

THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

PLXS - Q2 2017 Plexus Corp Earnings Call

EVENT DATE/TIME: APRIL 20, 2017 / 12:30PM GMT

OVERVIEW:

Co. reported 2Q17 revenues of \$604m and GAAP diluted EPS of \$0.84. Expects 3Q17 revenues to be \$595-625m and GAAP diluted EPS to be \$0.68-0.76.



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

CORPORATE PARTICIPANTS

Patrick John Jermain *Plexus Corp. - CFO and SVP*

Steven J. Frisch *Plexus Corp. - COO and EVP*

Susan Hanson *Plexus Corp. - Director of Corporate Communications & Brand Management*

Todd P. Kelsey *Plexus Corp. - CEO, President and Director*

CONFERENCE CALL PARTICIPANTS

Jeangul Chung *JP Morgan Chase & Co, Research Division - Analyst*

Jim Suva *Citigroup Inc, Research Division - Director*

Matthew Sheerin *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Mitch Steves *RBC Capital Markets, LLC, Research Division - Associate*

Sean Kilian Flanagan Hannan *Needham & Company, LLC, Research Division - Senior Analyst, Electronic Manufacturing Services and Electronic Components*

Shawn Matthew Harrison *Longbow Research LLC - Senior Research Analyst*

Sherri Ann Scribner *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Steven Bryant Fox *Cross Research LLC - MD*

PRESENTATION

Operator

Good morning, and welcome to the Plexus Corp. Conference Call regarding its fiscal second quarter 2017 earnings announcement. My name is Sylvia, and I will be your operator for today's call. (Operator Instructions) The conference call is scheduled to last approximately 1 hour.

I would now like to turn the call over to Ms. Susan Hanson, Plexus' Director of Communications and Brand Management. Susan?

Susan Hanson - *Plexus Corp. - Director of Corporate Communications & Brand Management*

Good morning, and thank you for joining us today.

Some of the statements made and information provided during our call today will be forward-looking statements, as they will not be limited to historical facts. The words believe, expect, intend, plan, anticipate and similar terms often identify forward-looking statements. Forward-looking statements are not guarantees since there are inherent difficulties in predicting future results, and actual results could differ materially from those expressed or implied in the forward-looking statements.

For a list of factors that could cause actual results to differ materially from those discussed, please refer to the company's periodic SEC filings, particularly the risk factors in our Form 10-K filing for the fiscal year ended October 1, 2016, and the safe harbor and fair disclosure statement in yesterday's press release.

Plexus provides non-GAAP supplemental information, such as ROIC, economic return and free cash flow, because those measures are used for internal management goals and decision-making and because they provide additional insight into financial performance. In addition, management uses these and other non-GAAP measures, such as adjusted net income and adjusted operating margin, to provide a better understanding of core performance for purposes of period-to-period comparison. For a full reconciliation of non-GAAP supplemental information, please refer to yesterday's press release and our periodic SEC filings. We encourage participants on the call this morning to access the live webcast and supporting materials at Plexus' website, www.plexus.com, clicking on Investor Relations at the top of that page and then Event Calendar.



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

Joining me today are Todd Kelsey, President and Chief Executive Officer; Steve Frisch, Executive Vice President and Chief Operating Officer; and Pat Jermain, Senior Vice President and Chief Financial Officer. Consistent with prior earnings calls, Todd will provide a summary comment before turning the call over to Steve and Pat for further details.

Let me now turn the call over to Todd Kelsey. Todd?

Todd P. Kelsey - Plexus Corp. - CEO, President and Director

Thank you, Susan, and good morning, everyone. Please begin with our fiscal second quarter results on Slide 3. After the close of market yesterday, we reported results for our fiscal second quarter of 2017. Revenue was \$604 million, with GAAP diluted EPS of \$0.84. The EPS result included \$0.13 of stock-based compensation expense.

Our GAAP diluted EPS was \$0.05 above the top end of our guidance range. Robust productivity improvements, favorable product mix and record revenue and profitability in engineering all contributed. We delivered this solid earnings performance despite weaker-than-anticipated sales, displaying the resiliency of our operating model. Our Communications market sector weakened considerably within the quarter, and our Healthcare/Life Sciences and Industrial/Commercial sectors softened slightly.

Advancing to our fiscal third quarter guidance on Slide 4. We currently expect continued end-market weakness within our Communications sector, coupled with a forecast adjustment with a large Industrial/Commercial customer to offset meaningful growth within the remainder of our business. As a result, we are guiding revenue in the range of \$595 million to \$625 million. When coupled with projected operating margin performance at the high-end of our target range of 4.7% to 5%, we expect fiscal third quarter 2017 GAAP diluted EPS to be in the range of \$0.68 to \$0.76. This includes \$0.13 of stock-based compensation expense.

Please advance to Slide 5. While we are mindful of the short-term revenue challenges, we remain confident in our longer-term outlook for achieving meaningful growth, as our long-term growth prospects are largely unchanged. In the near term, our revenue constraint is primarily associated with specific demand issues with a limited number of customers.

We continue to generate robust margins, provide solid economic return, accelerate our business development success and deliver results in key areas that will enable future success. For example, we continued our strong operating performance with operating profit of \$32.6 million, just shy of our record established last quarter. Our operating margin of 5.4% represents the best performance we've had since the fiscal second quarter of 2008.

In addition, the fiscal second quarter of 2017 represents the fourth consecutive quarter we met or exceeded our target operating margin range of 4.7% to 5%.

We delivered a return on invested capital of 16.8%, resulting in an economic return of 630 basis points above our weighted average cost of capital, delivering meaningful shareholder value. The economic return performance exceeds our 500 basis point goal and is a 570 basis point improvement year-over-year.

We continued to generate healthy cash. Our free cash flow for the fiscal year exceeds \$90 million after the first 2 quarters.

Our Manufacturing Solutions wins momentum is accelerating, as we achieved \$202 million of wins within the quarter. Our trailing 4-quarter manufacturing wins now stand at \$813 million, with a trailing 4-quarter win ratio of 32%, well above our 25% goal. Our quarterly wins included share gains with 4 of our top 5 customers, as we leveraged our commitment to operational excellence and strong Net Promoter Scores.

In addition to the strong wins performance, we increased our funnel of qualified Manufacturing Solutions opportunities to a new record of \$3 billion, as our teams continue to leverage our strong brand in the marketplace and refine our go-to-market strategy.



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

Finally, our Engineering Solutions team delivered record revenue and profitability in the fiscal second quarter. Our wins continue to be solid within Engineering Solutions as we leverage our differentiated service offering. Our engineering backlog remains strong for the remainder of fiscal 2017, which not only directly impacts profitability but also enables future manufacturing growth.

We anticipate that we will achieve significant sequential revenue growth in the fiscal fourth quarter of 2017 and into fiscal 2018. While our stretch goal of achieving a \$3 billion annual revenue run rate as we exit fiscal 2017 looks considerably less likely than just a quarter ago, we remain committed to meaningful sequential growth as we exit the fiscal year. Furthermore, we anticipate sustaining operating margins within or above our target range throughout fiscal 2017 and delivering economic return above our 500 basis point goal.

Please advance to Slide 6. In order to accelerate our growth, we will continue to leverage our reputation for delivering exceptional execution and providing customer service excellence as demonstrated by our strong Net Promoter Scores. Our focus on operational excellence enables long-term relationships and results in our ability to grow share with existing customers.

Further, we will continue to drive our differentiated portfolio towards more sustainable, less volatile markets. Currently nearly 90% of our manufacturing funnel is comprised of business in nontraditional, noncommoditized markets. By leveraging our consistent, deliberate and focused strategy to provide expertise within our key markets, we are confident in our ability to achieve our long-term growth goals.

I will now turn the call over to Steve for additional insight into the performance of our market sectors and operations. Steve?

Steven J. Frisch - Plexus Corp. - COO and EVP

Thank you, Todd. Good morning. Please advance to Slide 7 for insight into the performance of our market sectors during the fiscal second quarter of 2017 as well as our expectations for the sectors in the fiscal third quarter of 2017.

Our Healthcare/Life Sciences sector was slightly down in the second quarter, which was below our expectations of flat revenue. New program ramp delays with 3 customers and end-market softness with 1 customer were the main contributors to the slight decline.

Looking ahead to the fiscal third quarter, we currently anticipate a mid-single-digit increase in our Healthcare/Life Sciences sector. New program ramps and end-market demand are driving the growth. In addition to the new program transfers from our Healthcare/Life Sciences customers, our Engineering Solutions team is transitioning or in late-stage development of several medical devices.

Our Industrial/Commercial sector was down 7% sequentially in the fiscal second quarter, in line with our expectations of a mid-single-digit decline. A demand adjustment from a large customer impacted the sector and masked solid growth with other customers. 16 of the top 20 customers, including all semiconductor customers grew within the quarter.

Although we believe demand from the large customer will increase in the future, we have adjusted our forecast until we have better visibility. As such, we currently anticipate that our Industrial/Commercial sector will be flat in our fiscal third quarter.

Our Communications sector was down 18% sequentially in the fiscal second quarter, which was significantly below our expectations of a mid-single-digit decline. End-market demand softness from 4 of our top 10 customers drove revenue below expectations. Soft end-market demand and the timing of 2 new product introductions are expected to impact the fiscal third quarter revenue.

As a result, we expect revenue to be down in the low teens. Our teams are working closely with our customers to support the new product introductions. These successful -- the successful launch of these programs is the enabler for sequential growth for the Communications sector as we exit fiscal 2017.

Our Defense/Security and Aerospace sector was up 14% sequentially in the fiscal second quarter, a result that was in line with our expectations of a mid-teens increase. 7 of our top 10 customers grew sequentially, mostly due to end-market improvements. We expect sequential growth of



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

mid-single digits for the fiscal third quarter. Some continued strengthening of end-market demand and new program ramps are enabling the growth.

Please advance to Slide 8 for highlights of our manufacturing business wins. During the fiscal second quarter, we won 26 new programs in our Manufacturing Solutions group that we anticipate will generate \$202 million in annualized revenue when fully ramped in production. This result represents 4 consecutive quarters of strong new business wins and is the third consecutive quarter of new business wins exceeding \$200 million.

Wins with the existing customers in our Americas regions were healthy. They included 2 new product introductions of existing customers and a significant new communications customer for our Guadalajara facility.

Wins in our APAC region were very strong. Three of the sector teams won meaningful new programs from existing customers that will be ramping into the APAC region. In addition, the Healthcare/Life Sciences and Industrial/Commercial teams each added a meaningful new customer to the APAC region.

As a result of a slower decision-making process than anticipated with key opportunities, the EMEA wins were soft in the second fiscal quarter. However, we expect the wins to rebound in the fiscal third quarter, as we're anticipating closing a large opportunity with a key Defense/Security/Aerospace customer.

Please advance to Slide 9 for further insight into the wins performance of our market sectors. In the second fiscal quarter, the Healthcare/Life Sciences and Industrial/Commercial teams each drove strong manufacturing business wins in excess of \$80 million. The Defense/Security/Aerospace sectors new manufacturing business wins result was low. However, we anticipate a significant improvement in the fiscal third quarter that is led by the win in the -- of the opportunity in EMEA.

The distribution of the 26 wins was very good. Approximately 70% of the wins were for existing customers and 30% were for new customers. Our focus on operational and customer service excellence is enabling repeat business as well as attracting new customers in each of our sectors. This healthy mix of wins between existing and new customers, combined with balanced wins across the sectors over the past 4 quarters supports our diversified portfolio strategy.

Now advancing to manufacturing wins momentum on Slide 10. Our trailing 4-quarters manufacturing wins, as shown by the dark blue bars, is at \$813 million. This result is the fourth quarter of growth for our trailing 4-quarter manufacturing wins. This performance represents -- this performance results in wins momentum of 32%, above our target of 25%. Engineering Solutions also had a good quarter in closing new opportunities. Wins of \$24 million in the fiscal second quarter continues to keep the backlog for Engineering Solutions strong for fiscal 2017 and provides momentum for a great start for fiscal 2018.

Please advance to Slide 11. In addition to strong wins performance, our market development teams have been very successful in identifying new opportunities. Each sector increased their funnel of new business opportunities within the fiscal second quarter. As we enter the third quarter, our manufacturing funnel of qualified opportunities is in excess of \$3 billion for the first time in our history. The strength in Healthcare/Life Sciences and Industrial/Commercial funnels combined with the growing Defense/Security and Aerospace funnel supports our strategy of a diversified business mix.

Next, I would like to turn to operating performance on Slide 12. Although we are disappointed with the revenue result in the fiscal second quarter, we are very happy with our team's continuous focus on productivity improvements. These efforts, along with exceptional Engineering Solutions performance and a favorable product mix, contributed to the strong operating margin of 5.4% that we reported yesterday.

Looking at the fiscal third quarter, we expect our teams to deliver strong operating margins at the high-end of our target range. As a result, we are guiding operating margin in the range of 4.8% to 5.2%. The lower-than-anticipated revenue in the fiscal second and third quarters, along with new program ramps, created a higher-than-normal inventory level of 103 days in the fiscal second quarter. Although we anticipate to see a slight increase in the fiscal third quarter, the teams are focused upon returning inventory to a more normal level by the end of fiscal 2017 without impacting our customer service level.



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

A few final comments. Our focus on operational excellence and customer service excellence is being recognized by our customers. High customer satisfaction is enabling strong new business wins while simultaneously growing our funnel of new opportunities. The Engineering Solutions team and transition teams are busy with new product introductions. Our Manufacturing Solutions team is focused upon the operational performance required to deliver exceptional results for our customers and our shareholders. We are confident in our ability to maintain operating margins in our target range while accelerating growth.

I will now turn the call to Pat for a detailed review of our fiscal performance.

Patrick John Jermain - Plexus Corp. - CFO and SVP

Thank you, Steve, and good morning, everyone. Our fiscal second quarter results are summarized on Slide 13. Revenue of \$604 million was 5% below the midpoint of our guidance, while gross margin of 10.6% was above our guidance and 40 basis points above the fiscal first quarter. By continuing to deliver strong operational efficiencies and executing on supply chain productivity initiatives, we are able to overcome lower fixed cost absorption caused by the sequential revenue decline. In addition, lower-than-anticipated health care claims for U.S. employees contributed to the margin improvement.

Selling and administrative expense of \$31.2 million was in line with our quarterly guidance. Due to the lower revenue, SG&A as a percentage of revenue was 5.2%, up 30 basis points compared to our expectations.

Improved gross margin partially offset by a higher SG&A percentage resulted in operating margin of 5.4%, exceeding our guidance range of 4.9% to 5.2%. This result was 130 basis points above the adjusted operating margin reported during the prior year fiscal second quarter. Included in this quarter's operating margin is approximately 70 basis points of stock-based compensation expense.

GAAP diluted EPS of \$0.84 was \$0.05 above the top end of our guidance. Fiscal second quarter results include \$0.05 of foreign exchange gains not included in our guidance. These gains were primarily generated by our China operations. Partially offsetting the foreign exchange gains was \$0.02 per share of additional stock-based compensation expense, which was above our original guidance of \$0.11 per share.

Turning now to the balance sheet on Slide 14. Return on invested capital was 16.8% for the second quarter, significantly above our fiscal 2017 weighted average cost of capital of 10.5% and the return we delivered in fiscal 2016 of 13.8%. Contributing to the higher return was the combination of improved earnings and a reduction to our average invested capital.

During the quarter, we purchased approximately 123,000 of our shares for \$6.8 million at a weighted average price of \$55.61 per share. We continue to purchase our shares based on market conditions and free cash flow generation in the U.S.

In the second quarter, we generated approximately \$26 million in cash from operations and spent \$8 million on capital expenditures, delivering free cash flow of \$18.5 million, which was at the top end of our expectation.

At the end of the quarter, our cash cycle was 73 days, higher than our expectations and 7 days higher than our results in the fiscal first quarter. In total, working capital increased approximately \$15 million during the quarter.

Please turn to Slide 15 for details on our cash cycle. Sequentially, days in inventory were up 13 days, while the dollar value of inventory was up about \$45 million. Most of this increase was driven by a buildup of inventory that we had expected to ship during the quarter but did not ship based on lower customer demand. In addition, we are ramping new programs in several sites and have increased inventory to support these ramps.

To help offset the working capital impact, we have been successful in securing customer deposits and receiving carrying charges related to the additional inventory.

Days in receivables were 48 days, sequentially down 1 day, primarily due to the customer mix and timing of shipments at quarter end. Accounts payable days were 64 days, sequentially up 4 days and customer deposit days were 14 days, up 1 day from the prior quarter.



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

As Todd has already provided the revenue and EPS guidance for the fiscal third quarter, I will now turn to some additional details, which are summarized on Slide 16. Fiscal third quarter gross margin is expected to be in the range of 10% to 10.3%. The midpoint of this guidance suggests a sequential decline of 40 basis points, primarily due to our expectation for health care claims to return to a more normalized historical level. We anticipate the recent strong performance from operations to continue.

We expect SG&A expense to be consistent with our spending in the fiscal second quarter in the range of \$31 million to \$32 million. At the midpoint of our revenue guidance, anticipated SG&A would be close to 5.2% of revenue, similar to the second quarter. Fiscal third quarter operating margin is expected to be in the range of 4.8% to 5.2%, which includes approximately 70 basis points of stock-based compensation expense.

A few other notes. Depreciation expense for the fiscal third quarter is expected to be approximately \$11 million consistent with the fiscal second quarter. We estimate an effective tax rate of 10% to 12% for the fiscal third quarter and continue to expect 8% to 10% for the full year. Our expectation for the balance sheet is for cash cycle to be in the range of 73 to 77 days as we continue to ramp new programs and anticipate higher revenue as we move into the fiscal fourth quarter. We expect free cash flow up to \$20 million for the fiscal third quarter and to be about -- and to be above \$100 million for fiscal 2017. Capital spending for the fiscal year is anticipated to be in the range of \$40 million to \$50 million to support new program ramps, refresh of equipment and productivity improvements.

With that, Sylvia, I will now open the call for questions. (Operator Instructions) Sylvia?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Matthew Sheerin from Stifel.

Matthew Sheerin - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Just a couple of questions from me. Just first on the weakness that you're seeing in the Communications segment. It sounds like that's going to be down. You also talked about the overall business being up significantly sequentially in Q4. Do you expect the communications business to be up as well? Or will that be pushed out to Q1 of fiscal '18?

Steven J. Frisch - *Plexus Corp. - COO and EVP*

This is Steve. Maybe a little more color on the Communications sector. So during the quarter, we saw 15 of the top 20 customers drop their Q3 forecast for us. Most of that was end market. So now we're seeing about 14 of the top 20 that are down from Q2 to Q3. So for us at this point, we see stability in the long term at this point. We don't see it dropping any further beyond that. However, as we look to the back half of '17 here, we see the meaningful growth coming from a couple of new program ramps.

Todd P. Kelsey - *Plexus Corp. - CEO, President and Director*

Matt, so I'll add on with respect to the overall business. So we talked about some pretty solid sequential gains in the overall business as we exit the fiscal year. Part of that is the ramps in communications that Steve is talking about. But an additional piece of it is just the growth in the underlying business. So we are currently in a situation where we have a couple of near-term issues that are impacting our revenue in the near term in Q3 and Q4 and certainly leaving us at a lower level than we had anticipated. But what that's doing is it's masking some pretty impressive growth in the rest of the business that's occurring right now that will continue.



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

Matthew Sheerin - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay, that's helpful. And then, on the Industrial segment where you called out a customer adjusting their forecast lower both in the last quarter and the upcoming quarter. Is that an issue that you see continuing? Or is that sort of just a demand or a new program staging issue where you'll see that pick up as well into the back half?

Todd P. Kelsey - *Plexus Corp. - CEO, President and Director*

Yes. So one of the things that we're doing, we've called this out a couple of quarters in a row. So you can see it as being a bit of a push. But what we called it now is a forecast adjustment and really what we're seeing with that customer is, in general, there's, call it, a base amount of business that I'd call steady state that they're running at. And that's what we've set our forecast at. So -- and then beyond that, there's some additional, call them, demand bursts that occur with that customer, and we've essentially taken that out. So what I would say is that we view that there is upside at some point in the future. The clarity is exactly when that's going to be right now. So we just decided to take it right out of our forecast.

Matthew Sheerin - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

And you said that was a non-semiconductor customer, correct?

Steven J. Frisch - *Plexus Corp. - COO and EVP*

Yes, that's correct. This product that we're talking about is for internal consumption. So as the customer prioritizes what they're focusing on, it can shift for us a little bit differently from what end markets would be.

Operator

Our following question comes from Shawn Harrison from Longbow Research.

Shawn Matthew Harrison - *Longbow Research LLC - Senior Research Analyst*

I guess following up a little bit on Matt's question. But the goal previously was to hit that \$3 billion of annual sales number exiting the year -- fiscal year. I know it's going to be more difficult now. But would you hazard a guess as we move into fiscal '18 based upon what you're seeing in customer forecasts, new programs coming in whether that could be a first half fiscal '18 event?

Todd P. Kelsey - *Plexus Corp. - CEO, President and Director*

Yes. So what I don't want to do, Shawn, is try to commit to another goal and with the demand uncertainty we're seeing, have us hit it 1 quarter later or 2 quarters later than what we're thinking. So want to avoid putting a time line on it. But what I can tell you is what is driving our thought process right now. So if we look at over the course of the last several quarters, we had a very clear path to this \$3 billion goal as we exited the year. And if we went back just 1 quarter ago, it was really -- I'd call it likely was the scenario. We've had a couple of things change on that, that are relative to a few specific customers. And other than that, the remainder of the business continues to progress as planned and is growing significantly. So when we look out as to when will we hit this \$3 billion, it could be quickly if these situations that we're facing right now rebound quickly. If they're delayed in any way, it could just take us a little bit longer as we continue to grow the rest of the business.



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

Shawn Matthew Harrison - Longbow Research LLC - Senior Research Analyst

I understand the hesitance to put a -- to draw a line in the sand. Maybe I guess, back to the Comm weakness, with new product introductions, is there any concern from you that the products that are introduced don't take hold in the market? And so it's a step up and then all of a sudden a step back down. I guess, with the volatility we've seen that, that could be at least a worry on my end.

Todd P. Kelsey - Plexus Corp. - CEO, President and Director

All indications are they'll be successful product launches.

Shawn Matthew Harrison - Longbow Research LLC - Senior Research Analyst

Okay. And then lastly, I think last time on the call, there was an expectation that gross margin would dip as new programs ramp. Is that the expectation? As you see revenue acceleration in the fourth quarter you'd see some incremental gross margin pressure?

Patrick John Jermain - Plexus Corp. - CFO and SVP

We would see that, Shawn. But again, I think we'd get some nice leverage from operating expenses with that uptick. So I think you had a question around 5% margins for the year. And if you look at the last 3 quarters, we've achieved above 5%. At Q3, we're guiding midpoint at 5%. And I think we could achieve 5% for Q4. So I think for the full year, we'd be able to hit that 5%.

Operator

Our next question comes from Sherri Scribner from Deutsche Bank.

Sherri Ann Scribner - Deutsche Bank AG, Research Division - Director and Senior Research Analyst

Sorry about the background noise. It sounds like your issues in the Communications, the Industrial segments are all more customer-specific. So I was hoping you could maybe comment, is that the case? And what are you seeing in terms of the economic outlook, is this at all economic related? And then the second question relates to the European business, I think you mentioned that there was some weakness there, is that industrial related? Is that related to the end markets? And maybe you could give us some comments about what you're seeing geographically in terms of end demand.

Steven J. Frisch - Plexus Corp. - COO and EVP

I'll start maybe with the second one first. This is Steve. In regards to EMEA, the comments were really kind of more focused around the new business wins. We had a light quarter for wins. I think the thing to keep in mind for us is that we really focus on the trailing 4-quarters metric because we do not want our teams to -- artificially trying to do things to meet some quarterly metrics. So we saw a low number on wins, but it's not a concern for us. We'd expect it to rebound in this fiscal quarter. So no issues there in terms of where we're at from a business development standpoint. Related to the end markets, I think, we talked specifically about 2 areas; one was the Communications customer and the other one was the Industrial/Commercial customer, which I think Todd highlighted as being the things that are kind of masking growth in the underlying business. And that basically is kind of true across the whole company. So we do see the underlying business growing. We have commented in the past about the fact that organic growth is relatively slow. That is true in most areas, with probably the exception of semiconductor has picked up. We've seen a little bit of an uptick in oil and gas but not much. But really our growth and our expectations for growth are coming from the new business wins ramping into production.



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

Todd P. Kelsey - Plexus Corp. - CEO, President and Director

Just to add a bit on EMEA as well, Sherri. So with respect to the demand environment, we are not seeing it as being really much different than the U.S. demand environment. I mean, it's not really robust, but it's not generally any softer either. One of the things though as we look at our EMEA operations, we're going to get nice growth in EMEA in fiscal '17 and we foresee it in fiscal '18 as well, too. And we still have opportunity for further leverage within that business as we grow the business.

Operator

Our following question comes from Steven Fox from Cross Research.

Steven Bryant Fox - Cross Research LLC - MD

I guess I'm still not totally clear on the gross margin improvement in the quarter. I would imagine that you were surprised by how the revenues came in, yet, like you pointed out, you're up 50 bps quarter-over-quarter in terms of gross margin. So I was wondering if you can maybe dissect that a little bit more between mix and productivity and anything else that impacted it? And then I had a follow-up.

Patrick John Jermain - Plexus Corp. - CFO and SVP

Yes. Well, Steve, this is Pat. Starting with, I mentioned health care claims were lower than anticipated. That was about a 20 basis point improvement. And then Todd had mentioned engineering organization. We had more than 4,000 additional billable hours this quarter. So really strong performance by that team that drove improved margin. Around supply chain productivity, with the tools we're using and the focus on consolidating spend to preferred suppliers and getting ahead, frankly, of some price reductions that we'll be passing along to our customers benefited us and then finally, the customer mix, as we shifted the portfolio we saw improvement in margin.

Steven Bryant Fox - Cross Research LLC - MD

And just on that customer mix portion. Is that a function of the fact that some of the business you thought you were going to have in the quarter was lower margin or a function of ramping more business at higher margin? Can you just sort of explain that dynamic a little bit better?

Patrick John Jermain - Plexus Corp. - CFO and SVP

Yes. I think it was a combination of both. Some of our customers that were down for the quarter are traditionally lower margin customers. So we saw that improvement. But we started to ramp some customers that come along with ramp costs, as we've talked about in the past. But being below the revenue level we had guided, we didn't see as much of a drag on margins from the ramping activity as we would typically see.

Steven Bryant Fox - Cross Research LLC - MD

Got it. And then just as a follow-up, it looks like your funnel year-over-year is growing about at the same pace as your trailing 12 months of wins. So I would assume you could comment on win rates being okay. But within that, it looks like your average deal size has taken a jump up. And I was curious how much of that do you think is sort of transitory versus maybe a change in strategy going forward and what it means for volatility in the business.

Steven J. Frisch - Plexus Corp. - COO and EVP

In regards to the funnel size and the opportunities in there, we are seeing a few more larger opportunities. I wouldn't say from -- if you look over the last 4 quarters, we had lighter or smaller number sized wins last quarter. This one is a little bit bigger. So I wouldn't necessarily read a trend into



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

either direction. But the size of the opportunities are getting a little bit bigger, but not meaningful to say that I think there's a significant different expectation than we have going forward.

Todd P. Kelsey - Plexus Corp. - CEO, President and Director

Just to add a bit, Steve, I think if you looked at the trend of the number of wins over the past several years, last quarter was probably on -- or it was on the -- very much on the high end in regards to number of wins. This quarter is towards the lower end. I think if you look at those and you average those 2 quarters out, it's pretty typical of what our deal size is. So while we're seeing some bigger opportunities, I wouldn't view it as a move in our strategy toward bigger deals. It just so happened that we closed more of them this quarter.

Operator

Our next question comes from Mitch Steves from RBC.

Mitch Steves - RBC Capital Markets, LLC, Research Division - Associate

Just had one on the operating margin side actually. So basically it looks like the Communications will be a little bit weaker, maybe that onetime item on the Industrial side. So shouldn't that actually mean that the operating margin profile is actually a little bit higher on an overall basis for the company now?

Todd P. Kelsey - Plexus Corp. - CEO, President and Director

Are you referring to the longer term, Mitch?

Mitch Steves - RBC Capital Markets, LLC, Research Division - Associate

Correct.

Todd P. Kelsey - Plexus Corp. - CEO, President and Director

Yes. Well, one of the things I would say about in general about our margins -- so, of course, we've talked about our target range being 4.7% to 5%. And we've been over that a couple of quarters in a row. I think as we look at the rest of fiscal '17, we see strong margin performance. And we're guiding obviously right about at the top end of that range. Q4 looks like it could be above that range. But as we go into fiscal '18, we start to see more of these investments in new programs and ramps of revenue and things such as that as well as some other costs that we're incurring over that period of time. So we'd expect it to go -- to trend back more towards that 4.7% to 5% range in '18. So that's our current look as we look forward.

Mitch Steves - RBC Capital Markets, LLC, Research Division - Associate

Got it. And then secondly, when I think about the sequential trends just in Communications. Can you maybe just help us out if we think about what typical seasonality is, and what you guys expect just in terms of the shape of the year?

Todd P. Kelsey - Plexus Corp. - CEO, President and Director

Well, as far as the shape of the year, I mean, obviously, we've been in a downward trend right now. And we're seeing some pretty significant and broad-based weakness, I would say, within the sector for varying reasons across the sector. But as we get to Q4, we're expecting a pretty substantial



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

ramp within that sector. Now, our expectations overall as a company aren't completely dependent on that Communications ramp, as the rest of the book of business that we're also growing rather aggressively.

Operator

Next question comes from Sean Hannan from Needham & Company.

Sean Kilian Flanagan Hannan - *Needham & Company, LLC, Research Division - Senior Analyst, Electronic Manufacturing Services and Electronic Components*

And sorry to bring so much attention to Communications, but wanted to see if we could just get a little bit more clarity. When you referenced the demand weakness that you're seeing, can you characterize that a little bit more in terms of the extent that, that's demand weakness explicitly within your customers' markets versus if there are any program transitions or, say, end-of-life, next-gen scenarios that might have a timing impact? How do we think about that and perhaps more granularly characterize how this is impacting you?

Todd P. Kelsey - *Plexus Corp. - CEO, President and Director*

Yes. Well, I mean, I'll start with that, Sean, and then Steve can provide additional color. But I think, clearly, we have a large customer within that Communications space. And what I would say is we don't want to say anything beyond what they've said. But we do believe that they've been really transparent in their end markets as well as in their program ramps. So we are executing to what they've stated about their end markets and their new program ramps.

Steven J. Frisch - *Plexus Corp. - COO and EVP*

And as you look across the sector in general, I would say it's probably a 2/3 end market, 1/3 kind of shift in terms of where the softness is coming from in terms of people making a product transition versus end-market softness from a customer standpoint. That's probably the best color I can give you.

Sean Kilian Flanagan Hannan - *Needham & Company, LLC, Research Division - Senior Analyst, Electronic Manufacturing Services and Electronic Components*

Okay. That's actually very helpful. And then if I look at the wins that you folks have brought in for the quarter, obviously, again, coming back to some earlier comments, they look very healthy. Your funnel looks great. When you step back and you think about the opportunity set in front of you, I guess, part A to the question is when you think about the fact that 90% of that, specifically the funnel, is nontraditional, how much risk would you assign to some of those opportunities given that there might be a greater magnitude of customers that haven't gone through the outsourcing process as much before, might require a little bit more handholding, not as strong in terms of their ability to provide forecasts with you. So that's kind of part 1 to it. And then part 2, this seems to give an indication that we should have some very strong growth in '18. And even given the time to market, you should be setting up pretty well at least at a very early stage for even '19, given how long it takes to get into kind of a run rate with these markets. So just want to see if we can get some color around that as well.

Steven J. Frisch - *Plexus Corp. - COO and EVP*

Yes. In terms of the funnel, similar to the wins ratio, the funnel is approximately 70/30 between customers and targets as well. And so our confidence in what those opportunities are is pretty high, because they're with existing customers, either with -- or with divisions, new divisions of customers that we're working with. So our visibility into the funnel on those opportunities is pretty clear. I want to emphasize that we also qualify things before we put them in the funnel. So not anything can just get in there. And then as we look forward, I think you're right, and I think Todd hit on it. Some of the base business that we see growing is coming from some of those wins that we've had over the last 4 to 5, 6 quarters. And as we



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

continue to drive more wins out of those nontraditional markets, that does give us confidence for what '18 and beyond looks like. Again, we're pretty confident in our diversified portfolio strategy we have here and supported by the fall and supported by the wins and it's supported by the base growth. It's just not that visible this quarter.

Todd P. Kelsey - Plexus Corp. - CEO, President and Director

Yes. I'd just like to add on to that, Sean. If we look at fiscal '18, we are expecting strong growth in '18 and beyond. And one of the things as we sit here today, I think we're disappointed. You're probably disappointed about where the near-term revenue situation sits right now. But when we look at the rest of the business and what's happening within our business, we're really excited, and we feel really good about our margin performance, our earnings performance, which despite some revenue challenges is really falling in nicely for the year with what expectations were at the beginning of the year. We've got excellent wins in funnel that are -- we've been continuing to be able to take advantage of and harvest. We feel really good about our strategy. We feel really good about our performance with our customers right now. So we feel like we have -- we're in a great position, but we've got a couple of near-term challenges that we need to work our way through and in the typical way that we do here at Plexus, we'll work our way through them.

Operator

Our next question comes from Paul Coster from JPMorgan.

Jeangul Chung - JP Morgan Chase & Co, Research Division - Analyst

This is Paul Chung on for Paul Coster. So on gross margins, again, guidance suggests margins should exceed 10% for the fiscal year. Do you see more room to run? Can we even hit 2008 levels of 11% next fiscal year? And are these levels sustainable? Or are you going -- or is the firm going to reinvest cost saves beyond current levels back into the business?

Patrick John Jermain - Plexus Corp. - CFO and SVP

Yes. Paul, it's the latter. We will be reinvesting into the business. And with that type of growth and a lot of it coming from new program ramps and not end-market growth, there'll be a drag on margins from ramping those programs and just remaining competitive, passing along price reductions to our customers, we'll have to be doing that to remain competitive. But with that said, I think we've now focused on operating margin of that range of 4.7% to 5% and even if we see pressure on gross margin where we can gain leverage is on operating expenses with that additional revenue and still achieve that operating margin range of 4.7% to 5%.

Jeangul Chung - JP Morgan Chase & Co, Research Division - Analyst

Got you. And then my follow-up is on free cash flow levels for the full year. I know you mentioned above \$100 million, but it looks like you're already there, including guidance for F3Q. In what terms and magnitude above \$100 million?

Patrick John Jermain - Plexus Corp. - CFO and SVP

Yes. So in the first half of the year, if you look at capital spending, it's only about \$15 million, and we had delayed some of the CapEx and we'll see more of that improve or increase in the back half of the year. And as we see this ramp in revenue for the fiscal fourth quarter, we will see an increase in working capital needs, especially AR. And that's where we think there'll be some pressure on working -- on free cash flow generation. And so at this point, I'd like to stick to just saying it will be above \$100 million, but not quite sure to what extent at this point.



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

Operator

Next question comes from James Suva from Citi.

Jim Suva - Citigroup Inc, Research Division - Director

Maybe my math is wrong, but if I look at the March sales results and the June sales results, it looks like the year-over-year growth -- sales growth is actually negative, which is pretty unprecedented from a historical perspective for your company. When we just take a step back and look at, say, 12, 18 or 24 months in regard to win rates, I don't think anybody would say these type of results is what good new business wins and pipelines would necessitate. And then on today's call, it sounds like there's a customer, an industrial customer here, it just seems like. Can you help us better understand, can 2 or 3 customers really make that big of a difference? And/or was it maybe some of the new program ramps, a little bit too ambitious for what the ramp rates were supposed to have happened when we look at, say, 12 or 18 months ago to what happened in the March quarter and the June quarter outlook? We're just trying to kind of figure out that philosophically because the pipeline that you give is very encouraging, but the results, I think, make people take a step back and reconsider a little bit at least in the March and June right now.

Todd P. Kelsey - Plexus Corp. - CEO, President and Director

Right. Yes. So Jim, when we look at -- and it's a combination of the factors that you had talked about there. So when we compare year-over-year, there is some -- a pretty significant difference in those couple of -- those few cases that we talked about of specific customer demand issues. It's of a significant magnitude that it has an impact. And I would say the second one is, are there some programs that are ramping slower than anticipated? Yes, there's a few customer programs and even beyond things that have been reported as wins on deals that we have in play with customers that are -- that have significant revenue implications that are ramping slower than we had anticipated as well. So it does play into it as well.

Operator

Our final question comes from Sean Hannan from Needham & Company.

Sean Kilian Flanagan Hannan - Needham & Company, LLC, Research Division - Senior Analyst, Electronic Manufacturing Services and Electronic Components

I think most of my questions have been answered. But there is a point of curiosity I have. If I look at the September quarter wins from '16, and I look at the strong wins that you had within Communications, is it appropriate to consider that most of what had been won there is now effectively within your guidance and within kind of at an appropriate run rate for those programs? Or is there an element of what had been won there that continues to push out a little bit further than expected?

Steven J. Frisch - Plexus Corp. - COO and EVP

A fair amount of those wins that we talked about then are the ramps that we're talking about now that are basically in our forecast.

Sean Kilian Flanagan Hannan - Needham & Company, LLC, Research Division - Senior Analyst, Electronic Manufacturing Services and Electronic Components

Okay. For the fourth quarter of this year?

Steven J. Frisch - Plexus Corp. - COO and EVP

Yes.



APRIL 20, 2017 / 12:30PM, PLXS - Q2 2017 Plexus Corp Earnings Call

Operator

We have no further questions at this time. I'd like to turn the call back over to Todd Kelsey for final remarks.

Todd P. Kelsey - Plexus Corp. - CEO, President and Director

All right. Thanks -- thank you, Sylvia. So just in closing, I'd like to summarize again of what we feel about the state of the business. I mean, we're certainly conscious of the near-term revenue challenges that we have. And we're disappointed in them, and there's no other way to put it. But beyond that, we feel really good about the state of the business and the health of the business. We continue to remain committed to achieving our target operating margin range or beyond. We believe we're delivering solid economic return. We believe the base of business that we have within Plexus already is positioned to grow in a meaningful way and in a very rapid way. We also feel good about the funnel and the wins that we have as we look forward too. So while we certainly have some near-term challenges that we'll continue to work our way through, we remain committed to driving growth throughout Plexus. So again, I want to, in closing, thank our employees for all their efforts that they've put forth in moving Plexus forward towards our goals, thank our investors for their support, to all the analysts for the great questions and for following us and any other guests that we have online. So hope everybody has a good day, and see you next quarter.

Operator

Thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2017, Thomson Reuters. All Rights Reserved.