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Flex Ltd. (FLEX)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to the Flex Second Quarter Fiscal Year 2022 Earnings Conference Call. Today's call is being recorded and all lines have been placed on mute to prevent any background noise. After the speakers remarks, there will be a question-and-answer session.

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

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

Thank you, Jenny. Good afternoon and welcome to Flex's second 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 and recorded. And if you've not already received them, slides for today's presentations are available on the Investor Relations section of our flex.com website.

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

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

Also note, on October 18, we announced we had entered into a definitive agreement to acquire Anord Mardix. The guidance we provide on this call excludes any impact from the pending acquisition.

Lastly, with regards to Flex Nextracker business, as we previously discussed on April 28, we announced that we confidentially submitted a draft registration statement on Form S-1 with the US Securities and Exchange Commission relating to the proposed initial offering of its Class A common stock. 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. We continue to look to the market and we'll evaluate the right time to do the transaction, but we remain committed to doing one. Following SEC regulations, we will not make any further statements or answer any additional questions on the Nextracker filing at this time.

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

Revathi Advaithi

Chief Executive Officer & Director, Flex Ltd.

Thanks, David. Good afternoon and thank you joining us today for our fiscal Q2 earnings call. Firstly, I want to thank our employees for their contributions this past quarter and I really appreciate how hard our teams are working to support our customers and truly make a difference. I am very proud of what we have accomplished together.

Please turn to slide 3. We achieved a revenue of $6.2 billion, that is up 4% year-over-year. Revenue came in slightly below the midpoint of our previous guidance of $6.3 billion due to some interruptions to production late in the quarter, and I'll provide more contexts to that in a minute.

Total Flex adjusted operating margin came in at 4.6%, consistent with last quarter, but better than what we initially expected. As you can see, we continued to execute exceptionally well. Our adjusted EPS was $0.48, up from $0.36 in Q2 of last year and up from the pre-COVID level of $0.31 in Q2 of FY 2020. Adjusted free cash flow came in at $90 million. That brings us to over $300 million in free cash flow generation for the year.

Now going to the next slide. Let me start with a little bit of update on the supply chain situation. We said last quarter that fiscal Q2 would be a more challenging quarter due to a number of factors. We based our assumptions on a broad view of the supply situation and our demand analysis at the end-market level.

If you look at our results, you will see that what was in our control we executed very well, again delivering year-over-year growth and very strong margins despite some headwinds we saw late in the quarter, like some last-minute supplier decommits, some further logistic surprises, and short-notice automotive OEM production shutdowns, which you all have heard a lot about. That is why we did not quite reach our revenue goal, and we think it's prudent to revise our revenue targets for the remaining two quarters despite our demand being very strong.

Now, looking at the demand situation and past the supply situation, I would say that we're in a great position. Firstly, our bookings are very strong driven by the commercial initiatives we started driving last year, as well as growth themes like technology transitions and regionalization. As you're aware, our available markets are large, and we are driving growth in end markets that help continue to shift our mix, which has been our stated strategy.

Secondly, channel replenishment needs across most of our end markets is driving strong near-term demand. So, demand remains strong and we're continuing to navigate the global supply chain and logistics issues very well. In fact, the current situation speaks to the increasing value we can provide our customers, given the value of our supply chain resiliency, production regionalization, and product redesign capabilities. This value will only increase in the future with new ways of more advanced product outsourcing and sustainability, and all of this is aligned with our longer-term growth strategy.

Now, speaking of our growth strategy, I have said in the past we will invest in growth, whether it's organic or inorganic, when we find the right higher margin opportunities, particularly in key growing verticals. As you all have seen by now, we recently entered into a definitive agreement to acquire Anord Mardix. They are a leader in the critical power solutions market, especially going into large scale and modular data centers such as hyperscale and colocation. Anord Mardix brings strong products, services, and incredible talent, including decades of engineering expertise.

We're all aware of the secular trends driving global demands for data center expansion. And how does this acquisition fit with Flex? As you look at slide 5, you can see that Flex already has an important footprint in the data center core through our embedded power business, as well as numerous data center and communications infrastructure offerings from subcomponents to systems to fully integrated racks and services. From this position, we already have a broad cloud customer base across the globe that is complementary to critical power.

We can also leverage our expertise and efficiencies and advance manufacturing and global supply chain. So I believe this is a natural extension for us to combine critical power with our core cloud offering to expand our footprint and increase the value we can provide our customers. And of course, the deal makes sense financially. We think the combination will grow faster than the market, and we expect the transaction will be accretive to adjusted EPS and will deliver mid-teens EBITDA margin in our next fiscal year.

We have been clearer throughout our strategic transformation. We have said we would improve our mix and our operational efficiency, and you have seen it already show up in our margins. We said we will return capital, and it was the right move and that we'd invest for growth, and that's what we are doing now. We will certainly continue to do all of these as we execute in our longer-term strategy.

With that, I'll turn it over to Paul to return through our financials.

Paul R. Lundstrom

Chief Financial Officer, Flex Ltd.

Okay, great. Thanks, Revathi, and good afternoon, everyone. Please turn to slide 7 for our second quarter income statement summary. Flex revenue was $6.2 billion in the quarter, an increase of 4% year-over-year but down 2% sequentially, primarily attributed to what everyone else is seeing with global supply chain disruptions. Adjusted operating income was $286 million, up 16% year-over-year. Adjusted net income was $233 million, and adjusted earnings per share was $0.48, a year-over-year increase of 29% and 33% effectively.

Reconciling to GAAP, second quarter GAAP net income was $336 million and benefited from a $149 million favorable VAT-like indirect tax credit, partially offset by stock-based compensation, intangible amortization, and other charges. The credit, which you will see booked to the interest and other line in the P&L, is the result of a favorable tax ruling in Brazil that benefited a number of other companies as well.

Please turn to slide 8. Our second quarter adjusted gross profit was $481 million, up $58 million year-over-year. Despite the challenging macro environment, our disciplined execution delivered a Q2 gross margin of 7.7%, which was up 60 basis points compared to last year. In total, SG&A came in at $195 million, up $18 million from the prior-year period, and at 3.1% of sales, within our targeted range of 3% to 3.2%. Overall, adjusted operating income was $286 million, up 16% year-over-year. Although we faced headwinds brought on by COVID-19, along with industry-wide disruptions, Flex achieved a 4.6% adjusted operating margin, which was up 50 basis points year-on-year.

Turning to slide 9 to review segment performance, and please note, all growth metrics we're going to discuss are on a year-on-year basis, Flex Reliability revenue was $2.8 billion, an increase of 4.7%. Adjusted operating profit came in at $151 million, with a 5.4% adjusted operating margin. Margins decreased 130 basis points, mostly driven by two factors, namely, continued freight and logistics cost headwinds at Nextracker and numerous production disruptions within our Automotive business. In Reliability, Automotive revenue grew 3% in the quarter, with significant underlying demand, but was adversely impacted by the increase in unplanned OEM shutdowns late in the quarter.

As we pointed out during our last earnings call, our Health Solutions business faced a tough year-on-year comp this quarter, driven by last year's COVID-related critical care peak. As a result, we experienced an 11% revenue decline in the quarter. Lastly, Industrial sales were strong, up low-teens, led by growth in key areas including EV charging and renewables, semi cap, and robotics.

Moving to Agility, segment revenue of $3.4 billion was up 3.6% year-over-year. In total, the Agility segment delivered $153 million of adjusted operating profit, a year-over-year increase of 73%, which led to a record 4.4% op margin.

Within Agility, CEC demand was healthy across the board, particularly in cloud, 5G and optical, but shipments were hindered by component constraints, which led to a modest sales decline. In Lifestyle, revenue grew 16% driven by new product ramps, new customer wins and healthy underlying demand. Finally, Consumer Devices revenue was up slightly with demand recovery in emerging markets partially offset by component constraints in the beginning of a planned project completion.

Just picking up on Revathi's global supply chain comments, you'll notice each end market was impacted by the disruptions we're all reading about in the headlines. Scarcity of components and raw materials, chip shortages, and logistical constraints at ports and warehouses are pervasive across the entire value chain. We are closely monitoring the situation, and because the dynamics change daily, we are actively reevaluating our strategic approach when it comes to resourcing, production, and delivery. I'll also add that despite these challenges, the team still delivered a fantastic fiscal Q2 adjusted gross margin and operating margin.

We're also working with customers to see how we can leverage our extensive global supply chain to help them address their own supply chain shortages. This includes dual sourcing, regionalizing production and product redesign, all of which are significant value to our customers. The far-reaching effects of the supply disruptions have shown just how beneficial and critical it can be to produce closer to customers. While the upside remains limited in the near-term, longer-term these important initiatives remain a tremendous opportunity for Flex.

Now turning to slide 10, let's review our cash flow highlights. Despite component shortages pressuring inventory, we generated $90 million in adjusted free cash flow in the quarter. Our net CapEx for the quarter totaled $90 million as well and we continue to invest for future growth.

As many of you know, following our Annual Shareholders Meeting in August, the Flex board authorized a new $1 billion share repurchase program. This program is aligned with our strategic priorities and underscores our confidence in the business and commitment to enhancing shareholder value, all while maintaining a strong balance sheet.

During the fiscal second quarter, we repurchased 18 million shares totaling approximately $328 million. In total for the first half of fiscal 2022, we have spent $490 million, repurchasing roughly 27 million shares. Inventory at the end of the quarter was $5.2 billion with pressure from the continuing supply chain and logistics disruptions. Inventory turns were 4.8, which was down from 5.6 turns last quarter.

Overall, we're quite pleased with our cash generation over the last several quarters. Our first half was strong, and over the last 12 months, we've generated over $730 million in free cash flow. Long-term we expect strong cash flow as we move through fiscal 2023. However, given the persisting challenges from component shortages and logistics, we expect some pressure on working capital and cash flow as we move through the balance of fiscal 2022. The situation is fluid, but at this point free cash flow of approximately $500 million is probably a reasonable expectation for fiscal 2022. But, again, this is a timing issue and not a fundamental change.

Please turn to slide 11 for a segment outlook for the third quarter and our year-over-year growth expectations. As we look ahead, we expect our execution to remain similar to this quarter, though the fluidity of the supply chain challenges continues. We expect Reliability Solutions to be up low-single to down mid-single digits in Q3. Within Reliability Solutions, Automotive revenue will be down low- to high-teens as OEM customers continue to face their own production disruptions.

In Health Solutions, demand is solid with chronic care remaining strong. We are seeing heightened demand for COVID testing and diagnostic solutions, though anticipate revenue to decline high-single digits to low-teens as critical care will again face a high comp against last year's strong COVID-related demands.

Industrial revenue should be up high-single digit to mid-teens with broad-based demand steadily improving, particularly within EV power, gaming and semi cap equipment.

Agility Solutions revenue is expected to be down high-single digits to low-teens. Within Agility, Lifestyle should be flat to up low-single digit, benefiting from new product ramps as companies return to the office, though some end markets will continue to be impacted by component shortages and logistics constraints.

We expect CEC to be down low- to high-single digits due to component constraints. However, all long-term secular trends, including cloud growth and growing 5G adoption, remain strong and we expect this demand to be preserved despite near-term supply constraints.

Lastly, Consumer Devices is expected to be down double digits against a high comp that benefited from a rebound of consumer spending last year and a planned program completion.

Turning to guidance on slide 12, we expect the fiscal third quarter revenue to be in the range of $6.1 billion to $6.5 billion, with adjusted operating income between $250 million and $290 million. Interest and other is expected to be approximately $40 million. We expect our tax rate to remain at the high-end of our 10% to 15% guidance range and we expect adjusted EPS to be in the range of $0.38 to $0.44 based on 487 million weighted average shares outstanding. The adjusted EPS guidance excludes the impact of stock-based compensation expense and net intangible amortization. Therefore, we expect GAAP earnings per share to be between $0.30 and $0.36.

With that, I'd like to turn it back over to Revathi.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

Thank you, Paul. So, as we all know, the environment remains pretty fluid. With the current issues in the supply chain, we're giving a more prudent outlook to our second half revenue guide. However, we are maintaining our earnings guidance as we continue to execute well at all levels. So, on behalf of the leadership team, I want to thank our customers and our suppliers and our shareholders for their support.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question is from Ruplu Bhattacharya, Bank of America.

Ruplu Bhattacharya
Analyst, BofA Securities, Inc.

Q

Thank you for taking my questions. Based on the guidance for fiscal 3Q and the midpoint of fiscal 2022, looks like fiscal 4Q is estimated to be up in the low-single digit sequentially. I guess, my question is what is giving you confidence that the fourth quarter that was just typically a seasonally weaker quarter for Flex can be sequentially up, especially given these component constraints which are likely to continue into calendar 2022?

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

It's a fair question, Ruplu, and let me just give you a little bit color. So, you're right. Typically, if you look back over the last number of years, our fiscal Q4, which ends in March, tends to be a bit light of our fiscal Q3, which is the December quarter. That pattern has been historically based on demand. And so, I would say a couple of things are different this year. One, revenue is being constrained by supply, not demand. The second one is we have a fairly significant new program ramp in the hyperscale space which starts ramping in Q3 and gets closer to stable as we move into Q4 and beyond. So, that adds to the top line as well.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. And Ruplu, I mean, it's pretty simple, right. It's a different year than it's normally been, right? So, seasonality is working a little differently. And what's really happening in Q4 for us is, like Paul said, demand is strong, channel inventory still needs to be replenished and we have got couple of very specific large programs that are going into play in Q4 also that have started ramping up – that would start ramping up in Q3. So, that is also adding a delta to our traditional seasonality. So I think those are all the reasons why Q4 is looking different than you typically would see it.

Ruplu Bhattacharya
Analyst, BofA Securities, Inc.

Q

Okay. Thanks for the details there. If I can just for my follow-up ask about the same question on guidance but related to margins. Looks like based on your EPS guidance, you didn't take that down. I mean, you've taken down the revenue guidance, but the EPS guidance is still the same, which implies better margins.

So, I guess my question will be, again, what is giving you the confidence that you can have better operating margins given the lower revenues? And I know you mentioned that demand is strong, but again, what is giving you the confidence in that backlog which is probably very high. But if your customers are looking further out and giving you a larger forecast, but again their visibility is probably limited the farther out you go. So, again, what is giving you the confidence in the backlog and what is giving you the confidence in the margin guide?

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

So, Ruplu, let me start with margin and then we can talk about the backlog in just a moment. So, on the margin front, so what we originally said going back to April was we figured we'd finish the year, and this was at $25 billion to $26 billion top line, somewhere between 4.4% and 4.6%. That margin rate is intact. It's a little bit light of what we talked about in July, but at 4.4% to 4.6%, I would say nice, strong margins, above last year's margins, with $100 million of operating profit growth.

If you look at the EPS, which, to your point, we held versus our prior guide, we're quite confident that we're going to end up in that $1.70 and $1.85 range based on a couple of things. One, as you saw last quarter, we bought back a meaningful amount of stock. And so we're going to get a little bit of tailwind from the weighted average shares outstanding. You've seen our count go from 507 million to 499 million to 47 million shares, so share count's coming down, that helps; little bit of tailwind from interest and other from some FX and a couple of minor things over the last couple of quarters that we're essentially dropping through, but, again, highly confident in that $1.70 to $1.85 range.

In terms of backlog, there's talk in the industry about double ordering and all that, but what I can say is Flex has a tremendous amount of end market insight, because in most of our industries, we have numerous customers that service those industries. And so, the read-through that we have in our data analytics is quite strong. And so, just to give you one example, Revathi mentioned a couple of minutes ago channel replenishment, case in point would be automotive. If you look at inventories sitting on the lot in dealers worldwide, it is at two-year lows. That ultimately has to be replenished. And we're seeing that same channel replenishment need across our end markets.

So, we feel quite good, again, about the sequential improvement. And then looking forward, frankly, I think top-line expectations will be high as we move into 2023.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Ruplu, I'll leave you with couple thoughts. One is, I'd say if you look at our – I'll talk about margin for a second. If you look at our performance so far, it has been really executed extremely well. Our margin performance has been very good. And so we have room in our margin profile for Q3 and Q4. That's what gave us confidence in our guidance. In FY 2022, if you look at our midpoint of kind of 4.5%, that will be the highest operating margin in a long time. And based on our Q2 execution, you can see that we are consistently delivering that, so ton of confidence in delivering that margin commitment for sure.

Demand side is a really no-brainer. If you look at Q2, I mean, we still grew 4% in a time like this, right, which is probably the highest in the industry and a very, very strong growth. If you look at our demand profile, we have more than enough demand to have hit more than our top end of the guidance we had given earlier, which would have been a 13%, 14% growth year-over-year. So that demand is still there waiting for us to execute as the supply situation improves. So, all of that really gives us confidence in Q3 and Q4. I think just being prudent in revenue is the right thing to do right now.

Ruplu Bhattacharya
Analyst, BofA Securities, Inc.

Q

Okay. Thanks for all the details. Appreciate it. Thank you.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Thanks, Ruplu.

Operator: Your next question is from Matthew Sheerin with Stifel.

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

Q

Yes. Thank you. I'm hoping you can comment more regarding demand strength, but also the component constraints within the CEC. Is that across the key platforms, networking, servers, storage, et cetera? And it sounds like the supply constraints are getting worse there. Any signs of that abating as you get into calendar 2022?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. I would say, Matt, first is you're right, CEC is definitely – I think that sector for us and for our customers is probably one of the most challenged, because demand is the most strong there also, right, whether it is all the prevailing reasons of the macros, whether it is hyperscale growth, you have seen all the cloud guys report fantastic growth, whether it is 5G starting to accelerate now. So all the macros are driving a pretty significant demand profile for it. When I talked about our demand profile would have been at the higher end of our guidance or more than that, CEC would have been the biggest beneficiary of having that much kind of unfinished demand at this point in time.

I would say in terms of which sector within CEC is the most affected by supply chain constraint, I'd say they all are. This is a very equal opportunity issue here across every sector, unfortunately. But the way I see it play out is, I would say, the biggest growth sits in cloud, right? And so, in general, the more growth you have, the more pent-up demand you have, you're seeing it in cloud, you're seeing it in networking, you're seeing it in servers and storage, all of them have pretty significant supply chain constraints and also have strong demand that has not been met yet. So, we're seeing it across the board for CEC.

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

Q

Okay. Thank you for that. And then just on Automotive, we know the headwinds facing all suppliers to that market right now. But beyond those supply issues, you talked about an inventory replenishment, but could you talk about in terms of the content opportunity for Flex, particularly in EV, where I know you've got some strong customers?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. One thing I'd start with saying is, Matt, our automotive bookings this year is at record levels. We've just had a fantastic year in automotive in terms of our overall bookings. It's one of the strongest in a long time. What we like about it is also the mix of those bookings, particularly around autonomous and EV. And the autonomous space, I've said before, we're also more focused on kind of Level 1 through Level 4 because that is more accelerated revenue in the near-term. And so, our largest booking has been in those two spaces.

And the other good news on those bookings are, it's also the geography of those bookings are across the board. So we've had a strong China growth on automotive bookings and we're also seeing that in Europe and North America. So, we're really pleased with kind of the pivot that has happened in our automotive business in terms of our focus around EV. We recently announced a partnership with a battery company that has been looking at long-range batteries. And since we are so strong in BMS, we're partnering with them to provide a content for EV that we are quite excited about.

So, really the focus is the right one, the bookings are showing the results and we're well-positioned on the EV space, and we also continue to look to add technology there.

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

Q

Okay. Thank you very much.

Operator: Your next question is from Mark Delaney with Goldman Sachs.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Good afternoon and thanks for taking the questions. The first one's on the proposed Anord Mardix acquisition. Maybe you can talk a little bit more around how Flex became familiar with that potential asset. And then, is this a signal of how the M&A strategy may progress going forward in that this is a products type of business rather than an assembly business? Is that the type of acquisition we should expect Flex to focus on longer-term?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. So, Mark, I'd start by saying is we're super excited about this acquisition. One is because it just fits really well with Flex, and I'll explain that in a second, but also importantly I know this space really well from my prior history and then now I know Flex well. So the way it fits really well is Flex does a lot of system integration work for the hyperscale/colo space, right? So, we do racks and enclosures. We do server/storage integration. We also have our own embedded power business that works in that space.

And Anord Mardix brings fantastic synergy with it because they bring critical power, particularly to hyperscale and colo, and that's also a lot of racks and enclosures and system integration, along with the technology embedded within that system integration. And the biggest issue that hyperscale/colo people have is that it's hard for our folks to scale up. They find it difficult because when they scale up, usually the component suppliers are not able to, and Flex is really good at scaling up. So this is a really good combination of the product technology we have, and our ability to do logistics and modular solutions really fast for Anord to be really successful with Flex.

And we're really excited because hyperscale/colo is a fantastic place to invest in right now in terms of growth. We're seeing that in the base Flex business. So, bringing a business like this with high margin and a perfect fit, both in technology and system integration, is really the kinds of acquisition we'd like to see in Flex moving forward.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

That's helpful. A follow-up question about the implied fiscal 4Q guidance. As you already discussed, revenue is implied to be up a little bit quarter-on-quarter in fiscal 4Q. If I just take the midpoint of EPS guidance for Q3 and for the full year, it looks to imply a pretty flattish EPS quarter-on-quarter despite the higher revenue. So, am I just splitting the hairs too finely on using those calculations, or are you in fact expecting some incremental cost or margin pressure in fiscal 4Q as the guidance seems to imply?

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

I don't think we'll see – I don't think, Mark, we'll see sequential deterioration. I think what we've done here is put a prudent guidance out there that we think that we can hit. There has been some incremental challenges in the supply chain, as we talked about in the prepared remarks. So, as we move from Q2 to Q3, we will see a little bit of a margin bite. We expect some of that to continue as we move into Q4, but I don't think it will be significantly worse.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Thank you.

Operator: Your next question is from Shannon Cross with Cross Research.

Shannon Cross
Analyst, Cross Research

Q

Thank you very much. I wanted to dig a little bit more into the logistics challenges and the inflation that you're seeing. And what I'm trying to figure out is – because we've heard this from a number of companies, you're obviously not the first. But, I guess, how much visibility do you have into knowing that things aren't going to get worse with some of the vaccine mandates and other things that are going to come into play here in the next month or so? What kind of workarounds can you do from a logistic standpoint? I don't know if you can just give maybe some insight into what's going on behind the scenes because I think everybody is somewhat struggling with the supply chain situation that exists today.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. Shannon, I think that's a fantastic question because we have a ton of visibility and we also have a lot of conversations with suppliers to really understand what's going to come in and when and how is that going to come together for the full bill of materials. What is tending to happen today is, in general, is that even if you have like 99 of the 100 components available, if you have 1 component that is missing, whether it's due to Malaysia or some other issue, it's stuck on a boat, then you're really not able to put that product together. That's the reason you are seeing some of these supplier decommits and movement happening last minute because people have all the components and they don't have one.

I think so projecting in that is not very easy. That's the same thing that we're seeing is that we have the inventory, we have the labor and the resources, but if one product doesn't arrive and the automotive company announces a shutdown, we are in no situation to send them any product because it's a very last-minute issue. So I think that is just hard to predict, Shannon, no matter what we try. And that's why we have been somewhat prudent now in our revenue guidance because we think those things are hard to predict.

In terms of vaccine mandates, I think that's a more hot topic, I'd say more important for the US, which is a small portion of our overall workforce, right, so really not a large portion of our overall workforce. And we think that the US situation is manageable because it's less than 10,000 people in our 165,000 people. So our factories here, we already have a plan. We've got a very good understanding about how many vaccinated, how many not, how to manage to that.

We have 84% who've already had one shot across the company. So it's pretty good metrics we have. But is that going to affect kind of some site? Maybe. But I think all that fits into kind of how we're prudently giving the revenue guidance, which is what you're seeing all companies do, Shannon.

Shannon Cross
Analyst, Cross Research

Q

Yeah. No, it's definitely – it's certainly this turning season. With regards to inflation, how are the conversations going with customers? How much Flex is there in your contracts, given some of the increases we've seen in labor cost and that? Or do we have to wait until you renegotiate contracts in sort of the next iteration before you're able to make up some of that? Thank you.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

No. Shannon, absolutely, we don't have any concerns in passing along inflation. What our – we have become so good at executing through these ups and downs, right, whether it's COVID or whether it's trade issues and now the supply chain. We reacted quickly to the inflation issues and have been very systematically passing along claims to our customers or pricing to our customers on these claims – on these inflation issues.

So we're quite comfortable that we're tracking it well. We're methodical in terms of passing it. We have a high pass rate on our inflation, things that we are seeing across the company, which is why our margins are performing so well. And we're very comfortable that contractually and even outside of contracts that this is a time to get pricing, and we're definitely seeing that in our business.

Shannon Cross
Analyst, Cross Research

Q

Great. Thank you so much.

Operator: Your next question is from Paul Chung with JPMorgan.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Hi. Thanks for taking my questions. So, just a follow-up on the acquisition. So, does the fiscal year 2022 guide kind of include the cost impact there? And when can we expect to see some margin contribution from that business? I believe you mentioned it was in the mid-teens EBITDA, just quite attractive.

And then, it's been a while since you've acquired a large asset like this. Is your cap allocation priority kind of shifting? I know you've repurchased kind of quite a bit this quarter, but should we think about higher margin M&A as the bigger priority here moving forward?

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Sure. So maybe, Paul, I'll answer the Anord Mardix question first. So we have not baked that into our 2022 guide. We'll expect to close that deal sometime towards the end of the calendar Q4 here, November-December timeframe. Thinking about 2022, it'll probably add roughly $100 million to our fiscal Q4 as we move into that March quarter.

Looking ahead to 2023, don't want to get too far over my skis in terms of incremental disclosure, but I'll say this, I expect probably $0.05 to $0.10 of earnings accretions as we move into our fiscal 2023. In terms of capital allocation, no change from what we've said before. We're going to be disciplined, we're going to be opportunistic, and we're going to balance internal investment, external investment, and share repurchase or share capital return.

We're not going to over-constrain our own CapEx. As we see good deals, we will be opportunistic and get them where we can get them at good prices. We love the Anord Mardix deal. We think it's a great fit and it's going to have nice financial returns. But like you mentioned, Paul, a couple of minutes ago, we bought back a lot of stock last quarter, and we did that because we viewed the company to be pretty significantly undervalued. So, no major change to our capital allocation framework, we're going to continue to be opportunistic, we're going to continue to be balanced, and we're going to be thoughtful and think long term.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. And, Paul, you should be able to look at this and maybe profile it moving forward, because we've been very consistent in what we said we would do, right? So, organically, we're in a great position, right? Commercial growth is strong. We like our mix. Our execution in that is fantastic. So you're seeing the margin flow through on that, which only gets better by the way because there's so much inefficiencies in the system, right, so that only gets better moving forward.

If you think about our balance sheet, it's in a strong position, got a $1 billion authorization to buy back stock. We're executing on that really well. We have room to do M&A, which is fantastic. And if we can find deals like this, it's very easy to kind of see how this company looks moving forward. So we really think that we're prioritizing all the things we said we would prioritize.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Thanks for that. And then just a follow-up on Industrial, can you kind of expand on the broad-based demand there, where you're seeing pockets of strength? And are you seeing less impact on components in this segment? Thanks.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. I'd say, first, there's two things. One is Industrial demand is broad-based kind of across all sectors for us. So whether we have power, whether we are in capital equipment, or just in kind of core industrial devices, demand is very, very strong. We've had a fantastic bookings last year in Industrial, so we've been really steadily growing that business, which is now translating into this higher demand for us. So that's a big plus and we're seeing it across our targeted verticals and sub-segments in Industrial.

In terms of the component shortage, I would say, because Industrial is more kind of high mix, low volume, it is kind of more dependent on the next set of semiconductor players versus kind of the large-scale ones that you typically see. So I would say it is getting its pretty fair share of hit, right? After CEC, I'd say Industrial and Automotive are the two biggest that are constrained by supply. But it may come out of it earlier just because, I would say, those suppliers are committing to investments that is coming on earlier than the larger foundries, right?

So, I'd say our thinking is that Industrial demand is strong, so that plays through, but the supply situation in terms of mix probably helps that because it's lower volume, higher mix, and those suppliers are keeping up a little better right now.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Okay, great. Thank you.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Thanks, Paul.

Operator: Your next question is from Steven Fox with Fox Advisors.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Good afternoon. I apologize if this is a bit repetitive. I got cut off in the middle of one of the questions. I think I understand the delta in terms of how all these issues are hitting sales. I'm not quite sure I understand the math around the exact impact to the operating line. You called out things related to Nextracker and Auto, which sound big, and some other items. I was wondering if you can maybe quantify some of the impact to the bottom line from these issues. And then I had a follow-up.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah. No problem, Steven. I assume you're talking specifically about Q2, because that's the only thing we're really given Nextracker disclosure on. Am I correct?

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Yeah. Whatever you can provide will be appreciated.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah. Sure, okay. So, sure. So, specific to Q2, I would say two-thirds of the margin erosion that we saw in the Reliability segment specifically came from the cost headwinds that we've seeing from logistics and Nextracker. That was the preponderance. We had a little bit of mix headwind there as well. We talked about the Health Solutions business being off a little bit, but I think the bigger driver was Automotive OEM shutdowns, which again, as we moved through the quarter, they got progressively worse, and September, I think, sort of being hopefully the peak.

But as I think about the sequential change now moving from Q2 to Q3, here's what we're expecting. At the midpoint of the guidance for Q3, we're expecting a 4.3% op margin rate. That's down a little bit at the midpoint from the 4.6% we did the prior quarter. It's driven by a couple of things, largely the logistics cost headwinds that we know will continue as we move through the quarter, in particular in the Automotive business; the other piece is mix. Both Auto and Health Solutions are going to be down a little bit, and those are better than average margin rate businesses within the overall Flex portfolio.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

And Steve, well, let me just – maybe I understood your question a little differently. So what I'd say is, for Q2 straightforward, right, we did much better than what we said we would do just because we're executing really well and margins came in strong at 4.6%. I think looking forward into Q3 and Q4, if we hit the guidance we're giving, our full-year operating margin will be at 4.5% at record. But what we're trying to do with 3Q and 4Q is to continue to make sure that we're incorporating any of these ups and downs that we see, and we'll continue to execute really well and hopefully do towards the higher end of the range that we've given you.

I think at this point in time, with the complexities in forecasting, we're being prudent in our outlook. But you've seen our methodology of how we've done in Q2 and Q1, and you should apply that same logic as you think about 3Q and 4Q.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Okay. That's really helpful. And now for the hard question, which is, the past out of this is murky at best. I mean, even if you say things don't get worse, you're still sort of playing catch-up for quite a long time. And understanding that demand is very good, is there something specific to Flex that maybe you could outperform others and catch up quicker for your customers? Or do we think about it as this is the new base and you're growing from this base for the time being?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

I'd say, Steve, first is, at this revenue that we have done in Q2 of over $6.2 billion, I would say another 4% revenue growth year-over-year, we'd still be very high compared to most of our peers and compared to what most companies that have such strong hardware composition are doing. So, we're definitely coming out at the high end of it, there's no question about that, you can see it in all the comparisons.

And I think the reason for that is that, as a supply chain company, we're just executing just fantastically well. And we have more ins with our suppliers and are able to understand the investments and the commitments really much better than almost any company that I've seen. And then I'd say the second reason why Flex comes out very well is just what is happening on our commercial go-to-market strategy and all the new wins and the growth ramps that we're getting, which is sitting in demand that needs to be shipped.

So, the combination of those two things really gives us tremendous confidence in our forward-looking forecast. And then largely there's no question that we're executing well. and with all the inefficiencies built into the system. So, if you put all those together, I think you should have a real strong confidence that Flex is doing really well overall and will continue to outperform.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

That's really helpful. Thank you very much.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Thanks, Steven.

Operator: Your last question is from Jim Suva with Citigroup.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you. And a lot of the questions have been answered, but I have more of a strategy structural question. And that is, as we've now gone through trade wars, COVID crisis and now a supply chain challenge for every company and every end market, as companies, we're hearing that they're more sourcing more local on the continent or closer to their home to get closer to their product and not deal with future issues like shipping and all of these things.

Does it make sense that Flex could better utilize its factories that are underutilized, maybe like in Guadalajara where Nike was planned to go to and such, and therefore on a cost-plus model your operating margins have very much significant upside room for that because they've been underutilized? Or am I missing some key components there. But strategically and structurally, I'm just kind of curious about your reply to that.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. Jim, it's a fantastic question. One is, I would look historically and say, if you think about our 120 basis points of margin improvement that we've delivered over the last couple of years, all that has also been as a result of us being very focused on efficiency. But, if you look forward, you're absolutely right, you see the shifting of our PPE that is happening more to kind of North America, and that does drive tremendous productivity and utilization benefits in Mexico and in the US that we should benefit from.

So, we're doing well in terms of resizing and upsizing our factories with a very forward-looking view of how we should see things move. Our largest programs and ramps are happening as a result of regionalization in North America. And as you are aware, we have the room to do it, but more importantly, we have a really fantastic team that can execute. So, our view is that, yes, the margin upside potential is strong, not only because revenue is going to be stronger and that will drive better absorption through the system, but our efficiencies get better, just like you have pointed out, because of factory utilization that we're going to get some upside from.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Thanks, Jim.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

Okay. Are we done? Okay. I think that was our last question. So, thank you all for joining us. And I hope you all remain safe and in good health, and I look forward to speaking to you again. Thank you.

Paul R. Lundstrom

Chief Financial Officer, Flex Ltd.

Thanks everybody.

Operator: Goodbye. That concludes today's conference. You may now disconnect.