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Flex Ltd. (FLEX)

Q1 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to the Flex First 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 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, Rebecca. Good morning and welcome to Flex's first 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 have 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 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 and we undertake no obligation to update 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 also be found in the appendix slides of today's presentation as well as on the Investor Relations section of our website.

Lastly, with regards to Flex's Nextracker business. As we previously discussed last quarter, 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 public 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 at the market conditions, and we will evaluate the right time to do the transaction, but we remain committed to doing so. Following SEC regulations, we will not make any further statements or answer additional questions on the Nextracker filing at this time.

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

Revathi Advaithi

Chief Executive Officer & Director, Flex Ltd.

Thank you, David. Good morning, everyone, and thank you for joining us today on our Q1 earnings call. Of course, I have to start off by giving a shout out to all my Flex colleagues across the world for once again staying focused and delivering on solid results.

So, let's turn to slide 3 to review our financials, we achieved a revenue of $6.3 billion, up 1% sequentially, a little better than typical seasonality, and up 23% year-over-year. Our total Flex adjusted operating margin came in at 4.6% and core Flex operating margin, ex-Nextracker contribution, was 4.4%.

Similar to last quarter, our adjusted operating margin includes the absorption of costs related to a challenging components supply and logistics environment. Our adjusted EPS was $0.46, up from $0.23 in Q1 of last year, but also up from the pre-COVID level of $0.27 in Q1 of FY 2020. Our adjusted free cash flow came in very strong at $219 million.

Now moving on to the next slide, I'd say demand across the enterprise remains very strong, and, as you can see, the team executed extremely well again this quarter. Global supply chain and logistics issue remain a challenge and add a layer of uncertainty to the near term. However, we continue to expertly navigate through the environment with an army of supply chain professionals, which is almost 10,000 people strong, and of course, decades of experience, all supported by world class system and tools to provide the best visibility and agility.

Now, this is a real competitive advantage for Flex and for our customers. Our ability to quickly adapt to global changes is unrivaled. And the proof, of course, is in the results, especially when you look at the improvements we have made across the organization over the last two years. The June quarter of calendar 2019 was my first full quarter with Flex. Our adjusted operating margin at that time was 3.4%. Fast forward two years, and it is 4.6%, which is after two previous record quarters.

If you look at our gross margins, you'll see similar improvements. When I joined, our June quarter gross margins were 6.5%, and this quarter, it was 7.5%. So we're simply operating at a better level. I'm very proud of how well we are executing on our near-term and our longer-term goals. We continue to land, expand and elevate our relationships with our customers. We're winning in the key areas we've talked about before, such as diabetes care, medical imaging and throughout the electric vehicle ecosystem on ADAS and on premium durable goods, cloud and renewables.

The secular drivers for the next wave of outsourcing are now very clear with the need for more resilient and agile supply chain. The requirement for additional regionalized production and the demand for more sustainable approaches, we're winning new businesses as well as expanding our footprint with current partners. This performance is all a testament to our goals of deeper relationship with our customers and suppliers, and a continuous steady shift to higher value businesses. And all of this is leading to a higher quality of pipeline and bookings across both our segments. Now, while we've made good progress, we're certainly not done.

With that, I'll turn the call over to Paul to walk you through our results in more detail and then I'll come back with some closing remarks. Paul?

Paul R. Lundstrom

Chief Financial Officer, Flex Ltd.

Okay. Thanks, Revathi, and good morning, everyone. I'm on slide 6. Flex revenue was $6.3 billion in the quarter, which was up 23% year-over-year and 1% sequentially, better than our typical Q4 to Q1 seasonality. Adjusted operating income was up 78% year-on-year to $290 million, with 140 basis points of margin expansion. Obviously, we're lapping COVID year comparisons, but I'll note we saw material sales and profit growth compared to the quarter two years ago as well. And the 4.6% operating margin rate was the highest Q1 margin rate, we've seen here at Flex.

Our profit growth came from drop-through on significantly higher volume, continued improvements in the mix of our business and our constant push for productivity gains. There were some headwinds in the quarter. We continue to see COVID-19 disruptions, and industry-wide component shortages and cost pressure on logistics did affect our business in the quarter. Adjusted net income was $230 million, with adjusted earnings per share of $0.46. Year-on-year those were up 98% and 100%, respectively.

Reconciling to GAAP, first quarter GAAP net income up $206 million, was $24 million lower than our adjusted net income, primarily due to $20 million of stock-based compensation and $13 million in net intangible amortization partially offset by a net credit in tax and other.

On slide 7. Our first quarter adjusted gross profit was $476 million, up $158 million year-over-year, execution was solid with 130 basis points of adjusted gross margin expansion compared to last year, but also a full point higher than what we saw pre-COVID in the June quarter calendar 2019.

In total, adjusted SG&A spending came in at $186 million, up $31 million from a year ago but at 2.9% of sales, down year-on-year and slightly below our targeted range of 3% to 3.2% of sales. So for the quarter, adjusted operating income of $290 million led to a solid 4.6% op margin rate.

On slide 8. We saw better than expected top line strength in both Reliability and Agility in the quarter with both growing double-digit year-on-year despite component shortages in the industry and logistics cost headwinds. I said last quarter, and I'll say it again, credit to the Flex supply chain organization for solid execution in a very challenging environment.

Flex Reliability revenue was $2.9 billion in the quarter, up to 30% year-on-year. Q1 performance for all three business units within Reliability were up year-on-year. Automotive revenue was double that of a year ago, up 100% year-on-year with strong execution against the industry's continued global recovery and of course, aided by the easier comp from last year shutdowns. These were strong results and better than what we saw in the June quarter of calendar 2019.

Health Solutions revenue was up 9% year-over-year this quarter, chronic care strength continued and coupled with improving elective procedures offset the normalization we are seeing in the critical care space as it returns to pre-COVID levels. We continue to win in Health Solutions and that lends confidence to our strong longer-term outlook in the space.

Lastly, Industrial grew 20% compared to the prior year, led by strength in core industrial and renewables. Industrial continues to be a bright spot for Flex, up year-on-year, but up significantly for the two-year period as well, both with and without Nextracker.

Looking at profits, the Reliability business generated $170 million of adjusted operating profit and a 5.8% adjusted op margin rate. Margins improved by 70 basis points year-on-year but were tempered by higher costs due to inefficiencies created by the current supply chain and logistics environment. As you see in the footnote, Nextracker margins were down in the quarter with logistics cost headwinds we view as temporary.

Moving to Agility, segment revenue of $3.4 billion was up 18% year-over-year. Within Agility, CEC was flat year-over year, but recall, strength in cloud infrastructure and 5G rollouts remained strong through COVID last year, as data centers and networks had to quickly adapt to the changing workloads created by work and learn from home.

Lifestyle was up 36% year-on-year with new ramps and current customer expansions, driven by our strong value proposition as well as an increase in customers looking to broaden their regional manufacturing presence. Lastly, Consumer Devices benefited from continued recovery in consumer spending in developing markets and grew 50%, that's 5-0% year-over-year.

Turning to profitability, the Agility segment generated $137 million of adjusted operating profit and a 4% adjusted operating margin rate for the third consecutive quarter. This is well beyond a COVID recovery. Looking back to pre-COVID levels, our Agility business historically operated at margin rates with a two handle. So I would say, very nice to see the traction in that business. Agility is firing on all cylinders.

Last year, Agility margin expansion – year-on-year Agility margin expansion was driven by a continued push for new business wins and renewals at accretive margins, as well as continued cost management discipline from our Agility operating model.

On slide 9. For the quarter, adjusted free cash flow of $219 million was up substantially compared to the prior year, which was severely affected by COVID and the shutdowns in global automotive production.

Looking ahead to the full year 2022, we still expect adjusted free cash flow on a dollar basis to be roughly in line with 2021, albeit with some pressure in Q2. We closed Q1 with inventory of $4.4 billion, resulting in inventory turns of 5.6 down from 6.1 turns last quarter, but up from 5.3 a year ago. We continue to see component shortages in the supply chain and although it was manageable in Q1, we do expect continued working capital pressure as we move through Q2.

Our net capital expenditures for the quarter totaled $115 million. As I mentioned last quarter, CapEx of roughly 2% of sales is a reasonable expectation for 2022 and we remain committed to responsibly investing in strategic growth. Lastly, on share buyback, we stepped up our share repurchase program in the quarter, spending on repurchases was $162 million, which amounted to 9 million shares.

If you could turn to slide 10, and as you'll hear from Revathi in a couple of minutes, we're upbeat on the year. That said, we expect component shortages and logistics headwinds, as well as persistent waves of COVID-19 to remain a headwind in Q2, but the demand side is there, and all of our underlying demand signals remain strong.

Looking ahead to Q2, we expect our Reliability Solutions segment to grow low to high single-digits year-on-year. As I mentioned earlier, the demand side is strong, but likely will be tempered a bit by constraints in the supply base. We expect Automotive revenue to be up mid-single-digit to high-teens year-over-year, despite continuing component shortages and OEM production disruptions.

Looking back to last year, Q2 was our peak quarter for Health Solutions with strong demand from critical care products like ventilators. Moving into Q2 of this year, we're seeing normalization in critical care, and consequently, expect revenue to decline mid-to-high single-digits year-on-year. Please remember we saw a significant COVID-related product bump in Q2 of last year, and now we're seeing the normalization period. Based on our very strong pipeline, we fully expect the strong growth to continue for years to come.

And our Industrial business should be up mid-single-digits to mid-teens year-over-year, as we continue to see robust demand in renewables, gaming and kiosks, metering and a number of other areas.

Looking at Agility. Agility Solutions Q2 growth should be similar to that of Reliability with revenue up low-to-high single-digits year-over-year. Lifestyle should grow 10% to 25% year-over-year in Q2 with continued strong demand across multiple platforms and new business wins. CEC should be flat year-over-year in the quarter, but continued with – but with continued pressure from clear to build. Long-term, solid growth is expected in the second half for CEC. Consumer Devices is expected to be flat to up low single-digits year-over-year.

Turning to slide 11. Overall, we expect Flex Q2 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 should be roughly $40 million. We expect our tax rate in the quarter to remain at the higher end of our 10% to 15% guidance range.

We expect adjusted EPS to be in the range of $0.37 to $0.43 per share, based on weighted average shares outstanding of 499 million. Our adjusted EPS guidance excludes the impact of stock-based compensation expense and net intangible amortization. As a result, we expect a GAAP earnings per share in the range of $0.29 to $0.35 per share.

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

Revathi Advaithi

Chief Executive Officer & Director, Flex Ltd.

Thank you, Paul. Now turning to slide 12, last quarter we wanted to provide you as much visibility as we prudently could and give our outlook for fiscal 2022. As Paul said, it's important to remember that there are still challenges and some uncertainties to overcome, but hopefully we'll all be soon through the worst of it.

Now based on the current situation, we're increasing our full year revenue guidance range to $25.5 billion to 426.5 billion, our operating profit range to 4.5% to 4.7%, and our EPS range up to $1.70 to $1.85.

Now, on behalf of the entire leadership team, I want to thank my colleagues for their commitment and their hard work, of course our customers and suppliers for the trust and partnership and our shareholders for your support.

With that, I'd like to turn the call over to start the Q&A.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And your first question comes from the line of Matt Sheerin with Stifel.

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

Q

Yes, thank you. Good morning. I wanted to ask about the margin guidance for the September quarter, which is implied down sequentially, but still certainly up year-over-year. Are you seeing that pressure in both businesses, and is it some of the reasons that you talked about logistics, price, costs, as well as maybe some lower utilization levels on the healthcare side?

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah, you're spot on, Matt. You know, as we moved from Q1 into Q2, just like you said, 4.6% op margins here in Q1, at the midpoint of our guidance at 4.3% that would be down a bit sequentially. I guess what I'll say is, you're absolutely right, a little bit of pressure in both businesses. We talked about it in the prepared remarks there about some pressure in CEC from clear to build. We're doing everything we can to get components available so that we can ship, because, as I mentioned, the demand side is certainly there. So a little pressure in on the agility side, namely in the CEC business.

And then on the Reliability side, as you know, we have the Automotive business in there and that one is – the whole industry is struggling a bit with clear to build and component shortages, and that does create a little bit of inefficiency. But, again, that's the midpoint of our guide. I think that's – I think it'll be a pretty good – pretty good performance if we can nail that at 4.3%.

And as you mentioned, and I think very important – very important point to our owners here, that's still up year-on-year and continues to be outstanding performance for Flex particularly compared to last several years,

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

And Matt, I'll remind you at that midpoint, Q2 will still be the highest record for us in terms of operating margin for the guide we've given you. And we're very upbeat and as you can see from how we have previously managed the company and how we've managed through supply chain logistics, we always flag that Q2 would be somewhat tricky and I think that's what we're seeing. But we're very positive and very bullish about how the year looks and how Q2 looks also. We're just being prudent in terms of our guidance.

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

Q

Got it. Thank you. And I just wanted to also ask just about inventories relative with the supply issues that you're seeing, it was up quarter-on-quarter. What's the strategy there going forward in terms of working with customers, but also getting compensated, whether it be in deposits or other things, so that you're still meeting your working capital goals.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.
A

Yeah. Sorry.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.
A

Matt, I'll just start by saying, one is we're absolutely doing that. That's why you see our cash flow is so strong. We are getting compensated for inventory that we're putting in the system and we'll continue to do that. We have extreme discipline about this amazing coordination between our supply chain teams and our commercial teams.

And customers are very, very open to this, right? It's an industry-wide constraint that's going on. So we're seeing no issues in terms of translating what we're seeing in inventory to getting advances from our customers. But we also think that there is room to continue to improve inventory, as these things get a little bit more stable in the future quarters. So our goal is to still try to get inventory down, not just for us, but across the supply chain.

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

Thanks very much.

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

Ruplu Bhattacharya
Analyst, BofA Securities, Inc.
Q

Hey. Thank you for taking my questions. I have two questions, both on margins. First one, you mentioned higher freight cost impacted Nextracker, is there a way to quantify how much that impact was on Nextracker margins?

And on the slide 10, I think you mentioned that you expect logistics challenges to bottom in Q2. What are some of the things that you're seeing that gives you that confidence? Because, I mean, from what we are hearing, freight costs should remain high. So just – if you can just give us more color on your thoughts on logistics costs.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.
A

Yeah, absolutely, Ruplu. Happy to go through this. First is, I'll tell you that, Nextracker, as part of Flex, has really matured in terms of the supply chain company and having the right kind of hedging practices, but also how they pass on costs to customers is very different than the rest of the industry. So I wouldn't let that cloud the judgment of how Nextracker runs and operates. I'd say it really operates as a world-class supply chain company managing through that.

And as you can see, most of the commodity inflation, as we talked about, has already been offset, because they're passed through and how they manage contract pass-through and commodities is quite seamless and that's pretty incredible, given the environment and how significant commodity inflation has been.

On the side of logistics, the reason why we're very comfortable that we lap that very soon is, because it just has to run through the existing contracts and then it's priced into new contracts. And by the way, even in existing contracts, we are overcoming quite a bit of the freight increases with managing with customers in terms of renegotiating price. So we see the logistics issue as being temporary, even if the costs remain inflated, how we pass that through in contracts will flush through the system. That's why this is a very short-term temporary thing, and we're very comfortable that we will lap that very quickly in the next couple of quarters.

Ruplu Bhattacharya
Analyst, BofA Securities, Inc.
Q

Got it. Yes, Revathi, thanks for all the details on that. That makes sense. Maybe I'll ask you a different question then as my follow-up. You've outlined your growth strategies and you are focused on the longer life cycle end markets. At this point in the cycle, does it make sense to look at inorganic growth, your thoughts on just looking at acquisitions and what are you looking for if you are and what end markets would you be thinking about expanding? Thank you.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.
A

Yes, I would say first is I'd say the most important thing, Ruplu, for I think every company, including ours, is to make sure we deliver really well in terms of the core and organic side of the business. And as you can see, we really are hitting on all cylinders, right? Every business is growing organically, our growth rates are strong, our pipeline and bookings have done the best ever, and you can see that in terms of not only the quality of the bookings coming through, but the segments that we're growing in is consistent. And I've always said that, I want every segment to be doing well on its own, whether it's top line or bottom line and that's kind of what we're seeing, right?

So organically, I feel like the business is doing extremely well, but I also feel that there's tremendous room for us to continue to grow organically and drive a continued growth strategy in the segments we participate because our end segments are so big. And there's so much room to just focus on where you deliver value, and we're seeing that, that is the case, right?

You can see that in our Lifestyle segment, which is doing really well; Agility, which is doing really well because it's focusing on the right segments and delivering growth. If you look at how we are doing overall even from a bookings and pipeline perspective, we're expecting our growth to come in, that's accretive to the margin levels and to our ROIC levels, which is around 20%, right now this quarter. So really, we want to win in all segments organically and we want to invest organically really well.

That being said, I would say our cash position is in the best that this company has ever been in. So that's fantastic, right, because even with all constraints of supply chain and things like that, our cash flow is incredible in terms of how we've really managed this company, so we have tremendous optionality on how we use that.

And whether we focus on buybacks because I'd say our stock is really trading at a low right now, we think it's very valuable right now to continue to invest in our stock so we'll balance that between do we do more buybacks or do we invest in organic acquisitions?

The fantastic news is optionality everywhere, right, organically growing very strong, tremendous room in terms of our pipeline, our bookings. We want to invest more capital in terms of our growth strategy. And we think that our stock is undervalued and we need to focus on making sure that our buyback is strong and we'll continue to do that. And if we have great technologies to invest in, we will. So I think the good news, Ruplu, is we have options everywhere.

Ruplu Bhattacharya
Analyst, BofA Securities, Inc.

Q

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

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Thanks, Ruplu.

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

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Yes, thanks very much for taking the questions. I was hoping to start on margins and think through the sustainability of margins over the intermediate to longer-term. Margins, as you pointed out a record high, I mean, Agility in particular is very good and that's despite some of these temporary challenges around logistics and component buy. So maybe we could talk through some of the puts and takes to that?

I think perhaps there are some parts of this that are more structural and sustainable around the mix, and how the company is structuring its operations, but are there any potential offsets that we need to be mindful of going forward that are perhaps more cyclical components, that are temporarily helping you in terms of where asset utilization is running or anything like that that we need to be mindful of as we're thinking about the longer-term margin potential of the business?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

No, Mark, I'll start by saying one is if you look at kind of our margin guidance for Q2, it mean from the previous question that somebody asked, I think, Matt asked that there's inefficiencies we've built into that in terms of our current situation, particularly for chasing, expediting and supply chain issues. So, obviously, those are going to go away and we're going to continue to improve margins. If you look at our guidance for the year right now at a midpoint at 4.6%, that's a pretty significant guide in terms of how we see the full year come through.

And as you can see from our history of how we think about these things, we're quite thoughtful in terms of how we provide this guidance. So I'd say first is from a margin perspective, inefficiencies are there today. From a supply chain perspective, we think that gets better. So if anything, there is upside more than anything else.

But I think more importantly, the way I think about long-term is, we're a manufacturing company, and we're kind of just started on this journey that we're getting really good at in terms of how we look at productivity and efficiencies across our factory. And I'd say that if anything, there's more room to continue to do that better and better, I'd expect that Flex will be – in terms of lean and productivity and efficiency and using things like, our Flex business system will continue to be world class in that.

So if anything, I'd say there's more room just in terms of margin, driving more productivity and efficiency, managing our footprint better. But what's even better than all that will be I would say, if you look at our growth and the mix of our growth, right, we're very focused on the right kind of growth and making sure that the mix is flowing through, through our pipeline.

So I'd say, Mark, I have nothing to point to that you have to be thinking about in terms of that goes down from here, if anything, I'd say it's what we have to focus on is, I'd say our journey has just started, it has still only get better from here. You can see that right from where we were, like I said, couple of years ago at 3.4% to 4.6% gross margin and operating margin. So I'd say the tremendous room to continue to drive upside to this.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

That's very helpful. Thanks. And for my second question, I was hoping you could provide some more details on what Flex's expectations are on the component supply environment to the back half of this calendar year and into next year. Any details you can share about how you see the supply hopefully improving when some of these semiconductor and other component shortages are alleviated, and any differences in terms of, which end markets are perhaps currently most constrained and when various end markets could begin to be able to get the supply that they need? Thanks.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. So, Mark, I'd say that, there's nothing I'm going to add that you haven't read and seen and heard from all the other earnings calls that you got before us, right? I think we had predicted just a couple of quarters ago that we thought this particular quarter we're entering which is Q2 would be probably the most challenging, and we had done that based on our intelligence of lead times what we had heard from chip companies in terms of how their capacity would start coming in, particularly in the forms of assembly and test capacity.

So I'd say we had called us a long time ago to say that we think that this quarter will be the most challenged and that you should start to see some recovery as kind of assembly test capacity starts coming in, in the future quarters. You are kind of hearing that across the board. One is I'll say is, we see this issue across every segment. Some like medical and auto, I'd say kind of gets better quicker, one is because their volumes are much lower compared to tech and industrial.

And as Paul pointed out in his comments, right, CEC had constraints this quarter and we think tech and industrial will have kind of a longer tail, but that's more because of the scale of those segments, right, and how the end markets in terms of the supply chain and the chip companies have volume associated with those end markets.

But overall, right, I'd say this quarter is probably where we see some level of bottoming out. And then, we start to see it stabilize kind of moving forward and that's kind of where we're thinking this moves I'd say. But will it continue through next year? I think there'll be some pushes and pulls through next year. I think we'll just have to work through that.

Mark Delaney
Analyst, Goldman Sachs & Co. LLC

Q

Thank you.

Operator: Your next question comes from the line of Shannon Cross with Cross Research.

Shannon Cross
Analyst, Cross Research

Q

Thank you very much. I was hoping you could talk a bit about how your conversations with customers have been going, as we're in theory exiting COVID with regard to how they're thinking about moving out of China or other geographies? And just in general, how they're looking at outsourcing? And then, I have a follow-up. Thank you.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Thanks, Shannon. I'd say our conversations with our customers are very focused on what can they do to make their supply chain more resilient, right? And whether you think about trade issues that drive regionalization or now the pandemic drives different thinking around bringing the supply chain closer to the end customer. And the end customer could be any part of the world, whether it's Europe, Asia or North America.

I'd say our customers are driving more conversations and more decision making around that today than we've ever seen before. But what that has translated to already, Shannon, is that our pipeline of bookings, if you look at the focus on regionalization and what's driving some of our pipeline, that's pretty significant. And we're seeing those actions already come through.

We have tremendous amount of product launches that are going on, I'd say, across the world which is driven by some of these supply chain resiliency trends that we're seeing. So, I'd say the focus from our customers really is the conversation has gone into actions and the actions are driving our pipeline and bookings to be at this record level right now with a tremendous amount of program runs going on across our organization. So, I'd say – and that is across all sectors. I couldn't point to one sector where that conversation is not going on.

Shannon Cross
Analyst, Cross Research

Q

Okay. Thank you. And then, Paul, maybe you could talk a bit more about working capital. On a historical basis, it was quite strong this quarter. Is there anything we need to worry about reversion to the mean or anything within the various components? And I know you mentioned getting some prepayments. And is there anything else that you're doing that is driving this? Thank you.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah. So appreciate the compliments on working cap in the quarter. Pretty good performance, very good performance, cash flow, $219 million, we were quite pleased with that, and perhaps even a little bit surprised to the upside, had some inventory pressure in Q1, I think that will persist as we go into Q2, and we'll probably have a little bit of free cash flow pressure in Q2, because as inventory receipts came in at the back half of the Q1 quarter, you have to pay the bills for that as you move into Q2.

That said, for the full year, kind of hanging on to our free cash flow guidance which was essentially in line with last year. And I don't think there's anything rolling over. Lot of focus on working capital management within the business, our incentive programs are designed to drive strong working capital and cash flow performance. So I would say, overall, a bit, no change there, perhaps a little bit of pressure in Q2.

Shannon Cross
Analyst, Cross Research

Q

Great. Thank you.

Operator: Your next question comes from the line of Steven Fox with Fox Advisors.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Hi. Good morning. Couple of questions. First of all, I just want to make sure I understand the math around some of the supply chain assumptions. So if sales are flat quarter-over-quarter, roughly speaking, and your profits are down at the mid-point $20 million, is that $20 million all related to supply chain or is there other stuff we should consider? And is it limiting your ability to upside to customer forecasts? And then, I have a follow-up.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

I'd say Steven one is, it's all around supply chain. I think that's kind of a no-brainier. And I think doesn't limit our ability at all, in terms of upside I think I would say with demand, right?

This is all a question of not just whether we can find the components, but whether suppliers can find their other supplier – customers can find other suppliers giving their components to come to final assembly. So I'd say, all around supply chain, and kind of how we manage that and clear that will kind of drive all the upside, I'd say.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah. And I'd just add. I think Revathi mentioned it a couple of minutes ago as well, but at the midpoint of the guide and 4.3% op margin in Q2, that would be the best Q2 we've seen and up 20 basis points year-on-year, despite the challenges that we're seeing in the supply chain. So it is pressure, but still strict – really good performance by the operating team.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

And Steve, I would say that, if you look based on the last quarter, our supply chain team is just incredible, right? I mean, the things they can do what our customers rely on us in terms of finding components and dual sourcing and doing things like that, they can do things that nobody else can do.

So, I'm pretty comfortable that we've got a very solid game plan, not just for Q2 but through the next few quarters. And we'll do an amazing job managing through all of that.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Great. I think I got it now. And then as a second question, you mentioned on the healthcare side that you continue to win during the quarter, I assume you mean new programs. I know you don't want to name customers or anything like that. But can you give us a sense for, what that exactly means in the recent quarter? Any color around how your – what kind of programs you are winning or what kinds of success you're having on the engineering front, et cetera? Thanks.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah. I'd say, in terms of Health Solutions, we've been driving this kind of focus around pipeline and bookings even just as COVID had started, because we knew that there was an incredible area for us to grow and our capability was something we're consistently hearing from customers that, hey, you know what, as anything you do to increase capacity in terms of your own commercial design capability, we're going to be able to fill that up. And that's kind of what we're seeing, right, with the Health Solutions business and what we delivered last year with customers in terms of ramping up for COVID care in such a short time really tremendously also changed our credibility in the industry in a big way and we're already such a significant player in terms of medical devices.

So our wins that we're seeing is in every sector, we're seeing it in critical care, we're seeing in like we've talked continuously about kind of diabetes care, we've run several programs in that area. They were one of the largest suppliers in that space today. Everything around imaging. So all our key [ph] were picked in (40:24) our four areas around Health Solutions and all of those were winning, very, very focused large programs around.

And actually most of them are even ramping up right now. So the Health Solutions segment really picking in terms of all cylinders, in terms of the pipeline, bookings and then how we are ramping up all these programs.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Great. That's really helpful. Thank you.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Thanks, Steve.

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

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. Thank you. Revathi, you talked about the opportunity to get more efficient, and I look at the metrics, your SG&A to revenue is below your target range while your gross margin is healthy. When I look on an OpEx to GP basis, I think it's at all-time lows, so the operational model is being pushed more than ever right now. And I wanted to ask, first, how specifically, you can get more efficient, should we expect more restructuring opportunity? What does the ultimate operating structure look like? And lastly, what does this do to growth as you pursue that structure?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yes, Adam, I'll start by reminding you that the first thing is that our gross margin has grown like 100 basis points, right, in the last couple of years. So we've done an incredible job in terms of making sure that gross margin is improving with driving the right kind of mix, but also driving the right productivity and efficiency in our factories.

For me, OpEx efficiency, we went through, of course, a correction period when we changed our revenue a little bit and adjusted our portfolio the last couple of years, but we want to continue to drive OpEx efficiency across our business and whether that's in our back office or things like that, because we do an incredible job of driving OpEx efficiency too.

But our potential is in our gross margin, that's where we'll continue to drive improvements because we think there's tremendous productivity efficiency through footprint optimization. We don't see kind of any major restructuring. We think all of these should be managed through the business cycle. If there is any, it'll be puts in takes I would say through our business cycle, but gross margin is where we think through mix and through productivity efficiency, we'll continue to see improvements moving forward.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. And maybe as a follow-up for Paul. I just wanted to double click on the margin ramp that's implied in back half guidance. Just the back of the envelope, it looks like if I compare revenue and operating profit in the back half versus the first half, it's about a low double-digit contribution margin, which is really healthy. I think you talked about an auto ramp that's coming that should be a little bit of a headwind in Q3 and Q4. Maybe help us with the buckets of the key tailwinds that drive that level of contribution in the back half of this year since you guys sound really confident. Thank you.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yes, happy to do that. So I think, as Revathi had pointed out, probably the trough, in terms of supply chain challenges, and that would include cost headwinds, it's probably at its worst in Q2, and it gradually improves as we move into Q3 and Q4. And the challenge with this supply chain environment is, it does create stops and starts within our facilities and that just that leads to inefficiencies.

We feel confident in the back half and I'd maybe just go back to the April timeframe, March timeframe as we were thinking about our full year guidance. We expected that Q2 supply chain challenges would be there and we figured that Q1 would be tough, Q2 would be a little bit worse, but things would gradually start to improve as we moved into Q3 and Q4. And what I'll say is, fortunately, that view hasn't changed.

If this was moving all over the place and we didn't have that sort of consistent expectation, I guess I wouldn't be as confident as I am in the back half. But given that things are slowly starting to improve as we move through Q3 and Q4, we'll have less of that inefficiency. And that, coupled with new program ramps dropping in, I think we'll be right in the middle of that 4.5% to 4.7% margin rate for the full year.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Okay. Just a quick -

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

And then, we've got – Adam, I'll just point out that in the second half, we've got CEC is going to be stronger because we'll have better components availability, we've had tremendous new wins in that business that's going to help, the whole return to work is going to help that. Also we've also said that auto wins are, we'll see more some of that coming up in our next fiscal year cycle. But, we're quite confident that, in terms of second half, we're putting some supply chain issues behind us, but we also see mix being a good thing, but our midpoint of our guidance is pretty strong, I'd say, it'll be a record year for us again.

Adam Tindle
Analyst, Raymond James & Associates, Inc.

Q

Right. And a quick clarification on Nextracker, is that SEC review process complete and you're now just waiting on market conditions, are you still waiting on the SEC review? Thanks.

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

A

Yeah. We really can't comment on the process other than we're in the process with the SEC. So when that situation changes, you'll know.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Thanks, David.

Operator: Okay. [Operator Instructions] Your next question comes from the line of Paul Chung with JPMorgan.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Hi. Thanks for taking my questions. So on the customer side, we're hearing a lot of pressure not surprising, on shortages and higher freight costs kind of really hurting those OEMs that have kind of limited product diversification. So are you starting to see accelerating customer interests looking to offload a lot of the logistics and manufacturing, and do you have any pricing power there given the urgency, and if you could give some examples that would be helpful. And I have a follow-up.

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yeah, Paul, I'd say what we're hearing definitely from customers and more customer conversations on how they should be thinking about their supply chain in terms of having us help them think about the risks associated with it and how do they plan for it. It's coming through across the board, whether it's associated with freight and logistics, or whether it's associated with components itself that is in outdated tooling, or that needs to be second sourced. All of these conversations, because it's not one conversation, right, if it's an auto, it probably is about outdated tooling and outdated components that needs to – that needs a new design and a new source, right?

In the tech world, it could be a whole different conversation, because it could be focused on just developing second sources and having inventory and product available closer to their point of view. So every single business and customer base is having this conversation with us. And for us, it's all a question of making sure we're finding the right solution for each customer and that they value our expertise and experience quite a bit to help them design these.

And Paul, I would say that, pricing power absolutely exists because I think you can see from the supply chain issues that customers are very clear, they don't want to be in this situation again. So using suppliers like Flex to help them redesign that and make sure that they provide them the right solution is worth a lot because nobody wants to be in this situation again.

So I'd say, yes, absolutely. And then in terms of examples, I'd say I can give you examples in the – in our Lifestyle segment, which is very consumer driven, where our customers are very, very clear that from not only the product availability being closer to the point of views is very important to them and as they are willing to give – pay the price to make that happen, but then also full lifecycle off it, right, where they're able to bring in product to be fixed when the customer returns them.

So a full lifecycle solution for that segment is super important, and we're seeing customers really drive to that to say, hey, whether I'm located in Europe or in Asia or in North America, I want a full lifecycle solution, I want to be closer to the point of views and how can Flex do that for me. So – but I could give you an example in almost every segment on this, Paul, it's across the board.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Great. Thanks. It's very helpful. And then just a follow-up on free cash flow. I mean, you mentioned free cash would be kind of in line with fiscal year 2021. Now your revenues and margins are expected to be higher, weren't you kind of expecting free cash flow and conversion to be higher as well? If you could expand there. I know you mentioned some Q2 headwinds on working cap and whatnot, and your CapEx guidance would be helpful as well. Thank you.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Yeah, no problem. So, as I mentioned, we will have a little bit of free cash flow pressure in Q2. What I would say about the supply chain environment component shortages in particular is that, it is and continues to be a fluid situation. With the – if the outlook improves as we move through the back half of this year, we'll certainly update that guidance. But I think that free cash flow in line with last year which by the way was a very good free cash flow generation year for us. I think it is prudent guidance at this point in time.

In terms of CapEx, I'd mentioned before CapEx to sales about 2% is probably a good placeholder for you guys and allows us to prudently invest in strategic growth for the business and I don't think it constrains us in any way.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Thanks. Great. Appreciate it.

Operator: Your next question comes from the line of Jim Suva with Citigroup.

Jim Suva
Analyst, Citigroup, Inc.

Q

Thank you. And Revathi and Paul, you mentioned that there's some transitory costs, we're all very familiar of the shortages in semiconductors. And also the expediting costs or freight shipping cost, whether it be containers or airplanes from China or Asia or around the entire world, are you specifically talking about the ones about freight and you think that those are going to subside, or are you talking about more about also the component costs like steel, copper, resins, plastics and aluminum have recently rallied and you expect those to kind of subside in the next couple of quarters?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

So I would say, Jim, what I would say in terms of the commodity and the component side is that, in the semiconductor space itself, the component price increases that are being passed through, we're passing those through to. And those are going to stick for a period of time. So it goes through another cycle, Jim, as you know this very well.

In terms of commodities like steel, yes, they are rallying, but our ability, particularly our biggest use of that is in our Nextracker business. We basically pass through that like-for-like through our contract. So we don't carry any headwind because of that. And if that recovers, I would say it'll go through that same process, right, in terms of customer negotiations. So I would say freight is probably the only place and that also only in the Nextracker business where it takes couple of quarters to work through the contract headwinds.

And so, I'd say that's what happens in terms of pricing, but if you look forward and think about how long inflation stays across all these end markets. Jim, I'm not sure I can call that very easily today, I said all I can say is that we're passing through pricing as quickly as we can in all segments and they're sticking.

Jim Suva
Analyst, Citigroup, Inc.

Q

Great. Thank you so much for the details and clarifications. It's greatly appreciated.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Thanks, Jim.

Operator: And your next question comes from Christian Schwab with Craig-Hallum Capital.

Christian David Schwab
Analyst, Craig-Hallum Capital Group LLC

Q

Hey, guys, congratulations on another great quarter. Regarding your guys' ability to prove out over the last few quarters in a challenging environment to be a very trusted supply chain partner, and you highlighted many different examples of that. As we look to the mid-term, beyond this fiscal year, do you guys think, given that kind of example of partnership with your customers that you're – you'll be positioned to in essence outgrow the industry as we get to the kind of mid-term as far as a top line?

Revathi Advaithi
Chief Executive Officer & Director, Flex Ltd.

A

Yes, I would say – absolutely, I'd say correct, there's no question about that, right? I mean even if you think this quarter, as you can see our overall growth rate, right, even compared to the rest of the industry is very, very strong. I'd say in the mid-term, I have no doubts about that, our pipeline is very strong, our bookings have been fantastic, even with our focus on the right kind of bookings.

So I would say in the mid-term our ability to grow and grow in our end markets, in our sub-segments we want to grow is extremely strong. I'm very bullish about it and feel very, very comfortable that customers are coming to us because they know that we execute well, we really are a good trusted partner for them in terms of being able to grow with them. So, no question about that. I would say our growth focus from where we are right now it looks very bullish moving forward.

Christian David Schwab
Analyst, Craig-Hallum Capital Group LLC

Q

Fantastic. No other questions. Thanks.

Paul R. Lundstrom
Chief Financial Officer, Flex Ltd.

A

Thanks, Christian.

Operator: And there are no further questions at this time. Do you have any closing comments?

Revathi Advaithi

Chief Executive Officer & Director, Flex Ltd.

No, I'll just say thanks, everyone, for joining, and be safe and healthy. Thank you.

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