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Flex Ltd. (FLEX)

Q3 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, and welcome to the Flex third quarter fiscal year 2019 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 introductions, I would like to turn the call over to Mr. Kevin Kessel, Flex's Vice-President of Investor Relations. Sir, you may begin

Kevin Kessel

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

Thank you, and thank you for joining us for Flex's third quarter fiscal 2019 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 Chairman, Michael Capellas; Chief Financial Officer, Chris Collier; Presidents Doug Britt and Paul Humphries.

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. 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.

Now I would like to turn the call over to our Chairman, Michael Capellas. Michael?

Michael D. Capellas

Chairman, Flex Ltd.

Thank you, Kevin. Now please turn to Slide 2 for quarterly business highlights. As indicated in our last call, I along with some of our other board members have been working closely with management during the CEO transition. I will briefly address the quarter before turning it over to Chris and the leadership team. I will also update you on the CEO search later in the call.

During the quarter, we grew revenues, improved the quality of our sales mix, expanded adjusted operating margin, and returned to free cash flow generation. These results reflect our intense focus on execution in our core business and speak to the breadth of our customer base and the quality of our delivery capability.

Highlights for the quarter include: revenue of $6.9 billion was up 3% year-on-year; adjusted operating profit of $256 million was up 17% year-over-year; adjusted operating margin was 3.7%, up approximately 40 basis points year-over-year; free cash flow was $119 million; adjusted EPS was $0.34, up 11% year-over-year. We completed the wind down of our NIKE Mexico operation, stabilized operations in India and made progress in streamlining our investment portfolio. In addition to exceeding our financial targets, we continued to build market momentum with our customers.

Now I'd like to turn it over to Doug and Paul to provide highlights for each of their businesses.

Douglas Britt

President-Integrated Solutions, Flex Ltd.

Thank you, Michael. Please turn to slide 3. I will discuss the performance of our CEC, IEI and CTG business groups. CEC revenue of $2.3 billion was up 14% year-over-year with an adjusted operating margin of 2.8% versus 2.5% last year. Revenue growth was driven by the acceleration of 4G and 5G network infrastructure build-out and our increased participation in both hyperscale and edge computing programs.

For example, in major hyperscale computing wins we designed the servers, the battery backup units, the custom racks, as well as helped to specify and qualify the cable and thermal management systems. In another win, we will support the launch of a major 5G program for the North America market.

We continue to win design-led engagements with customers that leverage our regional and global capabilities and anticipate continued strong bookings momentum. For the March quarter, we're expecting CEC revenue to grow year-over-year, led by the continued strength in cloud and datacenter solutions and programs benefiting from increased 5G-related infrastructure spending.

IEI revenue was $1.7 billion, up 11% year-over-year with an adjusted operating margin of 4.7% versus 4.1% last year. Revenue growth was driven by strength in home and lifestyle, which more than offset the softening demand in semiconductor capital equipment.

Overall, IEI bookings remained strong across a broad range of categories from some of the world's largest diversified industrial companies. For example, we won a program for a beverage dispensing appliance that is being marketed by a leading global beverage brand. We are currently in the design phase that leverages our expertise in dispensing solutions. In another major win with one of the global leaders in commercial laundry equipment, we are assisting the design and manufacturing services to help the customer move from an analog control system to a digital and IoT-enabled platform.

We remain confident in IEI's overall growth prospects. However, for the March quarter, we're expecting IEI revenue to be pressured by continued weakness in semiconductor capital equipment and softness in energy.

In our CTG business, revenue was $1.8 billion, down 12% year-over-year with adjusted operating margin of 2.1% versus 1.9% last year. We continue to rationalize underperforming accounts and revamp our go-to-market approach to be more selective with our customers and categories. Our adjusted operating margin improvement reflected these benefits, as well as stabilization in our India operation and the wind down of our NIKE Mexico operation.

Going forward, we will continue to be selective and focused on participating with major brands that control multiple product categories which have significant regionalization and design requirements.

As an example, this quarter we won several programs that leverage our capabilities in audio. We won a program with a large enterprise customer that wants to bring high-end audio devices into its teleconferencing business. Another win is from a major professional audio solutions provider. This customer will be consolidating their manufacturing into our Mexico operations and using our audio design team to support their next generation products. For the March quarter, we're expecting CTG revenue to be pressured year-over-year, as we continue to actively optimize and prune our portfolio.

Now I'd like to turn it over to Paul Humphries to talk about our HRS business.

Paul J. Humphries

President-High Reliability Solutions, Flex Ltd.

Thank you, Doug. Total HRS revenue was $1.2 billion, down 1% year-over-year with adjusted operating margin of 7.9% versus 8.2% last year. Demand across our Health Solutions business remained strong. The increases were more than offset by ongoing headwinds in Automotive. Our Automotive business was impacted by the broad based market softness, which directly impacted our largest Automotive customers, resulting in Q3 revenue declining 11% from a year ago. Some of these Automotive customers are also facing challenges related to U.S.-China trade relations, increased tariffs, and a constraining automotive component environment. These are all contributing to a softer outlook for Automotive going forward.

However, the challenging Automotive headwinds have not diminished our ability to expand our business with new and existing customers. This is evidenced by year-to-date record bookings of $1.2 billion, which leverages our industry-leading capabilities in the areas of Autonomous, Connectivity, Vehicle Electrification and Smart Tech. This year we secured our single largest design contract for an autonomous compute solution for a major global OEM while simultaneously securing the associated manufacturing contract which is significant.

Health Solutions was up 14% year-over-year and is now running with sales over $500 million a quarter. The business is characterized by long product life cycles with stringent regulatory requirements. We are beginning to show the benefits of prior-year investments that strengthen and improve our capabilities and competitive positioning. Specifically, Health Solutions' focus on design-led engagements supported by its strong domain expertise has helped secure record year-to-date bookings of nearly $1 billion. Of note, there were significant wins we have secured in drug delivery devices during fiscal 2019, which leverages our capabilities and the increased investment in design and precision plastics over the past few years. For the March quarter, we expect HRS revenue to display growth in Health Solutions that will be more than offset by ongoing weakness in Automotive.

Now let me turn you over to Chris to discuss our financials in more detail.

Christopher E. Collier

Chief Financial Officer, Flex Ltd.

Thank you, Paul. We are pleased with the results of our third quarter, which exceeded our expectations on multiple levels as our core business remains sound and is performing well. Our solid financial performance is reflective of our focus on operating our well-balanced and diversified portfolio of businesses, which are designed to deliver more predictable earnings and growth.

Please turn to slide 4 for our Q3 income statement summary. Our third quarter revenue was $6.9 billion, up 3% versus a year ago and towards the high end of our guidance range as all business groups met their revenue targets. Our Q3 adjusted operating income was $256 million, which was above our guidance range and grew 17% year-over-year. Our adjusted net income was $181 million, resulting in adjusted earnings per diluted share of $0.34, which was also above our guidance range of $0.29 to $0.33. Third quarter GAAP net loss of $45 million, which was lower than our adjusted net income due to adjustments for stock based compensation, intangible amortization, and several non-recurring charges totaling $226 million or $0.43 per share. Our third quarter GAAP EPS was a net loss of $0.09.

During the quarter, we took focused actions to optimize our business portfolio, most notably within our CTG business. We completed the wind down of our NIKE Mexico operation and recognized a final charge of $36 million, which was primarily for non-cash asset impairments. Additionally, we reassessed our investment portfolio and began to reposition it, which resulted in a non-cash impairment charge of $70 million. Lastly, we eliminated certain non-core activities and repositioned some programs to align with go forward company strategies, resulting in restructuring charges of $86 million, the majority of which – or $56 million were non-cash in nature.

Now please turn to slide 5 for quarterly financial highlights. While our gross profit increased to $453 million, our gross margin declined 20 basis points to 6.5%. The gross margin pressure is reflective of various business mix shifts, most notably inside our HRS business due to lower Automotive revenues as well as incurring higher scrap rates in some inventory-related charges as we ramp certain mobile programs in India.

We've been intently focused on managing our operating costs. In our third quarter, we reduced our SG&A expense by 15% year-over-year to $197 million. We are confident in our ability to operate with cost discipline and thoughtfully invest into our design and engineering capability while delivering operating leverage. Our quarterly adjusted operating income came in at $256 million, up 17% from the prior year reflecting year-over-year margin expansion of 40 basis points to 3.7%. We benefited from greater cost discipline and improved operating performance in our CEC and IEI businesses as they leverage their installed cost structures and their design and technology investments.

Turning to slide 6, let us review our cash flow generation and highlights. We expect positive operating cash flow and free cash flow generation in the back half of this fiscal year as our earnings improve and capital intensity lessens, both in terms of lower net working capital and lower capital investments. This quarter, we generated $274 million in adjusted cash flow from operations and $119 million in free cash flow. We are pleased with our actions to aggressively reduce inventory towards more efficient levels as we saw a four-day reduction in inventory days. In Q3, we reduced inventory by $645 million or 13% sequentially. We have significantly reduced component constraints and improved inventory management in the majority of our businesses. We remain focused on driving further inventory improvements.

Our capital expenditures totaled $155 million for the quarter. We continue to invest in the CapEx necessary to support the underlying high-margin long-term programs in our IEI and HRS businesses. During the quarter, we developed a sustainable operating plan for India and will have our regional build-out in India mostly completed during Q4. For our fourth quarter, we expect our CapEx investment to be at or below our depreciation level. We expect our CapEx to return back to historical norms next year as CapEx investments for our HRS business will reduce this to historical levels and our regional capacity build-out in India will be completed. It is our expectation that we will be consistently generating positive operating and free cash flow generation as we move forward. We remain committed to returning greater than 50% of our free cash flow to shareholders via share repurchases. Despite having a very back end loaded quarter for free cash flow generation, we repurchased roughly 6.7 million shares for $64 million during the quarter.

Now turn to slide 7 to review our balanced capital structure. We continue to operate with a balanced capital structure and despite operating in a rising rate environment, we still have a relatively low average cost of debt. In addition, we have no debt maturities until calendar 2020 and have cash and access to liquidity that supports our long-term business growth objectives.

Please turn to slide 8 for our fourth quarter fiscal 2019 guidance. Revenue is expected to be in the range of $6.2 billion to $6.6 billion or roughly flat at the midpoint based on the following business group year-over-year revenue expectations. For CTG, HRS and IEI, we are guiding revenue to be flat to down high single digits. And our CEC revenue is expected to be up 5% to 15%.

Our adjusted operating income is expected to be in the range of $195 million to $225 million. Interest and other expense is estimated to be approximately $50 million. We expect our tax rate in the fourth quarter to remain in the mid-range of 10% to 15%.

Adjusted EPS guidance is for a range of $0.25 to $0.28 per share based on weighted average shares outstanding of 525 million. GAAP EPS is expected to be in the range of $0.18 to $0.21 after reflecting the impacts of stock based compensation expense and intangible amortization.

While our financial results showed marked improvement and momentum in the marketplace, we recognize that we have more to do to improve the consistency of our financial performance, to realize the full potential of our business, and to clearly communicate our progress to regain your trust.

With that, let me turn it back over to Michael for some closing comments before we open the call to Q&A

Michael D. Capellas

Chairman, Flex Ltd.

Thank you, Chris. Before we take questions, I would like to address two other important matters. First, during the quarter, we made significant steps to continue to strengthen our board with the addition of two highly respected and experienced executives. One is Jill Greenthal, who has spent 30 years in investment banking. The other is Chuck Stevens, who recently retired as the CFO of General Motors after 40 years with the company.

And in conclusion, I would like to update you on our CEO search. We have a well-defined process that is working well and has surfaced a good cross section of exceptional candidates. We anticipate finalization of our selection soon. In the interim, we are focused on delivering results and improving our business.

With that, I'd like to turn it over to the operator for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] The first question comes from the line of Steven Fox of Cross Research. Please go ahead. Your line is open.

Steven Fox
Analyst, Cross Research LLC

Q

Hi, good afternoon. First question, I was wondering maybe, Chris, you can expand on the operating leverage you realized year-over-year. With operating profits up 17% versus the 3% growth in sales, can you break down where that – what you would attribute all of that to? There was a lot of things mentioned. Just wanted to understand that a little bit better.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Certainly. I would highlight, there was some very strong performance on a year-over-year basis from our IEI business. You saw for the quarter, a very strong operating profit execution. We got that up healthily inside the target margin range. It pushed out at a 4.7% and put out at $79 million. That – those are records for that part of our business. And as a year-over-year basis, it's up nearly 30% in operating profit.

I'd also probably point out, the CEC business that is showing return to growth and printed out at a 2.8% operating margin for the period and had some real, sizable, almost 25% year-over-year profit expansion. In my prepared remarks I highlighted, both of those are benefiting from increased volumes that are – being able to leverage off a very strong installed cost structure.

And then in the prepared remarks I also highlighted we've been very disciplined around our cost. And we've been very thoughtful as we said at the start of the year about how we were going to optimize and leverage inside of SG&A. And we've been able to do a really nice job of bringing that down meaningfully, both on sequential basis and a year-over-year, and really been targeted around optimizing the design and engineering efforts to really true go-to-market capabilities in product categories.

So I think we're pleased overall with the strong performance and pushing ourselves to a 3.7% operating margin for the quarter.

Steven Fox
Analyst, Cross Research LLC

Q

Okay. And that's helpful. And then on India, you said you stabilized the operations and have plans to expand in place this quarter. So what does that mean in terms of what kind of volumes you're at now? And how you can grow it over the next year? And what kind of programs are going be produced out of India? Thanks.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Certainly. Yeah. So we've – we had a focus this year on entering the India market. We – as we talked in the quarter, we took efforts to develop a sustainable operating plan.

What that entailed was having focused efforts around capacity planning, material planning, working with the multiple customers that are multinational that have broad product categories that we're looking to position with. It was our intent to stabilize that and to grow that at a proper level. I would maybe turn the call over to Doug to maybe expand any further on how we think about that business.

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

Yeah, I think you highlighted it correctly. India, for our multinational customers, is a growing market; got a growing middle class. It's digitizing, and it's providing consistency with our plan to provide these multinational customers access points to regional markets. India is a growing market and we're providing that. So we see a measured approach, disciplined approach on how we grow India, but many of our multinational customers are going to utilize us for that footprint.

Steven Fox
Analyst, Cross Research LLC

Q

Thanks very much.

Operator: Your next question comes from the line of Ruplu Bhattacharya of Bank of America. Please go ahead. Your line is open.

Ruplu Bhattacharya
Analyst, Bank of America Merrill Lynch

Q

Hi, thanks for taking my questions and congrats on the strong margin performance this quarter. My first question is on the CTG segment. Can you give us an idea of how much more pruning do you think is left in this segment? And your margins came within the low end of the range, so 2.1%. Any guidance on how we should think about segment margins going over the next couple of quarters, because you are pruning the portfolio, but that should help margins. So, any guidance there would be helpful.

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

Yes, thank you. We do continue to prune and optimize the portfolio. We see that happening in Q4 but coming to an end. And in terms of the business itself, we have some seasonality in our Q4, which will impact as you could see our guide. It could impact our margins, but we are committed to getting this business into the guided 2% to 4% operating profit range in the next fiscal year.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

And, Ruplu, what I'd just expand onto that is what you'll see in our Q4 is that given the revenue decline due to seasonality provides us with some capacity utilization and absorption challenges. So you see some pressure on the margin there; as well as, as we take further optimization here. But clearly, our intent is to be hyper-selective in terms of engagements and we're committed to driving that business back into its target margin range.

Ruplu Bhattacharya
Analyst, Bank of America Merrill Lynch

Q

Okay, thanks Chris and Doug for that. Maybe one question for Paul, just the dynamics between Medical and Automotive. I mean, because Auto was weak, gross margins on a year-over-year basis this quarter was impacted, but when you look out over the next couple of quarters, I mean balancing Medical versus Auto, do you think the strong margin performance of 7.9%, are you concerned about margins at all over the next couple of quarters? And any thoughts on when the autonomous work that you are doing, when does that start kicking in and when do we see meaningful revenues from autonomous in the Automotive space? Thanks.

Paul J. Humphries
President-High Reliability Solutions, Flex Ltd.

A

Yes. I think from a margin perspective, we're comfortable that we can maintain within the targeted margin range. I'm not going to commit to a particular number. But while we are seeing sector weakness in Automotive, we're also really excited about the capabilities that we've built in areas like autonomous and connectivity and vehicle electrification. So we are confident in the capabilities that we've developed and how we can move that business forward. And we're also really happy to see the growth in our Medical business. As we mentioned in the prepared notes, we're up 40%. And we think that business is also doing really well, and we'll be able to maintain the position it's at into the next quarter. So, we're overall optimistic for the long term. Facing some headwinds and some secular trends currently, we're still confident about the long-term for the business.

Ruplu Bhattacharya
Analyst, Bank of America Merrill Lynch

Q

Okay. Great. Thanks so much for all the details and congrats...

Paul J. Humphries
President-High Reliability Solutions, Flex Ltd.

A

And then you also asked about autonomous, so....

Ruplu Bhattacharya
Analyst, Bank of America Merrill Lynch

Q

Yes, yes, please.

Paul J. Humphries
President-High Reliability Solutions, Flex Ltd.

A

And that we've won one major – we've actually won several autonomous programs. Some of those are actually giving small revenues today to design revenues, but we're probably out into 2021, 2022 before we start to see significant impact from those programs.

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

And I would just add on to that. I think the benefit that we've been able to see here is our ability to leverage the joint expertise of the enterprise across Automotive, across server storage and across networking design in terms of how we can capture and compel demand inside of the autonomous platforms.

Ruplu Bhattacharya
Analyst, Bank of America Merrill Lynch

Q

Okay. Sorry, maybe just one last thing. So over the next couple of years, I mean you've got opportunities, you've got bookings in both Medical and Automotive and you're talking about good demand in the autonomous space over the next couple years. How should we think about the relative balance between Medical and Automotive in terms of revenues? Do you think – like, which one can drive the segment more than the other if there's one like that?

Paul J. Humphries
President-High Reliability Solutions, Flex Ltd.
A

Yeah. I appreciate the question. We're just not going to get out in front and provide that level of color. But we – what we've tried to do today is provide some good insight in terms of the prepared remarks how we're really achieving record bookings inside of HRS, and it's across a broad array of categories, a broad array of customers. So, we'll be able to provide you better lens into some of that trajectory when we have our next Investor Day as well. Thank you.

Operator: Your next question comes from the line of Jim Suva of Citi. Please go ahead. Your line is open.

Jim Suva
Analyst, Citigroup Global Markets, Inc.
Q

Thank you very much for the details thus far. Hey, quick question on the geopolitical situation. With the trade wars and companies shifting manufacturing around, have you seen much action on that? If so, it seems like Flex would be a potential beneficiary from that, but will you also face some initial ramping costs, let's say for example moving some production out of, like, China to another location. How should we think about that and your ability to recoup the ramp cost and the pricing? Thank you.

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

Thank you, Jim. So, we have not really been materially impacted by tariffs to-date. We do believe it brings certain – it brings uncertainty with our customers. While we don't predict how this will play its way out, we are well positioned with our regional footprint to benefit from these trade transfers if and when they take place. We're already helping certain customers to assess potentials. We've had some instances where we've actually engaged with them and their process of transitioning. And when we're doing that, it is our intent to secure a return for the capacity that we're – and capability in the solutions that we're putting forward with them. So, it should enable us to increase margins and would be a practice that we'd entail as we partner and help them solve these complicated global trade situations. And maybe turn it over.

Jim Suva
Analyst, Citigroup Global Markets, Inc.
Q

Thanks.

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

Doug, you want to expand on anything you're seeing directly from the business?

Douglas Britt
President-Integrated Solutions, Flex Ltd.
A

I think you highlighted it pretty well. We're positioned well regionally to support any transfers. There's a lot of discussion, not a lot of movement yet. Currently, with the rates, if they end up moving up to higher levels, that many customers that are planning with us and looking at financial implications of moving business to North America or Europe. But no significant material movements at this point.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much for the clarifications. It's appreciated. Thank you.

Operator: Your next question comes from the line of Steve Milunovich of Wolfe Research. Please go ahead. Your line is open.

Steven Milunovich
Analyst, Wolfe Research, LLC

Q

Thank you. Could you comment a bit more on the overall economic impact on the company and then specifically on Automotive? It sounds like the look forward is a little weaker than maybe the last quarter was; so, are you beginning to see some economic impact that maybe you didn't see in the December quarter? And then specifically in the auto business, you used to be asked, "Hey, what if there's a recession, what's the impact?" And you would say, "Well, we're not that sensitive to SAR. We're more on the autonomous side," and so forth. But it looks like you're getting hit a fair amount on the Automotive side. So is that just kind of a natural industrial business where you're going to see economic impact even with the autonomous you're doing?

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

Yeah. Let me give you some insight, and then I turn it over and we can have Paul expand further with regards to automotives in particular. In terms of the broader demand environment, there certainly is a fair amount of uncertainty out there. There's some potential weighing on an overall macro softness. However, we're benefiting from – some strong underlying bookings that have been taking place over the last several years. I think the long-term fundamentals and where we position our self around evolving macro trends remains intact, whether it's the digitization, IoT. You heard in our prepared remarks about how we're growing inside of 5G in the cloud computing. And then into autonomous and the electrification of vehicles, I think that we have positioned our self very well across a broad array of categories and with a broad array of capabilities such that some of these headwinds that we face, we're able to deal with in a different way. Clearly, automotive has been and remains challenging and global production has weakened throughout the year. And in particular, we saw some really significant underperformance inside of China. However, our offering extends multi-regional and across a whole array of product categories. And so, while tariffs are probably – and component shortages are more accentuated in that business, I think we are doing a pretty well – good job of balancing that demand profile.

Paul J. Humphries
President-High Reliability Solutions, Flex Ltd.

A

So, what I'd say is we are I think well positioned for the long-term to capture the areas of growth in Automotive such as autonomous and connectivity, electrification. I mean, those are definitely the longer term trends that we're seeing. And so we are very confident that we are focused on the right areas. We have the right strategy in place. But in the short term, we are definitely seeing the impact of softness in Europe and North America, and particularly in China where one of our major customers has been fairly severely impacted.

And so we don't think that we're out of position in the long term, but we're certainly seeing the secular trends to a slower environment and certainly a level of caution as to what's going to happen in Automotive over the short-term. But long term, we believe we're well positioned.

Steven Milunovich
Analyst, Wolfe Research, LLC

Q

That's helpful. And, Chris, on the reduced SG&A level, is this kind of the go forward level in absolute dollars that we should expect over the next few quarters?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

I think it's been our focus all year around driving a real cost discipline. We targeted a 3% to 3.2% type of a range. I think we've taken some great measures. I think you're going to see some sustainability.

I think it's going to be around this range, plus or minus $5 million, $5 million, $6 million. It'll vary each period there's timing as it relates to funding on design and engineering as well as other aspects. But I think overall, you've seen a marked shift in terms of our cost discipline. And we can operate here at this level and see some really nice earnings leverage as a result.

Steven Milunovich
Analyst, Wolfe Research, LLC

Q

Thank you.

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

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Yes, good afternoon. Thanks for taking the questions. First question is around CTG, both a financial and a strategic angle to that area. So on the financial side – and Doug, if I heard you correctly, you're expecting to be done with the optimization in this upcoming quarter, fiscal 4Q. Are there any revenue implications for the June quarter that we need to be mindful of, if there is any larger program exits that are being contemplated for next quarter that maybe would happen late in the quarter? So that's the financial portion of it.

Strategic portion, maybe you can just help us better understand the thought process around mobility in India. Sounds like that's not part of the businesses being re-evaluated as part of the more focused CTG strategy in smartphones, in the past, got Flex into trouble, be it Sony Ericsson, or RIM or Motorola Mobility? So maybe you can just give us a little bit more color about what's giving you guys the comfort that doing smartphones in India is going to fit within this margin profile that the company is targeting? And why it will be more successful than your past efforts there? Thank you.

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

Great. Thanks for the question. As we discussed, we're pretty close to the portfolio rationalization, so that will be concluded in Q4.

Our commitment in this business is to multinational companies that have multiple product categories and that leverage our design and regional manufacturing capabilities. And as we've discussed, we're going to be selective.

The mobile business is a key element based on us being selective with the customers that we engage with. These customers have multiple product categories. They have IoT-enabled devices. And we've got commitments that we are engaged with these customers on.

So this will be part of the portfolio. But it's going to be very selective on how we engage. So overall, the CTG commitment is, we're working to get this business back in the targeted range of 2% to 4%. And our goal is to get there next fiscal year.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Okay. And just, is there any kind of big revenue dropdown in June from these program exits in the March quarter?

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

We've got pretty much our guidance laid out. And we have seasonality that occurs in this business during this quarter, so that's all taken in consideration in the guidance that we provided.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

And as you step forward, we'll be able to give you better clarity into June. But overall, it's – again, we're in a position of really focused repositioning, being very selective. We've been eliminating investments in areas and businesses that didn't yield. And I think you should just see us being very disciplined, very measured in this business as we move forward.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Okay, that's helpful. And my second question was on CEC, and that business is doing quite well. I think it's going to grow for a full year for the first time since 2012, if I model this correctly. And, Doug, you called out 5G in particular in your remarks as something that's driving the growth. Can you just give a sense about how sustainable this growth is for CEC overall? And how much of the mix is tied to 5G? Thanks very much.

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

Yeah. Thank you. We're excited about the opportunities that we're seeing in CEC. There's a macro trend globally where 4G and 5G networks are building out. There's a lot of applications that will be written to support that, artificial intelligence. We've talked about autonomous.

Also, the hyperscale and cloud CapEx expenditures continue to rise. And we're playing in both of those. We have a great design engagement. We have great design capabilities. And then couple that with our access to all the key markets, we're winning in the space. And we see a good opportunity to grow this business moving forward.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Thanks.

Operator: Your next question comes from the line of Matt Sheerin of Stifel. Please go ahead. Your line is open.

Matthew John Sheerin
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yes, thanks. Regarding the IEI segment where you talked about weakness in semi-cap, could you elaborate on that? And do you have expectations of that bottoming? And as you enter fiscal 2020, do you think that segment will continue to grow just due to the strength of the other segments within IEI?

And then relative to margins, you've had nice margin expansion for a few quarters now. And given the weakness in the key customer base there, do you expect that to be under pressure somewhat as you get into fiscal 2020?

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

Our IEI business, we think we're structurally well positioned for growth over the long-term. We're down, as we mentioned, in Q4 due to the softness in semi-cap. Semi-cap is at a six-year low for us.

As that cyclical market returns, we'll benefit from that. Our business is complicated in semi-cap and is accretive to the margin profiles in that business. And then, as we move forward in the next quarter, we have a richer business within IEI as we've developed more mechanical capabilities and we're benefiting – and our margins are benefiting based on that. We're excited about the pipeline and the bookings that we've recorded. We continue to win a number of new programs from a broad customer base across the industrial market. And we're excited about the margin performance that we delivered this quarter.

Matthew John Sheerin
Analyst, Stifel, Nicolaus & Co., Inc.

Q

But just on the margins going forward, you think they're going to continue to move in the right direction?

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

We're committed to maintaining margins in the 4% to 6%, and we'll benefit as we get higher revenues and better absorption. But we're committed to maintaining in the 4% to 6%.

Matthew John Sheerin
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. And just, Chris, a question relative to the inventory reduction and the free cash flow which has been nice to see. You're still on a days basis still above where you were a year or so ago. So – and given that lead times are coming in on most components, do you still see more improvements there over the next couple quarters?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Yeah, certainly, Matt. One of the highlights in the prepared remarks was just that. We're pleased with the execution this past quarter's meaningful reduction in management, bringing inventory levels back down. And further, see greater opportunity in this next quarter to bring it even further down, very similar to where we had been operating historically. So, the team's been very focused. We've been after several different activities, really been able to do a nice job of clearing a lot of the component constraints, working on better load and planning. And I just think you're going to see a continued nice trajectory in terms of our inventory management.

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

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. Thanks and good evening. I just wanted to return back to CTG margins. I think if we back out the year-over-year benefit from not losing money with NIKE, I don't think they're improving; profit dollars are declining, and March guidance implies more of the same. Now this assumes no meaningful losses in the non-GAAP numbers this quarter, so correct me if I'm wrong. But the same would hold for the March quarter, and you've got no NIKE losses there. India has stabilized. Why wouldn't it be better year-over-year for March? Doug, you sounded confident in margin for fiscal 2020. So I'm just hoping you can dig deeper on some of those topics, and maybe what changes to enable your confidence in CTG margins for fiscal 2020.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Certainly. I'm going to take a response here and then Doug, if you want to provide any color if I miss anything. Listen, the focus that we have right now on that piece of business is very clearly to be optimizing it. We talked about pruning. We've been eliminating different investments, thinking differently about different areas as well as different customers, as well as different businesses that just were not yielding. It is our intent to operate that business inside of its target margin range. We're taking distinct actions to achieve that. In the March quarter, you're going to see further efforts in terms of reducing our exposure inside of CTG, and it's reflective in terms of the margin profile. You've seen historically CTG in that March quarter come down meaningfully in terms of its margin profile. So it's no different, except we are actually taking distinct actions to prune. And the core of the business is still a bit weak. We're taking focused efforts to improve that.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. And then maybe just as a follow-up – I don't know if Michael or Chris wants to address this one. You talked about ample liquidity. You've got strong cash on the come. Your high mix segments are slowing. There is other assets in the space that could potentially accelerate the mix improvement through acquisitions. Many of those have pretty clean balance sheets and net cash. So maybe just talk about strategic thinking on M&A. Is there an opportunity to accelerate the move towards higher mix verticals? Thanks.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Yeah, certainly. For us, our capital allocation priorities is to take a long-term view. We had a – we have a commitment to take our free cash flow and 50% of that to return it to shareholders via the repurchase. We've been very focused over the past 18 months to reposition internal capability and capacity to support the growth in future earnings potential inside our IEI and HRS businesses. We've had limited M&A and we see that as being limited as we move forward because we possess a very well-built-out global system with sufficient capabilities to support our core target growth markets and an ability to support the megatrends that we're after. So, I would say it'd be limited in terms of M&A. I think you're going see us continue to be very supportive of our commitment to share repurchasing. And I think that you're just going to see us being very prudent and measured and driving a smart capital return that supports and sustains a sound financial condition.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

That's helpful. Thanks, Chris.

Operator: Your last question comes from the line of Christian Schwab of Craig-Hallum Capital. Please go ahead. Your line is open.

Christian Schwab
Analyst, Craig-Hallum Capital Group LLC

Q

Great. Thanks for taking my question here and congrats on a great start to the year. I want to go back to the 5G opportunity. And I'm wondering if you can expand upon, either by the number of platforms or the number of customer engagements you have – on the last quarter conference call, the CEO of Nokia when asked about the 5G spending cycle peaking, he said he believed it would take at least 10 years. And the reason for that is you're going have to upgrade the low, mid and high bands of all the spectrum. So with that as a backdrop, I'm just wondering how broad your exposure is. And I think a gentleman asked a question earlier – I don't know if you answered it, but what part of the CEC group is communications? What percentage of revenue, roughly?

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

Thank you. First, in our CEC group, we believe we're structurally well positioned for growth in the group. We mentioned 4G and 5G. We are involved in the infrastructure build-out, so that includes all the infrastructure; there's optical; there's a lot of different infrastructure equipment that goes into building out the new networks. We also build radios. And we're not speculating on the wins and the trajectory of our customers. We see really strong line of sight between 4G and 5G infrastructure build-out, the new wins that we have, as well as our hyperscale cloud and edge customer base. We're winning many new programs in that space, and that's the combination of our CEC. We believe that the backdrop – or the macro 4G and 5G will be here for many years and we're going to benefit it from it,

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

And I would just extend on that with, just that we're winning with existing, as well as creating new partnerships inside the cloud. We're not going to get into specifics around the number of those and we're also not going to be breaking out inside of CEC, the breakdown between networking, telecom, and that. We're just overall pleased it has a nice trajectory, and we're structurally well positioned with good technology know-how.

Christian Schwab
Analyst, Craig-Hallum Capital Group LLC

Q

Fabulous. Thank you. On the component constraint that we've seen, Sanmina talked about a loosening up in the December quarter that helped them. I assume it probably helped you a little bit work through some of that inventory. As you look through the remainder of the calendar year, how do you see capacitors and resistors and discrete components? Do you – is it really loosened up and not a headwind or is it just decreased from the extreme tightness that we experienced last year?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Yeah. Let me just try to give you a little color here. I would say that overall, we're managing the situation very well. We've been very successful in delivering demand, securing supply, working strategically with our partners. One of the unique things is that with our increased level of design and engineering expertise, we have created different relationships with many of these suppliers that's enabling us to have more than our fair share of allocation and securing supply. I think that overall, it's improving. I think for some of the – we even highlighted, though, there's still some challenge inside of the Automotive. The Automotive, especially inside of some of the capacitors where there's larger cap sizes, there's some more constrained demand. But more broadly speaking, from a Flex perspective we're doing a very nice job of securing our fair share and managing through this cycle.

Kevin Kessel

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

All right. I wanted to thank everybody for dialing in and for your interest. And this concludes our conference call.

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