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Flex Ltd. (FLEX)

Q1 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to the Flex First 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 introduction, I would like to turn the call over to Mr. Kevin Kessel, Flex's Vice President of Investor Relations and Corporate Communications. Sir, you may begin.

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

Thank you and welcome to Flex's first quarter fiscal 2019 conference call. We have published slides for today's discussion that can be found in the Investor Relations section of our website at flex.com. Joining me on today's call is our CEO, Mike McNamara; and our CFO, Chris Collier. Following their remarks, we will open up the call to questions.

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

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

Now, I'd like to turn the call over to our Chief Financial Officer, Chris Collier. Chris?

Christopher E. Collier

Chief Financial Officer, Flex Ltd.

Good afternoon and thank you for joining us for our first quarter results. Before we get into reviewing our first quarter financial performance, we wanted to provide you with an impact summary of two new accounting standards we adopted this period. Please turn to slide 2 for a summary of these impacts. First, we adopted the new revenue recognition standard, ASC 606, and did so under the modified retrospective approach, which means we are not restating prior years, but have captured the prior year income statement impacts in our retained earnings.

We had not anticipated a material impact to our income statement or cash flows upon adoption, and that was the case. Our revenue for Q1 was approximately $102 million less than the revenue without ASC 606 adoption, primarily due to a onetime reduction of revenue from certain contract amendments for small customers we executed in the quarter.

You'll also note on the face of the balance sheet a new asset called contract assets amounting to $324 million associated with unbilled receivables as a result of the adoption. On the right, you can see the impact of new cash flow presentation guidance related to our asset-backed securitizations or ABS programs, which we've been using for over 10 years as a strategic source of low-cost funding. These programs serve as a key part of our working capital management.

This new standard required us to separately report certain cash inflows from ABS programs as investment activities and have historically been treated as cash from operating activities. As a result of this reclassification, our Q1 reflects a decline in operating cash flows of $657 million, despite no change in the economics of our program or cash collection. As a result, we believe this reclassification impact should be adjusted back to give the true economic picture of our operating cash flows. We thought it would be beneficial to level set on these changes and their impacts up front. You'll see additional disclosures related to the newly adopted accounting standards in our 10-Q to be filed next week.

With that, please turn to slide 3 for our Q1 fiscal 2019 income statement summary. Our first quarter sales were approximately $6.4 billion, up 7% versus a year ago. This was within our prior guidance range and also reflects the onetime impact of reducing revenue by over $100 million in the quarter associated with the adoption of the new revenue standard that I just mentioned.

Our Q1 adjusted operating income was $188 million, which also was within our guidance range, and adjusted net income was $128 million. This resulted in adjusted earnings per diluted share of $0.24, which was at the midpoint of our guidance range of $0.22 to $0.26. First quarter GAAP net income amounted to $116 million, which is lower than our adjusted net income due to several adjustments. This resulted in a $0.02 reduction from our adjusted EPS as our first quarter GAAP EPS was $0.22. I'll discuss these adjustments shortly.

Now, turn to slide 4 for our quarterly financial highlights. This was our sixth consecutive quarter of year-over-year revenue growth, which was supported by growth across our IEI, HRS and CTG businesses, reflecting the

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continued expansion from new customers and programs. Our gross margin remains pressured as we ramp various new programs, and also due to impacts from a changing mix of our business.

Our Q1 reflects a margin impact from lower profitability on various programs in their ramp phase, as gross profits typically [ph] align (06:07) revenue growth, given higher levels of startup costs, operational inefficiencies and under-absorbed overhead during these production ramps. Also, the mix of our business with a greater portion of lower margin consumer products plays on our Q1 gross margin.

Our first quarter adjusted SG&A expense totaled $225 million, which was down 3% year-over-year, while we are achieving strong revenue growth. As highlighted at our Investor Day in May, we are focused on structurally repositioning our SG&A levels and are confident in our ability to leverage our [ph] installed account (06:49) structure to support our growth in fiscal 2019 and beyond. We expect that our SG&A expense will decrease both in terms of dollars and percentage for the remainder of fiscal – this year, and we expect to operate in the range of 3% to 3.2% of revenues this year as we simultaneously leverage our revenue growth while driving productivity gains and operating with a cost discipline.

Our quarterly adjusted operating income came in at $188 million, which was up nearly 6% from the prior year, and resulted in an adjusted operating margin of 2.9%. Our profitability continues to display the dampening impacts from elevated levels of costs and investments we are presently absorbing, as we continue to position our company for long-term profitable growth. Our return on invested capital, or ROIC, was 16%, consistent with last quarter. And while it continues to remain above our cost of capital, it does reflect the impacts from lower profitability, combined with higher levels of invested capital, as we have higher net working capital installed capacity requirement in front of anticipated ramping topline growth and profit expansion.

Turning to slide 5 for our operating profit performance by business group, our CEC business generated $46 million in adjusted operating profit, resulting in a 2.4% operating margin. Our business continues to see improving demand trends as revenue grows sequentially and [indiscernible] (08:44) modestly down in the year-over-year. We remain focused on making investments in engineering and building out our reference platforms for cloud data center solutions and continue to shift our CEC portfolio in this direction where we can generate higher returns.

Our CTG business earned $27 million in adjusted operating profit, resulting in an adjusted operating margin of 1.5%, which is below our targeted range of 2% to 4%. Our underperformance to target reflects the underlying mix shift, ramping of new programs and sustaining losses from our strategic partnership with Nike, although we continue to make improvements in tracked profitability in the second half of this year. We expect for CTG to expand its adjusted operating margin and move into our targeted margin range later this fiscal year, as our new programs' manufacturing volumes increase and our utilization rates and overhead absorption improves, and we benefit from the profitability improvement of Nike.

Our IEI business generated adjusted operating profit of $51 million, achieving a 3.6% adjusted operating margin, which fell short of our targeted range of 4% to 6%. During the quarter, IEI saw distinct pressure from demand softness from new customers in industrial, home and lifestyle, and reduced demand in semiconductor/capital equipment. Additionally, its energy business had lower revenue due to certain customer revenue declines and a temporary impact from reduced shipments of solar tracking solutions. These elements pressured margins during the period. However, we believe it to be temporary as we expect IEI to return back to its target margin range next quarter, supported by increasing revenue which will aid in improved absorption benefits.

Finally, our HRS business delivered quarterly adjusted operating profit of $94 million and an operating margin of 7.7%. As we highlighted at our Investor and Analyst Day in May, we are ramping several new customers and

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programs, and continue to invest in expanding our design and engineering capabilities to support autonomous vehicle and connectivity-focused efforts. The HRS team is focused on transferring its record $1.3 billion of booked business in fiscal 2018 into strong organic revenue growth, and expect to stay meaningfully within its 6% to 9% target margin range.

Please turn now to slide 6 to review our other income statement comments. Net interest and other expense for the quarter was $41 million and it was up significantly over the prior year, driven primarily by the higher interest rate environment and the higher level of outstanding debt, and it includes approximately $5 million of noncash losses from our non-majority owned equity method investments in our platform businesses such as Elementum and YTWO Formative. As we look forward, we anticipate our interest in other expense line will be in the range of $40 million to $45 million, reflecting losses from our equity method investments and the impact of our higher interest rate environment.

Our adjusted income tax expense for the quarter was roughly $19 million, reflecting an adjusted income tax rate of approximately 12.8%, and within our guidance range. Our long-term tax rate range of 10% to 15% remains unchanged and we anticipate executing to that range in fiscal 2019, as previously discussed.

There are several different elements that have an impact from reconciling between our GAAP and adjusted EPS, including $0.04 impact from $21 million of stock-based compensation and a $0.03 impact from $16 million of net intangible amortization expense. During the quarter, we realized a net noncash gain related to our platform business investments of $88 million or $0.16. This gain primarily resulted from the creation, spinout and deconsolidation of AutoLab AI, following the funding from third party investors and board composition changes. We excluded this gain from our adjusted results but it is reflected in our GAAP results. Mike will expand on this shortly.

Now, going forward, we will reflect our share of AutoLab AI's profit and losses in our interest and other line. Offsetting this gain were costs realized during the quarter, totaling approximately $62 million or $0.11. These costs included charges for certain distressed customers of over $17 million, employee-related costs of approximately $17 million, $9 million of costs related to the investigation lead by our audit committee and $19 million of other charges.

Turning to slide 7, let us review net working capital and cash flow generation highlights. As you can see from the chart on the top left, our adjusted net working capital ended close to $1.8 billion, including the $324 million contract assets. This amounted to 6.9% of our net sales.

The electronics supply chain environment remains challenging and we continue to see constraints across several component categories. The lead times have significantly [ph] lightened (14:55) and we see increasing shortages in parts that are on allocation. These constraints, along with our expanding topline in ramping businesses, have contributed to the expansion of our inventory levels by just under $400 million from a year ago. We continue to manage the situation well, in part, by leveraging our increasing Sketch-to-Scale engagements where we are now more meaningfully participating with suppliers through design discussions and a different level of partnership, which enables us to secure supply in challenging times.

Optimizing demand fulfillment for our customers remains a priority. However, the challenging supply environment began to hamper our business late this quarter as we experienced nearly $70 million of revenue being stranded due to material constraints. Despite the constrained inventory environment and a strong revenue growth, we expect that our net working capital as a percentage of revenue will remain within our targeted range of 6% to 8%.

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As planned, we continued to invest to expand capability and capacity this quarter as our capital expenditures totaled $170 million, [ph] achieving (16:14) depreciation by $74 million. This quarter, we heavily invested into both equipment and facility expansions, including in India, as we firmly established the foundation to support the significant business ramps underway. Like last year, we continue to invest greater percentages of our CapEx to support our expanding IEI and HRS businesses in Q1. As we previously discussed, these investments are supporting products with longer lifecycles, and in many instances, we are required to commit capital investment in advance of production ramps.

The near-term capital intensity of our business remains elevated as we invest in growth, which can be seen in lower adjusted operating and free cash flow generation, where for Q1, we used $15 million of adjusted operating cash flow, and our free cash flow for the quarter was negative $185 million. We anticipate that as we move into the second half of this fiscal year, that the capital intensity will abate both in terms of capital expenditures and the level of net working capital investment required.

Similar to both our fourth quarter, we were blacked-out from our share repurchase program during Q1. Our shareholder return commitment of 50% or greater of our annual cash flow remains, and we intend to resume buying back shares this current quarter and this year.

Please turn to slide 8 to review our balanced capital structure. We continue to operate with a balanced capital structure, with no debt maturities until 2020, and have strength and flexibility to support our business over the long term.

Before I turn it over to Mike, I wanted to update you on the investigation the audit committee completed in June. We filed our fiscal 2018 10-K without any restatement to prior periods. However, we did conclude that there are material weaknesses in our internal controls or our financial reporting. As a result, we have undertaken and will continue to undertake steps to improve our internal controls to remediate the material weaknesses. Our efforts have been focused around enhancing controls, procedures and training, as well as expanding resources over critical areas. We've taken these measures very seriously and will be driving these efforts throughout this year.

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

Michael M. McNamara

Chief Executive Officer & Director, Flex Ltd.

Thank you, Chris. Please turn to slide 9 for Q1 business highlights. Our revenue growth remains a function of new customers and projects that see the value of the Flex platform and its ability to take advantage of the broad collection of assets and capabilities that enable integrated cross-industry solutions. To that point, our first quarter of fiscal 2019 saw revenue growth of 7% year-over-year. This marked our sixth straight quarter of year-over-year revenue growth, reflecting a balanced and diversified service offering that enabled integrated industry solutions.

Our portfolio evolution remains firmly intact. Over the past five years, our focus of strengthening our design and engineering value add has improved bookings and expanded pipeline across all four of our business groups, while simultaneously creating differentiation in the marketplace. HRS and IEI totaled 42% of sales for the quarter and 67% of adjusted operating profit dollars. HRS achieved its 34th straight quarter of year-over-year revenue growth, while IEI logged its sixth straight quarter of year-over-year revenue growth. We have successfully diversified our portfolio, achieving substantial scale in our HRS and IEI businesses, with both achieved record Q1 revenue levels.

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In addition, both our CEC and CTG businesses are improving because of investments we have made to reposition our offerings around Sketch-to-Scale solutions. CTG was up 20% year-over-year, and CEC only declined 1% year-over-year, which is significantly better than expected. As our customers continue to recognize our increasingly value as an innovation partner, a growing percentage of them are coming to rely on our Sketch-to-Scale [indiscernible] (20:46) solutions early on in their product lifecycles. Investments we have made in data center solutions, in particular, are yielding strong results.

Several of our key value drivers for shareholders are the platform initiatives that we mentioned during Analyst Day. During this past quarter, we had two updates that we wanted to share. The first was a successful Series D funding round for Elementum that valued the company at greater than $750 million [ph] post-money (21:14), of which Flex continued to be a significant shareholder. While we are excited about this development and this is a significant valuation increase, there was no gain recognized in our financial statements.

The second was the creation of an independent company currently operating under the name of AutoLab AI, which is a leading edge full stack automation solutions company. The company was created from a portion of Flex internally developed automation team, and with the addition of third party capital, we'll be accelerating the development of software artificial intelligence and machine learning capabilities to optimize manufacturing.

We are thrilled to have recruited a world-class CEO to board of directors over the last few months, and we have successfully raised a significant Series A round which created a noncash gain for Flex this quarter of $92 million. Lastly, on March 26, we announced an agreement to divest the China-based operations of our subsidiary, Multek. This deal closed last night with proceeds of approximately $270 million, net of cash, which we plan to deploy into reinvesting in our business as well as our stock buyback program.

Please turn to slide 10 as we review revenue by business group in detail. Before I get in the details, I wanted to briefly address component shortages and tariff, two issues which we are actively managing. A number of asset components are in very short supply, are currently on allocation around the world, and this shortage, therefore, is constraining the revenue of many customers. We believe this constrained environment will continue into 2019 and we expect these impacts to increase over the next couple of quarters.

These shortages were also strained inventory and temporarily pressured cash flow generation, as Chris has already mentioned. We are actively and aggressively managing this situation and we are well-positioned to receive a significant allocation to these parts due to our scale, our relationships and our ability to create demand for our suppliers due to our Sketch-to-Scale strategy.

For instance, this year, we will purchase over $50 billion MLCCs, meaningfully higher than the $43 billion we procured last year. And we use these components across a very broad portfolio of products, which positions us well with the [indiscernible] (23:33) as we request increased allocations. But we still anticipate some impact on revenue, operating profit, and more visibly, on increased inventory level, until this problem dissipates.

The second major topic is tariffs, which will modify the supply chain strategy of many of our customers. Demand will become more regional, as each country works to support its own manufacturing base. As this distribution of work occurs, we will look forward to being a significant beneficiary of the redistribution, as we are the largest industry provider in every major non-China region. In the short term, we don't expect much to change, as it will take time for customers to assess and analyze the impact tariffs might have on their business. Long term, we believe many customers will request a more regional manufacturing footprint to shorten their supply chain and reduce the risk of tariff impacts.

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Our first quarter saw a year-over-year growth in three of four business groups, and the one that supplied slightly, CEC, still outperformed its revenue forecast. Our diversification remains strong and balanced, winning Q1 with a well-balanced distribution across industries and customers, with no customers above 10% of sales for the tenth consecutive quarter and our top 10 customers totaling 44% of sales.

Our CEC business was down 1% year-over-year to $1.95 billion, which is our expectation for a 5% to 10% decline. While CEC's legacy end markets remain challenged, its design capabilities continue to improve and expand, which is leading to new customers and business opportunities, particularly in cloud data center solutions, which rose over 25% year-over-year. For the September quarter, we expect our CEC business to grow year-over-year. More specifically, we see CEC expanding its revenue by 5% to 10% year-over-year, driven by continued strong growth in cloud data center solutions and year-over-year growth in telecom due to new wins in the beginning of 5G demand.

Our CTG business rose 20% year-over-year to $1.8 billion, in line with our guidance range of 15% to 25%. This growth was mostly driven by strength in products from high growth emerging markets such as India. As we mentioned last quarter, this is one region which had already implemented significant tariffs, where we saw a rapid increase in demand for regional manufacturing [ph] as well (25:58). For the September quarter, we are guiding CTG revenue to be up 10% to 15% year-over-year, and now planning for the continued expansion of new programs in emerging markets.

At our Nike business, we expect to significantly increase revenue over the remainder of the year. The manufacturing system is rapidly improving productivity, our [indiscernible] (26:19) is accelerating and our losses are improving. We remain confident in achieving our target for profitability during the second half of fiscal 2019. To this end, I've firstly taken direct ownership for our Nike operations to ensure its operational success.

IEI's growth streak continues, up 4% year-over-year to $1.45 billion, record for Q1 revenue. However, it was below our expectations for 10% to 20% year-over-year growth, as lower than expected growth from new programs in home, lifestyle, component shortages, lower demand for capital equipment, and the impact of ASC 606 and some of the energy businesses reduced IEI revenue by approximately $150 million. For the September quarter, we expect the IEI revenue growth to improve by 5% to 10% year-over-year, [ph] build by (27:09) new program ramps in home and lifestyle that are offsetting weakness, capital equipment and energy.

HRS revenue grew for the 34th straight quarter on a year-over-year basis. Revenue was just over $1.2 billion, also a record for Q1 revenue, up 7% year-over-year, versus expectations of a 5% to 15%, that includes automotive and medical group. Medical, in particular, saw the best Q1 growth in two years and had a spectacular booking level in Q1 of over $500 million, which is higher than all of fiscal 2018, which was also a record bookings year. All previously announced bookings are on schedule and will drive strong FY 2020 and FY 2021 revenue levels. In our September quarter, we expect HRS to grow modestly with a forecast of flat to up 5% year-over-year, as medical continues to drive solid growth, and automotive, as well, to be stable.

Turn to our second quarter of fiscal 2019 guidance on slide 11. We expect revenue in the range of $6.6 billion to $7 billion. Adjusted operating income is expected to be in the range of $200 million to $230 million, adjusted EPS guidance is for a range of $0.26 to $0.30 per share based on weighted average shares outstanding of 536 million. GAAP EPS is expected to be in the range of $0.18 to $0.22 as a result of stock-based compensation expense and intangible amortization.

With that, I'd like to open up the call for Q&A with the operator. Please, operator. Thank you.

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QUESTION AND ANSWER SECTION

Operator: Your first question comes from the line of Amit Daryanani with RBC Capital Markets. Your line is open.

Amit Daryanani
Analyst, RBC Capital Markets LLC

Q

Thanks a lot and good afternoon, guys. Two questions, if I may. One, on the September quarter guide, you guys are implying operating margin will improve by 25 basis points, 30 basis points, I think, sequentially. Can you just maybe outline what are the top two key levers that enable that margin expansion, as you – incremental revenue growth is one of them, but just what are the levers that are giving you margin expansion [ph] at the end (29:27) of September?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Certainly, Amit. So, one of the items that you quickly highlighted is the leverage that we'll have in terms of the topline growth. You're going to see a continued strong discipline of management over our SG&A. You're going to see productivity gains as a result of that. You'll be able to expect to see SG&A continuously sitting down around that $220 million level, which will be very beneficial.

Second to that is you're going to see some of the benefits of absorption from the increased revenue at various sites and across various programs as we get deeper into some of the ramps. We have more efficiency and productivity gains through there. You will see IEI improving back inside its target margin range and we would anticipate also having lower [ph] net (30:20) losses. So, those are some of the levers that I quickly highlight for you that can help fill into that improving and expanding both operating profit and margin.

Amit Daryanani
Analyst, RBC Capital Markets LLC

Q

Perfect. That's really helpful, Chris. And I guess, Mike, I just want to understand some of these investments Flex has been making in assets like Elementum, YTWO Formative, and I think you talked about AutoLab AI right now. How do you think about these investments, these assets holistically, and is there a road map or a timeframe where you would look to monetize these? Because clearly, these things have valuations that have sales multiple that are higher than your PE, probably.

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

A

Yeah. Well, as we talked a little about Investor Day, Amit, a large part of our strategy with these investments is basically leverage the capability and the knowhow and the – even some of the physical assets that reflect, take outside capital to fund them and then try to move them into a work which is ultimately maybe they had towards an IPO or some other form of monetization for Flex shareholders down the road.

The timeline is little bit longer but they're extraordinarily cash efficient, as you can imagine, because our prime objective of these is not to provide a lot of cash to them, but instead, to provide a lot of knowhow and market access and leverage the platform, if you will, these kind of assets. So, they have very, very strong theoretical IRR in terms of current valuation. They require very little cash on an ongoing basis. In fact, our objective is to take all

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of them and fund them with outside capital. And the payoff for Flex shareholders is just going to be down the road [indiscernible] (32:04) capital. It's a very efficient way for shareholders to benefit in equity appreciation over time and that – something that's using very, very cash – a lot of cash efficiency.

Amit Daryanani
Analyst, RBC Capital Markets LLC **Q**

Thank you, guys.

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

And one other thing I would add is every one of these things, we're using to leverage capabilities into the Flex system, so whether it's Elementum using very significant supply chain solutions. I just had a customer today talking about an integrated solution with both Elementum and Flex, and [indiscernible] (32:38) cost us anything, it helps pull business for Elementum and it provides an opportunity for Flex to get value creation off of providing additional solutions for the customer that they won't normally see.

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

Mark Delaney
Analyst, Goldman Sachs & Co. LLC **Q**

Yes, good afternoon and thanks for taking the questions. I have two as well. The first question is an update about how Flex is thinking about the full fiscal year. I mean, you mentioned some changes, the passive and MLCC shortages and also maybe some mix changes between some of the segments, more CEC, a little bit less IEI. So, is the company still on track to hit the $1.20 to $1.30 fiscal year EPS guidance?

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

Hey, Mark. Thanks for the question. Yeah, certainly, we sent out in May and framed out a guidance for the year. That remains intact. What you're hearing from us today is clearly a component environment that's changed a bit. You also heard from us that we believe we have strategic relationships with suppliers that can result in a better allocation than most. We are very focused around operating in that environment, clearly put some pressure on and some of the topline and some of the profit performance as we look to the year from where we sat in May. But we're still very laser-focused and confident in our ability to play within the range we set.

The other point you made with a bit more CEC and a bit less IEI, I think that's just kind of looking at what we just had in the current period and with the guidance. I think what we see for the year across each of our business segments is playing out still to the same degree as where we sat in May. We see a CEC that actually is providing hyper scale quality data center solution and getting more and more flexibility there, so that's improving a bit. And like I said in the prepared remarks, we see IEI coming back into its target margin range and growing each and every quarter as we move forward here. So, there's pushes and pulls in the system, but going back, we are confident in terms of the guidance we had set.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC **Q**

All right. That's very helpful, Chris. And my follow-up question is around Nike, and it's really nice to hear the company is making some progress on that front. I think one of the big issues to get into profitability had been

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making shoes that were designed to be built with your automated process. So, maybe you can just update us about how much of your mix of business is now of that right type of shoes that were designed to use your process, and how do you think about that mix evolving as you move through the year. Thank you.

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

A

Yeah. So, it's kind of a complicated question to answer. Some of the automation is not just in certain processes. We actually have some shoes which are entirely built for the process of automation. So, we actually work with Nike to actually do design for automation. That continues to be like a small total percentage in terms of a full process of a full shoe.

Now, I'll turn to the much of the automation that we're putting in place is for any shoe, so how we attach bottoms, how we glue the bottoms to the – we do a variety of different process steps, all also have automation. So, there's really incremental automation in virtually every process that we touch, and there's secondarily automation, something that we call the [indiscernible] (36:17) line, which is actually built for a design for automation process.

So between the two, I don't know what percentage it is but it's almost something that you need to think of as incrementally more and more, both on a process standpoint and in terms of design for automation every single quarter.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Got it. Thank you.

Operator: Your next question comes from Matt Sheerin with Stifel. Your line is open.

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

Q

Thank you. Just another question regarding the supply chain constraints that you're seeing. You talked about $70 million or so left on the table in the June quarter. I would assume that your guidance reflects some confidence in the supply in terms of inventory that you shouldn't see issues, although there could be issues if there's any potential upside from customers. How should we think about that this quarter and into the rest of the calendar year?

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

A

Yeah. The guidance implies the most likely outcome of parts that we'll get. If we get more, we could have upside. If we get less, of course, we could have downside. But we have a pretty good idea about those parts. Most of those parts – a lot of those parts we actually have commitments for and have a line of sight, too, because the quarter ends in, obviously, in nine months – or nine weeks. So, I think we've got – our guidance reflects everything, all the current information that we have available of today, which is I would call a reasonable good visibility [indiscernible] (37:50).

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

Q

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And in terms of the price increases for those parts that you're likely seeing, is that just a pass through to customers?

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

A

Yeah. Ideally – sometimes, there's going to be a timing effect on those and those prices are going to come in. You still have a lot of issues, that's starting with [indiscernible] (38:09) off inventory effects and FX and such. But ideally, as those component prices come in place, it would be our objective to move those costs and move them right on into the customer base. I mean, again, timing could be an issue, just in terms of the timing of what we recover from the customer, as opposed to what we get charged in from the supply base. But it is our objective to recover all the costs associated with this.

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

Q

Got it. And in terms of your commentary on some of the weakness in the IEI business, particularly semi/cap, some of your competitors have also called that as a soft patch now. Is that temporary or do you see a trend there in terms of across your customer base?

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

A

Yeah. We don't necessarily see an uptick in that business at this point and just in terms of our [ph] other profiles (38:58). So I think at this point, we'd have to say that we're just adjusted to a new level. So, the semi/cap system, over the last 10 years, has actually moved from more of a year-long or even a year and a half long kind of down-cycle and up-cycle, to more of a six-month up-cycle, down-cycle. It's actually the waves up and down have gotten shorter. So whether or not that will cover, we're not sure yet. But right now, we don't see this as temporary and then meaningfully coming up again in another couple of quarters. We just see it, right now, down at a more stable level.

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

Q

Okay. Thanks a lot.

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

A

You're welcome.

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

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. Thanks and good afternoon. I wanted to start maybe on CEC turning a corner there. The declines have bottomed and we're going to see some revenue growth next quarter. Should we see any falloff in the third quarter after a very strong 2Q or do those ramps and strengths continue throughout the year? And how can we think about the progression of operating margin in this segment as it returns to growth?

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

A

Yeah. Yeah, so I think what you're going to see is, first of all, as revenue moves into that group, you're going to see absorption of costs and you're going to see margins just naturally [ph] straight (40:21) up a little bit. So, we've been out of our target range for several quarters, and as we go forward, even into this next quarter, we expect to be moving into the target range, and it's mostly on the back of more volume that's coming in.

So whether or not just a onetime blip or sustainable, it's something we've been talking about for quite some time. We actually think data center business and the growth of data center business is going to continue to be robust. We actually have a very good investment profile for reference designs for those customers that are actually now being moved into production. And the other thing we have coming along is 5G.

So, I think what's different about the last couple of years is there are actually structural reasons as to why we would expect this to now turn to a little bit more growth. So, we're still going to be up and down maybe over the next couple of quarters on a quarterly basis, but structurally, you have a higher revenue level associated with this business on the back of 5G and data center growth.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. That's helpful. Maybe just one follow-up for Chris, you outlined at the Analyst Day that $900 million to $975 million of non-GAAP operating profit dollars for fiscal 2019. This would imply, I think, a high-single digit contribution margin in the back half of the fiscal year. I know that you're going to, hopefully, get some help with Nike on a year-over-year basis, but it's still pretty strong ex that. So, if you could help me unpack some of the assumptions and moving parts behind that. Thank you.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Certainly, Adam. One large lever, again, will be the sustainable discipline and productivity around SG&A, which we have an ability to clearly manage that in a controlled fashion, while simultaneously seeing incremental revenue growth each period. So, that's going to be a contributor. Additionally, you have an improving operating performance out of Nike. You have the company across multiple segments, customers and programs being able to digest the ramps and move into meaningful manufacturing sustained volumes which will enable greater absorption at site level. So, you'll have a combination of those levers that play back into having a greater contribution in the back half of this year.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

That's helpful. Thanks.

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

A

Next question, please.

Operator: Your next question comes from Jim Suva with Citi. Your line is open.

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Jim Suva
Analyst, Citigroup Global Markets, Inc.

Thank you very much and especially for all the details thus far. I have one question, probably for Mike and then one for Chris, and I'll ask them at the same time so you can pick and choose the order. But Mike, you'd mentioned a lot of ramping costs and challenges to margins when you ramp up new programs. The question is is this just now the status quo for Flex? Because you should always be having new business coming in as old business goes out. And if the answer is no, I guess the question is when then, all of a sudden, there would be a big uptick in margins?

And then, probably for Chris, I don't think you bought back stock this quarter. I assume that's because of the accounting investigation that was going on, that's now been concluded. Can you update us on your thoughts about putting cash to use? Because I believe you also had negative cash flow this quarter. Thank you, gentlemen.

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

Yeah. So Jim, let me start. So, ramp costs are a fundamental part of the business and that's actually literally never going to change. So, you just can't ship anything unless you bring on the equipment, you buy the inventory, and you hire and train the people, and it's only then that you can actually have revenue. So, that's never going to change. If you have very, very low growth rates, it's going to kind of get washed out and you won't really see it. If you're going to have the growth rates that we're looking at, which is, literally, last year, we saw about a $2 billion growth rate and we're seeing another $2 billion this year. So, you put the two years together, you got a $4 billion level of growth. These are significant programs that are ramping, that are margin scale.

I think I mentioned in one of the other calls that we expect to add about 40,000 people this year. We're not going be able to do that without filling it in the margins. And the answer is, yeah, after you ramp these programs, you're going to see margins increase just as a result of the startup costs dissipating. So, we're going to see that actually happen with Flex as we move towards the back half of this year. We're going to see a lot of those startup costs go away. And we're going to see the benefits associated with those startup costs just starting to dissipate. Simultaneously, we'll see the incremental volumes. Simultaneously, we'll see the lower SG&A and the cost efficiency around how we're running a very, very disciplined operating expense level. And all of that's going to create a margin expansion in the back half of this year. So, that's actually what we're expecting and we're continuing to see that play out.

So, all of these ramp costs that we're seeing in the first part of this year, even though our margins are going up to – I think the center of the range is about a [ph] 3-1 (45:55) or so, which is higher than last year, and obviously better than this last quarter. But we'll see those improvements happen over – even then, we're going to see more and more improvements of margin as we go across the next few quarters.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

And then, Jim, your question on capital allocation, I would start with the underlying premise for Flex, is that we're going to be creating shareholder value with a long-term commitment. In my prepared remarks, I had highlighted the cash flow pressure at the front end of this year. I had made a statement that we had anticipated as we move into the second half of this year, our capital intensity will abate, both in terms of the capital expenditures as well as the level of net working capital that's [ph] chairing (46:45) for us. But I also went on to say that, similar to our fourth quarter in 2018, our last quarter in June here, we were blacked-out from our repurchase program. And our

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shareholder return commitment of 50% or more of our annual free cash flow remains and we intend to resume that this quarter and for the year.

Jim Suva
Analyst, Citigroup Global Markets, Inc. Q

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

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

Paul Coster
Analyst, JPMorgan Securities LLC Q

Yeah. Thanks for taking my question. I'm wondering, Mike, why you started talking about the sort of new tariff regime and your ability to support your customers in the event that they need to sort of rethink the sort of allocation of resources by geography. Is this something that they're talking about and are you already investing in preparation for such developments?

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

Yeah. Well, one of the things is India already put a pretty big tariff on incoming PCDAs and had already created a point of stimulus and demand for us, and we have a relationship with a lot of those customers that were affected. So, that's something that's already in play and happening. The second thing is are tariffs going to change in the rest of the regions. The answer is yes, we're preparing for it. As we look across the world, we actually expect a redistribution of work to occur. Whether or not the tariffs happen or whether they don't happen, it's going to create some pause with our customers to rethink their strategy and maybe diversify a little bit about if there are too much manufacturing into China, that they'll distribute it around the world. So, we're preparing for it because we think it's an inevitable outcome. We think it's the right strategy for customers to actually move their work around and become a little bit more regional.

And so, we're preparing our operations to be a recipient of that. We actually are already seeing a lot of quotes coming in to say – to basically say if I reduced my exposure in China, how much will it cost and should I go to Malaysia, should I go to Mexico or Eastern Europe or where should I go. We're already seeing quote groups come in. It's going to take time to move supply bases around. But it's a very – in our view, it's inevitable that these supply chains are going to become redistributed.

Paul Coster
Analyst, JPMorgan Securities LLC Q

Okay, got it. And then, a quick question, I hate to sort of complain about the possibility that ramping will end, sort of damned if you do, damned if you don't. But does it actually mean the sort of pipeline of sales are wrapping up now and it's got fewer projects in the background ready to ramp in the next fiscal year?

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

Yeah. That's actually a good question. I mean, I think you have to really dissect it a little bit. I think you're going to have – we already talked about India. I think that ramps and those startup costs and that sort of thing are going to be done this year. So, that is something that's already played out. The people that want to redistribute the work have already done a lot of activities to go make that happen and a lot of that work moved. So step two is you got,

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hey, well, people just rebalanced their system on a regional basis just as an ordinary course of distributing risk and not having so much risk in China. So, that's something that can play out over the next year or so and that can actually create some incremental demand for us.

So, I think there's – and the other thing is HRS. A lot of the work that we're doing for FY 2020 and FY 2020 (sic) [2021] (50:35) ramps are actually, the work's being done this year. So, this is a place where we're not even seeing any revenue because the product lifecycles are longer and the ramp cycles and the qualifications are much longer. So, a lot of those ramp costs are playing out this year, which kind of go away the next two years. So, I think it's possible we may have more growth. I think it's great. We have another $2 billion of growth, but I think it's probably more likely that we're kind of going through our burst this year, and I think it will stabilize a little bit as we get into FY 2020 and FY 2021, which the downside is it won't be – maybe it won't be $2 billion of growth, but alternatively, that will immediately turn into much higher levels of free cash flow.

So, it is a little bit of a damned if you do and damned if you don't, but I actually think most of the burst is happening this year. It started two quarters – the last two quarters of FY 2018, and I think as we get into FY 2020, we'll have paid a lot of those ramp-up costs and I think we'll be more of a recipient of higher free cash flow and higher margin and a more stable look of it.

Paul Coster Q
Analyst, JPMorgan Securities LLC

Okay. Thank you.

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

Ruplu Bhattacharya Q
Analyst, Bank of America Merrill Lynch

Hi. Thanks for taking my questions. The first one on IEI, I was wondering if you can give us some more guidance on the expected margin trajectory this year. Which end markets are you seeing improving in the next couple of quarters? And exiting the year, should we still think about operating margin more near the low end of the range or can you get to the 5% midpoint?

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

Hey, Ruplu, this is Chris. So, how I would characterize the IEI is that it's very well-positioned in a rapidly digitizing industrial market. We're coming off of several years of very large bookings. We've seen those bookings manifest themselves throughout this year. We have new programs that we'll be ramping the latter part of this year. We have some transitory issues that we're going through in Q1. We've highlighted how we have drove and returned back into the margin range in Q2. If you'll look back over the last, I think, four years, five years, you'd seen a sequential improvement each year in terms of operating profit, so that trajectory continues. We go from 3% to 3.4%, [ph] 15% to 16% (53:04), and to 3.6%, then we closed out this past year at 3.9%, and we'll be in that range, the low end of our range this coming year. We will not be at the 5% but we will continue to be making structural moves higher inside of IEI's range as we progress forward.

Ruplu Bhattacharya Q
Analyst, Bank of America Merrill Lynch

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Thanks for that, Chris. That's helpful. And then, just a second question on CTG, in general, are – the two programs, Nike and Bose – are they tracking as you had expected or are they tracking slower or faster? And is Bose now at the target margins that you were trying to get to?

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

A

So, I would say Bose is tracking reasonably on schedule. I think there is a lot of ramp issues that we're dealing with right now. They've got a slew of new products that are coming out that we are actively working to chase quite a bit of upside now. So, Bose is a little bit more of a – it's extraordinarily seasonal. So, I would say we have to – we have to chase a lot of parts to make Bose really happen.

As far as Nike, I think we've kind of reset expectations that it's going to be a little bit slower and take a little bit longer. I think it is going to be slower and take longer if I think about the 10-year vision of where Nike is going. Alternatively, it's tracking exactly to where we thought [ph] like (54:39) three months ago. So, we're going to have significant revenue growth this year. We're continuing to expand productivity. We expect margins to move to profitability in the second half of the year. So, I would say we're like right on schedule to where we thought we would be three months ago.

Ruplu Bhattacharya
Analyst, Bank of America Merrill Lynch

Q

Okay, great. Thanks for the color. I appreciate it.

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

A

You're welcome.

Operator: There are no further questions at this time. I will now turn the call back over to the presenters.

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

Thank you very much, operator. I think Mike just want to finish up with a concluding statement.

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

Yeah. I'd like to first thank everybody for being on the call and be interested in Flex. We are finding a number of different ways to partner with our customers and enable our innovation by leveraging our deep cross-industry expertise. So, we are very focused, our company, on execution. We're focused on delivering the opportunities ahead of us, and driving sequential and year-over-year improvements. But thanks, everybody, for their interest and attendance.

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

Thank you. This concludes the call.

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

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