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PLXS - Q2 2012 Plexus Earnings Conference Call

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OVERVIEW:

PLXS reported 2Q12 revenues of \$573m and EPS of \$0.56. Expects 3Q12 revenues to be \$590-620m and EPS to be \$0.60-0.66.



CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good morning ladies and gentlemen, and welcome to the Plexus Corp. conference call regarding its fiscal second quarter 2012 earnings announcement. At this time all participants are in a listen-only mode. After a brief discussion by management, we will open the conference call for questions. The conference call is scheduled to last approximately one hour. I would now like to turn the call over to Mr. Angelo Ninivaggi, Plexus Senior Vice President, General Counsel, and Secretary. Angelo?

Angelo Ninivaggi - Plexus Corp - SVP, General Counsel and Secretary

Good morning, and thank you for joining us today. Before we begin, I would like to establish that statements made during this conference call that are not historical in nature, such as statements in the future tense and statements including believe, expect, intend, plan, anticipate, and similar terms and concepts are forward-looking statements. Forward-looking statements are not guarantees, concern current difficulties and predicting future results, and actual results could differ materially from those expressed or implied due to the forward-looking statements. For a list of major factors that could cause actual results to differ materially from those projected, please refer to the Company's periodic SEC filings, particularly the risk factors in our Form 10-K filings for the fiscal year ended October 1, 2011, and the Safe Harbor and fair disclosure statement in yesterday's press release.

The Company provides non-GAAP supplemental information, for example our call today will reference return on investment capital, Non-GAAP financial measures, including return on invested capital, are used for internal management assessments, because such measures provide additional insight into ongoing financial performance. For a full reconciliation of non-GAAP supplemental information, please refer to yesterday's press release and our periodic SEC filings. Joining me this morning are Dean Foate, President and Chief Executive Officer, Ginger Jones, Senior Vice President and Chief Financial Officer, Todd Kelsey, Executive Vice President of Global Customer Services, and Michael Buseman, Executive Vice President of Global Manufacturing Operations. Let me now turn the call over to Dean Foate. Dean?



Dean Foate - Plexus Corp. - President and CEO

Thank you, Angelo, and good morning everyone. Last night we reported results for our fiscal second quarter of 2012. Revenues were up 8% sequentially to \$573 million with EPS of \$0.56. Both revenue and EPS were above the midpoint of our guidance range. The revenue number set a record for the Company, and marked a return to sequential growth following four consecutive quarters of flat to down performance. While admittedly below our enduring target, our return on invested capital performance of 14.4%, was 190 basis points above our weighted average cost of capital, putting our ROIC result in value-creating territory. When considering end market dynamics, we believe we are experiencing relative stabilization and perhaps the early signs of recovery in most of our sectors. Having said that, the broader macro environment is unsettled, and the near-term performance of our Networking/Communications Sector remains uncertain.

Turning now to some insight into the performance of our market sectors during our fiscal second quarter of 2012 and our current expectations for Q3 and Q4. Our Networking/Communications Sector was down about 9% sequentially in fiscal Q2, a deeper decline than we anticipated when we set guidance in January. A couple of key customers in this sector significantly underperformed earlier forecasts, more than offsetting what was a surprisingly good quarter for the majority of our top 10 customers in this sector, with most exceeding earlier forecasts.

Consistent with the view that we provided last quarter, we continue to anticipate sequential growth in fiscal Q3 for our Networking/Communications Sector, while we benefit from program ramps. Current forecasts indicate that revenue will grow up in the low double-digit percentage range, although we expect performance among our top 10 customers to be mixed as customers appear to be struggling with forecasts in the uncertain end market environment. We currently anticipate a relatively lower pace of sequential revenue growth continuing through our fiscal fourth quarter. Our Medical Sector revenues were up just 1% sequentially in fiscal Q2, a slight improvement over our earlier expectations for a low single-digit decline, as the majority of our top 10 customers in this sector beat their earlier forecasts.

As we communicated last quarter, new program wins will drive growth in our Medical Sector during our fiscal third quarter. We currently expect revenue to be up in the low to mid-teens percentage range for Q3, with more moderate growth continuing through our fiscal fourth quarter. Our Industrial/Commercial sector is up sequentially about 40% in Q2. A result that was stronger than anticipated when we sent guidance last quarter. While a few of our top customers in the sector outperformed earlier forecasts, a significant part of the upside result of stronger than expected performance associated with our expanded relationship with Kontron, along with other customer program ramps. Following a strong Q2 comparative, we currently anticipate sequential revenue growth to slow in fiscal Q3, with flat to low single digit growth expected, as a few of our top customers in this sector are managing inventory positions.

Customer forecasts currently indicate end market weakness in our fourth quarter, when we anticipate a mid to low single digit decline in revenues. Our Defense/Security, and Aerospace Sector performed slightly better than expected, with revenue up about 18% sequentially in Q2. Our view on Q3 has changed since our guidance last quarter when we anticipated continuing growth. We now expect flat to down performance in the Defense/Security and Aerospace Sector as a few customers have backed off on earlier forecasts. We anticipate that we will experience better performance in fiscal Q4. Turning now to new business wins. During the quarter we won 28 new programs in our Manufacturing Solutions Group that we anticipate will generate approximately \$316 million in annualized revenue when fully ramped into production.

Included in the \$316 million is approximately \$100 million of the revenue associated with our expanded relationship with Kontron that we announced back in January. The \$316 million number sets a new single quarter record for new program wins, and follows two prior quarters of solid performance. Our Business Development Fund will remain strong at \$1.9 billion. Turning now to our guidance. We are establishing fiscal third quarter 2012 guidance of \$590 million to \$620 million, with EPS of \$0.60 to \$0.66, excluding any unanticipated restructuring charges and including approximately \$0.08 per share of stock-based compensation expense. The midpoint of the guidance range suggests healthy sequential revenue growth of approximately 5.5%.

With this level of revenue, we anticipate a modest improvement in operating performance. Ginger will provide more details on our operating performance in a few minutes, but I wanted to take a moment to highlight the reality of our current growth environment. When you dig into the numbers, it is clear that our near-term revenue growth is largely driven by our solid performance winning and ramping new programs. The operating performance of new programs is inherently challenged during the initial ramp phases, and improves over time as we optimize supply chains and



drive variable cost productivity. Our overall operating model targets are built on the assumption that the relatively better operating performance inherent in more mature programs mitigates ramp costs associated with new programs.

In the current environment, where end market growth for these more mature programs is muted or flat, it is challenging for us to fully achieve the leverage required to hit our operating margin target. We could engineer a better result by backing off on capacity investments that are also creating a near-term drag on margins, but we believe these investments are important to attract and enable longer-term growth. As a consequence, we currently expect our operating margin performance to remain modestly below our 5% target through fiscal year-end. Longer term, we remain committed to both revenue growth and return on invested capital performance that is solidly above our weighted average cost of capital, as we believe that this performance is fundamental to driving long-term shareholder value. Ginger?

Ginger Jones - Plexus Corp. - SVP and CFO

Thank you, Dean. As Dean mentioned earlier, second quarter revenue was above the midpoint of our guidance range. Gross profit was 9.5% for the fiscal second quarter. This was higher than our expectations and below our first quarter results of 9.8%. The stronger than anticipated results in the fiscal second quarter were the result of a favorable mix of revenue driving better leverage from our operations. As a reminder, our fiscal first quarter results were stronger than originally anticipated because of a significant project completed by our Engineering Solutions Group and the favorable outcome of an inventory disposition related to a manufacturing customer disengagement. Selling and administrative costs were \$28.9 million, above our expectations, which reduced EPS from our original guidance by approximately \$0.02.

This was largely a result of the amortization of an intangible asset from the Kontron arrangement, which was completed during the quarter. When we set our guidance in January 2012, shortly after we completed the Kontron arrangement, we had not yet determined if the premium paid would be treated as goodwill, which is not amortized, or as an intangible asset that would be amortized. The final accounting determination was made during the quarter, resulting in approximately \$350,000 of amortization costs during the fiscal second order. SG&A costs as a percentage of revenue were 5% in the fiscal second quarter, improved leverage from the 5.3% in the fiscal first quarter.

Operating profit was higher than our expectations at 4.5%, with the higher gross margin discussed above offsetting the higher SG&A costs. Return on invested capital was 14.4% for the fiscal second quarter, 190 basis points above our weighted average cost of capital for fiscal '12 of 12.5%. Our efforts to reduce working capital continue to show progress, as cash cycle days came down 4 days to 66 days. This is a good result, and well better than our expected range of 71 days to 73 days. I'll now get into the details by balance sheet line item. Days in receivable increased by 1 day to 47 days. This increase was primarily the result of the timing of revenue during the quarter, as shipments were more concentrated in the final weeks of the quarter.

This resulted in modestly higher accounts receivable at the end of the quarter. Days in Inventory were 87 days, flat from our results in the prior fiscal quarter, the dollar value of inventory was up about \$31 million from the prior quarter. Accounts payable days, at 62 days, was up 5 days from the prior fiscal quarter. This was largely the result of higher purchases with Plexus suppliers with extended terms, which benefits our accounts payable days. Some of this increase was also the result of purchases late in the quarter to support higher revenue expected in the coming quarter. Days of cash deposits were in line with the prior fiscal quarter at six days. The dollar value of cash deposits increased by about \$2 million to \$32 million. These were deposits received from customers to offset the risk of inventory that we hold on their behalf.

Free cash flow generated during the quarter was very strong at \$41 million. This cash was generated about equally from earnings during the quarter and lower working capital investments. During the quarter we spent \$11 million in capital expenditures, with approximately \$5 million of that for footprint expansions in Xiamen, China and Oradea, Romania. Our fourth facility in Penang, Malaysia is complete and began operations in our first fiscal quarter of 2012. The \$11 million of capital expenditures does not include the approximately \$5 million of equipment that was purchased in January 2012 under the strategic arrangement with Kontron. The appropriate accounting for this is to reflect this as an acquisition in the statement of cash flows.

I'll now turn to some comments on the fiscal third quarter of 2012. Gross margin is expected to be in the range of 9.4% to 9.6%, which is consistent with our gross margin in the fiscal second quarter. As we've discussed before, this includes modest drag from the new capacity in Penang, the transition costs for the new Kontron business, and the challenges of achieving our target model when a significant portion of our revenue growth



is coming from new program wins. We are continuing our focus to offset near-term gross margin pressure with aggressive cost containment, including SG&A, in an effort to protect operating profits. With a return to sequential revenue growth we are seeing leverage in SG&A, with a nice decrease from 5.3% in the fiscal first quarter to 5% in the fiscal second quarter.

SG&A for the fiscal third quarter of 2012 is expected to be in the range of \$29 million to \$30 million, modestly higher than our spending in the fiscal second quarter. Depreciation expense is expected to be approximately \$12.2 million in the fiscal third quarter, up slightly from the \$12.1 million in the fiscal second quarter. This results in expected operating margin of 4.5% to 4.7%, modestly improving from our results in the fiscal second quarter. We are estimating the effective tax rate for 2012 will be 10%. This is consistent with our communications at the beginning of the fiscal year and an increase from fiscal 2011, based on improved outlook for our US operations and for changes in the mix of forecasted earnings between taxing jurisdictions.

Our expectations for the balance sheet are for dollars in inventory to increase modestly to support the higher forecasted revenue, and for accounts receivable and accounts payable to increase slightly. Based on the forecasted levels of revenue, we expect these changes will result in cash cycle days, net of cash deposits, of 66 to 68 days for the fiscal third order. Our capital spending forecast for fiscal 2012 has been reduced to approximately \$75 million to \$85 million, down from the prior estimate of \$95 million to \$100 million. This is the result of work done throughout Plexus, primarily by our operations team, to reduce capital spending in support of reaching our return on invested capital target.

The primary work has been to find ways to better utilize our existing facilities and equipment to serve new customers, allowing us to delay some new investments. This reduction does not reflect any changes to our stated investments for future growth, such as our investments in Xiamen, China or our recently announced new facility in Oradea, Romania. We believe this focus on improving utilization will not diminish our commitment to serving our customers well. As discussed in our earnings release and as Dean just mentioned, we remained optimistic about our continued organic growth, and we will continue with our plans to expand our footprint in close proximity to our existing locations.

As Dean mentioned, our current customer forecast supports a trend of sequential revenue growth through the end of the fiscal year. Although gross margin and operating margin targets may be slightly below our long-term targets currently, we believe that we are delivering significant value to shareholders through the combination of significant revenue growth, industry leading operating margins, and the shareholder value created by our ROIC of 190 basis points above our weighted average cost of capital. With that, I will open the call for questions. We ask that you please limit yourselves to one question and one follow-up. Operator, please leave the line open for follow-up questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Wamsi Mohan, Bank of America Merrill Lynch.

Wamsi Mohan - BofA Merrill Lynch - Analyst

When you look at the 5% margin target, it sounds from your comments like you will be slightly below that exiting fiscal '12, but your revenues have actually tracked a little higher than guidance and expectations for both Q1, Q2, and now, frankly, even Q3, probably Q4. So what factors within costs are ramping that's causing this offset? Is it mostly the integration costs, or maybe you can give some more color on that?

Ginger Jones - Plexus Corp. - SVP and CFO

Well, Wamsi, I'll start and then I'll see if Dean wants to join in. I think we've summarized pretty well the key issues that are keeping operating margin modestly below our target. I'd say that there is some drag from the new facility in Penang, and there is also definitely transition costs from the new



Kontron arrangement that we've talked about. We certainly expected that to be below our target margin -- that business -- in the early quarters as we're transitioning that into our facility. And then I'd say the last part, which both Dean and I addressed today, in general, new business, ramping business, is not as optimized as existing programs with existing customers. And so, as most of our revenue, or a significant portion of our revenue, is coming from program wins, that makes it harder for us to achieve our model. Those are the major factors that are impacting our operating margins in F12. Nothing to add from Dean?

Dean Foate - Plexus Corp. - President and CEO

No.

Wamsi Mohan - BofA Merrill Lynch - Analyst

Okay. I mean, it sounds, though, that last quarter it sounded as though you might be able to potentially hit that exiting fiscal '12, and now it sounds more like you won't. So I'm just trying to understand the delta between last quarter and this quarter. Is it just macro, or is it what you're seeing from your customer forecasts that are also causing that, or it's basically as what you summarized just now?

Dean Foate - Plexus Corp. - President and CEO

Well, Wamsi, I think the reality is that our assumptions were built that we would see a stronger pull through from more mature programs as we came through the back end of the year, and we're just not seeing the level of strength that we originally anticipated. So while our numbers overall are still kind of in line with where the street had us from a revenue standpoint, the path to get there is somewhat different, and the path is not counting on a whole lot of end-market demand of existing programs. The path is really around more robust new program wins and the early ramps of these program wins driving revenues. As Ginger stated, in the first couple of quarters or so of new program ramps, those were not profitable, typically, out of the gate and it takes us some time to get the productivity levels up, to get the supply chain optimized, and to start getting the leverage from the new programs, and so we're seeing a drag.

Now, we're cautious about using this as an excuse because then you get into this debate about, well, whenever you're growing, you're not going to hit your margin targets, and so what is the validity of your margin targets? You need to stand still in order to hit them. Again, I think that we're saying is that our assumptions are that we're going to get some reasonable level of end-market growth of mature programs that mitigate these ramp costs. We're just not getting that level of growth at the moment. Now, we're not a long ways off, and of course there's a number of things that we can do to continue to try to drive us there. We talked about, we could have slowed down CapEx and investments in new facilities and those kinds of things, but we think with the new program wins, the right thing to do is to continue the capacity investments, because we believe that we are gaining share overall in the EMS space.

Wamsi Mohan - BofA Merrill Lynch - Analyst

Okay, thanks for the color, Dean, and as my follow-up, last quarter you noted that Juniper revenues would likely be up fiscal '12 versus '11. Now with two quarters behind us, do you still think that'll be the case, because I think it still implies a decent ramp here in the second half. Thank you.

Dean Foate - Plexus Corp. - President and CEO

Yes, go ahead, Todd.



Todd Kelsey - Plexus Corp. - EVP, Global Customer Services

This is Todd, Wamsi. With respect to Juniper, we still feel good about fiscal '12. I mean, we had talked about some decent growth. We still think there's going to be decent growth in fiscal '12 as we're ramping a number of new programs. We're perhaps tempered just a bit from what we had stated last quarter. I guess I'd leave it at that.

Wamsi Mohan - BofA Merrill Lynch - Analyst

Okay, thank you.

Operator

Will Stein, Credit Suisse.

Will Stein - Credit Suisse - Analyst

I want to ask about the margins, but in maybe the opposite approach. I don't know what others were doing; I certainly wasn't modeling you're getting to 5% by the end of this year on the operating line, and when the growth pendulum swings more towards new program ramps, away from organic, or from, let's say, end-market growth, one would expect the margins to be a little bit lower. So, I was a little confused by the focus in the press release and in your comments on that topic, and I'm wondering if we should take this to mean that margins, perhaps, would decline in fiscal Q4, despite the revenue growth, or do you think they're going to erode in fiscal '13, or was this just cautionary, making sure that investors understood that you're going to be just slightly below but still below?

Dean Foate - Plexus Corp. - President and CEO

Yes. Well, I think that it was really just a coming clean from our standpoint, because we had said in earlier quarters that we were going to do everything we could, from a cost control standpoint to productivity standpoint, to work our way back up to 5% as we exited the fiscal year. Now, in fact, I don't know that any of you, if I think about all of your models, really believed in that to a great extent. So you were, I think, all pretty much aligned somewhat below that ultimate target, but we wanted to make sure that we came back and said, look, we don't think we're going to quite get there, and that it's going to take us into fiscal '13 and some kind of better macro environment in order for us to really accomplish it.

But I think I just want to pause for a moment to make sure that folks are clear that we are doing, what we believe from a planning standpoint, the right things to get us back up to that margin target. As we look at -- we're going to get some benefits from scale with the revenue as the business continues to grow. That's going to allow us to get better leverage on our OpEx, and we think, over time, we're going to work that SG&A component down to try to protect operating margins and get back up to that target. And we think, longer term, the higher pressure is going to be on our 10% gross margin target. That's really where the challenge really is, I think, from a competitive standpoint; but we think that the relative 5% is still pretty clear, and certainly scale helps, and certainly end-market growth will help us as well.

Will Stein - Credit Suisse - Analyst

Okay, that's great. Now, maybe I'd like to transition to just a couple questions on customers. Coke and the energy customer that you discussed on the last call, it looks like Coke did over a \$100 million in the first half of the year, and so if you're still suggesting, or if we're still kind of targeting \$200 million for the year, I'd suggest Coke would be down sequentially, and half over half in the second half. So can you comment as to whether that's correct? If so, it seems particularly impressive that you're still going to grow sequentially for the next couple of quarters, despite this big customer dragging, in a sense; but maybe you could talk about that, and also give us an update on the energy customer that you started to ramp, I think last quarter.



Ginger Jones - Plexus Corp. - SVP and CFO

Yes. Well, I'll start and just give a little color on Coca-Cola and then Todd can jump in with what I've missed on Coca-Cola and the energy customer. So, Coca-Cola still remains inline with our total year around \$200 million, but you're right, it's weighted a little heavier to the first half than the second half. So, we expect it will be modestly down in the second half. So, you're right. Our sequential growth is nice in recognition that Coca-Cola will not be providing much of that growth as we go forward. Todd, anything else you wanted to add?

Todd Kelsey - Plexus Corp. - EVP, Global Customer Services

No, I think you hit it well on Coca-Cola, Ginger, and I'll turn to the energy customer. So, we continue to ramp that business, and it's a nice book of business that really spans three facilities in multiple geographies for us. I would say it's still at very much an early stage, though, and you're going to see the real impact of this in F13 as opposed to F12.

Will Stein - Credit Suisse - Analyst

Great, thank you very much.

Operator

Jim Suva, Citigroup.

Jim Suva - Citigroup - Analyst

Congratulations to Plexus. A quick question, on the clarification of your largest customer, the sequential decline was one of the biggest we've seen in quite some long time. Can you comment, do you believe that is Plexus maintaining share, or is there some type of transfer share loss going on, or was it just like end demand related?

Todd Kelsey - Plexus Corp. - EVP, Global Customer Services

Sure. So, Jim, I'll take this. It's Todd again. First of all, I want to point out that Juniper hasn't announced yet. They announce, I believe, it's next week. There's a few factors that come on. First of all, I'd say we don't believe we're losing share. There's been no takeaway of business, and there's lots of new program wins that we had talked about in the past. But a couple of factors that come into play. One is if you look at the comparable of Q1, that's seasonably their best quarter. So the comparable is a difficult one. The second thing I would say is that with Juniper, the mix can vary a lot, and of course we're one of multiple major suppliers that they have. So, depending on product mix, that can matter a lot. Probably the most important, I would say, is that if you look back to last quarter guidance, Juniper guided after we guided. So, I mean, if you look at the guidance, it was relatively soft by Juniper standards, and we had rolled our forecast prior to that. So there's some impact to that as well, too. Long term, we feel really good about our relationship with Juniper.

Jim Suva - Citigroup - Analyst

Great. It's just good to know that there's no big share shifts or transfers going on between your competitors and you. Then, as a quick follow-up, and maybe this is better for Dean or Ginger, when we look at your new program wins, which are really, really, really impressive, and realizing it takes a certain amount of time, whether it's 6 months or 9 months or 12 months to fully get those really ramping and the flywheel going. Dean, when do you think we get to the point where year-over-year sales really start accelerating to that mid-teens, double-digit growth, 15% sales growth? Is that still a couple of quarters away? Is that kind of a calendar 2013 thing? It just seems like, really, your backlog of new wins is so impressive, it just seems like a matter of time until that really kicks into place.

Dean Foate - Plexus Corp. - President and CEO

Yes. Well, Jim, I mean, hopefully we've turned a corner here this quarter, because we believe we had a pretty dramatic improvement here in revenue growth, obviously in spite of what was a disappointment in our Network/Communications Sector. The other sectors actually outperformed what our earlier expectations were. So, we saw a pretty nice result. I would say, though, that we're still cautious yet, because we have not seen kind of this consistent level of end-market demand from our customers' standpoint. It still is pretty choppy. We still feel that we're in a situation where customers are forecasting fairly pessimistically, and then coming back at us during the course of the quarter to crank up and incrementally add to those forecasts as we move through the quarter, and I think that's in many cases what happened to us in this quarter.

So, maybe a long-winded, I think, but clearly the momentum is building. We would believe at this point that we're going to see a much better result in our fiscal '13. We're just going to have to see how the kind of global macro plays out, and what impact that has on our customers and their end markets, which to me is really hard to get my head around at this point, given all the turmoil that we're seeing and the dependence on global markets for some of our customers for their products.

Jim Suva - Citigroup - Analyst

Thank you. And, again, congratulations to you and your team at Plexus.

Operator

Sherri Scribner, Deutsche Bank.

Sherri Scribner - Deutsche Bank - Analyst

I just was curious if you could give us the typical -- Dean, if you could give us the typical detail you give on the new programs, what percent came from which end markets, and also I think you typically give the as-tools capacity. I don't know if I missed that.

Dean Foate - Plexus Corp. - President and CEO

Actually, we did not give the capacity number. I'll let Mike speak to that in just a second. Yes, I'll give you a breakdown. The percentages of revenue, I guess, or the percent of revenue that was in each one of the market sectors here. So, if you look at Networking/Communications, of the total, about 30% or so was in the Networking/Communications Sector. Another 25% was into Medical. About 40% into Industrial/Commercial, with the balance in our Defense/Security and Aerospace Sector. So, Mike, do you want to talk just a bit to the debate we're having around our capacity utilization?

Michael Buseman - Plexus Corp. - EVP, Global Manufacturing Operations

Sure. So, Sherri, using kind of our traditional methodology, that has tooled numbers gone from maybe 3% to 89% over the last quarter. Now, with that said, we're driving a lot of improvements now, productivity improvements, and Ginger alluded to this earlier. We believe that the methodology we've been using probably hasn't kept up with all of those improvements, and as we work through this over the next month or so, I think what we'll be talking about next time we chat is probably a as-tooled utilization back down around that, probably, 82%, 83% range. As a reminder, again, as-tooled is what we've got installed capacity for. We have buildings that we are not totally tooled up yet. So all that dialogue is predicated on that as-tooled methodology.



Dean Foate - Plexus Corp. - President and CEO

I think also, Sherri, we're going to contemplate whether we give you kind of a mass capacity number. So, if we tooled everything up, what would be the max, where we'd be at from a revenue standpoint, from a max standpoint. Then maybe we'll give you the tooled number as well, but we're kind of, as Mike indicated, reworking that formula to get it caught up with current assumptions around revenue per line and revenue per square foot and all those kind of things.

Sherri Scribner - Deutsche Bank - Analyst

Okay, that's extremely helpful. Then, if I could just get a little more detail on the Coke business. I think you mentioned in the Industrial Section that you had some inventory, I don't know if you said build-up in that segment. Are you seeing a bit of a build up of inventory with the Coke product, and that's why you expect lower revenue in the second half on a half-over-half basis, or can you give us a little more detail on what you're seeing on pull through there?

Todd Kelsey - Plexus Corp. - EVP, Global Customer Services

Sure. So, Sherri, this is Todd. So, again, Q2 you can do the numbers, it was a very strong quarter for us with Coca-Cola, and they were public about several recent launches that they had. So, the idea of building inventory in support of those launches, I think, is an appropriate concept. As you look out for the balance of the year, there's certainly ability for upside, but I think based on what's in the funnel right now, we have it at an appropriate rate right now.

Sherri Scribner - Deutsche Bank - Analyst

Okay, great. Thank you.

Operator

Craig Hettenbach, Goldman Sachs.

Craig Hettenbach - Goldman Sachs - Analyst

Dean, in the medical market, it looks like after a couple quarters of business being relatively flattish or down, you're looking for a nice bounce-back there. Can you talk about just the timing of programs, and then, more importantly, just the pipeline of activity you have in medical, and where you see growth coming from there?

Dean Foate - Plexus Corp. - President and CEO

Yes. I think the medical story is actually pretty good in spite of the broader macro, and I think our teams have done a good job going out and developing some relationships with new customers, expanding the relationships into different subsectors of that marketplace, to continue to move away from what had been a high dependency on the imaging technologies, and so we have much broader portfolio of products today. That's certainly helping us. We also are being pretty successful in actually gaining share and taking some business from some of our competitors who've had some challenges executing on some of these more complicated medical technologies. So, as I indicated, we're expecting kind of a mid-teens growth profile into Q3. Certainly a pretty significant part of that is related to the ramp up of some newer programs that we're seeing, and I think that we're benefiting from this strong brand and strong development capability and pipeline that we have in this marketplace, and we think we can continue to gain share and drive performance here in the coming year in the Medical Sector.



Craig Hettenbach - *Goldman Sachs - Analyst*

Just going back to the comment of gaining share, any change to kind of pricing you're seeing in the medical market in the last 6 to 12 months?

Dean Foate - *Plexus Corp. - President and CEO*

I don't think anything in the last 6 to 12 months. I'd say if you went back further than that, there's certainly been a change. I think the medical technologies have become more commercial in nature in terms of their pricing, and in terms of the agility of fulfillment in the late purchasing decisions that are made, but I think we've gone through that change here over the last 5 to 10 years. The real question mark really revolves around whether or not there's going to be more pricing pressure as the -- of US health care plan. If that really gets fully implemented, it's going to come with this excise tax on medical technologies, and whether or not that's going to create at least some near-term pressure on pricing; but we really haven't seen the impact of that at this point. I think it's just going to force these companies to be more productive and consider outsourcing more products, because I think ultimately they're going to have to restructure their businesses to be more competitive in a tougher environment.

Craig Hettenbach - *Goldman Sachs - Analyst*

Okay. Then if I could, one for Ginger. Nice free cash flow in the quarter. You had done the buyback last year. Any updated thoughts in terms of buybacks or the potential for a dividend down the road?

Ginger Jones - *Plexus Corp. - SVP and CFO*

Not at this point, Craig. We are, as you say, generating some nice free cash flow for the quarter and my expectation is we'll have good cash flow for the year, particularly when you think about the reduction in our capital expenditure outlook. So, not at this point. As you know, we did do a buyback last year. That's not on our near-term plans at this point, and we are still considering the longer-term best use of excess capital. As you know, we've considered all the possibilities there, including a further buyback at some point in the future or the possibility of an ongoing dividend, but no decisions on that yet.

Craig Hettenbach - *Goldman Sachs - Analyst*

Okay, thank you.

Operator

Shawn Harrison, Longbow Research.

Shawn Harrison - *Longbow Research - Analyst*

Wanted to just get back into the program win rate, given just the success of the past few quarters. Prior to the past three quarters, you were averaging maybe \$125 million to \$135 million a quarter. Do you think that kind of it normalizes back to that level as we get in here to the third quarter, or kind of what's the initial insight in terms of where maybe the wins could shake out?

Todd Kelsey - *Plexus Corp. - EVP, Global Customer Services*

Sure. So, Shawn, this is Todd. I'll take the win rate question. With respect to, first of all the \$125 million to \$130 million, I think we viewed that as too low and not at a level that we would have considered acceptable to grow the business at the rate that we want. Now, on the flip-side I would say what we've experienced the last three quarters has been exceptional. So I don't think the expectation to stay at this level going forward is accurate, either. So it's really, I'd call it more in the middle. I mean, we've talked about a target of \$150 million in the past. I think \$150 million to

\$180 million is probably a realistic expectation that we'd be driving for now. Now, certainly as we grow, we're putting in place processes and methods and teams to be able to drive that over \$200 million on a consistent basis, but that's really not where we think we need to be today to meet the growth rate that we want in a typical economic environment. Now, currently today is not a typical economic environment.

Dean Foate - Plexus Corp. - President and CEO

I would also add, what Todd is not trying to signal is there isn't the opportunity to have strong wins, because there's still are a couple of very significant opportunities that are still unsettled in terms of how it's going to unfold and who's going to take that business. So, there's some opportunities here in the coming few quarters here where we could have another very successful quarter. We'll just have to see how those things shake out.

Shawn Harrison - Longbow Research - Analyst

Okay. Dean, you got part of my follow-up. The other part of my follow-up was tied to just kind of the engineering business, maybe where the wins were kind of visibility, the feeling about that business as well.

Dean Foate - Plexus Corp. - President and CEO

Yes. I think engineering has been a little bit choppy for us, but we just had a nice quarter here of new wins. I think they were rounded up to about \$16 million, which is kind of above what's necessary to kind of keep the backlog healthy. Now, there's still, we need to keep that pace. As we keep saying, the engineering business, it's not like a win rate sustains them a long time into the future. The program cycles projects are fairly short relative to manufacturing, and so they need to have a fairly rapid pace, but overall, the engineering part of the business is pretty healthy and we continue to win a lot of business into engineering and the medical sector, which of course is a key component of driving growth in medical technology.

Shawn Harrison - Longbow Research - Analyst

Okay. Thanks so much.

Operator

Sean Hannan, Needham & Co.

Sean Hannan - Needham & Company - Analyst

Sorry, another question around the win environment. This has been -- the strength of wins for you, as well as a number of other players, I think, has been prevalent for the last few quarters, and wanted to see, Dean and Ginger and Todd, perhaps, if you can elaborate on to what extent this is a fertile environment for EMS, where it's been a rising tide for a lot of you to have an ability to capture some of the newly outsourced programs or opportunities versus how much do you feel that Plexus may be either outperforming or has a better ability to exhibit some sustainability around this?

Dean Foate - Plexus Corp. - President and CEO

Yes. Well, we'd like to say it's all just us, and in truth I think that, give credit where credit's due, I think Todd and Mike Verstegen, and broader speaking, the operating leaders around the world, regionally, and further down the organization have just done an excellent job. First, in execution, not only in terms of delivery and performance to our customers, but also execution in turning our business development engine into execution engine, and I think that they're pretty modest folks but we have some really talented folks that are just doing an excellent job. I think, secondly,



that the Company, because of the excellent job we do, has got a very strong brand position in the marketplace and so we're many times first in consideration for these more complex assemblies. Customers seek us out based on our brand position, our reputation in the marketplace, and that gets us in front of opportunities that, going back maybe eight years ago or more, we wouldn't necessarily have gotten in front of.

So I think that certainly benefits us. But kind of to your earlier point, certainly the environment, with the sort of big recession and the very slow slope of recovery, if that is what we're in, continues to put an enormous amount of pressure on the OEMs to try to figure out ways to do things more productively, and to give themselves more flexibility and to lighten up their balance sheets, and give themselves balance sheet flexibility, and I think that is creating fertile ground for, broadly speaking, the overall EMS marketplace to capture some of these larger opportunities which are really manufacturing exit opportunities. When we speak about some others that are out in front of us, there are other opportunities like that, that takes these companies sometimes quite a bit of time to get through the decision process, and sometimes they just back off altogether, but we see some of those kinds of opportunities out in front of us. Now, the ones that we're looking at, at the moment at least, are not generally -- don't involve, again, any sort of facility purchases or new addresses for us. We're really generally talking about ones where the customers are looking to exit their facilities and have us transition the business into our current footprint.

Sean Hannan - *Needham & Company - Analyst*

That's very helpful. Then, different topic, drilling into Communications and Networking, you've hit on some of this already today, but was looking to see if you could maybe characterize for us a little bit more the types of volatility, or if there's any classification around the customers that you could provide some better granularity around for? What exactly has been volatile, and even as you're looking for a little bit of improvement in the coming quarters, just some better detail around that degree of volatility that may continue, and where it materializes?

Dean Foate - *Plexus Corp. - President and CEO*

I think I'll let Todd take part of this. I would just say that I thought with great wisdom I had this sort of figured out over the last couple of quarters, and that we're seeing this phenomenon where our biggest customers, not just customers to us but the biggest companies that are customers of ours even were performing the best in the end markets. Then this quarter we saw just the opposite, where companies that are smaller than the bigger customers actually had what was a surprisingly good quarter and a good recovery. So, it's an interesting marketplace. Todd, you might want to take a shot, if you want, about providing some more color if you have some.

Todd Kelsey - *Plexus Corp. - EVP, Global Customer Services*

Sure. So part of what we are seeing, I would say more than ever, first of all Networking and Communications is, I think, highly dependent, even more dependent on the broader economy than any of our other sectors. And, as you look at the bandwidth demands that are out there right now, there's a pent-up demand that's coming. So we feel like a bubble's coming if the network eventually -- or if the economy eventually turns in the right direction; but one of the phenomena I'd say we're seeing right now is, you could even call it individual orders being highly competitive. I mean, there's certain cases where we build products that perhaps compete for the same order, particularly as you look at service providers, and you can almost see the impact of that because it's such a competitive market out there, and the order levels just aren't to the level that they need to be right now. The same holds true from the enterprise. Of course, you don't get the same level of visibility there, because there's so many more companies and the orders are so much smaller, but that's part of what we're seeing. I mean, we really feel like eventually it has to tip, and it has to tip in the right direction, but it's not there yet. It's just a lot of ups and downs in this sector right now.

Sean Hannan - *Needham & Company - Analyst*

Thanks so much.



Operator

Amit Daryanani, RBC Capital Markets.

Unidentified Participant

This is actually Ryan in for Amit. I was wondering if you could just speak to how you see the next couple of quarters unfolding in the Defense/Security and Aerospace vertical. What linearity is like in that segment right now. Maybe you could talk about how aerospace is doing relative to defense, and maybe if you have any preliminary thoughts on fiscal '13?

Dean Foate - Plexus Corp. - President and CEO

Yes. I would just say that the biggest action for us at the moment is in aerospace. We think that there's an investment cycle here that's well underway in that marketplace, and of course we enjoy a nice position, not only with Honeywell International, just an excellent customer of ours, but a number of other really good companies that enjoy strong brand positions in some of the key platforms that are coming into the marketplace in aerospace. So we're -- feel pretty good about that. Todd, is there anything you can comment on relative to linearity or the defense sector part of this thing?

Todd Kelsey - Plexus Corp. - EVP, Global Customer Services

Well, I think we're starting to see stronger, well certainly I was going to go back to aerospace first, Dean. I think we're starting to see some strength on some of the new platforms coming out, like the 787 in particular. But if you go back to defense, I would say that defense is relatively soft from a new program standpoint, and that's where really the ability to win business comes in as new programs are being developed by defense contractors, and we all know what the budget constraints are, particularly in the US, where the bulk of the defense budget occurs. The amount of new program activity, I would say isn't real significant in defense right now, but we continue to work that piece of the market and continue to consider it important; but we're really focused heavily on aerospace right now.

Unidentified Participant

It's a smaller segment, but is there maybe a way to get a rough approximation of kind of how much is aerospace versus how much is defense related?

Todd Kelsey - Plexus Corp. - EVP, Global Customer Services

Yes, probably about three-quarters would be aerospace.

Dean Foate - Plexus Corp. - President and CEO

Now, we do include security in there, too. So I'm not factoring security into that overall number, but aerospace is over half of the whole.

Unidentified Participant

Okay, and then just one final question. I was wondering if you could talk about, are you seeing any competitive pressures on margins, gross margins particularly, now that most of the North American EMS players are also trying to collectively crowd into the high-mix, low-volume space, and do you think pricing is set to be an issue in the future quarters, I mean, as everyone tries to maybe emulate that model?

Dean Foate - Plexus Corp. - President and CEO

Yes, I don't know that anything has changed here dramatically. I mean, while everybody certainly appears to be more focused on it, and their kind of rhetoric around focus on it is heightened, the reality, as I keep saying, we've been competing with certainly all the other kind of North American EMS providers that have had business in our space since I've been in this business, which is a long time. I think that just generally, I think the pricing environment is more a consequence of the pressure and it's more a consequence of the market conditions right now, and the difficulty in growth where individual customers are really looking for some help; and we're doing everything we can, of course, to give them some help to be more competitive than it is necessarily, because we've got a lot of kind of crazy pricing going on from competitors -- not to say it doesn't happen from time to time, but I think there's more sanity around pricing now than probably there has been ever in the marketplace.

Unidentified Participant

All right. Thank you for your time.

Operator

Steven Fox, Cross Research.

Steven Fox - Cross Research - Analyst

First question is just regarding Kontron, is just, Dean, were there any surprises good or bad during the initial ramp with that relationship that you could talk about? I just wanted to get some more color on that, and then I had a follow-up.

Dean Foate - Plexus Corp. - President and CEO

Yes, just generally speaking, I think that any time you go into one of these deals you find and uncover some challenges and some issues, and I think nothing there that has really been anything that we couldn't work our way through. I mean, that's just the reality of it, and I think the relationship with the Kontron team is really strong, and we have great collaboration as we've worked through kind of the challenges that are associated with any kind of these deals. I think I'll let Todd talk a little bit more about the kind of revenue performance, which was actually a little better than we had expected during the quarter.

Todd Kelsey - Plexus Corp. - EVP, Global Customer Services

Yes. So first of all I'd say things are progressing much as we would have expected from certainly a margin standpoint, from a transition standpoint; and then I would say from a revenue standpoint probably a little better than we had anticipated. So there has been a positive revenue impact. As far as the transition itself is concerned, we've been managing the facility, the KDMS or Kontron facility, since the closing date and the employees now have transitioned over to Plexus. We've had really strong retention with the employees there, so we feel great about that, as does Kontron. We've qualified a number of the products into Plexus. We're beginning equipment moves and transition of those products into our Plexus facility, and we expect that, within a quarter, we should be largely done with this activity. So I would say things are going along as would be expected, with perhaps a little bit more revenue than we had anticipated.

Steven Fox - Cross Research - Analyst

Great, that's helpful. Then, Dean, just looking at the new program backlog that you've built. Can you just talk about the timing a little bit more? Is there any kind of unusual launch dates beyond, say, the typical 9- to 12- to 15-month type of window, and in terms of the backlog that you've discussed in the past or any new wins you've discussed in the past, are you seeing more push-outs or more things stay on schedule relative to, say, what you've talked about over the last couple of quarters?



Dean Foate - Plexus Corp. - President and CEO

First thing, Chris [sic], we're not seeing anything unusual, I don't think, from a ramp perspective or any of these things that are necessarily kind of we want them but we're not going to see anything for years to come kind of deals. This is business that we think is going to unfold largely consistent with the historical patterns. We're not seeing, at least from a manufacturing standpoint, any significant, I don't think, push-outs that would be out of the normal kind of volatility that you would see with any of these new program ramps. So I think things are unfolding reasonably well now. I'd say where we are seeing a little bit of volatility and reconsideration is around engineering, where we see programs that are won and sometimes delayed, and so companies are still kind of managing their R&D expenses and those kinds of things carefully yet, and there's still some volatility. But from a manufacturing perspective, things seem to be -- for the most part we seem to feel like things are stabilizing, with the exception, like I said, of what Todd spent a lot of time talking about, our Network/Communications, which is sort of hand-to-mouth a little bit from an order pattern standpoint.

Steven Fox - Cross Research - Analyst

Great. That's very helpful, thank you.

Operator

I'm showing no further questions at this time. I will now turn the call back over to Mr. Angelo Ninivaggi for closing remarks.

Dean Foate - Plexus Corp. - President and CEO

Actually, Dean's going to take the closing remarks, which I'll be very brief. Thanks, everyone, for joining us this morning. Hopefully you got a sense that we feel pretty darned optimistic about the business. We actually had a pretty nice quarter, and we didn't quite get there with the route that we originally expected. We saw some strength in Medical, Industry/Commercial, Defense/Security and Aerospace that offset what was a bit of a disappointment in our Network/Communications Sector, although we did see some signs of strength with some of our smaller customers in that sector that was surprising strength. So, we feel as though we're starting to move and turn the corner here a little bit, and hopefully we'll see some increasing stabilization across all of our sectors and we'll start to build momentum here as we move through the end of the fiscal year and on into fiscal '13. So, thanks very much for joining us.

Operator

Thank you, ladies and gentlemen, that does conclude today's conference. You may all disconnect, and have a wonderful day.

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