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Flex Ltd. (FLEX)

Q2 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to the Flex Second Quarter Fiscal 2019 Earnings Conference Call. Today's call is being recorded and all lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session.

At this time, for opening remarks and introductions, I'd now 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 thank you for joining us for Flex's second quarter fiscal 2019 conference call. We have published slides for today's discussion that can be found on the Investor Relations section of our website at flex.com. Joining me on today's call is our CEO, Mike McNamara; our Chairman, Michael Capellas; and our CFO, Chris Collier. Following their remarks, we will open up the call to questions with Chris, as well as our two business presidents, Paul Humphries and Doug Britt.

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 filing 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 slides. 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 Executive Officer, Mike McNamara. Mike?

Michael M. McNamara

Chief Executive Officer & Director, Flex Ltd.

Thank you, Kevin. Before we begin our call, I want to take a moment to reflect on my announcement today, that I informed the board of my intention to retire at the end of this calendar year. After 24 years at Flex and having had the privilege to serve as 12 years as a CEO, I believe now is the time for me to step back and allow new leadership to continue improving on what we have built. It has been an amazing journey, and as we have built Flex into an incredibly powerful company that I'm extremely proud of, I want to thank our employees and customers for their support throughout our journey.

Let me now turn it over to Michael Capellas, the Chairman of Flex Board, who would like to say a few words.

Michael D. Capellas

Chairman, Flex Ltd.

Thank you, Mike. On behalf of the entire board, the leadership team and our 200,000 employees around the world, I would like to thank Mike for his dedication and leadership over the past 24 years. Since becoming CEO in 2006, he has built Flex into a global leader with $25 billion in revenues today. We will miss Mike's incredible passion for the business and we wish him the very best in his retirement. Mike will remain CEO of Flex through the end of the calendar year. The board [indiscernible] (02:56) of Heidrick & Struggles has already launched a formal CEO search and we will consider external as well as internal candidates.

Now, I'll turn it over to Chris.

Christopher E. Collier

Chief Financial Officer, Flex Ltd.

Thank you, Michael. As you have noticed, we delivered a solid quarter with results largely in line with our guidance. I'll begin with a summary of our most recent operating results. It will be important to share our focus on how we plan to respond to the current CTG challenges which are causing the majority of the reduction to our previous fiscal 2019 guidance. Outside of CTG, the remainder of Flex is very healthy and performing well, which we will also cover.

Now, please turn to slide 2 for our Q2 income statement summary. Our second quarter sales were approximately $6.7 billion, up 7% versus a year ago and within the guidance range we've provided. Our Q2 adjusted operating income was $224 million, above the midpoint of our guidance range and grew 19% year-over-year.

Our adjusted net income was $153 million, resulting in an adjusted earnings per diluted share of $0.29, which was also above the midpoint of our guidance range of $0.26 to $0.30. Second quarter GAAP net income of $87 million was lower than our adjusted net income due to several adjustments totaling $0.13, which resulted in a second quarter GAAP EPS of $0.16.

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Now, please turn to slide 3 for our quarterly financial highlights. While our gross profit grew 4% year-over-year to $433 million, we saw our gross margin decline 20 basis points to 6.5%. The gross margin pressure reflects unfavorable mix shifts, most notably, inside our CTG business. Our second quarter adjusted SG&A expense totaled $210 million, down 8% year-over-year. We remain confident in our ability to maintain cost discipline to drive productivity gains that will provide operating leverage as the business grows.

Our quarterly adjusted operating income came in at $224 million, up 19% from the prior year, reflecting margin expansion of 30 basis points, for an adjusted operating margin of 3.3%. Several elements contributed to the improved results, notably, increased operating leverage in our CEC and IEI businesses, coupled with increased SG&A efficiency.

Please turn to slide 4 to review revenue by business group. The evolution of our portfolio is a cornerstone of our strategy. All four business groups achieved year-over-year growth and we ended Q2 with a well-balanced distribution across both industries and customers we serve, with our top 10 customers totaling 43% of our sales and we have no customers above 10% of sales.

While achieving year-over-year growth, our CTG business underperformed, as its revenues grew only 2% year-over-year to $1.8 billion, well below our expectation for 10% to 15% growth. Clearly, CTG performance has materially impacted the company's results and we will be focused on rebalancing the mix by addressing three major components of the business: NIKE, India, and core CTG.

Regarding NIKE, we have worked hard with NIKE to make our footwear operation in Mexico technically and commercially successful. In recent weeks, however, it became clear that we are unable to reach a commercial and viable solution with NIKE and have mutually agreed to wind down our NIKE footwear manufacturing operation in Guadalajara by December 31, 2018. We are finalizing the terms and details of the wind-down and we are striving to retain many of our affected employees and to repurpose our facility.

In connection with the closing of the operation, we recognized $30 million of exit costs primarily related to our estimated impairment of fixed assets. We may incur additional costs as we complete the wind-down.

In India, we have invested to capture a unique opportunity created by the newly implemented India tariffs that are driving heightened demand for in-country solutions, coupled with our strategy to operate with a diversified portfolio of leading global multinationals expanding in that market. While we grew our India business in the September quarter, we are unable to bring on additional facility capacity fast enough to support all of the booked business. We anticipate the capacity constraints in India to persist through the remainder of the year, and these constraints are the cause of the vast majority of our revised downward guidance adjustment both for December quarter and the fiscal year.

In our core CTG business, we have struggled to grow and profitably sustain customers across numerous spaces we've been focused, resulting in profit and revenue challenges in this business. We are actively managing underperforming accounts and we are revamping our go-to-market strategy to be selective on partnering with well-funded, leading multinational brands that control multiple categories of products and have regional demand requirements.

As we look to the December quarter, we expect CTG to be down 10% to 20% year-over-year due to the reasons I already outlined. Going forward, we will be focused on metering CTG's contribution level in our portfolio and we will be selective in the programs we pursue. We will focus on delivering margin expansion versus revenue growth and getting back into our targeted margin range of 2% to 4%.

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Our CEC business was a standout performer this quarter, with a growth rate of 13% year-over-year, compared to expectations of 5% to 10%, ending the quarter at $2.1 billion. This growth was driven by momentum from our cloud and data center businesses, as well as the launch of network infrastructure to support 5G programs. In addition, our design capabilities continued to improve and expand, which is leading to new customers and business opportunities, particularly in cloud data center solutions, which grew over 20% year over year. For the December quarter, we expect our CEC business to grow 5% to 15% year-over-year, driven again by new wins in cloud data center solutions and 5G programs.

HRS grew 4% on a year-over-year basis, marking its 35th consecutive quarter of year-over-year growth. Revenue of $1.2 billion was towards the high end of our expectations, as our medical business saw double-digit growth and helped offset automotive end-market weakness, most notably in China.

In our December quarter, we expect HRS to be flat at the midpoint of our guidance of plus or minus 5% year-over-year growth, as medical continues to experience strength and we continue to see softness in the automotive market. We remain very confident in the long-term growth trajectory of HRS, as evidenced by its record level of new business bookings. We have secured $2 billion year-to-date versus $1.3 billion for the entire fiscal 2018, and this is balanced across both medical and automotive.

IEI rose 8% year-over-year to $1.6 billion, in line with our expectation of 5% to 10% year-over-year growth. Past bookings in industrial, home and lifestyle ramped during the quarter, which helped offset softness in capital equipment and energy. For the December quarter, we are expecting IEI revenue growth of 5% to 15% year-over-year, led by continued strength in industrial, home and lifestyle, offset by weakness in capital equipment and energy.

Turn to slide 5 for our operating performance by business group. We are pleased to have three of our four business groups in their target operating margin range this quarter. Let me start this discussion with the business group that is not in the range and that we're determined to fix and have plans to do so. Our CTG business earned $31 million in adjusted operating profit, essentially flat with the prior year, resulting in an adjusted operating margin of 1.7%, which remains below our targeted range.

Despite benefiting from lower NIKE losses, both sequentially and year over year, the business remains pressured as we transition customers and products inside the portfolio. The capacity challenges in India are expected to persist for the balance of this year, and our CTG core is anticipated to underperform, resulting in no CTG margin expansion. As a result, we expect CTG will remain below its target margin range for the remainder of this fiscal year.

Now, let's turn to discuss business groups whose growth have met or exceeded our guidance expectations. Our CEC business generated adjusted operating profit of $63 million, up 47% from the prior year, resulting in a benefit from better absorption from our cost structure with greater revenues, as well as an improved margin mix, with greater concentration of cloud data center solutions and 5G-related programs.

Our IEI business generated adjusted operating profit of $66 million, up 29% year-over-year and achieving a 4.2% adjusted operating margin, back inside its target range of 4% to 6%. The return to its target operating margin range was driven by improved absorption benefits from greater revenues, primarily from new programs ramping in home and lifestyle, offset by reduced demand in semiconductor capital equipment and energy. Consistently operating within the operating target margin range has been a top priority and we plan to remain within this range as we increase revenues from the multiple new programs ramping.

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Our HRS business generated adjusted operating profit of $90 million, which was down a modest 3% year-over-year, and reflects an operating margin of 7.4%. Our macro portfolio of products and services are continuing to see a ramp of operating profits and margins as programs scale and mature, which offset revenue margin pressure in certain parts of our automotive offering, as highlighted earlier.

We continue to successfully ramp many new customers and programs across our HRS business, and remain focused on investments to expand our design and engineering capabilities supporting our automotive businesses, such as autonomous vehicle and vehicle connectivity, as well as multiple products in healthcare. The HRS team remains intently focused on transferring its record levels of booked business into strong organic revenue growth in fiscal 2020 and beyond, and expects to stay well within its target margin range of 6% to 9%.

Turning to slide 6, let us review our cash flow generation and highlights. We generated $120 million in cash flow from operations for the quarter. Free cash flow was a negative $60 million for the quarter just ended as the capital intensity of our business remained elevated, resulting in lower cash flow generation.

Our networking capital was up $126 million from the prior year, primarily due to higher levels of inventory, which are offset by increased accounts payable. Our inventory levels are now at near record levels, given challenges with constraints across multiple component categories. These constraints, which affects all of our business groups, impacted our business by trading revenue, elevating raw material inventory levels and pressure in pricing. We remain focused on driving activities to aggressively reduce our inventory levels over the next couple quarters and returning to historical inventory turn levels.

We continue to execute on our planned capacity and capability expansion as framed out at the start of the year. Our capital expenditures totaled $180 million for the quarter, exceeding depreciation by $78 million. We continue to invest in CapEx necessary to support our expanding IEI and HRS businesses, as well as building out capacity in India.

As we have previously discussed, we expect higher levels of investment in fiscal 2019 to establish the required capacity and capability for our booked business, with clear line of sight to this dissipating late in this year. As we move forward into fiscal 2020, we see ourselves dramatically reducing our CapEx level back below $500 million as our regional build-out in India will be largely complete, and our HRS CapEx will reduce to historical levels as our large expansion investments in HRS will be done. We expect to generate positive operating cash flow and free cash flow in the back half of this fiscal year, as our capital intensity lessens both in terms of lower levels of networking capital and lower capital investments.

Returning value to shareholders through our share repurchase program remains a top priority for Flex. We continue to fulfill our commitment to consistently return value to our shareholders. In this quarter, we repurchased roughly 4.4 million shares for approximately $60 million.

Turn to slide 7 to review our balanced capital structure. We continue to operate with a balanced capital structure with no debt maturities until calendar 2020 and have the flexibility to support our business over the long term.

Before we get into our guidance, let me provide you with a short update on how we see our business being impacted by tariffs and component shortages. Regarding tariffs and trade actions, as we have expected, the reality of their impact is beginning to hit the industry across a broad range of products. We anticipate a redistribution of work with a reduced concentration in China and towards more regional distribution around the world, as many countries provide incentives to support their own manufacturing basis.

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As one of the world's largest supply chain solutions provider in every major non-China region, we should be a long-term beneficiary of this shift. Over the coming year, we expect a significant amount of product volume to be moved into Mexico, Southeast Asia, India, and to a lesser extent, the U.S. and Eastern Europe.

While there have not been significant actual movements of product so far, there has been an acceleration in the planning and re-architecting of supply chains across a broad range of product categories. We are actively working with current and prospective customers to assess and analyze the impacts of tariffs having on their businesses and products, as well as their corresponding manufacturing strategy. In the short term, there remains uncertainty to the actual implementation of global tariff programs, the [indiscernible] (21:35) market demand and what actions our customers will take in response.

Turning to component shortages now, as many of you already know, total passive components remain in short supply and are currently on allocation, which constrains revenue and elevates inventory and pricing. As we forecasted, component shortages continue to be an issue and will likely peak this December quarter, and then, begin to dissipate as we move into the March quarter due to our ability to work with suppliers to secure additional supply. This is reflected in our guidance.

Now, let's turn to slide 8 for third quarter guidance. Guidance for Q3 fiscal 2019 is for revenue in the range to $6.6 billion to $7 billion. Adjusted operating income is expected to be in the range of $220 million to $250 million. Adjusted EPS guidance is for a range of $0.29 to $0.33 per share based on weighted average shares outstanding of 532 million. GAAP EPS is expected to be in the range of $0.19 to $0.23 as a result of stock-based compensation expense and intangible amortization. Our guidance assumes that Q3 operating losses related to NIKE will be similar to Q2 as we undergo exit activities, and that all of our business groups, except for CTG, will operate within their target margin ranges.

Please turn to slide 9 for updated fiscal 2019 guidance. Given the business dynamics we've highlighted today, we wanted to provide an update to our fiscal 2019 guidance we established at our May Investor Day. It is notable that this guidance was before component shortages took hold, but also before, we saw incremental reductions in our India ramp to the tune of nearly $1 billion, as well as smaller incremental pressures in both our automotive and industrial businesses. Our CTG performance has impacted our guidance forecast, and thus, accounts for the majority of the fiscal 2019 reduction in guidance.

Our updated fiscal guidance is for revenue of $26 billion to $27 billion, adjusted operating income of $815 million to $885 million and adjusted EPS of $1.05 to $1.15. The full-year GAAP EPS is expected to be in the range of $0.75 to $0.85, primarily as a result of stock-based compensation expense and intangible amortization and other charges.

Please turn to slide 10 for a business group recap. To sum it up, we have covered a lot of ground on this call, but there are three main points we want to leave you with. First, our CTG business is underperforming. We are focused on returning CTG to its margin range. We took the first step with the decision to wind down our NIKE Mexico facility. We are actively working to focus the remaining CTG business on opportunities that fit our targeted margin profile of 2% to 4%. Secondly, our CEC business is improving ahead of schedule. This was a very strong quarter for CEC and the outlook remains encouraging. Thirdly, our HRS and IEI businesses both are coming off record bookings and record revenue, both are operating in their long-term margin ranges and will continue to contribute to overall growth as we go forward.

With that, let me turn the call back over to Kevin.

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

Thank you, Chris. Operator, we're ready to poll for questions. As a reminder, in addition to Chris, we also have our business group presidents here to answer questions, Doug Britt, as well as Paul Humphries.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] The first question comes from Amit Daryanani of RBC Capital Markets. Please go ahead. Your line is open.

Amit Daryanani
Analyst, RBC Capital Markets LLC

Q

Thanks a lot. Good afternoon, guys. I have two questions. And first off, best of luck, Mike, in the future. Yeah, maybe the first one, I just want to understand what do you guys think went wrong with the NIKE relationship for you, because there was a ton of confidence from both you and NIKE up until a few months ago. So, what do you think went wrong and what are maybe a couple of things Flex has learned from this thing that – from the NIKE dynamic that helps us prevent something like this happening again in the future?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Okay, I would say that we are disappointed where we sit right now. We're limited in what we can say, as we're in the midst of negotiating the terms of disengaging with NIKE. What I can say is we actively build out our operation into a productive system that we are proud of. Part of fixing it was developing the commercial agreement where Flex shareholders would have a sustainable return, and we're unable to come to that agreement with our partner, and thus, this decision.

I think as we step back, NIKE was extremely unique in differentiating and I think that it was an important feature that we went after and we are just being very thoughtful at this stage in terms of where we sit. And since we can't get to a commercial agreement where our shareholders can have a sustainable return, we decided to exit.

Amit Daryanani
Analyst, RBC Capital Markets LLC

Q

All right. I guess broadly, when I think of the Flex portfolio today, right, I mean, you guys are doing – you mentioned CEC is doing better than you expected, HRS, IEI doing really well, could you just talk about why do you even want to keep investing in the CTG business as you go forward? Because if I think about all the challenges you've had in last seven, eight years, they tend to originate from this segment, right, be it the BlackBerry or PCs or now NIKE. So, why even bother to keep investing in this versus maybe just run this as cash cow and invest in other three businesses which, I understand, have lower growth potentially but seem to be a lot more sustainable with less headache?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Yeah. Certainly, we've seen a lot of volatility with that business. There are benefits that we see...

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[Technical Difficulty] (28:58)

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

There are benefit that we see with operating that within our portfolio. However, that needs to be at a very metered level. We get benefits in terms of technology adoption. We scale across our – and leverage our overheads as well as supply chain. So, we're going to be hyper-focused with regards to the contribution level in our portfolio that it plays and are going to be very selective as we move forward with who we partner in that space.

We are focused on margin and not revenue inside of this business. But as we were highlighting, we've been making significant investments across the rest of the business that's performing very, very well. We've amplified the level of investment we put to HRS and IEI and that remains a focal point. So, I think that – well noted the volatility in CTG and I think what you're going to see is a much more metered approach, very selective, very disciplined in terms of operating that within our portfolio, with a focus on our business driving greater margins, driving better earnings leverage and having real strong, sustainable underlying product lifecycles.

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

A

Next question, please.

Amit Daryanani
Analyst, RBC Capital Markets LLC

Q

Perfect. Thank you.

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

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Yes, good afternoon. Thanks for taking the questions. First question, I was hoping, with the updated guidance, you can help us understand the full-year losses that NIKE is contributing to this year's numbers, and I understand that the goal is to end that relationship by the end of this fiscal year. Do you anticipate having stranded costs that can maybe last beyond the end of this, I'll say, calendar year? Do you anticipate losses or stranded costs to continue after the end of the year?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Certainly, Mark. As we highlighted, we will be winding down that operation by the end of December. That will cease. We had guided the Q3 to include losses for NIKE in the same range, stable with what we just absorbed in Q2, and there will be no losses as we move forward. We will cease that business. So, that's been contemplated in how we structured and guided our Q3. And as we talked about earlier in the year, those losses had been abating as we move through this cycle.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

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Okay. And then, for a follow-up question on CTG more broadly, maybe you can just give us a better sense of the scope of the magnitude that you're considering within your CTG portfolio. It seems like there's maybe business that Flex will be disengaging in and trying to get a sense for how much revenue that could potentially encompass. Thank you.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Certainly. I'll let Doug weigh in here on CTG.

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

Hi, Mark. How you doing? So the overall CTG business, what we're looking at is we've been actively pruning the engagements with loss-making accounts over the last six months. We are revamping our go-to-market. We concentrate on the larger customers that have a broad portfolio of products and we're very disciplined on our commercial management to ensure that the business we bring is achieving the profitability levels within our guided range. So, we've been doing a lot of pruning in the business. It's taking some time. It's taking some effort. We're confident that we'll reposition the portfolio and we'll get this business back on track.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Maybe just to ask it a bit more simply, I mean, there's a number of issues going on in CTG and it seems like some of these issues could take quarters to – or several quarters to resolve. So, is there a timing we can have in mind to when CTG is back within the target margin range?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Yeah. Clearly, one of the things we identified here is that it'll take over the remaining part of this year. We'll be underperforming. And that is really not going to happen in fiscal 2019. We do take time and does the same. We're very active right now in going through the portfolio and eliminating those customers that are not viable long term, not strategic and do not provide a returning cash flow sufficient for the company. We would expect significant improvement as we move forward into 2020. We're just reassessing, as Doug highlighted. We're assessing multiple product categories, eliminating some of the businesses that we've been entering into, and just really honing in and refining and streamlining our engagement around CTG.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Understood. Thanks very much.

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

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. Thanks and good evening. So I just wanted to start, fiscal 2019 EPS was taken down by $0.15 for remaining two quarters. Can you maybe just help us think about fiscal 2020 EPS in light of this? Would it be fair to

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annualize the reduction today and think about a $0.30 hit to the $1.55 you talked about at the Analyst Day or does the lack of NIKE losses provide some offset? Just any help with the buckets would be helpful.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Yeah, certainly. Where we sit today, we just don't think it's appropriate to endorse getting back out really into 2020 with a lot of uncertainty in terms of the tariff environment. But what I can tell you is when you think about how we were moving the portfolio to achieve at 2020, there's a large part of our business that is intact.

If you think about the IEI business and where it's growing and the record bookings it's coming off of back inside the target margin range, its contribution will be healthy for next year. HRS, likewise, it's coming off of record bookings right now. It will [ph] helpfully (35:31) stay within that margin range and we see its contributions nicely into next year.

Jump into CEC, we're really pleased with where it has returned to growth and it's centered itself well within its margin range. And again, we've been positioning ourselves with some nice underpinning customers and programs that give us a degree of confidence as we move into next year. It just rather points back into CTG. And so, a lot of volatility there, a lot of uncertainty, as we have bridged out that view last time, we had [ph] part of (36:05) that is contributing pretty meaningfully to our growth. And obviously, the NIKE will be eliminating that loss that we carried this year. So, that's a plus in terms of year-over-year.

So, CTG is just going get healthier as we move forward. It's going be a lot smaller than anticipated. And I would say on balance, the rest of the moving parts that we had identified are largely intact. So I think just step back and if you think about it, it's the CTG area that we're focused on. It's going to take a little time. It's going to be depressed from the levels we had anticipated but the rest of that business is growing and positioning itself as intended.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. And maybe just as a follow-up, if Mike could comment – and best of luck in future endeavors – but I'd imagine one of the questions that might come up tomorrow for us is NIKE was supposed to embody the move of non-traditional customers, the EMS and moving more towards strategic relationships with customers. Can you just maybe reflect from an industry level perspective how we can think about whether or not the thesis is still intact and why this development today is more of a one-off than a case study? Thanks.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Yeah, certainly. I'll answer for Mike.

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

A

Yeah. Go ahead, Chris. Thanks.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

NIKE was something that was unique and it was positioned in a completely new industry that we're trying to revolutionize. We are entering into many different arrangements with many different customers on finding new

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ways to engage our platform and not to stray far from our platform, our capabilities and competencies and engage in meaningful ways to grow the business.

I would think that we'd shown some examples of those at our Investor Day, where we've done so. And I would just probably turn this over to both Doug and Paul to maybe elaborate how we're playing differently within their spaces.

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

Yeah, we've articulated it in our Investor Day, but the platform that we have, the overall global regionalization and digitization that's happening across industrial is accelerating. We've got a solid pipeline. And what's happening as this digitalization is moving forward, these customers are looking at how they modernize their supply chains and bring new supply chains in [ph] new markets with new (38:24) technology. That's why you see really the strength of our bookings and revenue and margin expansion over the last five years in the industrial business.

If you look at what's happening in the CEC business, there are some structural shifts that are occurring in CEC. We have the beginning of the build-out of the 5G network and network connectivity infrastructure is being built out now. We're benefiting from the bookings that we recorded back in Q4 that I articulated at our Investor Day. We're also seeing the acceleration of cloud opportunities across a bunch of new customers that we've revamped our approach with. That market is changing also the way that they're looking at sourcing decisions. They're look at more regional plays. They're looking at partners that can protect IP. Data security is important. And it puts us in a very strong position because we're very strong globally and we're very strong regionally and it provides an opportunity for us to bring a unique business.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Maybe Paul can add to that.

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

A

Yeah. From an HRS perspective, you've heard me talk in the past about the value of leveraging the competencies that exist across for that – to Flex to be able to target new markets in automotive. We see that key area focus for us going forward is autonomous, where we've been able to leverage the expertise we have in our [indiscernible] (39:55) group to develop new solutions for some of the key OEMs in the autonomous space. But [indiscernible] (40:03) expertise combined with automotive expertise is actually giving us a differentiating capability and we're seeing a lot of improvement as a result of that, a lot of growth as a result of that.

And if you think about medical, we're seeing a huge shift in medical throughout connected devices and digital health platforms. And again, leveraging the expertise of our platform, we've been able to build a strong capability in connected medical devices, and that, again, is contributing to the growth that we're seeing, not only this year but as we go out into 2020.

So I think the platform strategy, we've talked a lot about the value that that brings and I think we have actual, solid examples where we see significant growth as a result of being able to leverage that.

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

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Just to recap, I think we are just going to continue to move into some of these non-traditional markets, such as industrial, such as automotive and medical, where we can benefit from the greater margins, the underlying product lifecycles, and we just are not going to stray too far from our core.

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

Next question, please.

Operator: Your next question comes from the line of Steven Fox of Cross Research. Please go ahead. Your line is open.

Steven Fox
Analyst, Cross Research LLC
Q

Thanks. First off, I was wondering if you could maybe elaborate on some of the constraints you're having in India. Is it – relative to 90 days ago, was it an execution issue on bringing up planned capacity or is this unplanned demand that you're having trouble meeting? And then, I had a follow-up.

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

Yeah, certainly, Steven. What we have is we've had significant amount of demand that we're undertaking. And we've been having some challenges bringing up capacity, capacity being in terms of the facility necessary as well as other line capacity, given some challenges just in the infrastructure that exists over in India. In particular, we had a facility that just taking longer to come online than anticipated and that's going to take us a bit of time into the back end to this year to bring on that capacity to then be in line with the demand that exists today. But we're being very thoughtful in terms of the levels of investment that are going to go into that and how to support that capacity need, and be very measured.

Steven Fox
Analyst, Cross Research LLC
Q

Understood. And then, just in terms of the IP that was developed around the NIKE relationship, can you talk about whether you keep ownership of any of it or does that all go to NIKE? What happens with some of those assets? Thanks.

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

Yeah. Steve, we're just not going to be able to expand much on that. We're pretty limited right now as we're in the midst of negotiating in terms of the disengagement with our partner. So, we just – we aren't going to address that.

Steven Fox
Analyst, Cross Research LLC
Q

That's fair enough, Chris. Maybe just put another way real quickly, how do you look at just sort of your broad base of technology skills? Are there things now that you have to tear down based on some of the experiments you got into in the last couple years or do you think that everything that you have is still applicable one way or another? And that's all I had.

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

Certainly, Steve. So, I mean, there's a fair amount of good learning and benefits that we've captured in terms of automation and other activities in terms of manufacturing that are transferable into other areas of our business. I would think if you looked across broadly the portfolio, there's really no other area that we're stretching beyond our core – or beyond our capabilities. So, I think that we are – what you're hearing from us is a real measured approach and a refinement in terms of how we really think about one area being CTG. But more broadly, we are – I think we have a good, deep set of expertise and skill set that's building, that's enabling us to win significant new parts of business. So, that's where our focus is going be.

Steven Fox
Analyst, Cross Research LLC
Q

Thank you very much.

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

Thanks.

Operator: Next question comes from the line of Paul Coster of JPMorgan. Please go ahead. Your line is open.

Paul J. Chung
Analyst, JPMorgan Securities LLC
Q

Hi. This is Paul Chung on for Coster. Thanks for taking my question. So given the NIKE lessons learned, how much tradeoff on kind of revenue growth should we expect as you look for more margin-accretive deals?

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

So, I'd like to just start by highlighting – if you think of the portfolio evolution that we've been under and even in terms of just this past quarter the level of revenue expansion that we've seen in our non-traditional areas such as IEI and HRS and the capture rate that we have of over 60% of profits there, both of those being inside the target margin ranges, both with record level revenue, both with record level bookings. I think that you're seeing us building a very strong book of business and ability to compete and win significant business as we move forward, and that's exactly where our focus is going to be.

Paul J. Chung
Analyst, JPMorgan Securities LLC
Q

Okay. And then, just on the CEC segment, you had a nice spike there. So with scale, do you expect kind of operating margins to trend the higher end of the CEC range maybe in fiscal year 2020? Thank you.

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

I'll just give my view here and I'll let Doug expand. But we're very pleased with the trajectory that CEC is on right now. It's returning to growth. It's now moved its way back into its margin profile. It's benefiting from a good mix of business as we've shifted to greater percentage inside of the cloud data center as well as 5G developments. And we're benefiting greatly from capacity utilization, given the greater volumes we're running through that business.

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So, we have our stated range for a purpose. I think we're pleased with entering into that range and we would anticipate staying well within that range as we move forward.

Do you want to expand [indiscernible] (46:16)?

Douglas Britt
President-Integrated Solutions, Flex Ltd.

A

Yeah. [indiscernible] (46:17) that our investments in design and engineering have been yielding. We've been developing deeper relationships with our customers by adding more value. And there's such a disruption occurring in this market and we're in a very good position to benefit from this disruption based on all the different locations we operate and the supply chain we drive globally. So, it's great to see the team work so hard to get this business growing again. So, I'd like to congratulate the team for a great quarter.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Thank you.

Operator: We have time for one more question, and that is from Matt Sheerin of Stifel. Please go ahead. Your line is open.

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

Q

Yes, thank you for fitting me in. Just another question regarding the CTG revenue shortfall, at midpoint, you're looking at down 15% year-over-year. So, that's roughly $350 million or so. What percentage of that is due to the issues in India and unable to ramp into your previously – projections versus deselecting revenue versus expectations that you had for NIKE revenue in the quarter?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Yeah. So – hey, Matt, this is Chris – there's no impact in terms of that from NIKE – no meaningful impact from NIKE. As we were highlighting, the majority is from delayed ramp inside of the India but as well, significant repurposing, revisitation and refinement inside of the core CTG, as Doug alluded to, as we're thinking through that business and how we refocus efforts. That core has actually had more of an erosion on a year-over-year basis that's indicating that tip of the guide.

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

Q

And looking to – I know you don't have a ton of visibility into your March quarter, but should we assume that it's going to be down year-over-year in a similar rate if you kind of flow through the seasonality in that business?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Yeah, I would say that we anticipate having several of these sustained aspects continue. Our fiscal 2019 guide already reflects CTG continuing to have pressure. I would say that we will be rebalancing that portfolio, and as I also highlighted, we will be under pressure in terms of the margin as we go through that transformation.

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

Q

Okay. And then, relative to the capacity that you have now in Guadalajara due to NIKE, I believe that was like 1 million square foot facility. So if you think about it in terms of deploying your traditional [indiscernible] (49:13) board assembly equipment, et cetera, what kind of revenue capacity will we be looking at, because that would be an opportunity, as you said, your customers shifting out of China to places like Mexico. So, what should we think about the opportunity to fill that capacity?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Yeah, certainly. As we highlighted in the prepared remarks, we're working hard and striving to retain most of the affected employees, as well as to repurpose the factory capacity in Mexico. We're active in negotiations with NIKE. I think the other point to notice is that we highlighted the tariff environment is providing a lot of discussion with current and prospective customers around relocating business away from China into other regions. That regional distribution is going to be heavily seen inside of Mexico. We have the largest footprint and capability set to offer customers inside of Mexico and I would anticipate our ability to partner in an effective way, we'll be seeing.

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

Q

Okay. And just a quick follow-up, you just mentioned that you used the term negotiate with NIKE. Does that mean there could be some settlement in terms of some of the costs that you've incurred or they'll share some of those costs?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

Yeah, Matt, clearly, we're going to be limited in what we can say with regards to that. We're really in the midst of negotiating terms of the disengagement with them, and we'll leave it at that.

Operator: I would now like to turn the call back over to Mr. Kessel for closing remarks.

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

Thank you, and thank you for dialing in. We will see many of you at upcoming conferences, RBC and Raymond James. This concludes our call.

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

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