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Flex Ltd. (FLEX)

Q4 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

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

Kevin Kessel

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

Thank you, and thank you for joining Flex's fourth quarter and fiscal year end 2019 conference call. Slides for today's discussion are available on the Investor Relations section of our flex.com website.

Joining me on today's call with some introductory remarks will be our Chief Executive Officer, Revathi Advaiti; and our Chief Financial Officer, Chris Collier.

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

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

Now, I would like to turn the call over to our CEO, Revathi Advaiti. Revathi?

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

Thank you, Kevin. Thanks, everyone, for joining us. I'm excited to join all of you today on my first earnings call. Let me start off by saying that I joined Flex for its immense manufacturing platform and my passion for manufacturing. The last couple of months has validated for me that we need to get back to basics and focus on our core. This will help us fundamentally improve our execution in a sustainable way, leading to improved margins and free cash flow.

It has been a busy couple of months since I started. I've been traveling around the globe meeting and talking to our customers and employees. This is how I formulate my thoughts and our objectives as we move forward. I'd like to talk about two things that are important to our future: the first is our culture; and the second, our short and medium-term goals.

Let me start with culture. What I have learned about Flex and our employees is that we are extremely passionate about what we do. Our customers have shared with me that the Flex culture is uniquely customer-focused, and they work hard to meet their most important needs.

The other part of the culture that excites me is the speed and agility of this organization. The teams are entrepreneurial and open to change. What I've also seen is true process and product innovation across a diverse portfolio. Our teams have welcomed me with great excitement and ready and enthusiastic about our future journey together. I wanted to take a minute and thank my Flex colleagues around the globe for the warm reception.

In the short to medium-term, I see a tremendous opportunity for Flex. Our core business is sound, but there are many opportunities to improve. My initial view is that we have to focus on disciplined sustainable execution on our core business processes.

I see lots of room to improve our productivity and fixed cost in our factories and to drive basic process discipline around managing our working capital. What we will do differently is laser focus on the core business and drive operational excellence to consistently improve margins.

On the growth front, we continue to see the potential in technologies like industrial IoT, connective medical devices, autonomous medicals, 5G networks and data center infrastructure that touch a wide range of our global customer base and leverage our expertise in manufacturing and supply chain solutions.

Our breadth of global and regional manufacturing also uniquely positions Flex as one of the key market leaders. Growth is important, but we will be selective in where we grow and will rigorously assess its fit to our core portfolio. In the past couple months, we have become more disciplined in focusing on growth areas that will drive margin improvement and clearly display value for us and our customers.

Now, as we look at our business segments, we have the advantage of a diversified set of capabilities across many verticals and a great customer base. However, we must be more selective and disciplined about how we harness these growth opportunities and improve the quality of our business mix.

CEC remains our largest business unit servicing our core technology customers. We continue to evolve the portfolio towards emerging market trends like cloud and data center solutions and the forthcoming 5G rollout, and drive improved margins through product innovation. Our focus in this segment will be to drive sustainable growth.

HRS is critical to changing our mix. We will continue to invest in this business and benefit from the longer, more stable product life cycles. Innovation on process or product remains critical to how we grow this business, and the potential for this business really excites me. Our investments in HRS are paying off and we're seeing strong bookings in this business.

And similar to HRS, IEI has more complex configurations that allow us to take advantage of higher design content. As most of you know, I understand this business segment well and I'm committed to finding the right areas for growth. I believe we're structurally positioned for profitable growth in this segment.

CTG clearly has created the greatest volatility for our overall business. We're absolutely committed to actively managing the mix of business in CTG, and being very selective with customers and product categories. We will reposition our portfolio and eliminate non-performing customers. It is our intent to operate this business with appropriate risk-adjusted returns.

Overall, we're taking a long-term view towards value creation and we'll be focused on executing the business model to support sustainable organic growth, while providing return of capital to shareholders. So the mantra in the short-term will be reestablishing disciplined sustainable execution around a few key priorities that will consistently improve margins and generate free cash flow.

I will talk a little bit more about this later, but first let me briefly review the results for the year. Since this quarter marks the end of fiscal 2019, I would like to reflect on the company's overall annual performance. During fiscal 2019, we grew revenues \$865 million or 3% to \$26.3 billion; increased adjusted operating income dollars by \$86 million or 11% to 872 million; expanded adjusted operating margin to 3.3% from 3.1%; and had a 4.6% increase in adjusted EPS to \$1.14 from \$1.09.

Last year was highly volatile as we went through several organizational changes and business changes. And we fully acknowledge that we must not only continue to improve results, but also be more consistent in the way we communicate. That said, we have positive updates in our results and action to-date.

Capitalizing on prior-year investments, we achieved strong bookings in both of our higher-margin business groups, HRS and IEI, totaling a combined \$4.9 billion. We revamped our go-to-market strategy in CEC and experienced strength in both cloud data center and telecom, driven by both 4G and 5G, which helped returning to growth.

We began the process of rationalizing our CTG business, including stabilizing operations in India and exiting our footwear business in Mexico. We also streamlined our investment portfolio, and we returned to strong free cash flow generation in the second half of the fiscal year.

Going forward, here are four things that you can expect from us. Firstly, we will drive disciplined sustainable execution around customer performance, improving margins and generating free cash flow. Secondly, we will

manage our mix by investing in our higher-margin segments, but being selective in the markets and product categories we focus on. Thirdly, we will pursue Sketch-to-Scale opportunities which we define as design-led engagements that lead to full manufacturing and supply chain relationships. And, lastly, create value for shareholders to a return to strong free cash flow generation with disciplined capital allocation.

Now, I'd like to turn it over to Chris to expand on the fourth quarter financials, and then I'll come back with some concluding commentary before the Q&A. Chris?

Christopher E. Collier

Chief Financial Officer, Flex Ltd.

Thank you, Revathi. Please turn to slide 3 for our Q4 income statement summary. Our fourth quarter revenue was \$6.2 billion, down 3% versus a year ago and towards the low end of our guidance range. On all four of our business groups, we're within the revenue guidance ranges, albeit some on the lower end.

Our Q4 adjusted operating income was \$204 million, which was within our guidance range and up 2% year-over-year. Our adjusted net income was \$141 million, resulting in adjusted earnings per diluted share of \$0.27, which was within our guidance range of \$0.25 to \$0.28.

Fourth quarter GAAP net loss of \$64 million was lower than our adjusted net income due to adjustments for stock-based compensation, intangible amortization and several non-recurring charges totaling \$206 million or \$0.39 per share. This resulted in a fourth quarter GAAP EPS loss of \$0.12.

We streamlined our investment portfolio which resulted in a non-cash impairment charge of \$119 million. We also continued to take targeted actions to optimize our business, most notably within our CTG business where we have been rationalizing and pruning underperforming accounts, as well as eliminating certain non-core activities as we reposition it to align with go-forward company strategies. This resulted in restructuring and impairment charges of \$37 million, of which \$19 million were non-cash in nature.

Now, please turn to slide 4 for quarterly financial highlights. Year-over-year, our adjusted gross profit decreased to \$408 million, while our adjusted gross margin declined 10 basis points to 6.6%. The gross margin pressure is reflective of various business mix shifts, which were most notable inside HRS due to lower automotive revenue. Additionally, we experienced some transitory operational inefficiencies as we ramped new programs within our CEC business.

Operating with a stronger cost discipline has been a big focus the past two quarters, and the results can be seen in our fourth quarter adjusted SG&A expense which declined by 11% year-over-year to \$204 million. We remain focused on driving further productivity improvements and refining our cost structure, while balancing investments into our design and engineering capability with the objective of delivering sustainable operating earnings leverage.

Our quarterly adjusted operating income came in at \$204 million, which is up 2% from the prior year and reflects a year-over-year margin expansion of 20 basis points to 3.3%.

Please turn to slide 5 for our fourth quarter business group performance. I'll begin with our most profitable business, High Reliability Solutions, or HRS, which is comprised of automotive and health solutions. Consistent with our guidance, total HRS revenue was \$1.2 billion, down 4% year-over-year. HRS's adjusted operating margin was 7.7%, versus 7.8% in Q4 of the prior year.

Our automotive business continued to be impacted by market softness, most notably in China which has directly impacted our largest automotive customers, resulting in Q4 revenues declining 12% from last year. For fiscal 2019, automotive revenue declined 5% to [ph] \$2.8 million (00:14:37).

Despite the macro headwinds we have faced in 2019, we remain pleased with our global scale, diversified products and services and domain expertise, all of which led us to securing our single-largest design contract for a Level 4 autonomous compute module this past year, which also included the associated manufacturing contract.

We believe we are well-positioned on the secular trends of electrification, increasing connectivity and autonomous features. And with our recent bookings in North America, Europe and Asia, we're confident that customers recognize the value we bring across design and manufacturing in these growth areas.

Fiscal 2019 marked the year we began to show meaningful growth in health solutions. Its Q4 revenue was up 10% and has consistently grown revenue year-over-year every quarter in fiscal 2019, and ended the year at a record \$2 billion. We've benefited from our prior-year investments in design, engineering and automation that led to new customers and programs and drove delivery, diagnostics and medical devices, as we captured record-level bookings in this business which positions us well as we move forward.

Next, revenue from our Industrial and Emerging Industries, or IEI business was \$1.5 billion, down 8% year-over-year and was at the lower end of our expectations for flat to down high-single digits. The Q4 revenue decline was driven by anticipated weakness in both semiconductor capital equipment, which was significantly down, and energy. IEI is structurally positioned for growth as it continues to capture strong bookings from some of the world's largest diversified industrial companies.

Despite the lowered revenue, IEI grew its adjusted operating profit by 8% to \$73 million; and its adjusted operating margin was a strong 4.8%, up substantially from 4.1% in Q4 of the prior year. IEI continues to benefit from solid execution on various new businesses that it is ramping and greater levels of design-led engagements.

For Communications and Enterprise Compute, or CEC, revenue was \$2 billion, up 6% year-over-year, making this the third consecutive quarter of year-over-year revenue growth. However, this performance fell on the lower end of expectations of 5% to 15% year-over-year revenue growth. CEC's adjusted operating margin was also below our expectations coming in at 2.2%, down 20 basis points from the prior year.

Our Q4 revenue growth was driven from our increased participation in both hyperscale and edge computing programs and the 4G and 5G network infrastructure build-out. However, we experienced weaker-than-forecasted demand from several of our customers in networking, which pushed us to the lower end of our expectations.

In our Consumer Technologies Group, or CTG business, revenue was \$1.5 billion, down 7% year-over-year and within our expectation for the group to be flat to down high-single digits. CTG's adjusted operating margin was 1.6%. We continue to reposition our CTG portfolio and rationalize and prune underperforming accounts as we continue to manage the mix of this business. We will continue to be more selective with our CTG customers and product categories. In addition, as we continue our near-term portfolio rationalization during fiscal 2020, we expect CTG's profitability to remain under pressure.

Turning to slide 6, let us review our cash flow generation. Fiscal 2019 saw a completely different cash flow execution between the first half and the second half of the year. As we highlighted back in our Q2 earnings, we

had expected a solid return to positive adjusted operating cash flow and free cash flow generation in the back half of this fiscal year as our earnings improved and capital intensity lessened.

This quarter, we generated \$246 million in adjusted cash flow from operations and \$120 million in free cash flow. This brought our second half free cash flow generation to be \$493 million higher than the first half. This resulted in a second half free cash flow conversion of 77%. Our Q4 free cash flow conversion was 85%, which it is improving and is returning towards historical levels.

Our capital expenditures totaled \$126 million for the quarter. We continue to invest in the CapEx necessary to support the underlying higher-margin, long-term programs in our IEI and HRS businesses. Our fiscal 2019 net CapEx totaled \$631 million and reflected sizable investments into the regional build-out of our India capability and capacity.

As we look forward into 2020, we expect that our CapEx will more closely align with our annual depreciation levels, thereby providing improvement to our free cash flow. It is our goal to consistently be generating positive adjusted operating cash flow and free cash flow as we move forward. We remain committed to returning greater than 50% of our free cash flow to shareholders via share repurchases. During our fourth quarter, we repurchased roughly 6.6 million shares for \$65 million.

Turn now to slide 7 to review our balanced capital structure. We continue to operate with a balanced capital structure with staggered debt maturities and with a relatively low average cost of debt. We ended the year with \$1.7 billion of cash and access to liquidity that supports our long-term business growth objectives.

Please turn to slide 8 for our first quarter fiscal 2020 guidance. Revenue is expected to be in the range of \$6.1 billion to \$6.5 billion based on the following business group year-over-year revenue expectations. For HRS, revenue is expected to be flat to up low-single digits as we anticipate the auto demand environment to remain muted and we continue to see solid demand growth in our health solutions business.

We expect IEI to be up mid to high-single digits as we see several new programs ramping in home and lifestyles, and we continue to experience weak demand in our semiconductor capital equipment.

CEC's revenue is expected to be flat to up mid-single digits with the same strength in our cloud and datacenter solutions business and improvement in 4G and 5G spending, offset by legacy networking demand erosion.

And for CTG, we expect revenue to be down 15% to 25%, reflecting the effects of our consumer portfolio rationalization and a softer demand from certain consumer customers.

Our adjusted operating income is expected to be in the range of \$195 million to \$225 million. Interest and other expense is estimated to be approximately \$50 million to \$55 million. We expect our tax rate in the first quarter to remain in the mid-range of 10% to 15%.

Adjusted EPS guidance is for a range of \$0.25 to \$0.29 per share based on weighted average shares outstanding of 517 million. GAAP EPS is expected to be in the range of \$0.18 to \$0.22 after reflecting the impacts of stock-based compensation expense and intangible amortization.

We remain focused on improving the way we operate our well-balanced and diversified portfolio of businesses, and continue to do more to propel disciplined and consistent execution to drive greater productivity, margin leverage and free cash flow in our business.

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

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

Thank you, Chris. While we're only providing Q1 guidance today and at this point it's too soon for me to commit to the detailed fiscal 2020 guidance, there are a few things that I'd like to reinforce about my 2020 views and expectations.

Firstly, through my reviews of my executive team, I'm comfortable with the fiscal 2020 consensus adjusted EPS range that spans from \$1.20 to \$1.30 and currently sits at \$1.25. Our teams are focused on meeting and/or exceeding those levels. Next, we're structured and committed to returning to consistent free cash flow generation and get back to our historical levels that would result in a vastly improved free cash flow conversion. Lastly, it is my intent to establish a consistent and sustainable track record that you can have confidence in.

To summarize briefly, we have a heightened awareness that we have more to do than improve the consistency of our performance and realize the full potential of our business and drive attractive shareholder returns in the future. As I said before, my preliminary view is that we have lots of room to improve productivity, reduce fixed cost and working capital while enhancing the customer experience.

We're already pursuing in a highly prioritized fashion the short and medium-term actions that will drive this improvement. The team is ready and energized to do so, and so am I.

With that, I'd like to have the operator open the line for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And your first question comes from the line of Mark Delaney from Goldman Sachs. Your line is open.

Mark Delaney

Analyst, Goldman Sachs & Co. LLC

Q

Yes, good afternoon. Thanks for taking the question and, Revathi, thanks so much for all the detailed thoughts about your plans and initial impressions of Flex. I was hoping to start there, if I could, and appreciated the comments about the goal of improving margins and having a more sustainable mix of business going forward. One of the things you mentioned to try and achieve that is being a bit more selective on the types of programs that Flex is taking on. And I know there have been some efforts there to be a bit more disciplined and [indiscernible] (00:27:09) programs.

As you are evaluating the business, sounds like there may be more there still to come in particular in CTG, but maybe other areas as well. And so, am I understanding that correctly? And if so, any more details on the potential size of those programs that may be [indiscernible] (00:27:26) as you think about improving the mix of business? Thanks.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

Mark, thank you for that question. I'd say that that's a decision that we're making on an ongoing basis. And even in the last couple of months, as I've said, we've been very consistent in how we look at growth opportunities and how we're evaluating them. I can't size it for you at this time, but our plan for CTG is profitable growth, and we only focus on programs that drive it in that direction. And if that means that we walk away from certain growth opportunities that don't fit the profile of business that we are looking for, then we are ready and accepting to do that.

So it's hard for me to size this at this point in time. But as we're evaluating the portfolio, we're looking at the parts of the business that makes sense to grow, and the others that we think doesn't fit us as part of our overall portfolio, and, frankly, where we can create value for our customers and for ourselves. And that's the way we're evaluating it. So I don't want to size it at this point in time and give you a number. But it's a very disciplined process of evaluating every growth opportunity, and that's what we're doing.

Mark Delaney

Analyst, Goldman Sachs & Co. LLC

Q

That's helpful. And a follow-up along those same lines of margins. And, Revathi, both you and Chris, in your remarks as well you talked about being very focused on margins and cost. And as you are evaluating what that may mean, are you contemplating additional potential SG&A cuts or is this more about how you're running the factory network? Any more details on that would be helpful. Thank you.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

Mark, I'd say that is important for us to improve our gross margins, and we have to do that in how we run our factories and managing our mix. And, fundamentally, the sustainability of the business is based on driving that. So

that is important to us. That being said, Chris has said in the past that we have taken a pretty significant cost program on SG&A improvement and have implemented that in the last half of the year. Our plan is to continue to manage SG&A consistent with the revenue levels of the business, and we're driving to that. So that is a more longer term sustainable way to think about this.

Chris, anything to add?

Christopher E. Collier
Chief Financial Officer, Flex Ltd.

A

No. [ph] I think you're correct (00:29:51). I mean, we have taken some real distinct action in terms of our cost structure we're operating. We now brought that back down into the 3.2% of revenue and we're going to be laser-focused on sustaining that to drive meaningful leverage as revenues increase.

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

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Hi, thanks. This is Paul Chung on for Coster. Thanks for taking my question. So first up on HRS, can you just talk about the trends you're seeing there that can kind of get – jumpstart revenue growth there. We know auto has been weak, as you mentioned, kind of dragging on overall growth. But just want to get a sense to see where you see opportunities, whether it be regions or particular verticals and are you kind of reallocating resources and capacity there since it is your highest-margin segment?

Revathi Advaiti
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. So thanks for that question, Paul. I think HRS, as I said in my opening remarks, both medical and auto in those businesses are very important to us growing and growing profitably, and both segments are fundamentally important. I also said in my opening comments that if you look at both businesses put together, we've had a very strong bookings year for those businesses in 2019.

That being said, the underlying thesis was that automotive had a slower market than we expected going into the year and we saw the effect of that. However, we've managed to evolve the portfolio extremely strongly even with that with very healthy margin position. Health solutions is very well-positioned, taking advantage of all the macro trends. We have good process innovation and design innovation that's driving that growth.

So if you look at our overall outlook that we've given for Q1 on flat to low-single digits growth for that business, it is built with some softness in auto and a healthy growth in our health solutions business, but we see that the bookings profile in automotive helped us in the second half of the year in terms of going above market.

So that's kind of how the profile is built out. But it is a strong portfolio for us and very technology-led growth opportunities in that business, and I'm really excited to see us spend more capital and manage that business with a stronger growth outlook moving forward.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Got you. And then my follow-up on CTG, so when can we kind of expect some operating margins to kind of hit within target levels? Before Nike, you were at around 2.8%. And now, with Nike in the rearview, what other kind of

variables are causing CTG margins to kind of remain below 2%? How do we turn that corner? I know you aren't culling the portfolio, but just any other color there? Thanks.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

So, Paul, I'd say our work on CTG is not done. I think Chris said that in his comments and I said that in mine is that we have to continue to manage the portfolio of that business. We have to reposition non-performing customers. We have to manage the product portfolio. And then we have to also manage what we have seen historically, which is the volatility of the business. So the work there is really not done, and Chris made that in his comments before that we will continue to see some movement in the revenue and margins of that business given how we have taken into account in our 2020 outlook.

But it is our expectation and my expectation that the team is laser-focused on basically managing margins for that business and continuing to improve that and get it into the range that we have talked about last year. It's not going to all happen in a few months, but we're definitely driving to that. And it's my expectation that we get that back to the range level that we have committed to in 2020, and that's what we're trying to do.

Chris, anything else on CTG?

Christopher E. Collier

Chief Financial Officer, Flex Ltd.

A

No, I think you covered it very well. I think if you just step back, we've been actively rationalizing the portfolio over the last, say, six months. It's been a focus. We're going to be incredibly disciplined and selective on where we're going to be earmarking capacity and capital flows. And as you look to the Q1 in our guidance, it was reflective of both impact from the portfolio rationalization that's still underway, as well as we have some certain softness that we're seeing in some of the consumer customers.

Paul J. Chung

Analyst, JPMorgan Securities LLC

Q

Thank you.

Operator: And your next question comes from the line of Steven Fox from Cross Research. Your line is open.

Steven Fox

Analyst, Cross Research LLC

Q

Hi, good afternoon. Two questions, if I could, please. Revathi, I appreciated all the comments in terms of your early impressions on where you'd like to emphasize improvements at Flex. One of the areas that I was curious, if I can get your view on, is ramping new programs. The industry, and Flex in particular, has had sort of ups and downs with ramping new programs to expectations. Is there anything that you bring to the process that you think could change in that to make the business more predictable? And then I had a follow-up question.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

I'd say, Steven, I think I repeated the word disciplined execution many, many times through my whole commentary, because my view, I mean, we have all ramped many programs in various businesses before and being in a manufacturing business requires us to do that well, so it is all about planning and driving process

improvements in the beginning of it and having, really, a laser focus on making sure that there is consistency between the customer expectation and our expectation.

So, for me, the predictability issue in ramp really goes down to poor planning. And our teams will be laser-focused on disciplined execution. The processes will be clean. We'll make sure that we are well organized and we execute well, and that's what it comes down to is that it has to have incredible planning to make these ramps successful. And I don't think it's anything more than that, and that's what Flex has to do and do it consistently.

So when I talk about disciplined execution around key processes, ramping up, ramping down is an important part of that overall business process that I'm talking about, and we'll make sure that we're really organized around that, Steven. That's what we'll have to do to make sure that this is successful moving forward.

Steven Fox

Analyst, Cross Research LLC

Q

Great. I appreciate those comments. That's helpful. And then just understanding that you're not providing formal guidance for the full year. Can you sort of give us some positive offsets if you're sort of reiterating or signing off some consensus about, given that auto is weaker, semi-cap equipment is weaker and core traditional networking is weaker and you're pruning some consumer areas. So what would be the positives to offset those weaknesses in order to maintain sort of consensus numbers? Thanks.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

[indiscernible] (00:37:48).

Kevin Kessel

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

A

[indiscernible] (00:37:51).

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

So if you look at our overall portfolio, we said even starting with auto, well, overall market could be softer. We expect that we would have a stronger second half based on our bookings profile. We expect health solutions is going to have a strong year on the basis of the market being strong, but also the projects that we have won in our bookings portfolio. We expect industrial to be strong in the year, and that continues our trend of growing well within that portfolio and managing it well. And then, overall, CEC also, we have said, has come back to growth, and that's going to continue even through 2020. So quite a few offsets I would say, overall, to the general thesis of optimizing CTG, and auto being in a little bit of a slow period. There are quite a few growth offsets to that.

Steven Fox

Analyst, Cross Research LLC

Q

Great. That's all very helpful. Thank you very much.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

Thanks, Steven.

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

Adam Tindle

Analyst, Raymond James & Associates, Inc.

Q

Okay. Thanks and good afternoon. I just wanted to maybe start to clarify. I think you had previously thought that CTG would get back to the 2% to 4% operating margin range for fiscal 1920. And correct me if I'm wrong, but did I hear that, in the prepared remarks, that will remain pressured, so we should not expect it to get to that range? And if you could just touch on what changed?

Christopher E. Collier

Chief Financial Officer, Flex Ltd.

A

Certainly. The prepared remarks highlighted that while we're continuously going through the repositioning of the portfolio that it would remain under pressure. The comment you are referring to is from our last call where we actually said that we anticipate in 2020 to re-emerge into the targeted range. And so, it is our commitment to continue to take action into that business, being very thoughtful in how we're selecting partners and repositioning. And it's our intent, as we work through this year, to move that back into that target margin range.

I would say that what we're trying to do is lay forth a plan here and let us move forward throughout the year and show evidence of improvement. We're just not going to get out in front right now and define a period of time in which we're going to be entering that target margin range.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

And, Adam, simply said, you have seen the volatility in this and all we're saying at this point in time is that we will have some margin volatility as we manage the mix of the customer portfolio. But it is our goal and our objective to get it in the target margin range in 2020. But as you project the quarter, I think we have some ups and downs, but that's our intent.

Adam Tindle

Analyst, Raymond James & Associates, Inc.

Q

Okay. And maybe just as a follow-up, Revathi, I mean you've got a fresh set of eyes here and chance to re-evaluate. Just maybe if you could touch on the pros and cons remaining in CEC and CTG businesses versus seeking strategic alternatives and using that to double down on HRS and IEI or adding a third leg to that HRS and IEI stool. I'm sure you've considered a lot of different things. If you could just give us a view into that thought process? Thanks.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

Adam, thank you for that. I would just tell you that it's just too early for me to reflect on that right now. My real focus is basically to drive this business in a way that we can fundamentally improve and shift the margins from where we are right now. And we have to be laser-focused on that.

And as we do that and do that well, will that result in some mix change and some portfolio movement? Absolutely. But, Adam, I'm sure you appreciate the fact that it's really too early for me to make any major portfolio comments at this point in time around CEC or CTG.

But as I've said, both those businesses, they will operate with tremendous focus on improving margins that we definitely are committed to doing, and that's what the business teams are focused on. And we'll look at – my view on portfolio is we'll evaluate all our portfolios with certain set of financial constraints built in as we move forward. And we'll see which ones meet or don't meet that criteria. But clearly too early for me to comment on that.

Adam Tindle

Analyst, Raymond James & Associates, Inc.

Q

Fair enough. Congrats on the opportunity.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

Thanks, Adam.

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

Matthew John Sheerin

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yes, and thanks for taking the question. A question regarding the CEC segment where you talked about some areas of weakness, networking offset by strength in 4G, 5G and cloud. Could you drill down a little bit more in that segment, specifically on the networking weakness that you saw. Is that from multiple customers? Is that more in the enterprise side? And is there signs of inventory build or other issues there or is that underlying demand?

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

So, Matt, I have Doug sitting here with me and I'm going to have him comment on that. And, Chris, feel free to jump in too.

Douglas Britt

President-Integrated Solutions, Flex Ltd.

A

Yeah, great. As we shared towards the tail end of our quarter, we experienced some softness specific to our networking business. That's the enterprise network. And then as the 5 – or the 4G and 5G, essentially what we're doing is we're building up the infrastructure. The wireless portion of that business is rolling into the next fiscal year. And in terms of the cloud, we've been experiencing nice growth. But in terms of the forecast, it was really the networking data-com enterprise towards the tail end of the quarter that fell.

Matthew John Sheerin

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. That's helpful. Yeah.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

[indiscernible] (00:43:59).

Matthew John Sheerin

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Got it. And the margins there were just below the target and you've been managing that portfolio pretty well. As you get into – and I know the other issue you talked about, I guess, transitioning some programs and some costs there. But are the expectations to get the margins back into that range, the 2.5% to 3.5% range for the fiscal year?

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

Yeah, absolutely. Matt, for sure. Our focus on CEC is also to get it back into the target margin range. We have to grow, and we have to grow profitably. We don't get to do one or the other. And the expectation for CEC is the same thing is that we focus on making sure that we're getting paid for the product innovation that this business is driving, and that we continue to grow in the right segments and get it back in the target margin range in 2020.

Matthew John Sheerin

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. And just a quick question, if I can, just regarding the working capital and the inventory. Inventories were up modestly year-on-year. I know you're focusing on free cash flow and it looks like the component environment is certainly a lot more efficient than it was. We're not hearing about a lot of supply constraints yet. Could you talk about the opportunity to reduce inventory and working capital going forward?

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

Yeah. I'll take it first, Matt, and then hand it over to Chris for any other comments also. I'd say there is tremendous room in terms of improving working capital in the business. Again, if you think about business processes and managing everything from an S&OP, or Sales Inventory Operation Planning (sic) [Sales and Operations Planning] (00:45:43) process, to demand planning process, to inventory that's in our manufacturing facilities and our warehouses and when to we ship out, there is this fundamental thing that we can do to run this business differently, that's going to be about improving our business processes.

And my initial view on this is that there's real room to make this better than where we are today and do it in a sustainable way, not a volatile way. And we've already launched opportunities to go capture that, and there definitely is improvement. And you can see that the team already started on some of that in the second half, and you can see that our overall inventory levels continue to decline through Q3 and Q4. So that is the focus. And based on my initial assessment, I will say there is lots of room in terms of making working capital improvement.

Christopher E. Collier

Chief Financial Officer, Flex Ltd.

A

I don't have anything to add to that.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

Thanks, Matt.

Operator: And your next question comes from the line of Jim Suva from Citi. Your line is open.

Timothy Young

Analyst, Citi

Q

Hi, this is Tim Young calling on behalf of Jim Suva. Thanks for taking the question and thanks for color so far. Your CTG guidance implies a steeper year-over-year decline for June quarter. You mentioned you will continue to be more selective in CTG business. So I wonder does that mean double-digit year-over-year decline is how we should think about that for full year revenue level for CTG segment. And then I have a follow-up.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

Yeah. I'll start by saying we're very proactively managing this business, Tim, and we have been very open and forthright about that in my opening comments and in Chris's opening comments. And we do expect some results from that and how we're managing the business. So we are seeing some part of that business is because of us managing customers and removing customers from our portfolio, and some part of the Q1 impact is due to the market. So there is a little bit of a mix in there that you see for Q1.

Going through the year, I do think that that growth will be volatile and you'll see some ups and downs to the overall year. I think too early to comment on where full-year ends up. I don't expect it to be in the double-digit decline [indiscernible] (00:48:06) like we have in Q1. I think it will flatten out just because the comps will get a whole lot better in the second half of the year, but my expectation is that that'll level out some through the year.

Timothy Young

Analyst, Citi

Q

Thank you. And then can you comment on your regional demand of visibility, specifically in Europe and Asia? Thanks.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

I didn't understand the question. Can you repeat the question?

Timothy Young

Analyst, Citi

Q

Your demand visibility in different regions, specifically in Europe and Asia.

Christopher E. Collier

Chief Financial Officer, Flex Ltd.

A

Yeah. I don't think that there is anything of particular noteworthiness with regards to demand visibility in any region that's any different today than it was three months ago when we talked to you.

Timothy Young

Analyst, Citi

Q

Got it. Thanks.

Operator: Your next question comes from the line of Christian Schwab of Craig-Hallum Capital. Your line is open.

Christian Schwab

Analyst, Craig-Hallum Capital Group LLC

Q

Great. Thanks for taking my questions. Congratulations on the new job as well as the comfort in 2020. I want to make sure I understand what I'm hearing correctly, and it seems to me that improving operations in a contract manufacturing company with somebody from a manufacturing background isn't necessarily rocket science, although it is hard, but it's usually typically a focus on lots of little things. In essence, tuning everything out versus disrupting everything; improving new product development; faster time to market for new products which increases customer satisfaction; increasing yields; improve supply chain; organizational footprint, where the skill set and the best yields are; maybe not the cheapest labor, et cetera, et cetera. Is that what you guys kind of see is the biggest opportunity is just kind of tuning everything up over the course of 2020?

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

Christian, you should come work for us.

Christian Schwab

Analyst, Craig-Hallum Capital Group LLC

Q

Yeah.

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

Jokes aside, I would say that it is not just tuning. I mean, tuning happens on an ongoing basis. The way I work at what I see is that we find 5 to 10 major things that we can drive either operating margin or cash flow improvement in the business. And those will have some consistent themes and factors across our factories and across our portfolio, and you really have to drive those.

And in an organization like Flex, what I see is that there is tremendous room for that because there's a lot of entrepreneurship in terms of how factories operate and how businesses operate. But at the same time, we just have room to drive some rigor and this is our process discipline around a few key priorities. And we have decided what those are and we're working on rolling those out through the organization.

So it's not just picking hundreds and hundreds of little projects and trying to add those up. That's not the way I think about it. I think about trying to find 5 to 10 key priorities and really driving that across the organization horizontally and vertically, and that's what we're attempting to do. And I feel pretty confident that those are all big opportunities for both margin and cash flow improvement.

Christian Schwab

Analyst, Craig-Hallum Capital Group LLC

Q

And then – thank you for that – along those lines, what is a timeframe that you think is reasonable for you to believe whether you were successful or the team was successful in implementing all of those 5 to 10 changes to improve margins? Is kind of more of an inflection point of change in the operating structure of the company something that we could see as soon as fiscal year 2021? Is it something that just kind of happens slowly? Or is there some of those that if successful will kind of [ph] ladder step (00:52:14) the company?

Revathi Advaiti

Chief Executive Officer & Director, Flex Ltd.

A

Christian, for me, how I think about this is that we have to show sustainable margin improvement that will then drive sustainable cash flow improvement, right? So I don't think there is an end goal here that you can declare

victory at a certain point in time because most organizations like us will drive strong, consistent year-over-year productivity and margin improvement and cash flow improvement.

So too early for me to tell as to, hey, what 2021 looks like or anything like that, but my expectation is that there is enough opportunity in this business that we should start seeing consistent margin improvement in 2020 and be able to hold that through kind of consistently over a longer cycle. I don't want to call an endgame here because it's too early to do that. But I see that many organizations have done this, and done this well. And my expectation is you'll start seeing the results of this in 2020, both margin and cash flow and then we'll continue to drive that moving forward. So not calling an inflection point. I think that's too early to do. And I expect this to sustain over a long period of time.

Christian Schwab

Analyst, Craig-Hallum Capital Group LLC



Great. Thank you. No other questions.

Operator: There are no further questions at this time. I will turn the call back over to Kevin Kessel for some closing remarks.

Kevin Kessel

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

So thank you, again, to everybody who joined us. We know it's a very busy day of earnings, so we really appreciate your interest and participation on the call. We will be seeing, I'm sure, many of you over the next few months at some of the upcoming conferences. This concludes the call. Thank you.

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

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