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# EDITED TRANSCRIPT

## PLXS - Q3 2017 Plexus Corp Earnings Call

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**OVERVIEW:**

Co. reported 3Q17 revenues of $619m and GAAP diluted EPS of $0.74. Expects 4Q17 revenues to be $660-700m and GAAP EPS to be $0.77-0.87.





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## PRESENTATION

**Operator**

Good morning, and welcome to the Plexus Corporation Conference Call regarding its Fiscal Third Quarter 2017 Earnings Announcement. My name is Paulette, and I will be your operator for today's call. (Operator Instructions) The conference call is scheduled to last approximately 1 hour. Please note that this conference is being recorded.

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

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

Thank you, Paulette. 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 period -- 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.

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 call, Todd will provide summary comments before turning the call over to Steve and Pat for further detail.

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

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

Thank you, Susan, and good morning, everyone. Please begin with our fiscal third quarter results on Slide 3.

After the close of the market yesterday, we reported results for our fiscal third quarter of 2017. Revenue was $619 million with GAAP diluted EPS of $0.74. The EPS result included $0.13 of stock-based compensation expense.

I'm pleased we delivered fiscal third quarter revenue and GAAP diluted EPS above the midpoint of our guidance range. Our Industrial/Commercial, Communications and Defense/Security/Aerospace sectors all exceeded our expectations for the fiscal third quarter. In addition, our Healthcare/Life Sciences, Industrial/Commercial and Defense/Security/Aerospace sectors all realized sequential growth. Our continued strong operating performance enabled us to achieve fiscal third quarter operating margin of 4.8%, our fifth consecutive quarter of meeting or exceeding our target operating margin range of 4.7% to 5%.

Advancing to our fiscal fourth quarter guidance on Slide 4. We expect fiscal fourth quarter revenue to increase significantly as a result of previously reported program wins ramping. Consequently, we are guiding fiscal fourth quarter revenue in the range of $660 million to $700 million. The midpoint of this guidance suggests a record revenue quarter for the company. At this revenue range, in conjunction with continued strong operating performance, we anticipate GAAP EPS of $0.77 to $0.87. This includes $0.13 of stock-based compensation expense. Within the fiscal fourth quarter, we expect sequential growth in our Healthcare/Life Sciences, Communications and Defense/Security/Aerospace market sectors.

Please advance to Slide 5. Plexus has established an exceptional brand for designing products with demanding regulatory requirements and we remain committed to maintaining our differentiation with our engineering service offering. During the fiscal third quarter, we announced a significant expansion of our Engineering Solutions organization. First, we relocated our flagship design center in Neenah, Wisconsin to a new state-of-the-art facility located near our global headquarters. This new facility provides advanced innovation and laboratory space as well as capacity to add more than 100 additional engineers.

In addition to the relocation of our Neenah Design Center, we established a new Guadalajara Design Center, which is located within our existing manufacturing facility in Mexico. This is the first time we've offered our engineering capabilities within the region and we are pleased with the initial customer reception. The new Guadalajara Design Center will offer product commercialization and full product development capabilities. This new location marks our eighth design center globally as we continue to strategically expand our presence to provide our customers with access to the best engineering talent.

Please advance to Slide 6. We continue to successfully execute our differentiated strategy and drive strong operating performance, giving us confidence that we'll deliver meaningful growth while maintaining our target operating model. A few additional highlights from the fiscal third quarter that support this promise include the following. In our recent customer Net Promoter Survey completed in May, we achieved our highest score to date of 84%, which we believe to be best-in-class. Achieving our best score during this period of significant new production -- product introduction is an outstanding accomplishment by the team. This success highlights our commitment to operational excellence and customer service excellence. We continued our strong operating performance, achieving fiscal third quarter operating margin of 4.8% and we are well positioned to deliver record operating profit in fiscal 2017.

We delivered return on invested capital of 16.1%, resulting in an economic return of 560 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 360 basis point improvement year-over-year.

Our Manufacturing Solutions wins momentum continues to accelerate as we achieved $220 million of wins within the quarter. A trailing 4-quarter wins now stand at $839 million with a trailing 4-quarter wins ratio of 33%. Our quarterly wins included a significant aftermarket services win and a major business expansion in Europe.

In addition to the strong wins performance, our funnel of qualified Manufacturing Solutions opportunities remains healthy at $2.8 billion, as our teams continue to leverage our strong brand in the marketplace and our unique go-to-market strategy. The funnel is dominated by business in the nontraditional, noncommoditized markets or programs typically have longer life cycles. Our wins momentum and qualified funnel of opportunities remain robust, giving us confidence that we can achieve meaningful growth in 2018.

In an often overlooked area of the balance sheet, our retained earnings account exceeded $1 billion in the fiscal third quarter. This accomplishment highlights the success of our strategy and delivering long-term shareholder value.

Lastly, we are finalizing our fiscal 2018 annual operating plan. We anticipate that we will continue our strong operating performance and remain committed to our goal of achieving our target operating margin range each quarter. In addition, we expect meaningful year-over-year revenue growth for fiscal 2018.

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

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**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 third quarter of fiscal 2017 as well as our expectations for the sectors in the fiscal fourth quarter.

Our Healthcare/Life Sciences sector was up 2% in the fiscal third quarter, which was slightly below our expectations of mid-single-digit growth. Increased end market demand of 2 customers was offset by new program ramp delays of 2 customers as well as end market softness with another customer. Looking ahead to the fiscal fourth quarter, we currently anticipate a mid-single-digit increase in our Healthcare/Life Sciences sector. New program ramps are the main contributors for the growth. Achieving the strong finish would result in a high single-digit growth rate for the sector in fiscal 2017. The team's new business development successes in fiscal 2017 are driving a number of new program ramps. As such, we are optimistic about the growth of the Healthcare/Life Sciences sector as we look forward to fiscal 2018.

Our Industrial/Commercial sector was up 5% sequentially in the fiscal third quarter, above our expectations of flat revenue. End market strength with 3 semiconductor capital equipment customers drove the better-than-expected results. As we look towards the fiscal fourth quarter, end market strength of 1 larger customer is being offset by a significant product refresh cycle of 1 customer and multiple semiconductor capital equipment customers returning to a more normalized level of production. The net impact that we anticipate a mid-single-digit decline in our Industrial/Commercial sector in the fiscal fourth quarter. With this forecast, the sector would finish the year with a low single-digit growth rate for fiscal 2017.

Our Communications sector was down 9% sequentially in the fiscal third quarter, which was better than our expected low double-digit decline. Increased end market demand of 2 customers drove revenue above expectations. Significant end market strength mainly associated with multiple new program ramps is driving meaningful growth as we finish the fiscal 2017. As a result, we expect the Communications sector revenue to increase approximately 50% in the fiscal fourth quarter. The successful launch and ultimately the end market acceptance of these new programs is the key enabler for the Communications sector to achieve significant year-over-year revenue growth in fiscal 2018.

Our Defense/Security and Aerospace sector was up 10% sequentially in fiscal third quarter, a result that was above our expectations of a mid-single-digit increase. End market strength and efficient new program ramps of several customers drove the increase. The continued ramp of new programs and some strengthening of end market demand is expected to yield sequential growth of mid-single digits for the fiscal fourth quarter. We expect this growth to continue in fiscal 2018.

Please advance to Slide 8 for highlights of our Manufacturing business wins. During the fiscal third quarter, we won 32 new programs in our Manufacturing Solutions group that we anticipate will generate $220 million in annualized revenue when fully ramped in production. This was our fourth consecutive quarter of wins over $200 million and our highest quarterly wins in 3 years. Wins in EMEA region were very strong. Due to exceptional execution by the teams, an existing Defense/Security and Aerospace customer has decided to transfer additional programs to our Kelso, Scotland and our Oradea, Romania operations. In addition, the EMEA team won a meaningful program with a new Healthcare/Life Sciences customer for the Oradea facility. The APAC region is also benefiting from strong execution. Most of the wins came from existing customers where we are gaining market share. We expect these customers to provide additional growth opportunities in fiscal 2018.

Wins in our Americas region included a meaningful aftermarket services program for our Chicago operations. We expect future growth with this new Healthcare/Life Sciences customer as we expand our engagement into engineering and traditional manufacturing.

Please advance to Slide 9 for further insight into the wins performance of our market sectors. The majority of the 32 wins for the fiscal third quarter were with existing customers. Our focus on operational excellence and customer service excellence is enabling us to gain market share with several of our larger customers in each of our market sectors. For example, the Defense/Security and Aerospace sector has strong wins that expanded our current business. In addition to the opportunity I highlighted earlier for EMEA, the sector added a significant new program with an existing Aerospace customer. Although the strong wins result did expand existing business relationships, we were successful in adding new key customers to our portfolio during the fiscal third quarter. In addition to the aftermarket services customer, the Healthcare/Life Sciences sector and Industrial/Commercial sectors each added a strategic new customer.

Now advancing to manufacturing wins momentum on Slide 10. Our trailing 4-quarter manufacturing wins as shown by the dark blue bars is at $839 million. The positive trend highlights the cumulative strong manufacturing wins that the sector teams have achieved throughout fiscal 2017. The $220 million of new wins in the fiscal third quarter results in a wins momentum of 33%, well above our 25% target.

Engineering Solutions also had a good quarter in closing new opportunity. Wins of $22 million in the fiscal third quarter continues to keep the backlog for engineering strong as we finish fiscal 2017. Looking into fiscal 2018, the funnel of opportunities for Engineering Solutions is robust and we are aggressively growing this service offering.

Please advance to Slide 11. Leveraging our focus on operational excellence and customer service excellence, our go-to-market teams continue to identify new opportunities. The Healthcare/Life Sciences and Industrial/Commercial teams maintained their strong funnels despite good wins performance. Our Defense/Security and Aerospace sector funnel lowered slightly as a result of their impressive wins during the fiscal third quarter. The team is pursuing some early-stage opportunities that could add meaningful revenue to the Defense/Security and Aerospace funnel once they are qualified. The Communications sector funnel softened mainly due to removal of 2 opportunities that would not have achieved our financial goals. That team is working aggressively to strengthen their funnel. As we enter the fourth quarter, our manufacturing funnel of quality opportunities stands at a very healthy $2.8 billion.

Next, I would like to turn the operating performance on Slide 12. Our revenue in the fiscal third quarter finished at the higher end of our guidance range at $619 million due to modest strength in 3 of our market sectors. As Todd highlighted, we are guiding significant sequential growth for the fiscal fourth quarter. Additional investments to support those new program ramps and some inefficiencies with those ramps drove margins of 4.8% in the fiscal third quarter. Our teams are committed to delivering a high level of customer service while delivering solid operating margins. As a result, we are guiding operating margins in the range of 4.7% to 5.1%.

Inventory increased in the fiscal third quarter to 107 days. The significant revenue growth in the fiscal fourth quarter is the main contributor to the increase. We expect a meaningful reduction in the fiscal fourth quarter and a return to more normalized inventory levels in fiscal 2018 as our supply chain solutions for these new programs mature.

A few final comments. We have been focused on delivering operational excellence and customer service excellence with the belief that we can grow revenue while delivering strong operating margins. With the revenue guidance at a record level and our operating margins in our target range, we are committed to fulfilling on this goal in the fourth fiscal quarter and to build upon it as we enter fiscal 2018.

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

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

Thank you, Steve, and good morning, everyone. Our fiscal third quarter results are summarized on Slide 13. Third quarter revenue of $619 million was near the top end of our guidance while gross margin of 9.9% was slightly below our guidance. Gross margin was impacted by higher labor (inaudible) associated with program transitions and new product introductions. In addition, we experienced increased revenue from lower-margin programs and some labor inefficiencies caused by program delays within our Healthcare/Life Sciences sector. Comparing to the prior year third quarter, revenue is lower by approximately 7% while gross margin improved 50 basis points. Improving margin on lower revenue is a testament to our ability to drive productivity improvement and appropriately adjust our cost structure to align with revenue levels. Selling and administrative expense of $31.7 million was in line with our quarterly guidance and consistent with the fiscal second quarter. As a percentage of revenue, SG&A was 5.1%, similar to expectations. Operating margin of 4.8% was at the low end of our guidance as a result of the lower gross margin. Included in this quarter's operating margin are approximately 70 basis points of stock-based compensation expense, in line with our quarterly guidance. Diluted EPS of $0.74 was above the midpoint of our guidance. Fiscal third quarter tax expense was favorable to our expectations by approximately $1 million or $0.03 per share. The lower tax expense was primarily related to the deductibility of certain expenses which were approved by one of our foreign site's taxing authority. This resulted in a combination of lower current taxes due and the refund of prior taxes paid. We expect to see a benefit continue in the future periods.

Turning now to the balance sheet on Slide 14. Return on invested capital is 16.1% for the third 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 a combination of improved earnings and a reduction to our average invested capital. During the quarter, we purchased approximately 190,000 of our shares for close to $10 million at a weighted average price of $52.40 per share. We continue to purchase our shares based on market conditions and free cash flow generation in the U.S. One comment to make on our balance sheet classification. Since our $175 million senior notes mature next June, this debt has been reclassified from long term to short term within the balance sheet. Assuming no U.S. tax reform within the next year, our intention is to refinance the notes with the similar long-term product.

In the third quarter, we generated $16.3 million in cash from operations and spent $9.8 million on capital expenditures, delivering free cash flow of $6.5 million. At the end of the quarter, our cash cycle was 76 days, in line with our expectations and 3 days higher than our results in the fiscal second quarter. In total, working capital increased approximately $30 million during the quarter.

Please turn to Slide 15 for details on our cash cycle. Sequentially, days in inventory were up 4 days while the dollar value of inventory was up about $43 million. Most of this increase was driven by a buildup of inventory as we ramp new programs and prepare for higher revenue anticipated in the fiscal fourth quarter. We are also experiencing longer lead times for certain components. In order to maintain a high level of customer service, we are procuring components earlier, accepting that inventory will be increased in the short term. Days in receivables were 47 days, sequentially down 1 day and delivering the third straight quarter of improvement in receivable days. Accounts payable days were 65 days, sequentially up 1 day, while customer deposit days were 13, down 1 day from the prior quarter.

As Todd has already provided the revenue and EPS guidance for the fiscal fourth quarter, I will share some additional details which are summarized on Slide 16. Fiscal fourth quarter gross margin is expected to be in the range of 9.4% to 9.8%. The midpoint of this guidance suggests a sequential decline of 30 basis points. Product mix and ramping costs associated with the anticipated strong sequential revenue growth in the fiscal fourth quarter are contributing to the margin reduction. In addition, we are making strategic investments in aftermarket services, which are expected to create a slight near-term drag on margins. We expect SG&A expense to be consistent with our spending in the fiscal third quarter in the range of $31.5 million to $32.5 million. At the midpoint of our revenue guidance, anticipated SG&A will be 4.7% of revenue, sequentially down 40 basis points. Fiscal fourth quarter operating margin is expected to be in the range of 4.7% to 5.1%, which includes approximately 65 basis points of stock-based compensation expense.

A few other notes. Depreciation expense for the fiscal fourth quarter is expected to be approximately $11 million, consistent with the fiscal third quarter. We estimate an effective tax rate of 8% to 9% for both the fiscal fourth quarter and full year. Our expectation for the balance sheet is for cash cycle to be in the range of 69 days to 73 days. At the midpoint of this guidance, cash cycle would be sequentially lower by 5 days with most of the improvement related to inventory. We expect free cash flow up to $15 million for the fiscal fourth quarter. Lastly, capital spending for the fiscal year is anticipated to be in the range of $45 million to $50 million.

With that, Paulette, let's open the call for questions. We ask that you please limit yourself to one question and one follow-up. Paulette?

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) And our first question comes from Sherri Scribner from Deutsche Bank.

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

I wanted to ask you about the fiscal '18 numbers. I know it's still a bit early and you're doing your plans, but you guys have talked about meaningful growth in fiscal '18. Can you maybe quantify that as double digit? Is it more than mid-teens? And then maybe provide some detail on the mix of that business. I think most of that is coming in Communications from the program ramps, but maybe a little detail on where that growth is coming from would be helpful.

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

Sure. Sherri, this is Todd. I'll get started, and Steve may have something to add after I'm finished here. But first of all, with '18, I'd like to start by saying that it's certainly too early to guide or make any significant commitment to fiscal 2018. But what I would say is we have a goal and a target of double-digit growth in fiscal 2018 and things, at least in the current picture today, shape up for that to occur. Now what you're seeing, first of all, is significant sequential growth in Q4 F '17. I mean, at the midpoint, we're looking at about 10% sequential growth. Now we expect sequential growth as we move through fiscal '18 as well, but not to anywhere near the magnitude on a quarterly basis is what we're seeing in Q4. So we've taken a look obviously at the Street numbers that are out there right now and when we look at the slope of the growth that the Street has projected, I mean, that seems reasonable or a good place to start as we look at growth in fiscal 2018. But again, we expect it to be a good growth year. Things are lining up really well given the wins and the funnel that we've been able to generate over the course of the last fiscal year plus. Now if you look at things from a sector basis, I guess, what I'd say, it goes well beyond Communications. So we're expecting strong growth in Healthcare/Life Sciences, Communications and Defense/Security/Aerospace. Industrial/Commercial, we have -- as Steve mentioned earlier, we're starting to see a little bit more of a normalization of semiconductor capital equipment and we'll see if that becomes a reality. So that may make Industrial/Commercial the comparison a little bit more difficult. So -- okay? How does that...

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

That's excellent. That's a lot of good detail. I just wanted to ask a quick follow-up on the margin trajectory. Clearly with the new programs ramping, this quarter, next quarter, margins are down versus the first half of the year. How should we think about the margin progression as we move through fiscal '18? I assume new program ramps will have some impact on the first and second quarter. But can we get above that 5% operating margin level in the second half of '18?

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

Yes, Sherri, that's a possibility. I mean -- first, let me look at gross margin. I think operating within the range of 9.5% to 10% is reasonable especially with, like you said, ramping a lot of business and not having a lot of end market growth. I think we will get some leverage in SG&A, so that's an opportunity. But we're driving towards that target range of 4.7% to 5% in each one of our quarters next year. So that's really our goal.

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

Yes, a little bit that I'd add on that as well, Sherri, is, I mean, if we look at our commentary over the course of last year and of course, we're expecting to see the meaningful growth a little bit earlier in the cycle than we're seeing it, but our expectations were to drive the 4.7% to 5% with accelerated growth. And I think that's really what we're beginning to see right now as we need to -- because of the growth, we need to invest in the transitions. There are certainly efficiencies that occurred during the transitions, but we're committed to maintaining that 4.7% to 5% every quarter. So that's what the team's focused on is delivering that target range while accelerating the growth and occasionally we may pop above the 5%. But again, our target is 4.7% to 5%.

**Operator**

Our next question comes from Shawn Harrison from Longbow Research.

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

Just on the ramp in the Communications business being 50% sequentially and a little better than expected this quarter. Would you expect to be kind of back to status quo as you enter early FY '18? Or is there kind of more of a ramp to come in the early part of the fiscal year associated with the business?

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

Well, I think if you -- this is Steve. If you look where the Communications sector is at, we basically returned to the revenue levels that we had when we started the fiscal year. And so I'd say it's back to more of a normal level. So we do see it maintaining at that level and we do expect this sector to grow. So from a year-over-year growth standpoint, you would expect to see sequential growth in '18 because we do not anticipate the dip that we saw in '17.

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

Okay. I guess, within that though, is there some potential customers came out of the funnel. So it is a low single-digit kind of normalized growth environment. How to think about that business given where the funnel opportunities understanding that there's a comp dynamic in '17 that really helps you out?

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

Yes. So I think that'd be a good way to summarize it.

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

Okay. And then going back to the margin question. I think the comment was some investments in aftermarket services and understanding that, that could be a little bit of a drag. I initially thought you would have been at 5% in the back half of the year. So maybe -- I want to delve into what is the exact cost of the aftermarket services and maybe what is the benefit going forward? And then what kind of caught you off guard in terms of these ramps? Because I'm pretty sure you had higher expectations for the gross margins at least in the June and September quarters.

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

Yes, Shawn, I'll start off and then maybe Steve will want to add something. First of all, what caught us off guard, as I look across all of our sites, it was really limited to 1 U.S. site that had some challenges with revenue being below their forecast and they had some really challenging ramps in the Healthcare/Life Sciences sector that were very complex. And our first priority, as you know, is customer service excellence and we're going to put the resources in place that we need to satisfy customer delivery schedules and that's what we did. So it was limited primarily to that 1 site. With aftermarket services, Steve had mentioned a new program win. And the thing unique about aftermarket services is it's very labor intense, and when you win a program, you've got to add the headcount in advance of seeing that revenue. And that's what we're seeing in the fiscal fourth quarter. Now that's probably about a 10 basis point drag. So at the midpoint of our operating margin guidance, which is 4.9% for the fiscal fourth quarter, the fact that we won that program is about a 10 basis point drag for us in this quarter.

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

What I would add, Shawn, is that, that aftermarket services win is quite a bit or substantially larger than what would be a typical aftermarket services win. So that's why there is an impact that we wouldn't normally see from other aftermarket services wins.

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**Operator**

Our next question comes from Matt Sheerin from Stifel.

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

Just a couple of questions. You noted a few times of some wins in Europe and I know that you've had excess capacity there and have been trying to fill that capacity. And it looks like there is momentum there. Could you just talk about some of the wins there? And then also, what is that due to your -- in terms of your capacity leverage and profitability profile in Europe?

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

Sure, this is Steve. In terms of the wins, I -- we talked in the last quarter about the potential of winning a significant opportunity of the customer and that's a Defense/Security and Aerospace customer that's decided to outsource its facility. So that win is pretty significant. It's being split across both our Kelso, Scotland facility as well as our Oradea, Romania facility. The Kelso facility is reaching capacity. It's quite full. So we are talking with the teams as we get through the ramps about driving improved efficiencies out of that factory when it's at that level. And then, for our Oradea, Romania facility, the addition of this customer as well as I talked about a Healthcare/Life Sciences customer that's ramping, Healthcare/Life Sciences will take a little bit longer to ramp. But we do expect continued decent growth in the Oradea, Romania facility through fiscal '18. Oliver Mihm is our leader over there, and he and the team are doing a really nice job attracting and developing customers over there. So our expectation is that we will continue to ramp that well and we do expect to get leverage as it ramps.

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

To give you a bit of an idea of the magnitude of the ramp, in fiscal '17 we're looking at roughly mid-teens growth in the EMEA region. Fiscal '18 is looking to be significantly better than that. So we should continue to see leverage and better profitability within the region as we capitalize on those investments that we previously made.

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

Okay, that's helpful. And on your -- the inventory situation, you talked about the justification for the big inventory build given the strong growth rate that you're seeing next quarter. But you also talked about component lead times, stretching and the need to building some buffer inventory.

Could you elaborate on that? Is the component tightness worse than it was last quarter? Is it spreading to areas other than memory? And is there a situation where there are some parts on allocation and that might be an issue in terms of meeting demand?

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

Yes, I'll start with that, Matt. So yes, we're seeing the tightening of components especially in electronic components, mainly resistors, capacitors. As you mentioned, also memory, DRAM and NAND flash, but we're still able to procure the components and we're not -- it's no threat to customer deliveries at this point. So I'm not aware of any allocations that we're on. Steve?

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

Yes, maybe one thing to add. I think the issue is that the markets have tightened a bit. We haven't really seen this for several years, probably 8 or 10 years in terms of how some of this has been tightened. And I think some of the customers have gotten used to being able to drop in demand and then, we expedite and fulfill it. And so from my standpoint, I think the biggest risk might be associated with meeting customers drop in demand, but that's not built into our forecast. That's more of the concern I have on servicing the customers.

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

Just as a follow-up to that. Then would you expect that these inventory levels to remain fairly bloated? And what does that do to your cash flows?

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

Yes, we expect to see inventories coming down in the fourth quarter as we flush out inventory with the additional revenue.

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

And one final comment. I think it's important to note that we don't take on inventory risk ourselves. I mean, without permission from the customer to go procure the inventory and do this, it's not something that we're building Plexus kind of responsibility. It's more what we're trying to do to work with our customers to help them be successful meeting their demand.

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**Operator**

Our next question comes from Steven Fox from Cross Research.

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**Steven Bryant Fox** - *Cross Research LLC - MD*

Could you first of all provide a little bit more color on the exact type of end market services that you're -- you were alluding to earlier in the call that are ramping? And then, whether there is another wave of hiring that you would expect to come in? Or how it's leading to other aftermarket services businesses? And then I had a follow-up.

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

Yes, so the Healthcare/Life Sciences sector is the team that won the significant aftermarket services business. And so what we are doing is repair and refurb of complex medical devices. And so the customer will -- when they're out in the field and they need service or repair, they'll ship them back to us. And we'll do the service and repair, we may do kind of replacement offerings in terms of emergency fills, those types of things. So it's really associated with working with Healthcare providers to make sure that their facilities are up and running. So we take on that responsibility for our customer. As Pat highlighted, on these bigger programs, especially in this case, because in this case the customer is outsourcing it from an internal factory. We needed to add staff and resources to basically panel that transition and basically get up the learning curve on how to do this as they go through the transition. So that's a little color on that one.

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**Steven Bryant Fox** - *Cross Research LLC - MD*

And just as a follow-up to that. When you hire for something like that, can you sort of explain how you manage to what, I guess, can be an unpredictable rate of demand for that service?

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

It can be unpredictable but -- like in this case, the customer has a pretty good visibility in terms of what their quantity of repairs are and returns are going to be on a quarterly basis. They have some historical trend data that they have themselves. And so staffing level wise, you can get a pretty good estimate for what you're going to need. It's really just getting the people in and then developing the level of internal expertise to be able to service the product.

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**Steven Bryant Fox** - *Cross Research LLC - MD*

Great, that's helpful. And then, secondly, just on the Communications ramp. If we think about separating out the ramp from demand, it sounds like basically the sequential increase is all due to new programs. If you could just confirm that? And then, if I went and looked into fiscal '18 off of this type of run rate, can you again just sort of talk about new program potential versus maybe overall demand trends? And lastly, within that whether it's dominated by 1 or 2 customers this quarter in terms of the sequential ramp?

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

Yes, so if we look at Communications ramp in general, there's a number of new programs that are ramping across multiple customers. And certainly, we have a large customer within that sector. So that's certainly a piece of it. And then would need to be to have a ramp of that magnitude. If we look at new programs versus end market, we're seeing a modest strengthening of end markets but nothing substantial. It's mostly new programs that's driving the growth.

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**Operator**

Our next question comes from Paul Coster from JPMorgan.

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**Paul Coster** - *JP Morgan Chase & Co, Research Division - Senior Analyst, Alternative Energy, and Applied and Emerging Technologies*

So you just opened a couple of new facilities. You've noted that you may need to invest in Scotland to absorb new business. As you roll into '18 with growth ahead, is this a kind of a common theme that you're out of capacity? And could it weigh on margins as you add in new facilities?

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

Yes, so this is Todd, Paul. I'll take this. First of all, with respect to the new facilities we talked about, they were engineering facilities. So they're not of the scale of investment of a manufacturing facility. And just to provide a little bit more color around that, the Neenah -- the new Neenah facility that we're in is a leased facility. So we essentially changed addresses from our own building to a leased building. So pretty insignificant when we look at it from an investment standpoint. Guadalajara is in our existing -- we're putting our Guadalajara Design Center in our existing manufacturing facility. So while we have a little bit of (inaudible) for labs and office space, again, pretty minimal investment. And then, to further clarify on the EMEA wins, we won't need additional capacity -- additional facilities in Kelso or Oradea for the significant wins in EMEA. We have ample capacity in both those facilities. Now as we look forward, I mean, if we continue the growth trajectory that we believe we're starting, we're going to need to be thinking about capacity and additional facilities as we get perhaps 12 to 18 months out in the future. We've talked about Mexico and the potential, we need another facility there, for instance. But we would expect to be able to absorb that into our margin performance as our other facilities will be more highly leveraged as we have plenty of capacity across the globe right now.

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**Paul Coster** - *JP Morgan Chase & Co, Research Division - Senior Analyst, Alternative Energy, and Applied and Emerging Technologies*

Okay, and then my quick follow-up is, of the $2.8 billion funnel opportunities, to what extent is this existing customers? And to what extent is the existing kind of industry verticals? Is there anything that takes you into new sectors completely with potentially different operating margin profile?

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

This is Steve. From a -- the 4 sectors that we currently service were very happy with where we're at and we think we can grow within those 4 sectors. We always look within the subsectors or to different subsectors that we're interested in pursuing. And the answer to that question is really nothing meaningful and significant that's changing from our strategy standpoint in terms of where we're going. As you look at the funnel itself, it's roughly -- on an ongoing basis, you can say it's roughly 70% customers, 30% new customers, is kind of how we've historically trended and that's the way we kind of always look at it being a very healthy portfolio. We definitely would prefer to grow with customers. It's much easier to ramp than it is adding new customers. But we also recognize that adding new [logos] to the portfolio is important.

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**Operator**

Our next question comes from Mitch Steves from RBC Capital Markets.

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**Mitchell Toshiro Steves** - *RBC Capital Markets, LLC, Research Division - Analyst*

Just wanted to start on the Communications side. So while there's a product ramp that's happening on a sequential basis, if I think about the entire full year next year, is there any way to provide any kind of granularity around the seasonality for FY '18?

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

As I highlighted in the comments, I think one of the things that we're talking about here is that with these new program ramps, for us looking into fiscal '18, really the end market acceptance of those is really kind of driving -- will drive what our F '18 looks like. So it's a little bit early to call in terms of what the market acceptance will be. As Todd highlighted, we do see some modest growth in the Communications sector just as a general statement. But from a seasonality standpoint, there's nothing that we're seeing at the moment that we could predict as to what '18 looks like.

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

Typically, we don't see a lot of seasonality in our Communications business. Perhaps a little bit of strength in the fourth calendar quarter of the year would be typical but -- that's about it. Other than that, there's nothing really noticeable.

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**Mitchell Toshiro Steves** - *RBC Capital Markets, LLC, Research Division - Analyst*

Got it. And then from a margin perspective for September quarter. I mean, typically, the Networking segment is kind of closer to corporate average, I think, even slightly below the operating line. So is all that extension essentially due to revenue leverage? As you're going to be getting close to the kind of $700 million in revenue?

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

Yes, it is. Especially, Mitch, on the SG&A or operating expenses, you will see a lot of leverage we're getting there. And the fact that even though Communications is close to the corporate average, if we're putting a lot of revenue from certain customers, we can get leverage of those fixed expenses as well within those sites. So it's a combination of gross margin improvement and operating margin.

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**Operator**

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

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**Sean Kilian Flanagan Hannan** - *Needham & Company, LLC, Research Division - Senior Analyst of Smart Grid, Electronic Mfg Svcs, IT Components & Electronic Components*

Sorry, I'm going to actually ask something about the Communications as well. These ramps that start to come into the September quarter, should we expect that you're recognizing effectively a full revenue ramp rate through the course of the quarter? Or is there only an aspect of that and that should continue to ramp up into the December quarter? Just trying to get an understanding of how that impacts from a timing standpoint.

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

We would expect the majority of the ramp to happen within the quarter.

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**Sean Kilian Flanagan Hannan** - *Needham & Company, LLC, Research Division - Senior Analyst of Smart Grid, Electronic Mfg Svcs, IT Components & Electronic Components*

Okay. But then there would be incremental within December as well?

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

There may be some slight incremental but not nearly anything to the magnitude that we're experiencing this quarter.

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**Sean Kilian Flanagan Hannan** - *Needham & Company, LLC, Research Division - Senior Analyst of Smart Grid, Electronic Mfg Svcs, IT Components & Electronic Components*

Fantastic. Okay. And then in terms of looking at the funnel, so just trying to better understand that movement quarter-to-quarter. So obviously, some programs were pulled out of the funnel in terms of the wins. But I just want to see if I can perhaps better understand what's behind the dip. How much were either not won opportunities were walked away from versus than what was cultivated into wins. If you can provide a little bit more insight in terms of that quarter-on-quarter movement.

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

Sure. Maybe sector-by-sector. In Healthcare/Life Sciences, the funnel slightly increased. We backfilled what we won and really probably nothing significant in there. Very similar story for Industrial/Commercial. In the case of Defense/Security and Aerospace, the funnel dipped really due to just the quantity of the wins coming out. So certainly really good wins. As I talked about a bit, we've got some decent opportunities similar to the event that happened in EMEA that we're hoping to be able to add to the funnel in the next quarter or 2 and bring that funnel back up. So from that standpoint, I think the Defense/Security and Aerospace funnel is fine where it's at. The Communications sector is the one that dipped. We did take out a couple of programs. One, on a competitive basis, we decided not to pursue the cost model. And then, the other one, we determined that from a mix standpoint, it really didn't fit the business model for us, so we pulled those out of the funnel. We're pretty committed to being religious and diligent about making sure the business that we win is going to meet the financial portfolio and the mix that we want, so we're not afraid to walk away from it. So with that said, that leaves the Communications sector lower than where we like that, the team knows that and we're aggressively working to grow it.

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**Sean Kilian Flanagan Hannan** - *Needham & Company, LLC, Research Division - Senior Analyst of Smart Grid, Electronic Mfg Svcs, IT Components & Electronic Components*

Okay. And then if I could just ask one more follow up. Could you perhaps characterize how you're thinking about the current outsourcing environment today? Whether you assess there's any accelerated uptick in terms of some of the markets, the acceptance of the outsourcing model in utilizing supply chain partners as yourself? Or in the grand scheme of things, is this simply a good set of quarters reflective of good work that you folks are putting in, not necessarily bigger secular trends at OEMs?

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

Yes. I'd say, Sean, it's a little bit of both. I think our team's doing a really nice job of growing the funnel and generating new opportunities and getting in front of customers that we haven't spoken within the past. But I'd also say we are seeing a more large opportunities, perhaps than in the past, a more acceptance to at least explore outsourcing as a solution from some of the more nontraditional sectors.

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**Operator**

Our next question comes from Jim Suva from Citi.

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**Jim Suva** - *Citigroup Inc, Research Division - Director*

This probably may be the last question on the Communications segment. But the ramp that you saw this quarter, of course, was strong. But if my memory is correct, I think you had some design wins in past quarters that maybe got deferred as far as the timing of it this quarter. Was that the material reason for the upside or large increase in Communications for this quarter? Was the deferral of past timing of what it was supposed to hit? And then my follow-up question is, I think you had mentioned in your prepared remarks something about you received a lot of design wins. I think you said in Aerospace and Defense, if I'm correct. So can you talk to us a little bit about those ramp next year? Is that helpful to margins or neutral to margins? Or how should we think about that as the timing of that segment ramps?

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

Maybe I'll address your second question first. Defense/Security and Aerospace team has done a really nice job this year, growing our Engineering Solutions relationships with our existing customers. And so from a -- I'd call it -- we call it kind of the stickiness factor where we've expanded the service offering behind manufacturing to include Engineering with some of our largest customers. And that's a very healthy thing to do. Although those programs are -- engineering programs get better margins. From an overall scale of the sector standpoint, they're probably not meaningful in terms of changing the dynamics of the sector. But from a relationship with the customer, significantly important. In terms of the Communications question in terms of where engineering ramps, these programs that we're talking about here, we've had engineering involvement in some of them. But the magnitude of the ramp is not really related to the engineering engagements that we've had.

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

Yes, one of the things, Jim, just to add on here to clarify is that we don't have any significant deferred revenue out there. So basically, we're reporting revenue as we earn it. So the current quarter had no impact as a result of deferred revenue nor do we really have anything of -- anything significant that's out there. And Steve talked a little bit too about the Aerospace wins in EMEA, the manufacturing wins. And one of the things that's maybe -- they were large. One of the things that's unique about is, it's a little faster ramp than typical Aerospace business. So it is something that could have an impact in F '18. Not to the full magnitude but certainly a partial magnitude.

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**Operator**

And we are showing no further questions. I will now turn the call over to Todd Kelsey for closing comments.

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

All right, thank you, Paulette. Just a few final closing thoughts. I'd like to start by saying I'm pleased we're starting to finally see the anticipated revenue growth materialize. So I think our commitment to our strategy has helped to really get us to this point. Again, to reiterate what that's all about, it's exceptional execution to grow share with our existing customers. We'd like to call it operational excellence and customer service excellence, a differentiated portfolio aligned with noncommoditized markets, expertise in our customers markets, and then just being focused, consistent and deliberate. So with that, I would expect the end result would be accelerated growth and operating margins within our target range while we deliver a strong economic return. So that's what our target is for fiscal '18. In closing, again, I'd like to thank all the Plexus employees that are listening. We appreciate all your hard work. I'd like to thank our investors for their support of Plexus and also the analysts for their great questions and the support of Plexus in your notes. Thank you very much.

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**Operator**

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

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