26-Apr-2018

Flex Ltd. (FLEX)

Q4 2018 Earnings Call

Copyright © 2001-2018 FactSet CallStreet, LLC

CORPORATE PARTICIPANTS

Kevin Kessel
Vice President-Investor Relations & Corporate Communications, Flex Ltd.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

OTHER PARTICIPANTS

Amit Daryanani
Analyst, RBC Capital Markets LLC

Steven Milunovich
Analyst, UBS Securities LLC

Steven Fox
Analyst, Cross Research LLC

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Ruplu Bhattacharya
Analyst, Bank of America Merrill Lynch

Paul Coster
Analyst, JPMorgan Securities LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to the Flex Fourth Quarter Fiscal Year 2018 Earnings Conference Call. Today's call is being recorded and all lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session.

At this time, for opening remarks and introduction, I would like to turn the call over to Mr. Kevin Kessel, Flex's Vice President of Investor Relations and Corporate Communications. Sir, you may begin.

Kevin Kessel
Vice President-Investor Relations & Corporate Communications, Flex Ltd.

Thank you and welcome to Flex's fourth quarter of fiscal 2018 conference call. We have published slides for today's discussion that can be found on the Investor Relations section of our website at flex.com. Joining me on today's call is our CEO, Mike McNamara; and our CFO, Chris Collier. Following their remarks, we will open up the call to questions.

Before we begin, let me remind everyone that today's call is being webcast and recorded and contains forward-looking statements which are based on current expectations and assumptions that are subject to risks and uncertainties, and actual results could materially differ. Such information is subject to change and we undertake no obligation to update these forward-looking statements. For a discussion of the risks and uncertainties, see our most recent filings with the SEC including our current, annual and quarterly reports.

Copyright © 2001-2018 FactSet CallStreet, LLC

If this call references non-GAAP financial measures for the current period, they can be found in our appendix slides. Otherwise, they are located on the Investor Relations section of our website along with the required reconciliations.

In addition, as mentioned in our press release, in accordance with our high standard corporate governance, the Audit Committee of our Board of Directors with the assistance of independent outside counsel is undertaking an independent investigation of allegations made by an employee, including that the company improperly accounted for obligations in a customer contract and certain related reserves.

The Audit Committee is working diligently to complete the investigation with expedience and beyond what is provided in the press release. And this is very important; as this is an ongoing legal matter, we will not be able to provide any more information or answer any questions on this issue today.

With that, I would now like to turn the call over to our Chief Financial Officer, Chris Collier. Chris?

Christopher E. Collier

Chief Financial Officer, Flex Ltd.

Good afternoon and thank you for joining us today for our fourth quarter and fiscal 2018 year-end results. We'll start on slide 2 with our fourth quarter fiscal 2018 income statement summary. Our fourth quarter sales were approximately $6.4 billion, up 9% versus a year ago and at the high-end of our guidance range as all four of our business groups met or exceeded their respective sales guidance ranges.

Our Q4 adjusted operating income was $200 million, which was at the low-end of our guidance range. And adjusted net income was $150 million. This resulted in an adjusted earnings per diluted share of $0.28, which was at the low-end of our guidance range of $0.28 to $0.32.

Q4 GAAP net loss amounted to $20 million, which is lower than our adjusted net income due to several elements. During the quarter, we recognized $94 million or $0.18 primarily from workforce reduction and other costs associated with the targeted restructuring plan we announced in January.

These activities were focused primarily on reorganizing our corporate and business group functions and also included consolidating activities at several locations. The GAAP result also includes $22 million of stock-based compensation expense, $20 million of net intangible amortization, and $33 million of other charges primarily related to a non-recurring non-cash charge associated with a change in the tax filing position. These adjustments had a $0.32 impact on adjusted EPS resulting in a fourth quarter GAAP net loss of $0.04.

Now, turn to slide 3 for our quarterly financial highlights. This was our fifth consecutive quarter of year-over-year revenue growth, led by our IEI and HRS businesses, which continue benefit from expansion with new customers and programs.

As highlighted last quarter, we have been ramping several new programs this year and continue the development of our long-term strategic partnership with Nike. These factors have pressured our gross margins due to elevated investment costs and under-absorbed overhead.

For the quarter, our adjusted SG&A expense totaled $229 million, which was up year-over-year by $15 million. The year-over-year quarterly expense growth was primarily driven by incremental design and engineering investments to support our Sketch-to-Scale offering as well as an impact from fiscal 2018 acquisitions which carried higher design and engineering costs.

Copyright © 2001-2018 FactSet CallStreet, LLC

Our SG&A expense will decrease in terms of both dollars and percentage of sales as our restructuring efforts provide benefits moving forward. Our quarterly adjusted operating income came in at $200 million, which was modestly lower than the prior year and resulted in an adjusted operating margin of 3.1%.

The depressed operating performance is almost entirely attributed to the increased levels of costs and investments required to support our new businesses and our platform as we continue to position our company for long-term profitable growth.

Return on invested capital or ROIC was 16%. While remaining above our cost of capital, our reduced ROIC reflects the impact from lower profitability combined with higher levels of invested capital as we're ramping top line growth that is requiring net working capital in installed capacity.

Turning to slide 4 for our operating performance by business groups, our CEC business generated $45 million in adjusted operating profit, resulting in a 2.4% adjusted operating margin. We continue to make investments in engineering and building out our reference platforms for the cloud data center marketplace while we transition our customer portfolio in this direction. Both on a year-over-year and sequential basis, the business had lower revenues which pressured profitability with under-absorbed overhead and higher investment costs.

Our CTG business earned $24 million in adjusting operating profit, resulting in an adjusted operating margin of 1.5%, which is below our targeted range of 2% to 4%. This performance was driven by the seasonal decline in revenues, the pressured profits due to the lower contribution, and continued losses from our strategic partnership with Nike.

Our IEI business generated a record adjusted operating profit of $68 million, achieving a 4.1% adjusted operating margin, which is inside the targeted range of 4% to 6%. The improved profitability reflected strong revenue expansion which has been led by several new customer programs and an improving overall demand across its diverse market that is contributed to absorption benefits. Additionally, IEI continues to benefit from greater Sketch-to-Scale engagements, thereby realizing higher margin content and the mix of its products and services.

Lastly, our HRS business delivered quarterly adjusted operating profit of $97 million and an operating margin of 7.8%. The business continues to deliver solidly inside its targeted margin range while it simultaneously invests in expanding its design and engineering capabilities and ramp new customers and programs.

Turning to slide 5, let us review our cash flow generation and highlights. Our operating cash flow remained solid and came in over $750 million for fiscal 2018. Our fourth quarter cash flow from operations amounted to $323 million, which marked our 15th consecutive quarter of generating over $100 million in cash flow from operations.

Our inventory level has increased over $400 million from a year ago as we continue to operate in a challenging and constrained supply environment that is requiring us to carry higher levels of inventory to support our revenue growth and multiple large programs that are ramping.

Our inventory management helped us to fulfill customer demand and achieve better inventory turns than a year ago. Overall, our net working capital ended just over $1.6 billion and amounted to 6.4% of our net sales. We believe that our current and prospective business mix will result in our net working capital as a percentage of sales to remain within our targeted range of 6% to 8%.

Copyright © 2001-2018 FactSet CallStreet, LLC

We continued to invest to expand capability and capacity this quarter as our capital expenditures totaled $128 million, exceeding depreciation by just under $19 million. A greater percentage of our CapEx has been allocated to support our expanding IEI and HRS businesses. These investments are supporting long underlying product life cycles and, in many instances, have required us to outlay capital investments in advance of ramps.

Our free cash flow for the quarter was $195 million and $236 million for the year. For the year, we repurchased roughly 11 million shares for approximately $180 million, which amounted to 76% of our free cash flow and reflected our commitment to return value to our shareholders. During the fourth quarter, we did not repurchase any shares.

Please turn to slide 6 to review our balanced capital structure. We have no debt maturities until calendar year 2020 and we have over $3 billion in liquidity. We continue to operate with a balanced capital structure and, together with our cash flow generation, we have the strength and flexibility to support our business over the long term.

Before I turn the call over to Mike, I want to reinforce that fiscal 2018 marked an important year for Flex as we undertook numerous actions to evolve our business, to improve our Sketch-to-Scale solutions capabilities, and to strengthen the platform. So while elevated levels of investments pressured our operating performance in the near term, they've also positioned Flex for future earnings leverage as we move into fiscal 2019 and beyond.

Now, I'll turn the call over to Mike.

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

Thank you, Chris. Fiscal 2018 marked a return to overall revenue growth for Flex. It also highlighted that our strategy of driving portfolio evolution and investing in our Sketch-to-Scale capabilities is driving new engagements and revenue momentum.

Please turn to slide 7 for Q4 fiscal 2018 business highlights. Our portfolio evolution created accelerated revenue growth over the past year and has positioned us for the same in fiscal 2019. As Chris said, this is the fifth straight quarter of year-over-year revenue growth for our business.

IEI and HRS have led the way, up 26% and 19% year-over-year in Q4. Both IEI and HRS ended fiscal 2018 with revenue growth above their long-term target of 10% due to successfully expanding to Sketch-to-Scale capabilities and adding new customer relationships.

IEI and HRS totaled 45% of sales for the quarter and 43% for the full fiscal year. Our profitability mix also continued to skew heavily towards IEI and HRS, which accounted for 71% of operating profit dollars in Q4 and 68% in fiscal 2018.

As expected, IEI set a new individual record for quarterly revenue and profit and HRS hit record revenue. Our top line momentum continues to be fueled by new engagements and customers that are attracted to Flex platform for its ability to take advantage of a broad collection of assets and capabilities that enable integrated cross-industry solutions.

To further support this, we continue to improve and expand our design capabilities and reference platforms for new products and markets. The face of disruption is accelerating as technologies converge which plays to our strength because we are at scale in so many industries.

Copyright © 2001-2018 FactSet CallStreet, LLC

We're finding numerous ways to partner with customers and enable their innovation by leveraging our deep cross-industry expertise into complementary industries or supply chains [ph] with success (14:03). To accelerate this transition, we announced a targeted restructuring plan that will make Flex a faster, more agile company that will be more responsive to the changes that are rapidly occurring in the marketplace and better leverage our cross-industry capabilities.

Our efforts were focused at corporate functions and breaking down systems and silos that reduced our speed and effectiveness. Our plan was deployed and completed by the end of Q4. We will see the benefits in both the top line and profitability over the next few quarters.

We continue to make broad investments in manufacturing automation. These investments are being actively leveraged in our Nike strategic partnership. This depressed our operating results through fiscal 2018. And while we saw improvement in the performance of this project, our Q4 performance did not meet our targeting of exiting at a breakeven level. For the year, we incurred just over $70 million in losses related to Nike. While fiscal 2018 was a difficult year in terms of learning, creating and investing for the partnership, it was not without many positive developments that emphasized why Flex and Nike remain extremely committed to our strategic partnership.

For example, during fiscal 2018, we made a few very important breakthroughs such as moving into our new factory in Q3 and further optimizing in Q4, which has allowed us to realize productivity improvements of over 40%. Ramping and delivering NIKEiD volumes successfully from our factories at substantially reduce lead times and, importantly, co-developing a unique automation system together with our partner which was released to production two weeks on April 11. This new system is designed to deliver even greater productivity gains, skill improvement and enhanced equality. Most importantly, Nike has released a full set of products designed for our automation system which is now beginning to ramp in mass production.

We are confident that these accomplishments will enable us to significantly improve our fiscal 2019 and position us for greatly reduced losses in the first half of 2019. We are targeting profitability during the second half of fiscal 2019.

Now turn to slide 8 for highlights from the year. Fiscal 2018 also marked a return to overall top line revenue growth with just under $1.6 billion or 7% growth versus fiscal 2017. IEI and HRS drove 43% of total sales and 68% of adjusted operating profit, capping an extraordinary year of portfolio evolution. It's worth noting that, exiting fiscal 2018, the combined IEI and HRS were nearly $11 billion in sales with double-digit compounded annual growth rate for both revenue and operating profit.

During fiscal 2018 we managed to the balance organic investments with new business expansion and returns to shareholders.

Please turn to slide 9 as we review revenue by business group in detail. Our fourth quarter saw a strong year-over-year growth in three out of our four business groups. Our diversification remained strong and balanced. Our top 10 customer revenue concentration improved to 42% of total sales from 46% year ago, a very well balanced distribution across industries and customers with no customer above 10% of sales for the ninth consecutive quarter.

Our CEC business was down 5% year-over-year to $1.9 billion versus our expectation for a 5% to 10% decline. While CEC's legacy end-markets remain challenged, its design capabilities continue to improve and expand,

Copyright © 2001-2018 FactSet CallStreet, LLC

which is leading to new customers and business opportunities particularly in cloud data center and converged infrastructure structural solutions which rose over 20% year-over-year.

For the June quarter, we expect CEC's year-over-year revenue reduction to be 5% to 10% driven by reductions in traditional legacy businesses offsetting strong growth in cloud data center and converged products.

CTG revenue of $1.65 billion was up 7% year-over-year in line with our guidance range of up 5% to 10%. The growth was mostly driven by strength in products from high-growth emerging markets such as India. We are seeing substantial demand for consumer products for our India operation, which we have scaled over 15,000 employees. For the June quarter, we're guiding CTG revenues to be up 15% to 25% year-over-year [indiscernible] (18:50) from the expansion of new programs.

IEI's strong growth streak continued once again with record revenue of $1.6 billion, up 26% year-over-year and above the expectation of 15% to 25% led by successful new program launches and expanding end markets.

IEI saw continued growth across its home and lifestyle and energy portfolios and continued to experience strong Sketch-to-Scale related bookings across its diverse offering which came in at new record levels for fiscal 2018. For the June quarter, we're expecting continued strong IEI revenue growth, up 10% to 20% year-over-year led by new program ramps.

HRS revenue grew for the 33rd straight quarter on a year-over-year basis. This quarter, revenue rose to a record $1.25 billion, up 19% year-over-year and at the high-end of expectations for 10% to 20% growth as both automotive and medical grew. In our June quarter, we expect HRS growth to remain strong with revenue up 5% to 15% year-over-year as we introduce new programs and expand existing programs for both medical and automotive.

Let's turn to our first quarter fiscal 2019 guidance on slide 10. Fiscal 2018 was an important year for Flex as we expanded our platform businesses and Sketch-to-Scale solution capabilities and positioned ourselves for accelerating growth. We anticipate some near-term pressure on our profitability as we support the revenue growth. As we progress this year, we expect fiscal 2019 to show strong growth in revenue, adjusted operating profit and adjusted earnings per share.

Let me provide little more context how we see fiscal 2019 shaping up. [indiscernible] (20:43) plan to provide more detail at our May 10 Investor and Analyst Day, ahead of that, I would like to level set the discussion. Revenue growth was roughly 10% year-over-year in the back half of fiscal 2018 and we expect a strong rate of growth to continue throughout fiscal 2019. To support this strong growth, there will need to be higher investments into working capital and CapEx and will incur greater startup costs.

The result of this should be accelerated earnings growth and year-over-year earnings growth in the back half of fiscal 2019. The higher revenue will enable better absorption of manufacturing overhead and display substantial SG&A leverage due to both higher revenue and also the reorganization we implemented in Q4. We view these as a very positive development for long-term earnings, cash flow and also competitive positioning while understanding they will pressure our short-term results in Q1 and Q2 of fiscal 2019.

For the June quarter, we expect revenue in the range of $6.3 billion to $6.7 billion, adjusted operating income is expected to be in the range of $170 million to $200 million, adjusted earnings per share guidance in the range of $0.22 to $0.26 per share based on weighted average shares outstanding of 535 million.

Copyright © 2001-2018 FactSet CallStreet, LLC

GAAP EPS is expected to be in the range of $0.15 to $0.19 as a result of stock-based compensation expense and intangible amortization. This guidance excludes the impact of new revenue recognition accounting which will be adopted by Flex in our first quarter. The adoption will change the timing of revenue recognition for certain customer contracts but does not change the overall profitability or cash flows.

With that, I'd like to open up the call for Q&A, so operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Amit Daryanani with RBC Capital Markets. Your line is open.

Amit Daryanani
Analyst, RBC Capital Markets LLC

Q

Thanks a lot and thanks for taking my question, guys. I have two questions. Maybe first to start with on Nike, Mike, I think you said losses up until we get to the back half of fiscal 2019. Could you maybe just help us understand what changed versus expectations for breakeven in the March quarter that's getting pushed out by two, three quarters? And is the trajectory of the expectation that losses remain fairly consistent with that $70 million kind of run rate till we get to the back half or does that burden kind of start to ease up?

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

A

Yeah, so what changed? As you know, we're undergoing a very new program. We expected – we had hoped to be breakeven, we had set a goal of exiting the end of the year at breakeven. This has been a consistent goal all through the entire year and something that we tried to achieve and we didn't achieve it. Now, what changed?

There were a couple of levers that were driving us towards that goal. One was, going into the new factory, we thought it would bring us a lot of productivity gains, which they did quite frankly, we went into the factory in Q3, and I call like full implementation in Q4, we still didn't open the [ph] cafeteria until (24:14) Q4 and some other things.

We saw huge productivity gains on the back of not being spread out into like three different factories. I quantified that by about 40% so that was a huge positive, but the one thing from the very, very beginning that we really need to have is we need to have the supply/demand process and the design for automation products really coming to us in volume.

And that was something that wasn't even [indiscernible] (24:46) when we set the goal at the beginning of the year, and so we've probably been very consistent to talk about that beginning of the year, the whole concept of regional manufacturing is automation, the whole concept of automation is you can't do automation you have to do design for automation. So it's not something we control entirely, we have to work with our customer to create the right solution.

I think our automation system took maybe a little bit of time because not only do you have to actually invent the automation, but then you have to go back and invent the products that need to go on the automation and then you actually have to find the whole market standpoint for those new products. So it's not a trivial set of things to all get

Copyright © 2001-2018 FactSet CallStreet, LLC

working together. It's new. In the grand scheme of things, if we push this to the second half of the year, it means we're off by, call it, six months.

Your second question is would the losses go down over the first six months, the answer is absolutely. We would expect them to – in a very gradual and linear way over the course of the next six months, the losses will dissipate, and then hopefully, in the second half, will switch to profitability.

So, in the grand scheme of things, we always thought this would be a long program. We couldn't be precise with it because we're inventing. It was an entire new product category and we're very new to it. We always felt this would be a decade-long kind of implementation and commitment. And what has proven that, we've been working on it for two years, we hope to get to losses breakeven. It's going to take two-and-a-half years is our current forecast in the grand scheme of things that is not huge, but it's going to push out.

The revenue expectation and the breakeven and then the transition into higher margins will push out by that amount. So we're still committed to the long-term potential of the program. We're still committed when we look out to the margin target that we have out there. I think it's just – think about it as just being pushed as opposed to not being possible.

Amit Daryanani
Analyst, RBC Capital Markets LLC

Q

Fair enough. That's really helpful. And then if I could just follow-up, Chris, when I think about when you guys are talking about increased investments in working capital and CapEx, could you maybe just level set how do we think about fiscal 2019 from a free cash flow, from a CapEx perspective because 2018 was obviously a very heavy CapEx year for you already, so just maybe help us think about free cash flow CapEx in 2019 that would be great thank you.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Certainly, Amit. So, as you highlighted, fiscal 2018, we invested [indiscernible] (27:28) to the tune of over $8 million. It was a bit higher than what we had talked about midway through the year. Our CapEx continues to be focused around growth areas of the business as well as a lot of pre-staging for HRS and IEI type of activities.

And what we have been finding is, in many instances, we are essentially having to pre-position our investments much sooner and then before the ramp stages [indiscernible] (28:05), so there is a fair amount of investment that's gone into this year that had no revenue associated with it similar to this next year. We also talked about some accelerated growth that we're seeing that's requiring us to put capital to use in certain areas to expand necessary capacity and capability.

So, as we think through the fiscal 2019, which we're going to be able to address at more length at the Investor Day, you're going to see us still carrying elevated levels of CapEx beyond depreciation. This is a departure from where we were at last year. It's also a different type of a revenue picture that we're seeing and the successes that we've been able to see in terms of bookings of business inside of HRS and IEI have also enabled us to have confidence around expanding some of those investments.

So I think, overall, you'll see a continued increase in CapEx in 2019. To be able to give you more detail on it, I'd say that what you'll see for the first quarter is going to be very similar level that we had back in December.

Copyright © 2001-2018 FactSet CallStreet, LLC

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.
A

And I'll just add. There is really two categories of CapEx investment that we are doing in this year and one of which you're already starting to see because, in the last half of FY 2018, we're already growing 10% a year, so we're continuing along that trend as we get into FY 2019. So there is the CapEx required for the near-term revenue growth, that's one avenue of CapEx.

The other thing is we'll put close to $100 million of CapEx into HRS programs where there will be no revenue in FY 2019, but obviously very significant ramps going into 2020 and 2021 as a result of new programs coming on. So that's a $100 million pressure that is going into what we consider to be much better higher margin HRS programs, but there is no revenue from them in FY 2019. So there's really two classes of investments in the CapEx this year: one, the near-term revenue growth that you're seeing, and the second one, some major programs that we'll actually see revenue on in FY 2020 and 2021.

Amit Daryanani
Analyst, RBC Capital Markets LLC
Q

Perfect. Thank you, guys.

Kevin Kessel
Vice President-Investor Relations & Corporate Communications, Flex Ltd.
A

Next question, please.

Operator: Your next question comes from Steve Milunovich with UBS. Your line is open.

Steven Milunovich
Analyst, UBS Securities LLC
Q

Thank you. I know you're going to want to address this more at your Analyst Day, but you did have the $1.80 number out there in 2020 and the $1 billion run rate on Nike is there. Any update can you give us? Are we talking more like $1.40, $1.50 in EPS? And at the time, I think you had said that Nike was maybe 15% of the earnings improvement between then and 2020, so it wasn't anywhere close to the majority, it was still IEI and HRS. So does that suggest you can still get somewhere close to that goal?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.
A

Thank you, Steve. Definitely, we're going to have the opportunity to provide that longer-term vision at the upcoming Investor Day. But I would highlight today there is a couple of key fundamental levers that remain intact, and I'd say some of them are even ahead of track. But, as we talked on the call, certain ones such as Nike and CTG overall are a bit behind.

Nike in terms of that vision was a substantial portion of the CTG lever. We didn't quantify specifically, but we had anticipated a significant revenue provision from that group plus an elevated level of margin at that time. So, [ph] with regard to this (31:53) $0.22 that we are targeting around for CTG, a significant portion, roughly half you could say, was earmarked to see improvements and growth on Nike.

Obviously, we're disappointed that we're having to continue to push this out, but we have long-term line of sight into this being an achieved goal, it's just not going to be in the 2020 vision. So that itself will put some pressure

Copyright © 2001-2018 FactSet CallStreet, LLC

on. What I go back to is that we're solidly diversified across the portfolio. We have substantial scale now inside of our IEI and HRS businesses. IEI is positioned nicely itself, it has a growing portfolio, capturing more business itself and an improved operating performance.

HRS, as you think about it today, has truly positioned itself as a tier one partner and scale globally and has numerous capabilities and has real nonperishable bookings, so that's pretty much intact. And our CEC business continues its portfolio transition to greater cloud data center and converged infrastructure opportunities and leveraging its investments. Then you go back to CTG, and CTG has a depression from where we sit within Nike, but as Mike was highlighting, we're seeing upsize growth in emerging markets that's going to contribute nicely with operating profit dollar expansion.

So, lots of puts and takes. We're going to unpack that for everyone here in another couple of weeks, but we continue to invest and operate and manage the business to deliver meaningful long-term revenue growth. And we anticipate that journey to $1.80, whether it's achieved in 2020, we have a line of sight to achieving that in our future.

Steven Milunovich
Analyst, UBS Securities LLC

Q

Thank you. And could you talk a bit about the tariff discussions and what that might mean for you in terms of either margin pressure and your ability to move work around the world as necessary?

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

A

So we're actually pretty well structured to be able to handle whatever tariffs come at us. I mean I think we have the largest system in Mexico, Brazil, India, Eastern Europe; we're the largest electronics manufacturer in the United States. These tariffs move around. We're actually built to be able to handle the moves. And anyways, that's actually a core feature of how this industry was actually created and the value-add that actually happened. The only place we're not number one in terms of size and scale and experience and breadth of manufacturing technology is actually in China.

So everywhere else we've got a very strong footprint. So if companies want to move around the world, we actually think that's an opportunity for us to help them out. The bottom line is, we actual don't anticipate any real revenue or OP shifts relative to the tariff story. There will be little puts and takes here and there, but on average, if things move around the world, I think we're well positioned, if things don't move around the world, I think, like Chris said, we got this massively diversifying portfolio, and as different tariffs happen, they're going to happen, so we don't view it as being meaningfully impacting our business.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Yeah. And just to expand on that. We're well positioned given where the tariffs are sitting today in terms of not having a significant portion of our goods and services being directly impacted. And there's a lot of uncertainty in how these develop, but again most of the goods that we're dealing with today are not under these existing tariffs.

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

A

And one thing I'd add just getting back to India conversation. Like Chris said, we didn't anticipate such a rapid growth in India, which was actually new demand for us. So it's incremental operating profit dollars that we'll see

Copyright © 2001-2018 FactSet CallStreet, LLC

on the back of that. That's going to be one of offsets when we get to Analyst Day about with the Nike being pushed out. But the tariff changed dramatically in India and that's actually usually helpful for us.

So the tariff on inbound goods on average among electronics coming in from China is like 10%, so where they may have been a lot of goods being manufactured in China that now need to be manufactured in India. Good chance we weren't building those in China and we will be building them in India and even some of the India demand because on the strength of that developing economy and the strong growth rates, we're going to have new demand.

So that tariff we're going to see substantial opportunity as a result of it. And the reason I say we'll see substantial opportunity is because we've already got 15,000 people there, huge operations and quite a bit of experience. So I would expect that available capacity and know-how is going to be able to put to use right away. So that is one tariff that's probably incremental and will meaningfully move a little bit of our business.

Steven Milunovich
Analyst, UBS Securities LLC

Q

Thank you.

Operator: Your next question comes from Steven Fox with cross research. Your line is open

---

Steven Fox
Analyst, Cross Research LLC

Q

Thanks. Good afternoon. Just two questions from me. First of all, just bigger picture, Mike. The company's always had a lot of ambition around leveraging a lot of core competencies probably more than most companies do, but you get into these situations where making the investments come ahead of the actual revenues and then there's other investments that follow. So I was wondering, as a public company, how you're managing all these opportunities in a way that doesn't continue result in sort of further investments without seeing the net returns. And then I had a quick follow-up.

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. That's a good comment. One of the things that we try to do is take the opportunities available to us in the marketplace consistent with the returns. The Nike thing was unanticipated. If Nike wasn't a $70 million loss and that was a $20 million loss, you wouldn't have asked this question just now. So we have one program that we really got behind on, which is disappointing. The one thing I can say about the new programs that we're ramping, they're massively low risk programs, so I don't think we would go into a high risk program.

So, for example, if we saw an opportunity as a result of our knowledge of Nike to go into the apparel industry to kind of reinvent the apparel industry, we would not do it. Because it's a risk profile that's too high for us and we already have – until we mitigate the other risk profile like a Nike and figure that industry out, we won't invest in it. The progress we have that we're ramping revenue on, we view as very low risk programs. They're typically [ph] SMP lines (38:47) or massively solid companies with very stable marketplace position.

So, we kind of view the investments we're making as being really low risk. We're not trying to reinvent things. The only other place that we have some investment is really in YTWO, which is minor. You can't even see it. And what's interesting about YTWO is there is virtually no inventory and no CapEx, so it's actually more of a trading

Copyright © 2001-2018 FactSet CallStreet, LLC

model than it is anything else. It's a trading and an IT model as opposed to a heavy CapEx model like our typical business.

So, I actually think that the investment that's a little upside down is – you know it's Nike and we just got to get that behind us and the other ones we kind of view are in balance with the opportunities in marketplace.

Steven Fox
Analyst, Cross Research LLC

Q

Great. I appreciate that perspective. And then just, Chris, as a follow-up, understanding the environment you're operating in from a working capital standpoint, is there any – do you have any clear line of sight into when some of these pressures start to ease in terms of building inventory like you have been or is it kind of hard to read in fiscal 2019.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

So if you're talking about the inventory environment and the need to...

Steven Fox
Analyst, Cross Research LLC

Q

Yeah.

Steven Fox
Analyst, Cross Research LLC

Q

...yeah, I mean, as we said and we've been operating in a pretty dynamic supply environment for a while now and definitely there is elevated tightness, extended lead times, and a bunch of different items that will be on allocation. We have been contending with that. We're actually seeing that as something that's going to be sustained for a while.

And while we're ramping not to displace the demand, we've been able to capture and carry a bit higher inventory level. We'll probably see that sustaining itself throughout this year. That coupled with the incremental investment is going to be what is the elevated levels of cash utilization that's going to take down some of that free cash flow generation that we have anticipated.

Kevin Kessel
Vice President-Investor Relations & Corporate Communications, Flex Ltd.

A

Next question, please.

Steven Fox
Analyst, Cross Research LLC

Q

Great. Thank you.

Operator: Your next question comes from the line of Adam Tindle with Raymond James. Your line is open.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Copyright © 2001-2018 FactSet CallStreet, LLC

Okay. Thank you and good evening. Mike, first, I just wanted to ask, I understand that the Nike losses weighed on the year, but if we add back that loss that you quantified, operating margin would still be flat despite more than 6% revenue growth and strong growth in IEI and HRS. Peers are seeing improved margins in their EMS businesses. So ex-Nike, can you just reflect on the rest of the businesses and what changes moving forward to start seeing margin improvement?

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. I think – well, to me, it's what we've already outlined. Nike has to get to breakeven. If it goes above breakeven, it will be additive – pretty additive. But even just getting to breakeven, that's an important requirement to get to good margin expansion. When you look at the other businesses, you have IEI, which is in its fourth or fifth year of margin expansion, so you'll see that continue over the course of the year.

So I think, this last year, they ended up with – last few years are – last year it did 3.9%, the year before that 3.6%, year before that 3.4%. It closed the year at 4.1%. And we would expect their margins to expand over the course of FY 2019. So they're basically on a tear both from a revenue growth standpoint and from a margin expansion standpoint.

HRS is also very, very strong in terms of margin. It's at 8%; it's not going to go significantly higher from there. We view that as [ph] core margin kind of profile (42:41). And they have an opportunity to improve the margins, but it won't be that much. So they'll continue to be – we look forward to them continue to be revenue and growth story as opposed to margin expansion.

And when you look at the CEC business, which is another driver, one of the things we said last year is we expect [ph] in FY 2019 (43:06) we needed to start to move to a revenue growth year. And we do expect to see that over the course of FY 2019 as well. So that vision is intact from where we were last year. We'll have to see – we expect that to be a second half story, but that's consistent with exactly what we saw last year and communicated at Analyst Day.

But it's interesting, when you start adding the 10% growth into – and looking to have a very substantial growth year in FY 2019 and you also add the SG&A optimization that we did, you'll see a very significant move in the SG&A rate both on the back of revenue growth and also margin [ph] reduction (43:48). So you'll actually see that margin expansion to occur relatively rapidly once we get past our startup cost in Q1 and Q2. So we would expect that to start getting in Q3 and Q4, and that margin expansion will be on the back of a much stronger top line. So that's when you're going to better see it. And I think the steps and activities that we've laid out are actually real positive for margin expansion. And that's what we actually expect to see in Q3.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. That's helpful. And just as...

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Adam, just to build off of that. Using your math when you add back the Nike losses for the year, operating profit dollars for the company would be up 5%, and that's also reflective of while we're still making many investments whether it's into expanding the design and engineering capabilities across the portfolio as well as funding several new businesses that are in the system that have yet to yield or even ramp to earnings. So, those are reflective of

Copyright © 2001-2018 FactSet CallStreet, LLC

a position for us today that the earnings power is not reflective of what we anticipated being able to accomplished as we move through and also get the benefits of scale.

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

A

But I think it's worthwhile in the Investor and Analyst Day in like two weeks we'll unpack our strategy for each of the different business units, what we think the margin and growth profile looks like with them and we'll also give you an update on the 2020 vision. We actually view the opportunity to get higher margins as being enhanced by this strong revenue growth.

And outside the Nike being late six months, which if I put into – may be not six months, sometime in the second half, hopefully, six months. Outside of that, our story remains intact. IEI is killing it, HRS is killing it, our portfolio evolution continues to make very, very strong progress in evolution. And our CEC continues along flat and is not contributing to margin expansion of the company as you know, but as we move towards these data center investments paying off, we actually think they'll pay off. So, you'll see that unpacked in pretty good detail in just a couple of weeks. And I think you'll find it to be a very strong operating profit dollar, earnings per share and even margin percentage expansion story will be pretty significant over the course of the year.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

But we also understand your point here in terms of the fiscal 2018 performance wasn't at a level that we had anticipated and we actually are making decisions and operating the [ph] management to overlay for (46:39) improvement.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. That's really helpful. Just as a very quick follow-up, could you just help us understand, you alluded to this, but the nature of how back-end weighted fiscal 2019 might be. You typically do somewhere around 55% of EPS in the second half, are we talking more like 65%? And just what level of visibility into the drivers of that? Thank you.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

I think what we framed out earlier one of the larger drivers is really the improved performance in the back-end for Nike. I think you'll also see another lever being the revenue leverage that comes into the system as we've been able to really cap and contain our cost structure. The abatement of startup or ramp costs in multiple locations and programs [indiscernible] (47:33), and so those are some of the more direct levers. I would say that it will be a heavier weighting in the back-end of this year. But we're just not going to be giving that clear projection at this time. We'll be able to give you a better view to how the whole framework rolls out at Investor Day.

Operator: Your next question comes from the line of Mark Delaney with Goldman Sachs. Your line is open.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Good afternoon. Thanks for the opportunity to ask the questions. I have two. First question is a follow-up on Nike. And I was wondering if you can be a bit more explicit about whether or not the company has identified the steps that it needs to take to get Nike to profitability.

Copyright © 2001-2018 FactSet CallStreet, LLC

It sounded like revenue volume was one of the things that needs to take place based on your earlier comments. But if you could be more specific is there's an exact level of revenue you need to achieve and is there other things on productivity and cost that need to take place, and have you identified those or is there still work that needs to be done figure to out what needs happen to fix that? Thank you.

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

A

The key to Nike is to have design content – shoe content that's designed to run on a highly automated line. The highly automated line is turned on, the content has been developed and it just needs to ramp. So this is the key thing we need. We don't need any more optimizations of a factory. We have a good factor flow. We just need the right content to run. You can't automate a Vietnamese manufacturing – hand stitched kind of manufacturing. You can do pieces, but you can't actually achieve the goal of doing real regional manufacturing without that process.

So maybe I'm bumbling around a little bit, but it's like you have to have design content, that design content has to run on fully automated lines. We turned those fully automated lines on. They're running really well. We'll ramp up those fully automated lines over the course of the year and get to volume. And this is what we need to get to profitability: the right shoe with the right automation system and this is our way of getting out of it.

So it's a very, very discreet, specific activity that we're undergoing, all with the help and support of our customer who has been in this with us for quite some period of time. And what we'll see as that ramps is we'll expect to see the losses dissipate and move. It's disappointing that we're talking about this still, but it's actually complicated, that's why we kind of started off two years ago saying think about this in a decade. We had no idea how long it would actually take because we were reinventing shoes and that's a category that we never gone after before. But that's the very specific activity that we need to move to profitability. And we think it's going to happen over the course of these next few quarters.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Okay. That's helpful clarification. And then for my second question...

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

A

While we're waiting – I mean Nike is killing me too, but while we're waiting IEI killing it, HRS is killing it, so you see what's in the corner. We have a whole new category coming up which is called India manufacturing, which will be, at the end of the day, for a broad range of categories, which is going to be pretty incremental in terms of earnings per share even over the course of FY 2019.

We've got very, very strong bookings in our intelligent product categories in HRS going into FY 2020, but we do run a very, very diversified portfolio. So we will work on all those other levers kind of to make up for the delay in Nike getting to where we need it to be.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Got it. That's helpful. My second question is actually on the HRS and IEI guidance. And certainly, I know the guidance for the June quarter is still a good absolute growth rate in both those groups, but it is a bit slower in both segments in the June quarter versus March, so it sounds like that's just a one quarter moderation and that it stays

Copyright © 2001-2018 FactSet CallStreet, LLC

at a pretty high level throughout the year, but anything you guys would point to that's maybe causing a little bit of lower growth rate in the June quarter in those segments. Thanks.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

I don't think there's anything that I would clearly identify. Inside of IEI, we had a really strong Q4 with the greater than 25% year-over-year growth. That was driven by multiple programs that are ramping. I think that you just see some positives. Some of those are at a level that is sustaining and more stable. We anticipate bringing on several other ramps [ph] that are to be reflected (52:30) just yet in terms of the revenue inside of HRS.

I think it's a balanced mix of the programs that are in place and there are several new programs that we continue to bring up that will be coming on the latter part of this year, some larger scales ones and we'll have all in [indiscernible] (52:49) in terms of future for HRS, but I don't think there is anything clearly identifiable that I would point out. And Mike, I don't know if you have anything you'd highlight.

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

A

Those operations are doing extraordinarily well. IEI was up 20% last year and HRS was up 15% last year. And these are big numbers that combined balance like $11 billion now. We're not going to see that level of growth every single year. What we said kind of four or five years ago, we expected 10% growth rate out of the bundle for the foreseeable future. And for the last five years, the growth rate in that bundle has probably been around 10%.

So it is going to have ups and it's going to have downs. This year was a killer year because not only did we achieve the revenue growth rate, but IEI just continued to improve margins all year long. The bookings of both groups are very, very strong. And so we're really pleased with how they are operating and think they're a super valuable part of the portfolio. And every year that we did more and more in each one of those categories, we build a stronger and stronger portfolio by which to compete with. So there's really two advantages of driving revenue in our business because every time you drive revenue, you drive more experiences into a product category that you can then go to the customer and sell. So all we see is a continually competitively advantaged position building that sets us up for the future. So we're real pleased with them. We don't have any complaints about them.

Kevin Kessel
Vice President-Investor Relations & Corporate Communications, Flex Ltd.

A

Operator?

Operator: Your next question comes from Ruplu Bhattacharya with Bank of America Merrill Lynch. Your line is open.

Ruplu Bhattacharya
Analyst, Bank of America Merrill Lynch

Q

Yes. Thank you for taking my questions. Two questions, the first one on Nike. Is the sequential operating margin decline between the March and the June quarters all Nike related? And Mike, I think you said maybe in two quarters you'll get to breakeven. Realizing that this is a very complicated ramp, how confident are you and what steps are you taking to enable that? Are you restricting the models – the number of models that you currently take on? How can you measure and how do you know that you're going to get to breakeven in two quarters versus in three quarters? Why wouldn't it take longer than that?

Copyright © 2001-2018 FactSet CallStreet, LLC

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.
A

Hey. So, we don't know if it's going to take two quarters or three quarters. We haven't got there yet. So we don't know the future. We just know what we're implementing, what we're trying to get to. And yeah, we said in two years we can get to breakeven. And maybe it will be two-and-a-half, maybe even two and three quarters. We're not sure and we don't know.

But what we do know is we're running a whole portfolio of businesses and the losses aren't just Nike. In our business, when you ramp 10%, when you have a system as large as ours and you have to ramp-up 10%, it's a huge business, because anytime we ramp business, we're going to have a startup cost in a system of this size. And what I mean by startup cost is you have to buy inventory before you can have revenue. You have to buy equipment and install it and qualify it before you can run revenue across it. And you have to train operators before they can build revenue. And then after you do all those things, you have to give it a yield. In a rapidly growing business in this industry we're going to have a startup cost. So we're actually having rapidly growing revenue, which I actually don't see and there's a comment about the other manufacturers.

I don't know anybody that's growing revenue as rapidly we are growing and, as we grow that revenue, we're going to have to pay those costs of early production. We're going to have prime – so those are also headwinds for us right now, it's not just Nike. So we're happy that we are booking lots of business, we're happy that we're competing in the marketplace in a positive way, and we're going to have through startup costs, but once we get through startup costs, it will take the plateau of our earnings up and we're not going to get the plateau of our earnings up unless we do some investments to move them enter into a new plateau, and that's actually – the plateau is what we're expecting, what we're trying to communicating as we think about getting into the second half of FY 2019.

So we'll unpack that more in detail with you as we go forward, but I do want you to appreciate that being in the manufacturing business, all the cost of production you have to ramp up and there are the costs before you actually achieve revenue and will be at yield targets.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.
A

And Ruplu, in part of the prepared remarks, we were identifying several elements of what we were calling breakthroughs that are enabling that operational view that we set as being confident that we'll significantly improve fiscal 2019 in comparison to 2018 and especially greatly reduce the losses in the first half of 2019 versus 2018. So the trajectory that we're on with Nike continues to improve, it is sustaining losses, it will be sustaining losses, as Mike had highlighted, so we turn – we see ourselves at breakeven later in the year.

Kevin Kessel
Vice President-Investor Relations & Corporate Communications, Flex Ltd.
A

Operator, it looks like we're at the top of the hour now. I know that we got started a minute or two late. I believe there were some webcast issues. So I think we can go ahead and have time for one more question.

Operator: Your final question comes from the line of Paul Coster with JPMorgan. Your line is open.

Paul Coster
Analyst, JPMorgan Securities LLC
Q

Copyright © 2001-2018 FactSet CallStreet, LLC

Yeah. Thanks for taking the question; two-part question really. Can you talk just a little bit about the sort of the contract rules or parameters of the relationship with Nike? Is it take-or-pay? And do you have the option of using some of the capacity that you've created there in Mexico for other customers and are you actually doing so? Thank you.

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. So we're not going to go through the contract details of our customer. So we can't actually do that. Let's just say that we believe we've developed a mutually beneficial relationship. It's a relationship that we continue to work on and develop and adjusting changes we need to, we still believe we'll earn on this deal over time with the help of our partner. They have massive scale and there's a massive opportunity in front of us and we're still chasing that. We continue to look at this in the lens of a decade as you guys know.

And although we like it to happen a lot faster and start earning on that, we still believe that's in sight. We have a fair relationship with the customer and we continue to move forward. But we can't go through any details about this. And as far as would we want to think about doing another contract, I think we already have a contract with a market leader that has like, I don't know, 60% of the world's market. I think that's probably enough for us that we don't need to be thinking beyond this. We need to think about kicking it for Nike and not worry about other guys. So let's get this one profitable.

Paul Coster
Analyst, JPMorgan Securities LLC

Q

Okay. Thank you.

Michael M. McNamara
Chief Executive Officer & Director, Flex Ltd.

Okay. Let me finish it up and say that we're going to be – we're excited to having our Investor and Analyst Day on May 10. As you can tell by the questions, there's a lot to unpack. We're actually excited to do it. And it's going to be in San Francisco and we're going to look forward to seeing you there. We'll further expand on the power of our platform. This is what's driving a lot of re-ignition of growth.

We're going to show you the strength of the portfolio and the breadth of the portfolio, the evolution of portfolio, and how we're positioning our investments for the future. So I think you'll get a lot of detail on that just in the next couple of weeks and we'll look forward to seeing people there.

Thank you very much.

Kevin Kessel
Vice President-Investor Relations & Corporate Communications, Flex Ltd.

Thank you. This concludes the call.

Operator: This concludes today's conference call. You may now disconnect.

Copyright © 2001-2018 FactSet CallStreet, LLC

Disclaimer

The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2018 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.