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Flex Ltd. (FLEX)

Q4 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and thank you for standing by. Welcome to Flex's Fiscal Fourth Quarter 2022 Earnings Conference Call. Presently, all participants are in a listen-only mode. After the speakers' remarks, there will be a question-and-answer session. As a reminder, this call is being recorded.

I will now turn the call over to Mr. David Rubin. You may begin, sir.

David A. Rubin
Vice President-Investor Relations, Flex Ltd.

Thank you, Carl. Good afternoon and welcome to Flex's fourth quarter fiscal 2022 earnings conference call. With me today is our Chief Executive Officer, Revathi Advaithi; and our Chief Financial Officer, Paul Lundstrom. Both will give brief remarks followed by Q&A. This call is being webcast live and recorded. Slides for today's presentation along with a copy of the earnings press release and summary financials are available on the Investor Relations page at flex.com.

As a reminder, today's call contains forward-looking statements, which are based on our current expectations, assumptions and predictions. These statements are subject to risks and uncertainties that could cause actual results to differ materially. For a full discussion of these risks and uncertainties, please see the cautionary statements in our presentation and press releases, the Risk Factors section in our most recent filings with the SEC. Note, this information is subject to change, and we undertake no obligation to update these forward-looking statements.

Unless otherwise specified, we will refer to non-GAAP metrics on this call. The full non-GAAP to GAAP reconciliations can be found in the appendix slide of today's presentation as well in the summary financials posted in Investor Relations website.

As previously disclosed, the draft registration statement on Form S-1 relating to the proposed initial public offering of Nextracker's Class A common stock remains on file with the US Securities and Exchange Commission. The initial public offering and its timing are subject to market and other conditions and the SEC's review process. We made this announcement in accordance with Rule 135 under the Securities Act following the SEC regulations. We will not make any further statements or answer any additional questions on the Nextracker filing at this time.

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

Revathi Advaithi

Chief Executive Officer & Director, Flex Ltd.

Thank you, David. Thank you, and good afternoon, everyone. Today, we'll talk about our results for our fiscal Q4 and also our full year results, which was another outstanding year in the midst of lots of macro challenges. Paul will then take you through the detailed results.

First, I'll start by saying I'm very proud of our team for delivering exceptional results for our customers and all our stakeholders. Their continued dedication helped us deliver strong performance this fiscal year.

I also believe that in the midst of crisis is when true partnerships are built and we have significantly strengthened our partnerships with our customers and suppliers as we navigated through the dynamic supply chain environment.

While delivering record performance this year, we have kept our eyes focused on the longer-term direction of our company. We laid this out for you in our most recent Investor Day, which sets the stage for our next phase of profitable growth.

Now, going to the next slide, let's look at some of our accomplishments. Q4 was up over 9% year-over-year and over 3% sequentially. As you all know, seasonally, this is usually our weakest quarter with overall revenue typically down about 10% sequentially. Our ability to deliver revenue growth shows the continued strength and demand across the portfolio as well as the team's incredible execution while operating in this environment.

A good example is in our Automotive business. Despite the major industry disruptions, our Automotive business grew both sequentially and year-over-year, while S&P global auto production volumes declined. Both Industrial and CEC also had very strong quarters, all of which led to strong revenue and record adjusted EPS levels in the quarter. For the full year, revenue was up about 8% year-over-year, and we delivered record full year adjusted operating margins as well as a record EPS on both an adjusted and GAAP basis.

Our Industrial business was also very strong for the full year with ramps in a number of key markets, including next-generation robotics, EV charging stations and multiple ramps in renewables and power technologies. Remember, these ramps and renewables are in addition to our Nextracker business, which is now its own separate segment. As you will see, Nextracker also saw very strong revenue growth this year.

Lifestyle strength continued, driven partially by strong current demand, but more importantly, much of this is from winning new business as we solve increasingly complex challenges and provide customers with value-added services such as logistics and fulfillment and expanding our circular economy activities.

I will also point out that we executed on our capital allocation strategy this year, as we stepped up our investments in future growth. We increased CapEx by about 60% with over 60% of that allocated specifically for funding anticipated organic growth.

We also completed our Anord Mardix acquisition, expanding our presence in data center critical power, which creates cross-selling opportunities with our core data center business. And in addition, we repurchased a record $686 million worth of stock.

Now, turning to slide 4; as we covered in our recent Investor Day, there are several macro and secular trends driving growth in outsourced manufacturing. At its core, these trends are about increasing complexity that many companies are finding more difficult, sometimes even impossible to solve by themselves.

This complexity is creating higher value growth opportunities for Flex, because we have the right capabilities. We have the global footprint and the scale to solve these challenges for our customers. We have transformed into a more adaptable, resilient, advanced manufacturer, and in recognition of our progress, we are honored to have been recently recognized with three manufacturing leadership awards for outstanding leadership and achievements in the categories of enterprise integration and technology, operations excellence and sustainability.

And our focus on strengthening our core capabilities in each of our six business units and delivering in key end markets continues to manifest in new wins that will drive growth in the years to come. At our Investor Day, we highlighted just three of these key end markets that we've doubled down on.

They were the next-generation mobility, the digital health care and cloud expansion. Now, putting these three markets in perspective, next-gen mobility, for example, is fueling our growth with new wins in support of EV and autonomy technology transitions.

Our technological knowledge and domain expertise is leading to new opportunities and expanding collaborations. Of course an exciting example of this is our recent announced partnership with NVIDIA's DRIVE program for Level 2+ to Level 5 autonomy.

We also recently announced a major win with Enphase, a leading global energy technology company. And that's expanding on 15 years of partnership, where we have been selected to support Enphase's European market expansion for microinverter solar solutions.

In our health solutions group this year, we began several medical device ramps addressing multiple aspects of chronic care and these wins will drive growth through the next few years. And in our cloud business, we initiated multiple new ramps with a few of our hyperscale partners late in the year, which led to strong growth for CEC in Q4 and but more importantly, will contribute to accelerating growth for fiscal 2023. Again, these are just a few examples from the diverse end markets we play in.

We're in a strong position to capitalize on these long-term opportunities through our continued focus on manufacturing and supply chain technology and targeted growth markets. We remain focused on the factors that will drive sustainable growth, margin improvement and creating shareholder value.

With that, I'll turn it over to Paul to take you through our financials. Paul?

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

Okay. Great. Thanks, Revathi, and good afternoon, everyone. I'll begin on slide 6 with a review of our fourth quarter results. Please note, all remarks will be based on non-GAAP results, unless stated otherwise. The GAAP reconciliations can be found in the appendix of this presentation.

Our fourth quarter revenue came in at $6.9 billion, up 9% year-over-year. Operating income was $295 million with earnings per share at $0.52 for the quarter, a year-over-year increase of 6%. Free cash flow was $252 million and up year-over-year.

Just taking a step back, and looking at our full year performance on slide 7; with focused execution throughout a very dynamic environment, we delivered full year revenue of $26 billion, up 8% year-over-year. Operating income for the fiscal year 2022 totaled $1.169 billion, that was up 13% year-over-year despite the challenges caused by component shortages and COVID flare-ups. For the full year, Flex achieved record EPS of $1.96, which was up 25% year-over-year. 2022 free cash flow was $593 million.

Turning to our fourth quarter segment results on the next slide. Reliability revenue was $2.8 billion, an increase of 12% year-over-year, driven by improved execution against strong demand in Auto and Industrial and with some tailwind also from Anord Mardix. Operating income was $140 million. Operating margin was 4.9%, with pressure from material shortages that created some inefficiencies in Industrial.

In Agility, revenue was up $3.6 billion, up 4% year-over-year, driven by strong demand across Lifestyle and CEC partially offset by planned declines in Consumer Devices. Operating income was $152 million, up about 12% year-over-year, with nice margin expansion, up almost 30 basis points to 4.2%. And finally, Nextracker revenue was $440 million, up 38% year-over-year due to continued strong demand. Adjusted operating income for Nextracker was $22 million with pressure on margins from higher freight logistics costs.

On slide 9, looking at performance for the full year, Reliability revenue was $10.6 billion, with operating margins up slightly at 5.1%. Within Reliability, Automotive revenue was up 15%, primarily due to new program ramps, reflective of the growing demand for our next-gen mobility portfolio.

Health Solutions was down slightly against a tough compare. Recall that in 2021, Health Solutions was up 25% with record growth driven by critical care products that were instrumental at the height of the pandemic. Now, that we've lapped that comp we expect Health Solutions to be growing in the range that Randy outlined at our Investor Day.

Lastly, Industrial had a strong year with revenue up 17%, primarily from solid organic growth, and with some tailwind from Anord Mardix.

Just moving down the page here; Agility segment revenue came in at $14 billion, delivering a record 4.3% op margin. That was up 1 full point for the year. Within Agility, CEC was up roughly 3%, with growth from new project ramps but had some headwinds due to the continued component shortages. Consumer Devices revenue was down mid-single-digits caused largely by planned contract completions and is representative of our active program management.

And finally, Lifestyle had record performance with revenue increasing 14%, primarily due to outstanding execution, successful program ramps and robust end market demand.

Nextracker completed the year with revenue of $1.5 billion, a year-over-year improvement of about 22% and ended the year with a 6.2% operating margin driven by higher freight logistics costs. Overall, solid performance with all segments returning to revenue growth this year, and we have some great momentum as we head into the fiscal year 2023.

On slide 10, cash flow. Net CapEx for the quarter totaled $108 million, and for the full year came in at $431 million. That's about 1.7% of revenue. Free cash flow was $252 million for the quarter and $593 million for the full year. Free cash flow conversion for the year was 63%.

In the quarter, we repurchased 6 million shares, totaling about $105 million. For the full fiscal year, we spent $686 million, repurchasing 38 million shares, and that represented about 8% of the shares outstanding. We closed the quarter with inventory of $6.6 billion. Inventory turns were down to 4.1%, indicative of the dynamic supply chain environment that's challenging the industry.

Please turn to slide 11 for our segment outlook for the fiscal first quarter and our year-on-year growth expectations. Beginning with Reliability Solutions, we expect revenue to be up high-single-digits to mid-teens with healthy demand across all three business units. Automotive and Industrial will have multiple program ramps beginning this quarter as well.

Turning to Agility Solutions, revenue is expected to be up low- to high-single-digits year-over-year. As Revathi had mentioned, the significant macro trends driving robust cloud demand should fuel a strong growth in CEC. We also expect positive demand trends to continue into the quarter for Lifestyle, offset by Consumer Devices, which is facing a tough prior year-comp that includes a program that we wrapped up in Q2 of last year.

On to slide 12 for our quarterly guidance; we expect revenue in the range of $6.6 billion to $7 billion, with adjusted operating income between $285 million and $315 million. Interest and other expense is estimated to be between $40 million and $45 million, and the tax rate should be within that 13% to 15% range. We expect adjusted EPS and between $0.44 and $0.50 a share based on approximately $471 million weighted average shares outstanding.

On the following slide, we have our fiscal year 2023 guidance. We walked you through this at our Investor Day, so I won't spend a lot of time on it, but I'll remind you that we're expecting 8% year-over-year revenue growth at the midpoint of our guidance of $27.7 billion to $28.7 billion. Adjusted EPS is expected to be between $2.09 and $2.24 a share. That's about $2.16 at the midpoint.

To wrap it up before we begin Q&A, closing out a tremendous fiscal year 2022, we remain focused on driving profitable growth as we execute on the high-value opportunities presented by long-term secular trends. We've demonstrated that our strategic initiatives have established a solid foundation and Flex is uniquely positioned within the industry to serve those growth markets.

With that, I'd like to turn the call over to our operator, to begin Q&A. Carl?

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. Ladies and gentlemen, we will now begin the question-and-answer portion of today's call. [Operator Instructions] Our first question comes from the line of Mark Delaney with Goldman Sachs. Your line is open.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Good afternoon. And thank you very much for taking the questions. Looking at the fiscal 2023 outlook relative to what was discussed about a month ago at the Analyst Day, it looks like the revenue and the midpoint of the EPS guidance are both slightly higher and that's despite some of the continued challenges around COVID in particular, in China, and hoping you can better understand what's driving the updated view on fiscal 2023.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah. I'll start that, Mark. And if Revathi wants to chime in here, she'll do that as well. But relative to the Analyst Day, we came in Q4 a little bit better than what we had – we'd expected. And so we dropped some of that revenue through. So you see the midpoint of our guidance did come up a little bit for the year.

At this point, we held EPS flat to what we had indicated at the Investor Day. I think we had said $2.16, really didn't give you a range. Right now, I would say $2.16 is still the midpoint, pretty upbeat about that high-single-digit top line growth that we had messaged and a pretty good EPS.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Okay. That's helpful. And my follow-up question, hoping to better understand some of the headwinds that are weighing on EBIT margins, you talked about some of the cost and logistics headwinds. Could you be a little bit more specific on how you expect those to trend over the course of fiscal 2023, because I think you need to go from the lower 4% range at the midpoint of the fiscal 1Q guidance and see that improve over the course of the year in order to get the full year to the 4.7% to 4.9%. So maybe talk a little bit about what you're seeing and how you expect that to be over the course of the year. Thank you.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah, Mark, I'll start by saying that in the last few years, we have shown our ability to really continuously improve our margin dollars, our margin rates. So we've really shown well, in the middle of all these ups and downs and all the macro challenges that we've been really good at driving the right mix, the right kind of growth and managing through all our inefficiencies that happen as a result of supply chain and pandemic and all that.

So, I'd say so fiscal 2022, again, very good margin improvement. Our fiscal 2023 guide right now still shows very good margin improvement. And I'd say that that will move around a little bit in the quarter just because we continue to work through some of the supply chain inefficiencies, whether it's China shutdown or things like that.

And we have to ramp up and down as we see availability of critical products. And so that will tend to happen, but we feel very good about kind of first is the mix of our bookings that converts to revenue that is improving our overall margin profile and which really gives us confidence in our ability to guide where we are guiding right now for fiscal 2023.

I'd say, yes, it will move around a little bit in the quarters based on how much inefficiency happens with supply chain disruptions and things like that. But our history shows that we manage this extremely well, and we'll continue to feel strong about how we can deliver the rest of the year.

Operator: Our next question comes from the line of Matt Sheerin with Stifel. Please ask your question.

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

Q

Yes, thank you, and good afternoon. I'm just following up on the question regarding supply chain challenges and the component constraints. It seems like you over-delivered and a lot of your peers did too. And of course, you and your peers have built inventory over the last few quarters. Is that starting to benefit you where you're putting materials in place for orders a month, two months out and you're now helping fulfill that? And is that the strategy going forward with this inventory build?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah, Matt, first is – spot on, right? I mean the idea always as this inventory built up, we said before that it's all about kind of that golden screw mindset where it's waiting for one component and as that component clears up, we want to be able to meet the demand for our customers, right? And that's what you're seeing us execute to with the revenue upside that we're seeing in these quarters that as products comes in and we're able to free up the bill of materials and build the product, we're able to execute really well.

I'd say the inventory buildup itself, I expect that it will start balancing out, right, towards the end of the year, and you're going to see that happen, and that's the right thing to do because my eventual focus will always be to get turns back to where we think we want it to be. And this is a very unique situation with what's happening with the supply chain congestion. And so we're very committed to delivering the growth our customers want us to. That's why you see the inventory build-up.

But the strategy won't be to continue to keep inventory at an inflated level to meet that demand. The hope is that the supply chain congestion at some point starts to ease up, so you can get to the right level of turns to deliver the growth that we're looking for.

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

Q

Got it. And just regarding the inventory, are your customers paying you in advance? Or are you seeing an increase in customer deposits?

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah, Matt, I'll take that one. They are. I wish it was a dollar-for-dollar offset. But if you look year-on-year at our working capital advances coming in from customers, Q4 of 2022 versus Q4 2021 we're up almost 3x. So that's, I'd say, close to $1 billion worth of help in terms of that offsets to inventory growth. So they are helping. I wish it was dollar-for-dollar, but it certainly has helped to mitigate the impact.

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

Q

Okay. Thank you.

Operator: Our next question comes from the line of Steven Fox with Fox Advisors. Please ask your questions.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Hi, good afternoon; couple questions. First off, the cash balance is up substantially into the end of the year, approaching $3 billion. Can you sort of talk about what's behind that? And you guys – your investors don't want you to hoard cash, what you're thinking about doing with it in the coming fiscal year, especially with regard to the guidance, whether any usage of cash is factored in? And then I have a follow-up.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah, sure.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Paul, this is all yours.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Okay. Sure. So okay, I'll just maybe start with this, on free cash flow, [ph] you didn't hear us talk about in the script (00:23:50), but I'll just kind of voice it over just so everyone is clear. $550 million is the free cash flow expectation for 2023 here, that will likely be more back-end-loaded, as Revathi had alluded to. I mean I think we'll continue to see some pressure on inventory for the next couple of quarters, but I would expect that to start to abate. So probably more a back-half-loaded free cash year for us.

In terms of the cash on the balance sheet itself, look, we've been operating in a very unusual environment over the last few years. You got COVID, you got shortages, you got logistics constraints, now you have war. And I think we've all concluded with that backdrop, it's smart to have flexibility and to have some liquidity, and that liquidity has been beneficial for us.

You look at the intra-quarter working capital requirements, the cash requirements from peak to trough. They're more significant than what they've been in the past couple of years. That peak to trough for us typically is, I don't know, 30%-plus of our inventory level. And so, you kind of do the back of the envelope math on it, that's a fairly high peak-to-trough use of cash throughout a quarter.

Inventory, as you know, it's significantly higher than it was that sort of that pre-COVID level. And there's – we need some balance sheet support – we need some balance sheet strength to support that. I'll say this, we like where we are. We're in a very strong financial position to manage through what is a, as you know, very dynamic environment because of the liquidity that we have.

We don't want to be in a position to pinch ourselves here should things soften up a little bit. So we like where we are. It's a high balance as I see it today. But I think it's appropriate given the dynamic environment and what we've been seeing with inventory.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

And the guidance for the full year doesn't assume use of cash for anything outside of working capital and organic initiatives?

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

So, you are correct. We are assuming that share count is flat. And so the $2.16 EPS that we're guiding to here at the midpoint presumes that we take care of things like dilution from equity comp, but we have not baked in share count declines.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Great. And then just as a follow-up on the – like you pointed out, the Auto – your Auto sales are significantly outgrowing vehicle production right now. And I'm just curious if we start to assume whatever normal production looks like maybe later in the year, hopefully, does that outgrowth sort of normalize also or should we think of the outgrowth you're having right now as sustainable in the subsequent quarters? And if so, why or why not? Thanks.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

We'd said in the Investor Day, we spent a lot of time talking about our focus on kind of the EV space and kind of next-gen mobility. And we feel very strongly and we did a deep dive on it for the reason that we really feel strongly that we are outperforming the industry because our technology is very strong. We're really getting rewarded in terms of bookings for this next-gen mobility.

So our reason for outperforming, I feel, is twofold. One is we're always able to perform well in terms of supply chain shortages and how we manage that. We have a strong relationship with our OEMs and suppliers. So that definitely helps, but I feel comfortable with our outperformance for the sector even moving forward just because of the pieces we laid out in the Investor Day that this is a high focus area for us, lot of new wins. You saw the kind of estimated EAR number that Mike Thoeny laid out for this space. So our view is that we'll continue to outperform the IHS guidance for this space.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Great. Thank you so much.

Operator: Our next question comes from Ruplu Bhattacharya with Bank of America. Please ask your question.

Ruplu Bhattacharya
Analyst, BofA Securities

Q

Hi. Thanks for taking my questions. Revathi, you took up the fiscal 2023 revenue guide by $400 million. Can you talk about which end markets are outperforming versus what you thought at the Analyst Day?

And this might be nitpicking, but I mean, you kept the EPS guidance at $2.16. That $400 million probably translates to about $0.03 or $0.04 in EPS; is there any further headwinds to margins than what you had thought at the Analyst Day? Or is it just you're being conservative on the EPS, given the macro situation now?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Ruplu, first, thanks for the question. I'd say the first thing in terms of overall lifting our revenue guide, we really outperformed our Q4 number, as you saw, right? And looking at that and our ability to just manage this whole shortage clearance and everything for the year, we felt like we had to take up revenue for FY 2023 right now, even though it's early in the year. We feel really good about how we're clearing shortages and how we're managing demand. And so that was kind of the overall view.

And the sectors, I would say, is across the board. And the reason I would say, Ruplu, that's the case is because we have demand backlog in all of our six segments. It's not one or the other. So because of that, I would say, overall, all six segments are outperforming to what our original thesis for the year was, and we feel quite comfortable that we will continue to see that over the next few quarters that we'll be clearing shortages and improving our demand outlook pretty well to the guidance we've given.

I'd say in terms of EPS, Paul will jump into this. I'd say it's just a little early – and the first is we feel very comfortable about our margin guide. Let me be very clear about that, our margin percent, we have shown our ability to deliver this.

Yeah, will there be efficiencies through quarters, because of China shutdown or something else? Yeah, absolutely, that's going to happen. But we always come through in terms of how we manage the combination of kind of productivity and managing this efficiency.

So feel very comfortable about our adjusted operating margin guide of 4.8%. And I think just a little too – we have given you a very nice EPS guide year-over-year improvement. Just a little too early to start changing our numbers for fiscal 2023. And you know how we are in terms of how we guide, Ruplu. I think we feel like, its first quarter is too early to do that. So we'll look through the year and see how it comes through. And then hopefully, EPS will move up with the rest of the numbers.

Paul, anything to add?

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah, maybe just like a couple minor things, [ph] Ruplu, do you know what I mean (00:30:45), for modeling purposes, you probably want to model a little bit more interest cost. That's probably a couple cents of headwind and probably the higher end of that 13% to 15% tax rate given what we know today. That's the sort of the offset to incremental margin that you would expect from that $400 million more in revenue, so it all kind of rinses out.

Ruplu Bhattacharya
Analyst, BofA Securities

Q

Yeah. No, that makes sense. Thanks for the details on that. And then, just on some of the investments you're going to make in fiscal 2023. I think you had said CapEx of 2%, is that still the case? And what areas are you going to be investing in organically? And then, any thoughts on M&A, I mean, do you think that's feasible in this environment, so any thoughts on the capital allocation? Thank you.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. I'd say, let me start with overall CapEx. Yes, we're going to have to continue to invest in the CapEx rate we committed to just because our organic growth is so strong, right? We're going to have to invest in growth to deliver the bookings we're seeing and then the commitments that we've given to our customers.

So absolutely, I'd say in terms of the areas itself, all our five segments, I'd say, outside of Consumer Devices will show strong year-over-year growth, and we'll need to have capital invested for those businesses. We always tend to see a little bit more in Reliability just because of the capital intensity of that business.

We'll also be looking to add square footage in areas that we are running out of space and it tends to be all the places where you see the whole reshoring, regionalization trend, whether it's North America or parts of Europe or parts of Southeast Asia.

So we'll continue to look at adding that.

We're also making some strong productivity investments. I talked about how we feel very good about our manufacturing technology excellence. And so continuing to invest in that to really drive the productivity investment, so we can see that long-term 5% margin growth margin percent that we talked about is important. So I'd say we'll see a little bit of everywhere is kind of how we're thinking about investing for growth. Paul, you want to take the...

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yes. And then in terms of M&A, we want to leave the door open to that. You never know when opportunities arise at fair price. But I would say on balance, priority for us is more stock buyback right now than M&A.

Ruplu Bhattacharya
Analyst, BofA Securities

Q

Okay. Thanks for all details and congrats on the strong execution.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Thanks. Thanks, Ruplu, appreciate it.

[indiscernible] (00:33:20)

Operator: Our next question comes from Jim Suva with Citi Group. Please ask your question.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you. And my question as well as the follow-up are kind of the same question, so I'll kind of pose the same question to Revathi and Paul with just kind of a different angle. And that is now that we've had multiple years of trade wars, shipping costs, COVID outbreaks, component shortages, power outages, all these challenges I'm wondering, first, for Revathi, do you think the just-in-time delivery model needs to be adjusted to permanently build in some buffer?

And then kind of the same question to Paul – is it worth your contracts of instead of just doing a straight cost plus model now, not knowing what the future shipping, inbound steel costs, outgoing steel costs are, is it worth building in contracts that are different than in the past with like some type of indexing or is that just too forward-looking. Thank you.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. Thanks, Jim. I'd say – let me start with the just-in-time delivery model. I've spent my entire career in operations, supply chain and at many other end markets outside of kind of what Flex is in. And what I see with what is happening today, which is such a shift in globalization, moving to the regionalization, reshoring, manufacturing to the point of use is a huge trend, right?

And then you combine that with the supply chain congestion that people are learning from which all the things you talked about, whether it's trade or pandemic issues. Then there's a view of, hey, should I have more buffer inventory to manage for all of that and is the just-in-time delivery model dead, right? I would say, Jim, my thesis on all of this, and we'll say time plays out in terms of how all this works is that we'll land somewhere in the middle. I think customers, all of us, including we'll be a little bit more reticent to have very lean inventory models, right? And that will be important, particularly when you have products that have long supply chains.

But on products that have shorter supply chains, because we are going to reshore them or bring them closer to the point of use, there, the just-in-time models will have some justification to continue. So it will really depend on the product and the end market that you're in.

And I'm very sure you're going to end up with a blended model based on the complexity of the supply chain. So I wouldn't say all dead, but definitely, in some cases, if there's long complex supply chain, everybody is going to be talking about that more and saying, let's build a different model than we had before.

And we look at that very, very closely in terms of our planning processes and what would provide the best value for us and customers? And how can you get the best level of delivery performance with kind of all this volatility built in.

So, I would say my view is, it's going to end up somewhere in the middle, and it will depend on the products and the complexity of the supply chain. Paul, do you want to jump in on the contracts?

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah, happy to. So, I'm glad you asked the question, Jim, because it's helpful to maybe demystify this a little bit for investors. If you look at the model, the contracting model in this industry, like you said, it is largely cost-plus. When you have episodes of higher than usual inflation or micro shocks to the system, a good example would be a big shutdown in Malaysia in July of last year – June of last year, which basically shut the country down for a month, similar to what we're seeing here in Shanghai.

There is various mechanisms in our contracts today and contracts in the future to protect us from those headwinds, hard pegged costs, so very specific component inflation costs, specific expediting fees, those are fairly easy to contractually just pass right through. We unfortunately don't have the benefit of 15% OP margins to absorb all that. We just can't. And so that's the nature of the industry. Those costs, again, that you can hard peg get passed back to the customers and that protects the overall margin dollars for companies like Flex.

The softer costs, things that you'd mentioned, COVID, the stops and starts, inefficiency from under absorption, that's a little bit more difficult to hard peg. We work on ways to mitigate that. I think for the most part, we've got really good relationships with our customers, and we find ways to work things out. But that's kind of how it works. For the most part, those incremental costs do get passed through directly as often as we can, so largely protected.

You bring up another interesting point when it comes to inventory. Look, is the just-in-time model broken? Is there going to be more inventory in the system going forward, particularly as we continue to see trends with things like regionalization? I don't know. But it's a very interesting question, because we're seeing it today with the support that we're getting from our customers in the form of working capital advances.

I think I had mentioned to Matt that we've got significant year-on-year growth in working capital advances. It's up almost 3x. That's an operating model difference. I think our customers in the past haven't been asked to help share the burden of that inventory growth because I don't think we've been in a situation like this in a very, very long time. That's a potential shift in the operating model.

And what I would say is we're – this is too lean a margin business to bear all of that inventory cost ourselves. If something does happen structurally, we'll need customer support, continued customer support on that. And I would say that's no different than anyone else in the industry. But very good question.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you, Revathi, and Paul, for the detail. It's greatly appreciated, and congratulations.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Thank you, Jim.

Operator: Our next question comes from Paul Chung with JPMorgan, Please ask your questions.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Hi. Thanks for taking my question. And just want to echo, very nice execution here. So first, just want to talk about the, the redesign opportunities you mentioned, driven by some of the legacy component constraints. So are you seeing opportunities where you can kind of capture higher margins here on key products doing – expanding some of that design work? And is this dynamic kind of expanding across all your products or are you seeing this more so in Health Solutions?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah, Paul, I'll answer that. I'd say first is the redesign opportunity is across the board. I see that in Lifestyle. I see that in Health. I see that in Automotive. I see that in Industrial. And the reason is because, as our customers are understanding the kind of the platform effects of how their chip design is, the significance of that, they're really relying on Flex to provide them a new solution that longer term will provide them better resilience than where they are today, right?

So I would say this redesign opportunity for us is across the board. And we are being asked to do that every day or we are providing that to customers all the time. I'm seeing that in small, medium-sized customers in Lifestyle or very large kind of Health Solutions customers. Everybody is asking about, hey, how do I do this differently and how can you do this for me?

So I'd say this is really good work, because this is the kind of complexity that I talked about that now customers are relying on us to solve for them. And it is, of course, our job to make sure that these redesigns also work in a way that it's a win-win for our customers and for us and longer term it's better margin for all of us. So Paul, I'd say this is definitely happening and happening across the board.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Great. And then, my follow-up on Consumer Devices, where are customers going if they don't make the cut on your kind of profitability hurdles? Are you seeing some customers actually come back after shopping around? And is this in turn kind of improving the overall pricing environment in your view for the overall industry? Thank you.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. Thanks, Paul. What I'd say is I think in general I'd say the overall EMS industry has become disciplined, right. So let me start with that. I would say in my last three years, across the board, we have seen discipline emerge in this industry, in terms of in how we look at projects or how we execute.

So I think that we have seen general discipline and you've seen that in the margin rates of the industry itself, right. Everybody has started improving in the last few years in terms of margin rates.

I'd say for Consumer Devices itself, there's enough people and I'm not going to name names of people who would where these hurdle rates would be fine for them right and they're the ones who will win and take that business and it works for their business model where they have a different cost of capital or they're fine with working with those margin rates.

In some cases, we do have customers who come back to us and we work with the parameters that we have laid out and what Flex offers as a solution. And that's a win-win for both of us, right, because they saw something in Flex that works for them. But we are very good at – you have seen in the last few years, we've become really good at managing the Consumer Device business to within the parameters of what we want to see. So that's why overall margins improved for that business. It is contained in terms of the type of growth that the mix within that Consumer Device business is changing. We like the more mid-sized customers for that.

So I'd say, yeah, there's always people to take the business that we may not want. And in some cases, customers come back and we welcome that because that's a win-win for both of us.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Okay, great. Thank you.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Thanks, Paul.

Operator: Our last question comes from the line of Melissa Fairbanks with Raymond James. You may ask your question.

Melissa Fairbanks
Analyst, Raymond James & Associates, Inc.

Q

Hi, everyone. Thanks very much. Glad to make it in under the wire. I think you referenced some of the inefficiencies related to China shutdowns that have happened most recently. Just wondering if you could quantify the headwind this quarter or what's baked into the 1Q outlook, if anything.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. Melissa, I'll start. Paul can jump in. One is, I'd say, I'm not sure I want to quantify like on a case-by-case basis, but we expect some of these inefficiencies to continue at least for the next quarter. You've seen that China is definitely not freed up. And particularly where this kind of impacts us in areas like our Industrial business, which has got a lot of kind of lower volume, higher mix, right?

So managing that mix with the shortages becomes really, really tough, and they have a lot of supply chain dependency on China, in particular. So I'd say we kind of expect these inefficiencies to continue through next quarter because China is not easing up anytime soon.

But that's why we have a diverse portfolio. We have a diverse portfolio, and you've seen it's played out well for us over the last few years, right? One segment, one business unit is down, the other is up. We get – we are able to manage the mix through all of that.

But at the end of the day, right, highest EPS year that we've ever had, higher EPS quarter. Our guide for Q1 is still very strong. Full year, we have a very strong EPS guide. So I'd say you'll see some pluses and minuses and inefficiencies, some more in the near term, but we expect that we're very good at managing them. So we'll see that margin rate continue to move up through the year.

Melissa Fairbanks
Analyst, Raymond James & Associates, Inc.

Q

I'd say so, very excellent execution in the face of all of these challenges. And then if I could, just one quick follow-up. The detail that you gave us for Nextracker is extremely helpful. It's obviously a question that we get asked about quite a bit [indiscernible] (00:46:16). Just wondering if as that business starts to gain scale, does it become lumpier in nature as you get to larger-scale deployments? Or for the near term, should we just kind of assume just kind of the steady-state growth rate?

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

I don't – yeah, I think steady state is more likely, Melissa. Nextracker is a project business. But as you see the scale of that business continue to grow, I think you get a bit of a portfolio effect. So yes, there will be large projects that ramp up and ramp down. But one, the nature of the accounting, which is percentage of completion accounting sort of helps to smooth that a little bit. And also, again, back to portfolio theory, I think you get such a large base that it becomes a little bit more immune to project-specific stops and starts.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah, and it's such – it's got so much backlog and so much growth in it, Melissa, that at this point, we're just expecting that growth to be more steady state. So we think that just as you clear that pipeline and backlog, which is there for the next few years, it will be steady state as we go through that.

Melissa Fairbanks
Analyst, Raymond James & Associates, Inc.

Q

Perfect. Thanks very much. That's all for me tonight.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Thanks, Melissa.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

Okay, great. Hey, thank you, everyone. I just want to close by saying on behalf of my leadership team, want to thank all our customers and our – for your trust and partnership and our shareholders, of course, for your support, and then most importantly, the Flex team for all their hard work and their achievements through this past fiscal year. So thank you, everyone, for joining us.

Operator: This concludes today's conference call. Thank you for joining. You may now disconnect.