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Flex Ltd. (FLEX)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Flex Third Quarter Fiscal Year 2021 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, I would like to turn the call over to Mr. David Rubin, Flex's Vice President of Investor Relations. Sir, you may begin.

David Rubin
Vice President, Investor Relations, Flex Ltd.

Thank you, Rob. Good morning and welcome to Flex's third quarter fiscal 2021 earnings conference call. With me today is our Chief Executive Officer, Revathi Advaithi; and our Chief Financial Officer, Paul Lundstrom, both will also give brief remarks followed by a Q&A. This call is being webcast and recorded, and if you've not already received them, slides for today's presentation are available on the Investor Relations section of our flex.com website.

As a reminder, today's call contains forward-looking statements, which are based on our current expectations and assumptions, and are subject to risks and uncertainties, so actual events and results could differ materially. Also, such information is subject to change and we undertake no obligation to update these forward-looking statements. For a full discussion of the risks and uncertainties, please see our most recent filings with the SEC.

Lastly, this call references non-GAAP financial measures for the current period. The GAAP reconciliations can be found in the appendix slides of today's presentation as well as on the Investor Relations section of our website.

With that, I'd like to turn the call over to our CEO. Revathi?

Revathi Advaithi

Chief Executive Officer & Director, Flex Ltd.

Thanks, David. Good morning, everybody, and thank you for joining us today for our fiscal Q3 earnings call and that to at an earlier time. I do hope you and your families are healthy and safe. Of course, before I start, I want to thank all my Flex colleagues for their continued hard work and commitment. I would say that our strong third quarter results are a true testament to the efforts of all my colleagues across the world.

I'd also like to provide you an update on our NEXTracker business. As I've previously said, we continuously evaluate our portfolio positioning, improving the mix, finding and investing in great opportunities, and taking a disciplined approach in finding the right ways to maximize long-term shareholder value.

As such, the company is now actively pursuing alternatives for this business. This may include, among others, a full or partial separation of the business through an initial public offering, sale, spinoff or other transactions. As you can understand, there's only so much we can share with you today and we'll continue to provide more information on this topic in the future.

Now, please turn to slide 3. Our revenue was over $6.7 billion, up 12% sequentially and up 4% year-over-year. Our adjusted operating margin came in at a strong 4.6%. This figure includes the absorption of continued macro-related challenges I'll touch on in a minute, new [ph] programs (00:03:09) as well as a full elimination of the previously implemented austerity measures. Our adjusted EPS was $0.49, up from $0.38 in Q3 of last year. Our adjusted free cash flow came in at $289 million, demonstrating another strong quarter in free cash flow generation.

Now, moving on to the next slide, as you can see, these are very strong results. Fiscal Q3 is historically our strongest seasonal quarter. However, we executed even better than our prior expectations as we navigated the challenging environment and delivered to meet improved demand. This led to sequential and year-over-year revenue growth in both our Reliability and Agility segments, with five of our six business units growing sequentially as well as year-over-year.

In our Reliability segment, our Health business is well positioned for continued growth as we invest in new program ramps, and our chronic care products continued to ramp this quarter. We also saw a slower than expected decline in COVID-related critical care products. Unfortunately, this is due to the resurgence in COVID cases.

Automotive benefited from a stronger than anticipated global recovery, led by North America, with improvements in all regions. The team has been working very hard to deliver in a very difficult macro environment, but they continue to make progress, and we see a very bright future, particularly in our growing electrification and autonomous businesses.

Industrial improved sequentially as expected on continued strength in core industrial. However, as we discussed on our last call, we still faced a year-over-year decline due to a customer-specific headwind in power solutions as well as a tough comp in renewables related to Safe Harbor.

I want to point out, both of these items are transient. We remain very confident in the secular drivers in both of these spaces and there's absolutely no change to our market positions.

Our Agility segment performed very well across the board. We continue to manage our mix to capitalize on important long-term secular drivers in areas such as cloud and 5G as well as shift to premium brands in mid to high-end products in our Lifestyle business.

We also continue to benefit from the recovery in consumer spending, which led to a solid holiday uptick as well as continued spending related to work and learn from home. The key here is that the teams really executed very well to meet strong demand while driving productivity and focusing on the right kind of growth. This led to improved profitability and growing revenue, which are goals we previously laid out.

I'm very proud of the strong results we achieved this quarter, but I also want to point out that this is no time for us to take our eye off the ball. We have all read the latest headlines on the devastating impact from the COVID second wave. So far, there have only been a few regional lockdowns, such as in Malaysia and Brazil, but it goes without saying that our number one priority is to protect our people and their families.

We've also heard about the confluence of events that led to increasing supply constraints in everything from semiconductor components to transoceanic shipping containers. This has created an additional layer of uncertainty in the number of end markets. So far, we have anticipated and managed through these latest challenges, however, we'll continue to monitor this rapidly evolving situation.

Rest assured, these are near-term potential challenges, and overall, we continue to see an improving environment and growing opportunities. One last item, I wanted to touch on before I turn the call over to Paul, I have said before that ESG is an important focus for Flex and I'm really proud of the work we have done so far.

Flex currently ranks number one in the electronics manufacturing sub-industry and is in the top 50 out of almost 13,000 companies globally as rated by Sustainalytics. I look forward to discussing ESG in more detail on our Q4 call, but I wanted to point out our most recent achievement.

We launched and closed on January 7, our new $2 billion sustainability-linked five-year revolving credit facility with our banking partners. This was to replace our previous $1.75 billion facility.

Flex is the first company in the tech space to have an ESG-linked loan where the pricing is linked to Flex's performance and meeting specific ESG key performance indicator targets; in this case, greenhouse gas emissions reduction targets and work-related safety incident rates. Again, I'll update you more on our broader ESG efforts in Q4.

With that, I'll turn the call over to Paul, who'll walk you through our results in more detail. I'll then come back at the end to share some closing remarks. Paul?

Paul R. Lundstrom

Chief Financial Officer, Flex Ltd.

Okay, great. Thank you, Revathi, and good morning, everyone.

If you could please turn to slide 6, Flex revenue was $6.7 billion in the quarter, which was up 12% quarter-over-quarter and up 4% year-over-year. Q3 was stronger than expected, with top-line growth in both the Agility and Reliability segments and with broad strength across the portfolio.

Adjusted operating income was up 22% year-on-year to $311 million, with 60 basis points of margin expansion. Profit growth was bolstered by stronger volume with good mix as well as productivity and efficiency gains. I also want to remind everyone that this figure continues to include some headwinds from COVID-19 costs.

As a result, our adjusted net income was $251 million, with adjusted earnings per share of $0.49. Year-on-year, those were up 30% and 29%, respectively. And to reconcile adjusted net income to net income on a GAAP basis, third quarter GAAP net income of $208 million was lower than our adjusted net income due to $25 million of stock-based compensation, $13 million in net intangible amortization and $4 million of net restructuring and other costs.

On a gross basis, restructuring was $30 million in the quarter, partially offset by $26 million of other investment gains. We continue to track to the targets we outlined in Q1 and still expect to close to about $100 million of restructuring costs between Q2 and Q4, as we had previously committed.

On slide 7, our third quarter adjusted gross profit was $514 million, up $55 million year-over-year. Adjusted gross margin was also up 50 basis points to 7.6%, which is record performance for Flex and reflective of strong execution in the quarter.

In total, adjusted SG&A spending was flat from a year ago and 3% of sales. We continue to believe that our repositioned cost structure will provide meaningful earnings leverage as we execute on our long-term growth strategy. Summing it up, adjusted operating income of $311 million was up 22% year-over-year, and 60 basis points of margin expansion led to a record 4.6% operating margin rate.

Flex Reliability revenue on slide eight was $2.9 billion in the quarter, up 8% sequentially and up 2% compared to a year ago. Q3 performance for all three businesses in Reliability met or exceeded our initial expectations going into the quarter.

Automotive, in particular, benefited from the industry's ongoing strong global recovery as demand has improved substantially from trough levels last spring. Automotive revenue was up high single digits year-on-year with improvements seen across all regions, led by the Americas.

As expected, Health Solutions sales were up double digits year-over-year. Critical care products, diagnostics and patient monitoring programs continue to be in demand, with perhaps a touch more volume than we expected.

Lastly, Industrial was down high single digits compared to prior year. As mentioned last quarter, a customer-specific headwind and a tough comp in renewables related to Safe Harbor created some pressure in Industrial, but was partially offset by strong growth in the balance of the business.

Turning to profitability, Flex Reliability Solutions generated $178 million of adjusted operating profit and a 6.2% adjusted operating margin, which was down 40 basis points year-on-year due to headwinds related to Automotive product transitions as well as investments associated with new product ramps in Health Solutions.

Flex Agility revenue of $3.8 billion was up 16% quarter-over-quarter and up 6% year-over-year. Within Agility, Lifestyle was the standout for the quarter, up 10% year-over-year, thanks to continued strength in the high-end audio, floor care and appliance end markets. CEC also did better than expected, up low single digits year-over-year, led by cloud and critical infrastructure, while enterprise IT spending remained muted, in line with the broader market. Lastly, Consumer Devices was up high single digits year-on-year, benefiting from seasonal upticks in consumer spending and demand.

Turning to profitability, Flex Agility Solutions generated $153 million of adjusted operating profit and a 4% adjusted operating margin, driven by strong volume and mix.

Turning to slide 9, for the quarter, stronger earnings and favorable working capital again drove sequential growth in operating cash flow, while adjusted free cash flow of $289 million also benefited from disciplined CapEx. We've spoken in the past about targeting an 80% or greater free cash flow conversion on an adjusted basis.

Looking ahead to this fiscal year ending in March, we expect to achieve roughly 80% free cash flow conversion on a non-GAAP basis, with adjusted free cash flow over GAAP net income likely closer to 100%. We closed Q3 with inventory of $3.7 billion, which was up 2% sequentially, but flat year-on-year, resulting in inventory turns of 6.8 times, up half a turn from a quarter ago.

We like others in the supply chain are seeing significant component constraints, and of course, we are working diligently with our partners to secure needed parts and fulfill demand. Our net capital expenditures for the quarter totaled $65 million. We continue to efficiently manage CapEx while supporting the strategic goal of increasing our technology and capabilities in higher value end markets.

I'm also happy to share that we resumed our buyback program during the third quarter. As you'll remember, our repurchase program had been on pause since March as we focused on preserving our strong cash and liquidity position during the initial period of uncertainty. But as we've said before, disciplined and prudent buybacks remain a central consideration of our capital allocation strategy so we made the decision to get back into the market as visibility has continued to improve.

Speaking of cash and liquidity, I wanted to provide a quick update on our new $2 billion undrawn revolver. We entered into this five-year facility on January 7 of this year, replacing the existing $1.75 billion revolver that was set to expire in 2022. As Revathi highlighted a moment ago, this was the first ESG linked credit revolver agreement for the tech industry, tying the cost of the facility to key metrics that support Flex's long-term sustainability plan, namely reductions in greenhouse gas emissions and improvements in workplace safety incident rates.

Overall, we are pleased with our balanced and flexible capital structure, which enables us to meet our current and future business needs, while simultaneously remaining investment grade rated.

On slide 10, a couple of thoughts on the quarter, and maybe before we get into guidance, I just want to reiterate what we've said previously on every earnings call over the last year. And that's that we are still operating in a dynamic environment and we must be mindful of the need to protect the health and safety of our workforce.

Given all the recent news around supply chain constraints, I would also add that we do see component shortages as a headwind in Q4. And we have contemplated those effects in the guidance that I'm about to share.

This is a rapidly evolving situation that we will continue to closely monitor. Our guidance is therefore based on our current visibility information that is available today on those expected impacts to the business.

So let me get started with the guidance. I'll start with Flex Agility Solutions, which is expected to be up low to high single digits year-over-year. Within that, Lifestyle is expected to be up high single digits to low teens year-over-year in Q4, reflecting sustained demand for products that support remote work and school.

For the quarter, CEC is expected to be up low to mid single digits year-over-year, with critical infrastructure demand balanced by muted enterprise IT spend. Lastly, Consumer Devices is expected to be up low single digits as compared to last year.

Turning to our Flex Reliability Solutions segment, we expect revenue to be up low to high single digits year-on-year. Fourth quarter Automotive revenue will be up low to mid-single digits year-on-year. And again, we're carefully monitoring the potential supply chain disruptions due to the ongoing tightness in the component environment.

Health Solutions will be up low double digits to mid-teens year-over-year in Q4, with continued growth from new program ramps. And then lastly, our Industrial business will be up low to mid-single digits year-over-year from strong growth, driven by core industrial and power products.

On slide 11, given the some of those outlooks, we would expect our quarterly enterprise revenue to be in the range of $5.6 billion to $6 billion. Our adjusted operating income is expected to be in the range of $225 million to $265 million. Interest and other we estimate to be roughly $40 million. And we think our tax rate in the quarter should remain in the 10% to 15% guidance range.

Adjusted EPS is in the range of $0.32 to $0.38 per share based on weighted average shares outstanding of 508 million. Our adjusted EPS guidance excludes the impact of stock-based compensation expense, net intangible amortization and restructuring charges that we expect that restructuring charges in Q4 will largely be offset by one-time gains. As a result, we expect GAAP earnings per share in the range of $0.24 to $0.30.

With that, I'll pass it back to Revathi.

Revathi Advaithi

Chief Executive Officer & Director, Flex Ltd.

Thank you, Paul. I wanted to reiterate that I remain extremely confident in our strategy and our execution. In fact, some of the challenges over the last 12 months showed the increasing value we can provide to customers. Production in multiple geographies, scale and expertise in managing complex supply chains, design and engineering capabilities, all contribute to help our customers build products that make a difference in people's lives.

More and more companies are relying – are realizing the advantages of partnering with Flex. And this value will only increase as we continue to invest in technologies and capabilities to grow in higher value markets.

Lastly, on behalf of the entire leadership team, I want to thank our customers for your trust and partnership and our shareholders for your continued support.

With that, we'll start our Q&A.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Matt Sheerin from Stifel. Your line is open.

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

Q

Yes. Thanks. Good morning, everyone. My first question, Revathi, just regarding your outlook for the March quarter, which you said reflects some conservatism relative to expectation of component constraints. Is that coming from customers and are you starting to see some rescheduling or orders pushed out because of that, or is that more internal in terms of your own outlook?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Matt, thank you for that question. I would say it's twofold, right. We're definitely not seeing push out of demand from customers at this time, but we're seeing the inability to deliver some components from our side as coming from suppliers. And then, we're also seeing customers having other suppliers having shortages, which really starts to constrain the entire supply chain end-to-end. And we haven't seen any order cancellations from customers. We are only seeing shifts I would say, which is a very highly evolving situation on a day-to-day basis.

So we have done our best to take all that into account, but, Matt, as you know, this is an ever-evolving situation every day. I've done more CEO calls in the last 20 days than even during the COVID time. So, it really shows kind of the effect that's happening in the industry. So we are being somewhat cautious about it and monitoring it very closely.

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

Q

Okay. Thank you for that. And then just related to that, in terms of your own working capital requirements and inventory, are customers asking you to start placing some inventory maybe for out quarters? We're starting to hear that from several component suppliers and distributors in terms of very strong book-to-bill ratios. And what does that do to the near-term cash flow story for the company?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

I'd say one thing that, Matt, we have learned to do very well even last year was really kind of manage the incoming demand from customers, put some intelligence to it, help our customers make decisions and then be somewhat realistic in the demand we put on suppliers. Our last quarter's inventory performance is a good indication of that.

But you know what we are seeing right now is the so-called bullwhip effect that happens every time when shortages occur in the industry, right. Lead times get moved out, people put more orders than they need and it creates an effect that kind of ripples through the entire supply chain.

So we are seeing more orders than we think that we should see, and that could be a little bit of inventory going into the system. It's natural to happen in a time like this. And we do our best to apply intelligence to that as we accept orders from customers and as we look at what inventory we should put into the system. We have considered those in our working capital metrics that we are thinking about for Q4.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah. So, maybe just comment on the guidance there, Matt. So a little bit of pressure on the top line potentially, a little potential on the cost lines as logistics and other potential cost headwinds do affect the P&L, and then a little bit conservatism in the cash flow outlook as well, because of what Revathi just said about inventory. So, I would say sales, cost and balance sheet, all are potentially adversely affected here a little bit in Q4. And again, that's all contemplated in the guidance.

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

Q

Okay. Thanks, very helpful.

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

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Good morning and thanks very much for taking the questions. Maybe to start I can pick up on the questions Matt was asking around supply chain. And I think Flex is probably one of the companies that's best positioned to speak on this topic, given how broad-based of a role Flex plays in the broader tech and macroeconomic landscape. As you're talking to your suppliers and looking at things like shipping and component constraints, do you currently expect that the peak of the problem is going to be in the calendar first quarter, as the supply chain is trying to work to potentially mitigate some of these issues or you think it potentially even gets worse beyond the March quarter?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Mark, this has been written about so much right now in every newspaper you pick up. I would say, our view, we do have a very broad industry perspective and we also have – we buy components across many different diverse industries.

I'd say first thing is that it's difficult to assess because it depends on which component, right. So if you're thinking about a chip shortage, you know that that takes longer to ramp up, right. So some of the projections you hear today is that that could be more in the second half of the calendar year. If you think about kind of assembly and test capacity, those are easier to ramp up and we're hearing those would get ramped up more towards the end of calendar Q1 getting into Q2.

So I'd say it really depends on which component and how all those come together, I think, is hard to predict. So in general, what you're hearing from the industry, which is what I'm hearing from suppliers that I'm talking to and I'm talking to many supplier CEOs, is that sometime late Q2 is when you'll see all this coming together in terms of a full recovery; but it's really hard to assess, I would say, based on what we see today because it's just evolving constantly. I think there'll be more clarity in the coming weeks as we get better view into supplier capacity that they're adding in.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Thank you for that. That's helpful. And my second question I was hoping to discuss NEXTracker and perhaps Flex could update on the size of the NEXTracker business in terms of revenue or EBITDA, especially given the upside that the company has been seeing. Perhaps the run rate of the NEXTracker business is different than what you described on the last earnings call. And then, as you're thinking about the strategic alternatives you spoke to today, can you talk a little bit more about what the key factors are that Flex is considering about how to best maximize shareholder value with that asset, and any idea about how long it may take to come to a decision on that? Thank you.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. Thanks, Mark. I'd say one is, I think we're going to stick to what we told you last quarter, which is pretty accurate still, that revenue will be north of $1 billion and operating margin will be in line with industry peers in terms of double-digit operating margin. So, I'd say no updates to that. Obviously, it becomes clear as we go through the process.

And in terms of how we think about strategic alternatives, I think one thing, hopefully Mark, you and all our investors will give us credit for is being disciplined in everything we approach, right. And we will do the same for this, also. I'd say we'd go through all the options. We'll see what makes the best sense for Flex and our shareholders.

And long-term, I think, making sure that this is the right decision for our shareholders and Flex is important, which will lead to kind of our decision of how we give back money to shareholders in terms of buybacks or how we invest in M&A, particularly in our Reliability segment, where we want to clearly move higher up the value chain. Those will be the decisions we'll be looking at.

In terms of how long, I'd say you can see that we're moving pretty fast. Last quarter, we talked to you about that we're assessing it. And this quarter, we are already announcing that we're looking at alternatives. So, there's always a sense of urgency in the things we do, but we're also very disciplined.

So I would say I'm not giving any predictions, because I don't want to tie myself up to a timeline, but we will move as fast as we can in this process.

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

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you. And I have two questions and I'll ask them at the same time, so you can answer them in any order that you want. But, Revathi, whether it'd be you or your discussions with your senior management or the board, has something changed over the past, say, six months or from when you entered the company at Flex where now doing things like considering unlocking the value of NEXTracker is a lot more on the table, and before Flex really hasn't been known for that? So, has anything changed there or was that just you bringing it in or shareholders or management? So kind of what really changed, because I think a lot of investors look at that value [ph] and hidden gem (00:29:45), and they also wonder are there other things behind the doors of Flex to unlock value?

And then, my second question is on the Automotive. It seems like – you talked about you're having some great success there, but also there's a big rebound in autos. Are you actually seeing on a run rate go forward that you have gained a fair amount of share in autos? And is that something that is kind of going to set up for a potential new chapter of growth for Flex in autos because it seems like there's a lot of innovation in the electronification and electronics of an automobile? So I'm just wondering if it's actually more of gaining share rather than just simply a rebound that is happening more near-term.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Thanks, Jim; both very good questions. Let me handle the first one first. I'd say, I don't know – I can't comment on history, but I think, Jim, what I would say for currently, how the board and I are approaching things is that our first focus was all operational: make sure that we are focused on being disciplined in how we execute; make sure we're disciplined in how we think about growth and driving good growth. But during that time, we also were thinking about portfolio management, right. I think it's very important for any company to be focused on how do you want to change your mix over the long-term. And so, evaluation of portfolio has been considered over the last kind of one year to really think about what do we want to be, and that you saw the launch of Reliability and Agility. You see us talking about making more investments in Reliability, moving up the value chain. You also hear us talking about NEXTracker, and looking at alternatives for it.

So I'd say we're just running the business as any disciplined board and business leader should be running the business. And I think we're being very pragmatic in our approach. So not sure about history, but I'd say all I can say for today is we're doing what good businesses should do, I think.

In terms of the auto rebound, our – two things. One is, Jim, is our auto business is – has really grown over the last kind of few years, as you have seen. It is a very strong business for us today. We're excited about how fast that business has been coming back in the last two quarters, but obviously, we're like most people struggling with shortages. We have gained share, I would say, in both the electrification and the autonomous space, both of which are focus areas for us. We want to continue to invest very heavily in our electrification space. We have our own products and our own technology in the electrification space, and we want to continue to invest in that to make that a bigger part of our portfolio.

So we do believe that our share is very strong and has been growing, and we'll continue to invest in that space as we move up the value chain.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much for the detail. It's greatly appreciated.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Thanks, Jim.

Operator: Your next question comes from the line of Steven Fox from Fox Advisors. Your line is open.

Steven Fox
Analyst, Fox Advisors LLC

Q

Thanks. Good morning. Two questions if I could. First of all, on the operating margin performance, I was wondering if you could break down the 60 basis points of year-over-year improvement a little more. And I understand the reasons you gave, just a little bit more math on that. And then, what's its implications for margin targets when we look out maybe the next year or two? Is the 4.6% sustainable, et cetera?

And then secondly, just real quick on the Health Solutions business. You're growing double-digit year-over-year. You mentioned new program momentum. Do you see that continuing for a few more quarters or should we think about some of that year-over-year growth slowing as you ramp some of these big programs? Thank you.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.
A

Yeah.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.
A

Thanks, Steven. I'll have Paul probably take the margin question.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.
A

Yeah, sure. So appreciate the questions, Steven. So strong margin growth in the quarter. We're very pleased to see. I would say, simple math, volume and mix certainly was helpful, top line growth with strong drop through. We did have some productivity in there. A couple of small tailwinds. We did have a little bit of COVID-19 headwind. We had a little bit of – we talked about in the script, a little bit of ramp cost investments as we continue to ramp on some pretty strong growth in Health Solutions. But I would say what I was particularly pleased to see was Agility margin growth. Agility was up 130 basis points in the quarter, which is very, very strong.

And you heard us talk about mix and continuing to focus on mix. And sort of the big picture theme on Flex, as we look forward over the next few years is, continued strong growth in the Reliability side of the business, which typically has a little bit better margins. But managing mix is very much – it's something that we're doing in the Agility side of the business as well. And so very pleased to see that, I think the types of customers and types of business that we're going after within that segment. You're starting to see the fruits of our labors there, which is good. And that coupled with strong margin from the Lifestyles business. Lifestyle, as I mentioned, was up 10% year-on-year in the quarter, and so that helped us to mix up there as well.

So really pleased with the performance. And short answer would be good mix, good volume dropping through with some productivity tailwind as well, so very happy with that performance.

In terms of Health Solutions, that business has had tailwind in our fiscal 2021 from some of the critical care demand coming from COVID and the COVID response. And so, as we – as that starts to roll off over the next couple of quarters, we expect that to be replaced with tailwind from some of these new program ramps. But as I look forward the next few quarters, I do see a little bit of an air pocket as COVID comes down. Hopefully, critical care – not critical care. Hopefully, elective comes up and as we ramp into those next-gen programs, but I would say we won't be down, but the growth won't be robust in Health Solutions over the next two, three, four quarters.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.
A

So the only thing I'd add to that would be to say to the Health Solutions question is that we do have a one-time that we're seeing right now from ventilators and COVID demand that we expect not to continue, but also Health Solutions is also booked out for kind of many years. We have a very healthy booking trend. So our base business is expected to grow in double digits, and we see that continuing at least for the next three to four years, and we expect that'll continue as we book new businesses. I think we'll just have that one-time effect from COVID, particularly on ventilators. There was a huge demand this year that'll even out, but the base business is projected well to be in the double-digit growth.

In terms of long-term margin targets, I would just say, Steve, that our strategy is paying out, right. We said that we'll focus on the right kind of growth, manage our mix. And we have – we are focused on developing these dedicated delivery models for our Agility and Reliability business, which really focuses on productivity and efficiency.

Last year, in Investor Day, I told you our aspiration for operating margin was mid-single digits and you can reach your own conclusions in terms of whether we're headed in that direction or not, but I feel like the strategy is working and our margin targets long-term that we gave you is sustainable.

Steven Fox
Analyst, Fox Advisors LLC

Q

Great. I appreciate all that color. Yeah. Thank you very much. That's very helpful.

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

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. Thanks. Good morning. Revathi, I just – in light of the potential NEXTracker monetization, I wanted to ask a high-level question on your view of M&A in the industry. It's been pursued in the past. Success has been somewhat mixed. Selectron comes to mind, for example, but the industry has evolved. I'm just wondering if you could maybe update your view on why or why not M&A makes sense in this industry with your fresh look at it?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. Thanks, Adam. See, I would say that my personal view, and of course, everybody has their own views on this is that this space doesn't need any new capacity. So we're not looking for consolidation in this space. I think our base organic business, we will just look at productivity, efficiency, right mix. In terms of M&A, we're clearly looking for higher value, both technology and product M&A in the Reliability space, which is Health Solutions, electrification in Automotive, and power and Industrial. So that's the part that we'll be thinking about. So our M&A strategy will be clearly focused on moving up the value chain with products and technology in these three spaces. And that's how we are going to think about M&A moving forward, Adam.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. And just to clarify, are there any dissynergies that investors should think about associated with the NEXTracker strategic alternatives?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Paul, you want to -

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah, but they would be small.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. And Paul, on the topic of costs, I wanted to ask, you're already at the low end of SG&A targets. It sounds like you still have some of the $100 million on the come. You're still incurring some COVID costs. Wondering if you maybe help quantify those two buckets. How much incremental of the $100 million is still to come? How much COVID cost is still embedded? And kind of your view of the right SG&A metric, can you stay at 3%, does it get below 3%? Just some color around that would be helpful. Thank you.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah. Happy to do it. So I don't think you're going to see much better than 3%. I think 3% is best-in-class in the industry, and we're, for the most part, tapped out there. Can you still get some productivity as you hold SG&A costs essentially flat with a little bit of top line growth? Maybe, but, boy, it's certainly going to be on the margin, and I don't see that going below 3%.

In terms of the restructuring, look, we've got 120 facilities around the world. We operate in 30 different countries. There's always room to do more in terms of productivity, and we'll continue to watch that as we move forward. Your question on restructuring is a good one. Look, we're – restructuring costs and what we had committed before was about $100 million. We did $35 million in Q2. We did another $30 million or so in Q3. I'm thinking it'll be $20 million to $30 million or so in Q4, which puts us right at that $100 million or so.

Just one point I want to make is, as we kind of mentioned this in the script, what I am expecting in Q4 on restructuring spend though is probably some offset from gains. So net-net, restructuring will be net of gains restructuring probably closer to zero. But we're going to focus on factory productivity. I do think there's more to do there, as I mentioned before, and we'll continue to work on that as we move forward over the next couple of years.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Very helpful. Thanks, and congrats on the results.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Thank you.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Thanks, Adam.

Operator: Your next question comes from the line of Shannon Cross from Cross Research. Your line is open.

Shannon Cross
Analyst, Cross Research

Q

Thank you very much. Maybe sort of a follow-up to Steve's question. I was wondering – we're hearing from some of the – sort of across supply chain and certainly in tech that there may be a bit of over-earning right now in terms of sort of across the entire supply chain, because things are so tight. Just maybe the end customers aren't pushing back on pricing, which sort of trickles all the way down. And I'm curious if you're thinking about that, or if maybe the incremental COVID costs are offsetting. So when we get past this challenge that everybody is in, everything will sort of equal out and we'll continue this progression from an operating margin perspective. But I'm just curious with your thoughts as you talk to some of your customers on that, if maybe there is just a bit more room in the margin these days because, again, things are so tight.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

So this is Paul. I wouldn't say over-earning right now. I mean, to your point, we continue to have headwind from COVID costs, and that's stuff that we didn't have in our comps a year ago. You look at where we are here in Q3, and what I expect to see as we're coming into Q4, we're probably still talking $10-or-so million of COVID-related costs.

And in terms of the logistics, we certainly don't feel like we have pricing power on that sort of thing right now. I mean, it's costs that are kind of being passed through us and on to the ultimate OEMs. And so, we're certainly not a beneficiary of that. If anything, I would say it's the opposite. As Revathi had kind of highlighted, what have we contemplated in our guidance, we talked about sales. I talked about the balance sheet side. On the cost side, there's a number of elements. As you look at the full chain logistics challenges that we have here that are manifesting themselves in things like – even oversea containers are constrained. We're looking at 40-foot container pricing changes. It used to be $2,500 a container, and now, it's $6,500. We used 3,000 to 4,000 containers a quarter, and so you can do the math. On an annual basis, that could be $50 million to $60 million. So that's big.

So again, I wouldn't say over-earning. I would say, if anything, there's short-term cost headwind that we hope to be able to pass through down the road, but those are my thoughts. Revathi, maybe [indiscernible] (00:44:09) ...

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah, Shannon, I would agree. I'd say I wish over-earning, but definitely not. I'd say our customers are very disciplined and our suppliers are very disciplined. So you do see these things kind of flow through the value chain. Like Paul mentioned, logistics costs are high, and then lot of chasing, right, supply and expediting supply shortages. I'd say our, I'd say, margin improvement comes from our strategy, which is better mix and delivering volume with better productivity. I'd say those are the major things.

I think these puts and takes, how we manage that in a disciplined way is how we'll see it pass through the P&L. But, Shannon, really good question.

Shannon Cross
Analyst, Cross Research

Q

Thank you. And I guess it bodes well for future years. My second question is just in terms of enterprise spend. We continue to hear from the supply chain, things remain very weak. You talk to some of the end companies and they're seeing at least some stability and some hope. I'm curious, did you see any improvement earlier in the fourth quarter, and then we went back into shutdown, or has the linearity for enterprise been pretty weak throughout the whole quarter? And then, what do you think the key drivers will be to restart that? Thank you.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Maybe just on the top line, as we had mentioned in the script, enterprise was down a little bit year-on-year and we're expecting that to continue as we move into Q4. I think it's tough because – it's just a little too early to call. We really don't see people coming back into the office right now. And I had kind of jokingly said a quarter ago, I don't see a whole lot of CFOs wanting to invest in enterprise spending right now, given the continued uncertainty and the fact that people just – they're not back in the office right now.

So, I think we're upbeat on the future. And I'm hoping that what we see here is some pent-up demand and a bit of a snapback as we move forward into the – our fiscal 2022 and maybe the back half of the calendar 2021, but a bit of a TBD.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Thanks, Shannon.

Shannon Cross
Analyst, Cross Research

Q

Great.

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

Paul Coster
Analyst, JPMorgan Securities LLC

Q

Yeah. Thanks very much for taking my question; just a quick follow-up on strategy. I mean, you have this amazing platform that you make available to your customers, of course, to go global and scale up. And you've now clearly had a great success with your own brand through that same platform; in this case, NEXTracker. I'm just wondering, does this sort of feed the strategy a bit and is it – does it make sense for you to start to nurture brand initiatives that are not competing with your customers, but that can then subsequently be potentially spun out in the manner that maybe NEXTracker will be?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah, Paul, I'd say that the way I think about portfolio is that – and I've said this before in our Investor Day call, is I see each of our business units, which NEXTracker is part of our Industrial business unit, to be able to stand alone independently in terms of their performance to the available market. They should be growing share. They should be delivering that share and that volume in a productive and efficient way. And that's kind of how I see each of our independent business units perform.

I'd say in terms of does this become a strategy to take individual brands and scale it up and then decide how to monetize it, I'd say I don't see it like that. I see it as each of our business units needs to perform. And then, as they add value to the overall Flex, that helps our multiple and our shareholders. And that's how we think about strategy. So I'd say no comprehensive change to that strategy.

Paul Coster
Analyst, JPMorgan Securities LLC

Q

Got you, and then quick follow-up. The change of administration in DC, priorities changing in infrastructure and global trade may change in some ways. Any thoughts on how that affects Flex?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. I would say that our personal hope is, one, is from a sustainability and climate change perspective, we'd be very supportive of the measures that the Biden administration would be bringing through, which helps our business like NEXTracker.

I'd say in terms of trade, I think me personally, like most CEOs, want to see a trade policy, particularly with China, that's less aggressive. We continue to support some of the things that the Trump administration started with regard to trade policy with China, like focus on IP and security, but we also think there is a better way to handle this moving forward that is helpful for all industries.

We do think that the focus on onshoring and bringing businesses back to individual countries, that trend will continue. And Flex is very well positioned to help that trend with our customers because we have great manufacturing capability in almost every country in the world. So, we're hopeful for continued building on some of the themes that the last administration worked on, but in a way that's more mutually acceptable and more positive for industry, in general.

Paul Coster
Analyst, JPMorgan Securities LLC

Q

Excellent. Thank you very much.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Thanks, Paul.

Operator: And your final question comes from the line of Ruplu Bhattacharya from Bank of America. Your line is open.

Ruplu Bhattacharya
Analyst, BofA Securities, Inc.

Q

Hi. Thanks for taking my questions. On the Industrial side, can you give us a sense for the relative growth rates of the different end markets? So you have renewables, you have industrial devices, capital equipment and power systems. Just on a relative basis, which one is going faster, which one is going slower?

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Sure. Ruplu, so you think about Q3 specifically, I think we had mentioned earlier that there was a little bit of a headwind on the renewable side due to Safe Harbor and that was the tax policy favorable to that industry that created some accelerated buying in the calendar Q4 of last year. So a little bit of tough comp on that one did give us some headwind in that renewable side of the business, I would say, in the double-digit range.

Power, we had mentioned before, we did have a customer-specific headwind, but core was up, up mid-single digits, and I would say pretty strong performance. And as we look ahead, maybe to give you a little bit of thoughts on Q4, I think power will be flattish, I think the renewable side flattish, with strong growth in core, high single-digit plus.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

And Ruplu, but all three sub-segments on a year-over-year will have growth, which is pretty incredible considering this as a COVID year, right. So, for a full year fiscal year 2021, all three segments will have positive growth.

Ruplu Bhattacharya
Analyst, BofA Securities, Inc.

Q

Okay. Yeah, that makes sense and that's helpful. Just for the follow-on question, Reliability Solutions margins declined 50 basis points sequentially on higher revenues. I think in the prepared remarks, you talked about Automotive product transitions. Do you see the situation improving in the fourth quarter or do you think that you're still going to have headwinds? And should we think about – I mean, 6.2% is not bad in terms of margins, but, I mean, it's lower than the high 6s that you've had in the past. So, I mean, any thoughts on whether this is a more long-term headwind or is this transitional? Thanks.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah. So long term, I would say no. Maybe answer the tactical question real quick on the Automotive side. Look, that's going to be a watch item as we continue to see how this component shortage drama plays out over the next couple of quarters. So, we'll watch that carefully.

In terms of the – in Q3, a little bit of margin headwind, as you had mentioned. We did have some headwinds, one on the Automotive side, as I mentioned, one on Health Solutions side. Also, as I mentioned, both of those were next-gen contract related. And if you think about the Automotive side of the business, we had a little bit of a supplier blip. I don't see that repeating, but we were transitioning some products and then, look, it happens.

And on the Health Solutions side, we're investing pretty heavily right now in what I think is a substantial ramp on new products that – and that investment was a bit of a drag in the quarter. But that's – those are – that's high-quality investment with an expected ramp over the next few years in the Health Solutions business.

As we move into 2022, I think that growing Health Solutions business, the new product growth offsets a little bit of the air pocket that I had mentioned on some of the COVID-related healthcare spending. But if you look to 2023 and beyond, that Health Solutions business is going to grow nicely.

And again, as Revathi has been saying over the last several quarters, we love the profile of that business. We like the margin profile. And I think as we continue to invest in and grow that business over the next few years, you'll continue to see mix up at the overall Flex level.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

And then, Ruplu, the only thing I'd add to that is that, as we have room to make these investments in business ramps and product transitions, we want to continue to invest in Reliability. And like you said, it's still a great margin profile. But when we have room to invest, it's going to get an unfair share of kind of funding from the business to be able to support that because it sets us up well in the long-term. So, it's a very planful way of how we're executing in that business.

Ruplu Bhattacharya
Analyst, BofA Securities, Inc.

Q

Yeah, that makes sense. Thanks for all the details. Appreciate it.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah. Thanks, Ruplu.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Okay. Thanks, Ruplu.

Operator: And there are no further questions at this time.

Revathi Advaithi

Chief Executive Officer & Director, Flex Ltd.

Okay, great. Hey, thank you for joining us today. I'm very excited and confident in the future for Flex, as you can see from the great performance we delivered in Q3 and our guidance for Q4. I do wish that all of you remain safe and in good health. And I look forward to speaking to you again next quarter. Thank you, everyone.

Operator: Ladies and gentlemen, this concludes the Flex third quarter fiscal year 2021 earnings conference call. Thank you for participating. You may now disconnect.