactical radio spares to the US Army and several civilian agencies.

Space and Intelligence systems on slide 6. Revenue was $458 million, and up 5% compared to prior year, primarily driven by higher revenue from intelligence community customers. Operating income was $77 million, compared with $68 million in the prior year, from continued strong program performance and higher pension income.

Electronics Systems on slide 7. Revenue was $384 million, and up 6% on an organic basis, compared to prior year. Higher revenue from electronic warfare solutions and the continued ramp of an integrated battle management system in the Middle East was partially offset by lower wireless product sales. Operating income was $79 million, compared with $68 million in the prior year, driven by benefits of higher volume, continued strong program performance, and higher pension income.

Critical Networks on slide 8. Critical Networks segment revenue was $454 million, and up 2% compared to prior year. Higher revenue from FAA's NextGen modernization program and NASA's Space Communications Network program was partially offset by lower IT services revenue. Segment operating income was $75 million, compared with $66 million in the prior year, reflecting the benefit from a contract settlement, partially offset by less favorable mix of program revenue.

Moving to slides detailing the two divestitures and the expected impact in FY17 and FY18, slide 9 outlines the two transactions, including previously expected FY17 results for CapRock and IT services. IT services is anticipated to close before the end of FY17. But regardless of the timing of the close, it will be reported as discontinued operations beginning in the third quarter. Total proceeds from the sale of businesses are expected to be $1.06 million, and we plan to use $225 million of the proceeds to pay down debt, $400 million to prefund pensions, and $435 million to buy back shares.

The bottom right box on the slide details the sources of the expected share repurchases of $700 million in FY17. So far this year, we have repurchased $100 million in open market, and expect to repurchase $350 million through an ASR program that will be initiated in the third quarter, and the remainder, either through an ASR program or open market purchases in the fourth quarter. We will see full accretive benefit from this repurchase activity in FY18.

Moving to slide 10, and the waterfall chart detailing FY17's expected dilution of $0.50 as a result of moving CapRock and IT services to discontinued operations for full year and only partially benefiting from the proceeds of the sale. The new non-GAAP EPS guidance range of $5.40 to $5.60 reflects the dilution from the divestitures and the partial offsets of a one-time tax benefit of $0.12, and a reduction in the corporate tax rate from 31% to 30% from [radio stacks] planning activities that is worth an additional $0.08. And, until we have clarity on the timing of the one-time tax settlement, we are assuming that the settlement will take place in the fourth quarter.

While Q4 is typically our strongest quarter for revenue and EPS, we expect this year's Q4 to have even greater weighting due to the timing of specific international tactical opportunities, the one-time tax settlement, and the benefit from additional share repurchases all falling in the fourth quarter. FY18 dilution, shown in the next column, is expected to be in a range of $0.10 to $0.15, reflecting a full-year benefit from the use of cash proceeds, restructuring actions to minimize stranded costs, and partial recovery of stranded costs on cost-loss programs.

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Turning to slide 11, which is our typical guidance slide, FY17 updated guidance for revenue and EPS is changing only to reflect both CapRock and government IT services reported as discontinued operations for the year and the change in taxes. Total Company revenue is expected in a range of $5.76 billion to $5.88 billion, about flat to down 2% on an organic basis, excluding revenue from the aerostructures divestiture. Full-year GAAP EPS is expected in a range of $5.21 to $5.41, and non-GAAP EPS in a range of $5.40 to $5.60, excluding Exelis acquisition-related integration charges.

Guidance contemplates IT services transaction closing before the end of the fiscal year. Also, we have updated our tax rate guidance for the year to 28.5% to reflect the changes discussed on the previous slide.

Expectations for free cash flow of approximately $800 million are unchanged, with the exception of prefunding the pension, which is reported in operating cash flow. Prefunding of pension is in addition to our annual contribution of approximately $188 million for a total pension contribution of $588 million in FY17. Excluding the prefunding, cash flow guidance is consistent with our previous expectation of approximately $800 million of free cash flow for the year.

Moving to slide 12, outlook per segment is unchanged, with the exception of giving effect to the organizational change of operating in three instead of four segments. Electronics Systems is now a combination of previous expectations for both Electronic Systems and the air traffic management business. Critical Networks segment has been eliminated. For simplicity, stranded cost and FAS pension income related to the divestitures are shown separately.

On slide 13, we have provided preliminary estimates of historical information for the ongoing business in the three new segments. This will be updated later with the final stranded cost and to reflect reallocations of stranded cost and FAS pension to the three segments. And with that, back to you, Bill.

Bill Brown - *Harris Corporation - President & CEO*

Okay, thank you, Rahul. These two divestitures simplify our business model, leaving us with a more focused portfolio of technology-based higher-margin and higher-growth businesses. As a result, FY17 guidance on a newco basis now reflects margin expansion over the prior year of 70 basis points, to 19.4%, and high-single-digit EPS growth.

Looking to FY18, the clean slate of core franchises provides a much stronger platform for returning to total Company growth. And the more than $1 billion in net proceeds supports increased FY17 share repurchases, offsetting much of the FY18's dilutive effect of the divestitures. And we will continue to drive our operational excellence agenda to find other ways to lower costs and increase earnings power, providing even greater operational leverage as we return to growth in FY18. And with that, I would like to ask the operator to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Robert Stallard with Vertical Research.

Robert Stallard - *Vertical Research - Analyst*

Thanks very much. Good morning. First of all, on the bookings in the quarter, so start with that, they came down a little bit from what you saw in the first quarter. Is this a natural seasonal pattern? And what might you expect for the rest of this fiscal year?

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Bill Brown - *Harris Corporation - President & CEO*

We saw bookings, the book to bill was a little bit below 1, 0.83 in the quarter, but we're just over 1 in the first half. As we talked about last time, we still target to hit about 1 for the full year. So, we feel good about where the orders happen to be over the first half of the year.

Robert Stallard - *Vertical Research - Analyst*

Do you expect the level of volatility from quarter to quarter to be there in the second half of the year?

Bill Brown - *Harris Corporation - President & CEO*

Quarter 2 was a little bit lighter. We came out of the gates pretty strong in Q1. We're operating under CR in Q2. We will see good orders growth in the back half, and I think for the full year coming in around 1.0 book to bill.

Robert Stallard - *Vertical Research - Analyst*

Okay, thanks. And then just a quick follow-up on the pension, I was wondering if you could being clarify the prepayment. I think you said that this now means you don't have to have any obligatory payments beyond FY18. Is that correct? And what's the impact?

Rahul Ghai - *Harris Corporation - SVP & CFO*

With the $400 million of pension contribution, this pension is now fully fund from an IRS perspective in FY17. So, at this point we don't see any contributions for 2018, 2019, 2020, assuming the rate of return, the discount rate and the mortality tables do not change. So, that is the expectation.

There is an expectation that the mortality tables would change over the next couple of years, and that may drive a small contribution in 2020. It won't be material. And beyond that it is difficult to understand how it would shape up given the change in discount rates with the expiration of the Highway Act and the mortality table's rate of return. So, we feel good about 2018 and 2019 and 2020, and beyond that it is difficult to project.

Robert Stallard - *Vertical Research - Analyst*

Yes, this stuff moves around. But it does sound, therefore, you save $188 million of free cash flow in 2018, 2019 and 2020, is that correct?

Bill Brown - *Harris Corporation - President & CEO*

Yes, that's correct.

Robert Stallard - *Vertical Research - Analyst*

Okay that's great. Thank you very much.

Operator

Gautam Khanna with Cowen and Company. You may begin.

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Gautam Khanna - *Cowen and Company - Analyst*

Could you update us on the timing of some of the bigger international awards you are anticipating, such as the Australian order, Algeria, et cetera?

Bill Brown - *Harris Corporation - President & CEO*

First, on Australia, we are in negotiations there. We still anticipate a sizable order. We size it around $300 million, $350 million, in that range. We still expect it in our FY17. It is going to happen probably at the back end of FY17. But we are in negotiations so there's really not much more to report on that. It is moving along and we still feel very good about that. And regarding Algeria, otherwise known as that country in northern Africa, we did see some good progress earlier this quarter.

Gautam Khanna - *Cowen and Company - Analyst*

Okay. And what about some of the other bigger international campaigns -- Saudi, Iraq, what have you -- are you seeing any life after a big decline that we've seen in the Middle East over the last couple of quarters?

Bill Brown - *Harris Corporation - President & CEO*

I think for Middle East and Africa we see continued slow pace of awards through the back end of this year. It's at a relatively low level now in the Middle East. Saudi is in the $10 million, $15 million range, so it's not very big.

Iraq, we saw some progress this quarter. We saw an important booking come through that was delayed from FY16. And we derisked the back end of the year. Even though international tactical is coming up, we've derisked the year. We still see strong support for Iraq. Some of the ITEF funding is a little bit slow to flow through there so we've derisked that. But Iraq looks very positive to us on an ongoing basis. It still remains probably the biggest opportunity that sits in our medium-term pipeline, so we feel good there.

UK moved out a little bit. The Morpheus program, that's probably in 2021 time period, but there are some opportunities in the nearer term on providing some product in wave form enhancements for enhanced radios HCDR radios in the UK. So UK is still sitting out there, as well.

And we continue to see good momentum being built in a number of important countries in Central and Latin America. So, overall, I think that all looks pretty good.

I think the big story really is around Europe and where Europe happens to be. It is substantially stronger today than where we stood three months ago. It is pretty much clearly going to be a record year. A lot of it is Eastern Europe.

And we see a number of sizable opportunities that are moving through the pipeline. The LOAs have been signed, funding has been allocated. And for them it's mostly administrative in nature, and they will book here in the next few months. So, we feel very good about what's happening on the international side here, Gautam.

Gautam Khanna - *Cowen and Company - Analyst*

And, Bill, one last one. With the JTRS Manpack award being LPTA, I'm just wondering, what do you expect will happen to pricing on that contract over time? Do you expect it to be fairly aggressively bid on a task order to task order basis such that the return profile won't match what you do at the segment now? I'm just curious, do you think it will be accretive to the segment average or dilutive? And, if so, when and by how much?

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Bill Brown - *Harris Corporation - President & CEO*

I think it's going to be competitive, as it has been. I think the good news is that it has been open to competition. And I think the good news is we won a position on a very large ID/IQ contract, $12.7 billion. We feel very good about our product. We have been through qualification testing. We are now starting into customer testing. We've shipped radios.

We've got, I think, a great position here. And the fact that we've got tremendous scale in Rochester and an incredibly large international business, it does bring us some advantages in that particular offering. It will be competitive. And we'll compete every year for delivery task orders. But I think we feel very strongly about the offering we happen to have in the marketplace,

And, of course, as you know, Gautam, we continue to invest in bringing capabilities and feature upgrades that radiate over time. And I think that's going to pay some strong benefits. So we feel good. We feel good about where we stand on the Manpack.

Gautam Khanna - *Cowen and Company - Analyst*

Thank you.

Operator

Noah Poponak with Goldman Sachs. You may begin.

Gavin Parsons - *Goldman Sachs - Analyst*

Hi, this is Gavin Parsons on for Noah. Good morning, everyone. When you look at the Middle East orders that you talked about, some encouraging signs there, does that look more like it is just the catch up of the slippage? Or does it look like you maybe have some visibility into an inflection and better spending in general in the region?

Bill Brown - *Harris Corporation - President & CEO*

Most of what we saw in the second quarter was a catch up of the slippage. I would say the Middle East is continuing apace, maybe even a little bit slower than what we thought before. We still see, as I said, we moved out some of the opportunities we're seeing in the back half of the year in Iraq into next year. They are there, they are going to happen, they need funding, but we've shifted that out.

We have derisked a couple of other opportunities. Saudi remains at a very low level. We moved the SINCGARS opportunity, which we had sized before on this call around $40 million to $50 million, and moved that out of the year. So, we've derisked that, as well.

So I think the Middle East I would characterize as not getting any better, maybe incrementally a little bit worse. But the fact is that we are seeing very strong opportunities elsewhere, and it's causing us to get more optimist and increase our guidance for the year on where the international tactical business is going to land in.

Gavin Parsons - *Goldman Sachs - Analyst*

Thanks. And then on US bookings is there any impact from the continuing resolution?

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Bill Brown - *Harris Corporation - President & CEO*

First of all we started the year, I think, maybe relatively conservative. We said it would be flat to up at the beginning of the year. Now it is probably about flat, so it is not collapsing. It has come down a little bit. And I think we are well calibrated there.

We did a pretty careful review of opportunities in the back half. We have a good sense of what has been booked and how much backlog flows into the back half. And we pulled out of the back half any opportunities that aren't mission critical or hinge on a FY17 budget. So the things we have in the back are mission critical, can be funded out of the CR or are funded by the 2016 budget. I think we are relatively calibrated at DoD being about flat from the full year. So we think that's pretty good. That came down a little bit offset by the international business being stronger.

Gavin Parsons - *Goldman Sachs - Analyst*

Okay. And lastly, is your free cash flow target for FY19 still $1 billion, post the divestitures?

Bill Brown - *Harris Corporation - President & CEO*

It is yes. We still see a path to get to $1 billion. Keep in mind we've lost, I would say, about $100 million, more or less, in free cash from the divested businesses. But as Rahul pointed out, we will not have to make cash contributions in the next couple of years into our pension -- mandatory cash contributions. They tend to offset one another. And the same drivers of getting to about $1 billion in several years remain there.

Working capital improvements, we see some of the cash integration expenses and restructuring expenses coming down. We see interest expense coming down. And we see earnings continuing to grow. It hinges on some new programs, hinges on a good budget. But that would be the closing item that gets us to about $1 billion as we get into 2019, maybe into early FY20.

Gavin Parsons - *Goldman Sachs - Analyst*

Great thank you.

Operator

Seth Seifman with JPMorgan. You may begin.

Seth Seifman - *JPMorgan - Analyst*

Thanks very much. Good morning. Bill, after the portfolio move that you made here, I don't mean to imply that there is more to do because you've obviously done a ton over the past several months, but is the portfolio where you want it right now, or are there other pieces that you might be thinking about moving out of? And then when you think about how Harris fits in going forward, you are obviously a little bit smaller now, and if you think about the opportunities for a Company in the $5 billion, $6 billion sales range, is this the scale level that you think is sufficient to accomplish the type of things that you want to accomplish?

Bill Brown - *Harris Corporation - President & CEO*

I feel very good about the some of the portfolio shaping we've done, not just recently, really over the last four or five years. And I referenced some of that in my prepared remarks. We are much leaner, more focused, more streamlined -- more strategically focused, I should say, higher margin business. And I think we are really well positioned in a number of important areas that are defense electronics, mission-critical communications, high-capacity networks that are well positioned, given where the budgets happen to be going.

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But, as you know, portfolio management is not a start-and-stop sort of game. We always take a look at the portfolio businesses we happen to be in, and making sure that we are optimizing the business that we are in and where we're investing to drive shareowner value. The fact is that at about $6 billion in revenue, I wouldn't consider us to be sub scale, I would consider us to be focused. And now we can take our management team and focus in on those business that really can truly drive shareowner value going forward.

Seth Seifman - *JPMorgan - Analyst*

Great. Thanks. That's helpful. And just as a follow-up, maybe if you can talk a little bit more about the piece of critical networks that you are keeping -- the FAA work, and I believe, although maybe you can confirm, there is some NASA work there, as well, and that will include the Florida work that you want, as well, and how that business fits in. We always knew it was relatively high margin, but I think it's actually, the statements you put out this morning show it is quite profitable actually. How you see that profitability profile going forward, and the growth outlook going forward. Because it seems like this is something where maybe there are one or two big chunky opportunities from time to time rather than a consistent pipeline.

Bill Brown - *Harris Corporation - President & CEO*

Yes, that business that we called Mission Networks is primarily FAA air traffic management business and related business, also international opportunities that fall into there. It's mostly there. It is very little NASA. We will obviously report that Pacific missile range facility in that segment but that's very small. But it is primarily air traffic management related. It's roughly $700 million last year. It's growing mid single digits.

It's rolling into the electronics systems segment at about that segment margin level. It's helped this year, at least a little bit, by a contract settlement we had in the quarter. Call that business a mid- to high-teens margin business, with, I think, good growth outlook, both within the FAA, as well as, importantly, international opportunities, like we've seen in the UK, like we've recently won some opportunities in Turkey and Taiwan, we'll see some opportunities in India and Brazil over time. So that business has, I think, a good, positive growth outlook, and, again, the margins on a normalized basis rolling in between mid teens and high teens.

Seth Seifman - *JPMorgan - Analyst*

Great. Thanks very much.

Operator

Carter Copeland with Barclays. You may begin.

Carter Copeland - *Barclays Capital - Analyst*

Hi, good morning, guys. Just a couple of clarifications on the pension. Rahul, I just want to make sure, the $188 million you mentioned was, I thought, a gross contribution on the pension, so the addition to cash flow of no contribution needs to be a net, I would assume, unless it was wrong. And then I wondered if you could tell us how much of the gross liability moved with the divestitures, as well?

Rahul Ghai - *Harris Corporation - SVP & CFO*

Sure, Carter. You're right that the net contribution -- and that is what Bill was talking about earlier when he was projecting giving color on the cash flow for 2019, he was talking about the divested cash flow from divested businesses at about $100 million, and the net pension benefit offsetting that. So, you are right, $188 million is the gross. And then you take the tax rate off that. So they offset each other. So that's the pension piece.

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None of the pension liability really moved with the divested businesses. We are retaining both the liability and the associated income. Right now our deficit, we started the year at about $2.3 billion, and with the movement in interest rates and the additional contribution that we are going to make, assuming interest rates stay constant, it will be about $1.5 billion, $1.6 billion at the end of the year.

Carter Copeland - *Barclays Capital - Analyst*

So, the liability that you are keeping or that portion of the plan has FAS income. Does it have a CAS expense? Does it have a billable expense associated with it?

Rahul Ghai - *Harris Corporation - SVP & CFO*

Yes. So, we will keep both, Carter. We will keep the CAS recovery and the FAS income.

Carter Copeland - *Barclays Capital - Analyst*

And how much is the CAS? Can you disclose that?

Rahul Ghai - *Harris Corporation - SVP & CFO*

It's in low tens of millions. It's not a significant piece of what we recover, because of all of that, it was on the legacy Harris side so it is not big. Most of the recovery is coming through space and ES segments.

Carter Copeland - *Barclays Capital - Analyst*

Okay. And then just a clarification on the international softness, I don't know if you could give us some color around regionally what that looked like, Bill? It would seem that if were isolated to the Middle East, it would imply that the Middle East was down quite sharply. So, I just wondered if you could give us some color about that. And I know you mentioned that Saudi was at a very low level. Is that at nearly no level, waiting to recover? Or any color you could provide is helpful.

Bill Brown - *Harris Corporation - President & CEO*

We started the year with the legacy international tactical business down mid teens, and now it is down high single digits. So, it has improved over the last 90 days. And, as I said, Europe has gotten quite a bit better. I said before it was about one-third of the international business, now it is probably 40% to 45%. We see that being up strongly. It will be another record. And you saw a pretty important order come there in Q2 in eastern Europe, about $75 million, we noted in my remarks and in the press release. So that's pretty good.

The Central America, Latin America business is still about 10% to 15% of the business. That is up. It is firming. It is firming to the upside. We took an order from USSOUTHCOM for counter narcotics and that is starting to bring some orders through. So, the CALA region looks pretty good.

And in the three other regions, the Middle East - Africa is going to be a little bit softer. The Asia-PAC - Australia business is going to be a little bit softer. That is probably more like flat to down a little bit as opposed to flat to up. And then Central Asia is about the same, maybe a little bit weaker, it's about 5% to 10% of the total business. But we are seeing some significant headwind in Central Asia that reported last time because of a transition that's going on in Afghanistan from radio buildout to sustainment. That's not a change, that's still what's happening today. But that business is going to be down pretty much in Central Asia.

So, Carter, those are the basic pieces. Overall international are now down high single digits versus down mid teens.

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Carter Copeland - *Barclays Capital - Analyst*

Great. Thank you for the color, Bill.

Operator

Pete Skibitski with Drexel Hamilton. You may begin.

Pete Skibitski - *Drexel Hamilton - Analyst*

Good morning, guys. I'll just start by saying great use of cash proceeds. Bill, on the CR going to April or May, your domestic radio sales are up through the first half of the year, what do you attribute that to, because I think there's a lot of expectations that the CR going so long going was going to be a lot of headwinds for you. But it hasn't turned out to be that way. What do you attribute that to?

Bill Brown - *Harris Corporation - President & CEO*

I think we are bumping around at a relatively low level, Pete, on the DoD tactical side. The size of the business in the $300 million, $350 million I think is, in many ways, like base sustainment. It's not a lot of modernization, tens of millions of dollars in modernization business that is flowing through. That is pretty much fully booked and being realized. So, it is really just a base business. I really attribute it to that.

We started the year, and I think the first half was pretty decent on the DoD side, a little bit softer in the year with the CR shifting from December to April. If it moves out beyond April, it could be a little bit incrementally worse than that. But we are optimistic of a budget by then and a good Q4. That is how we see it shaping up. Again, DoD about flat for the year.

Pete Skibitski - *Drexel Hamilton - Analyst*

Okay. And I just want to get your thoughts on some of the emerging initiatives out there in DoD. I imagine it is a positive for you if the Army forestructures increase. And there's 350 shipped Navy. I wouldn't think that's a big impact to you but was interested in your thoughts.

Bill Brown - *Harris Corporation - President & CEO*

I think every indication I've seen, including recent correspondence from the new Defense Secretary Mattis is encouraging for us. It's making sure the force is prepared, is ready, is sized appropriately, has mission-critical capabilities, which I'd also include in that the ability to communicate amongst themselves and with coalition partners. Some of the things that we've seen recently in the last year and a half in Eastern Europe, which is very strong for us, really comes from this ability to communicate with our US war fighters. So, I feel good about where we happen to be.

Every indication is that there remains strong support going into our FY18 for modernization. SOCOM is moving along well, both on the handheld radio as well as on Manpack. And every indication has been that the Army Manpack program is going to stay on track through the summer into next year.

We've all shipped, all three parties, CT radios -- customer test radios. They are on track for testing that in the next few months with a delivery order coming towards the end of the summer and shipments starting in the fall. So, all of that feels, I think, Pete, pretty good for the outlook for that DoD tactical radio business.

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Pete Skibitski - *Drexel Hamilton - Analyst*

Great, thank you.

Operator

Jason Gursky with Citi. You may begin.

Jason Gursky - *Citigroup - Analyst*

Good morning, everyone. I was wondering if we could start with space and intelligence systems and talk a little bit more about the classified adjacency. Two fronts here -- maybe just talk a little bit about how you got here, and then, secondly, perhaps define for us what you view to be a franchise program.

Bill Brown - *Harris Corporation - President & CEO*

first of all, how we got here is by, I would say, number one, really strong execution on the programs that we have had with this community for really decades. It goes back a long time. So, the team does a very good job. And we have been investing in IRAD in this segment. We have talked before about the amount of IRAD we are spending at Harris Corporation, just on a normalized basis. If you pull out services in CapRock, we'll be about 5% of revenue this year in IRAD. And it has been remaining at a relatively high level even with sequestration and some of the budget pressures. So, we are investing in IRAD in lots of places, including in the space and intell segment.

And the third part is the additional capabilities that we have acquired with Exelis that allows us to offer more end-to-end solutions than we have been able to provide in the past. All of those things, together with really good execution by the team, I think allows us to step up and provide a different mission solution to our customers. Obviously it's classified, so we are not really able to talk a whole lot about it. But that is really what puts us in a great position. The budgets are strong here and we happen to be in areas in satisfying needs that are important, like space resiliency and protecting our space assets. Those kinds of things are very important.

So, what is a franchise? A franchise, to us, is something that has the potential to be hundreds of millions of dollars, not tens, and sustainable over a period of time and lead to broader opportunities. This now ground adjacency, it's adjacent because it does evolve from a capability that we have been providing on a component basis, and allows us to take on a much bigger role in this particular community. Unfortunately, that is really all that I can say here, Jason, but I think we feel great about the developments and trajectory that space and intell happen to be on, last year into this year and going into next year, as well.

Jason Gursky - *Citigroup - Analyst*

That's very helpful. I appreciate that. And then just secondarily here, on the 2017 guidance you talked a little about the impacts or potential impacts on the CR. So, my question is going to be away from that, I suppose. I was just wondering if you could comment, outside of CR, what the risks and opportunities are to your FY17 guidance. If we end up being higher what do you think drove that? And if we end up being lower where do you think we may have gone wrong?

Bill Brown - *Harris Corporation - President & CEO*

I think we have done a pretty decent job of calibrating the year, Jason. We obviously look very hard at, given where the new Administration is and what we are hearing coming out of the defense department, there is a lot of uncertainty in funding. So, we have tried to derisk our business to the best extent that we can and look at, including in guidance, opportunities that are funded by FY16 dollars that are already appropriated and where there is some support for that, or mission-critical requirements that can be funded under a CR. And that's where we happen to stand today.

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We have, as Rahul mentioned, the international tactical business. And tactical in general will be stronger in the fourth quarter than in the third quarter. We've got to make sure that we execute those opportunities so they do happen in our fourth quarter, and that's what we are really focused on.

Jason Gursky - *Citigroup - Analyst*

That's great. Thank you very much.

Operator

Our next question is from Josh Sullivan with Seaport Global. You may begin.

Josh Sullivan - *Seaport Global - Analyst*

Good morning. I just had one, digging into public safety. How do you see public safety operating as the FirstNet contract comes into play here?

Bill Brown - *Harris Corporation - President & CEO*

FirstNet, it was anticipated to be awarded toward the end of last year on the November-December time frame. That has been delayed. There is no hard date now as to when that will be awarded. But that is intended to be a very large investment in a national dedicated public safety broadband network. So, LTE across the country, driving interoperability across all state agencies and with federal agencies high-capacity bandwidth to provide video and other things, and tie directly into the existing LMR system.

That is the intention of FirstNet. Again there is no awardee yet. We don't have any insight as to what the timing of the award is going to be at this point. But I would say, regardless of who ends up building out this network -- which, by the way, is going to take probably five years, it is a very large investment to build out this dedicated network -- regardless of who wins, we will be in a position to provide products, devices, applications to whoever happens to be the winner of that particular program.

We have developed and launched an important radio, the XL-200P, which has LMR- and LTE-capable radio. There's a mobile radio we have done. There's a mobile router. All of which positions our devices and applications such that when LTE does happen, when this public safety broadband network does happen, we'll be in a great position to provide products and devices to whoever wins that.

Josh Sullivan - *Seaport Global - Analyst*

Okay, thank you.

Operator

Noah Poponak with Goldman Sachs. You may begin.

Noah Poponak - *Goldman Sachs - Analyst*

Thanks, guys. Thanks for the timing on Manpack. Thanks for the update. When should we expect that to start to contribute to bookings? Is that not until calendar 2018?

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Bill Brown - *Harris Corporation - President & CEO*

Yes, that will be probably calendar 2018. We expect the first delivery order, at least what the Army is telling us, sometime in the fall of this year. So, the production award around August-September, deliveries starting maybe after October. So, maybe a little bit towards the back end of 2017 but more likely it starts to ramp into early 2018.

Noah Poponak - *Goldman Sachs - Analyst*

And then for your expectation for revenue growth in FY18 should we also think of higher margins?

Bill Brown - *Harris Corporation - President & CEO*

I think what I would comment on here is that we do expect higher revenue in FY18 from FY17 because this year modernization revenue is so is in the tens of millions. So, it is going to be more than that into FY18. And, frankly, all of our programs in this area, we expect to come in at attractive margins. I don't think I would comment any more than that.

Noah Poponak - *Goldman Sachs - Analyst*

Thank you.

Pamela Padgett - *Harris Corporation - VP of IR*

Thank you everyone for joining us today.

Operator

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

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