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PRESENTATION

Operator

Thank you for standing by, and welcome to the Garmin Ltd. Fourth Quarter 2021 Earnings Conference Call. (Operator Instructions) As a reminder, today's conference call is being recorded.

I will now turn the conference to your host, Ms. Teri Seck, Director of Investor Relations. Ma'am, you may begin.

Teri Seck *Garmin Ltd. - Manager of IR*

Good morning. We would like to welcome you to Garmin Ltd.'s Fourth Quarter and Fiscal Year 2021 Earnings Call. Please note that the earnings press release and related slides are available at Garmin's Investor Relations site on the Internet at www.garmin.com/stock. An archive of the webcast and related transcript will also be available on our website.

This earnings call includes projections and other forward-looking statements regarding Garmin Ltd. and its business. Any statements regarding our future financial position, revenues, earnings, gross margins, operating margins, future dividends or share repurchases, market shares, product introductions, future demand for our products and plans and objectives are forward-looking statements. The forward-looking events and circumstances discussed in this earnings call may not occur, and actual results could differ materially as a result of risk factors affecting Garmin.

Information concerning these risk factors is contained in our Form 10-K filed with the Securities and Exchange Commission. In particular, there is significant uncertainty about the duration and impact of the COVID-19 pandemic. This means that results could change at any time, and any statement about the impact of COVID-19 on the company's business results and outlook is the best estimate based on the information available as of today's date.

Presenting on behalf of Garmin Ltd. this morning are Cliff Pemble, President and Chief Executive Officer; and Doug Boessen, Chief Financial Officer and Treasurer. At this time, I would like to turn the call over to Cliff Pemble.

Clifton Albert Pemble *Garmin Ltd. - President, CEO & Director*

Thank you, Teri, and good morning, everyone. As reported earlier today, we ended 2021 with fourth quarter revenue of $1.39 billion, up 3% over the prior year, representing a new record for Garmin. During 2021, quarter-by-quarter comparisons to the prior year have been difficult to interpret due to pandemic-driven swings of 2020. It's interesting to note that revenue grew 12% on a CAGR basis compared to Q4 of 2019. We believe this comparison better reflects the underlying strength of the business and we are very pleased with our development over these past 2 years.

Operating profit came in at $315 million, down 15% over the prior year. Gross margin declined due to pressure that every business is facing, notably higher freight costs. In addition, operational expenses increased for a variety of reasons, including higher associate head count, increased compensation costs and the increase of certain operational expenses as business activities normalize. Even with these headwinds, operating margin remained very strong at 22.6%.

2021 was our sixth consecutive year of revenue and operating income growth, establishing new records for the company. Revenue increased 19% to nearly $5 billion and operating income grew 16%, exceeding $1.2 billion. Each segment delivered strong double-digit revenue growth. I'm very proud of what we accomplished, especially considering the challenging operating environment everyone is facing.

The availability of electronic components has been a major topic of conversation over the past year. While we are not always able to get everything we need, we believe we've been very effective in managing this situation as evidenced by our results. Our vertically integrated business model gives us greater levels of agility and flexibility in this dynamic supply chain environment. However, it's the creativity, determination and teamwork of our associates that made these accomplishments possible. I'm very proud of our associates, and I'm grateful for all they have done.

Looking forward, we are encouraged by the opportunities of the new year. We have a great lineup of recently introduced products, with additional introductions planned throughout the remainder of the year. We anticipate consolidated revenue will increase approximately 10% to $5.5 billion, driven by new product introductions and strong market trends in many of our segments. Our results and outlook for the new year give us confidence to propose a 9% dividend increase, which will be considered by shareholders at the upcoming annual meeting.

Before moving on to segment highlights, it's important to share context on how we see the business and markets evolve in 2022. The pandemic drove additional demand in certain product categories, which is starting to normalize from peak levels. This will create additional dynamics to consider for the coming year, and I will note these as I covered each segment. The nuances of individual categories are not a major concern for us. Rather, it's our strategic focus on diversification that brings many opportunities for growth, which is the basis for our outlook for 2022.

Starting with the fitness segment, revenue increased 16% for the year as strong demand for advanced wearables and cycling products fueled our growth. Full year gross and operating margins were 53% and 24%, respectively, resulting in operating income growth of 17% over the prior year. In the fourth quarter, fitness revenue was flat over the prior year as growth in wearables was offset by lower revenue in cycling.

Product differentiation is a key factor in our ability to compete in the market for wearables. Lily is a great example, with its small form factor, appealing design and unique display that hides when not in use. Customers buying Lily are overwhelmingly new to the Garmin brand, demonstrating the power of differentiation to attract new customers.

The cycling category has more than doubled over the past 2 years, fueled by pandemic-driven demand for both indoor and outdoor cycling products. The market is starting to normalize at levels below recent peaks but well above pre-pandemic levels. With this in mind, we expect Fitness revenue to be flat year-over-year as growth in wearables is offset by lower revenue in cycling products. In addition, we expect revenue to decline in the first half as we compare against stronger periods from the prior year. In the back half of the year, we expect to return to growth as the cycling market stabilizes and with contributions from new products.

In the outdoor segment, full year revenue increased 14%, with growth across multiple categories, driven by strong demand for adventure watches. Full year growth and operating margins were 65% and 38%, respectively, resulting in operating income growth of 9%. In the fourth quarter, outdoor revenue decreased 8%, primarily due to component constraints in our traditional handheld and dog product categories. We ended the year with unusually high back orders, which were pushed into the new year.

On January 18, we announced sweeping updates to our fenix adventure watch series, featuring a distinctive new design and a touchscreen display. We also announced the all-new epix with a bright AMOLED touchscreen display and class-leading battery life up to 16 days. Last week, we announced the all-new Instinct 2 series in 2 sizes, which will expand the addressable market for this unique adventure watch. Select Instinct 2 models with solar technology can operate indefinitely using only the power of the sun, which is a breakthrough achievement in the smartwatch market. Demand for these new products has been very strong, and we expect them to be a significant catalyst for growth in the coming year. With these things in mind, we anticipate Outdoor revenue will increase approximately 20% for the year.

Looking next at the aviation segment, full year revenue increased 14% due to contributions from both OEM and aftermarket categories. Full year gross and operating margins were 73% and 27%, respectively, resulting in operating income growth of 40%. In the fourth quarter, Aviation revenue was up 13% driven by growth in OEM categories. Aftermarket sales were flat due to component supply constraints. Aviation also ended the year with unusually high levels of back orders, which carried into the new year.

The pandemic highlighted the unique value proposition of General Aviation. Aircraft OEMs are reporting robust orders from both new and existing customers. Aftermarket demand is also strong as customers invest in new cockpit systems. We expect these trends to drive revenue growth of 10% for the year, with revenue exceeding the peak we experienced during the ADS-B mandate. We expect incrementally stronger growth in the back half as production levels increase over the course of the year.

Moving to marine. The segment delivered another year of impressive results. Revenue increased 33% with broad-based growth across all categories, led by strong demand for chartplotters. We benefited from both market expansion and share gains driven by our strong product portfolio. Full year growth in operating margins were 57% and 28%, respectively, resulting in operating income growth of 39%. In the fourth quarter, marine revenue increased 14% as the strong trends we experienced throughout the year continued.

We recently acquired Vesper Marine, a company specializing in the design of modern VHF radio systems for the marine market. Looking forward, we anticipate the strong interest in boating and fishing will remain strong. Boat builders continue to report strong sales and retail partners are preparing for another year of growth. With these things in mind, we anticipate revenue from the Marine segment will increase 15%, surpassing the $1 billion threshold for the year.

Moving finally to the auto segment. Full year revenue increased 26% with contributions from both auto OEM and consumer auto categories. Full year gross margin was 39%, and we recorded an operating loss of $71 million driven by investments in auto OEM programs. In the fourth quarter, auto revenue was up 21%, with contributions from consumer specialty categories and new OEM programs. In consumer auto, we continue to launch new specialty categories that lead to growth opportunities.

At CES, we announced the Tread series for side-by-side vehicles, bringing off-road specific features and in-reach communications to the side-by-side market. Last week, we announced the Instinct dezl edition, the first smartwatch designed specifically for the trucking market. BMW recently unveiled their vision for in-car entertainment, bringing a truly cinematic experience into the vehicle. This immersive entertainment system is powered by a multimedia computing platform designed and built by Garmin. We continue to invest heavily to bring this and other BMW systems to market. The investment has been more significant than anticipated, and these investments are expected to continue throughout the remainder of the year as we fulfill our obligations to BMW.

This will result in auto OEM operating loss for the year that is roughly comparable to that of 2021. We expect to start production of the next-generation BMW computing platform later this year at low volumes, with a more meaningful production ramp occurring in 2023. With these things in mind, we expect total auto revenue to grow approximately 5% for the year.

So that concludes my remarks. Next, Doug will walk through additional details on financial results and our updated guidance. Doug?

Douglas Gerard Boessen ***Garmin Ltd. - CFO & Treasurer***

Thanks, Cliff. Good morning, everyone. I'd like to begin by reviewing our fourth quarter and full year financial results, provide comments on the balance sheet, cash flow statement, taxes and 2022 guidance.

We posted revenue over $1.3 billion for the fourth quarter, representing a 3% increase year-over-year. Gross margin was 55.5%, 300 basis point decrease from the prior year quarter. Decrease was primarily due to higher freight costs and favorable impact of foreign exchange rates. Operating expense as a percentage of sales was 32.8%, 170 basis point increase. Operating income was $315 million, a 15% decrease. Operating margin was 22.6%, 480 basis point decrease from the prior year. Our GAAP EPS was $1.48. Pro forma EPS was $1.55, a 10% decrease from the prior year pro forma EPS.

Looking at the full year results. We posted revenue over $4.9 billion, representing a 19% increase year-over-year. Gross margin was 58%, 130 basis point decrease from the prior year. The decrease was primarily due to higher freight costs. Operating expense as a percentage of sales was 33.6%, [3 basis point] decrease. Operating income was $1.2 billion, a 16% increase. Operating margin was 24.5%, 70 basis point decrease from the prior year. Our GAAP EPS was $5.61. Pro forma EPS was $5.82, a 13% increase from the prior year pro forma EPS.

Next, look at fourth quarter revenue by segment and geography. During the quarter, we achieved consolidated growth of 3% with double-digit growth in the aviation, marine and auto segments, partially offset by a decline in the outdoor segment. Fitness segment was relatively flat year-over-year. By geography, 8% growth in APAC and 5% growth in Americas was partially offset by a decline of 2% in EMEA, which was negatively impacted by foreign exchange rates during the quarter. For the full year 2021, we achieved 19% consolidated growth with solid double-digit growth in all of our 5 segments. By geography, we achieved double-digit growth in all 3 regions, led by 21% growth in APAC, followed by 19% in Americas, 18% EMEA.

Looking at operating expenses, fourth quarter operating expenses increased by $37 million or 9%. Research and development increased $22 million year-over-year, primarily due to engineering personnel costs. SG&A increased $15 million from the prior year quarter, primarily due to increases in personnel-related expenses, information technology costs. Our advertising expense was consistent with the prior year quarter.

A few highlights on the balance sheet, cash flow statement and dividends. We ended the quarter with cash and marketable securities of approximately $3.1 billion. Accounts receivable increased sequentially $343 million due to strong sales in the fourth quarter and was relatively flat year-over-year. Inventory increased year-over-year to $1.2 billion. The increase was due to several factors including preparation for first quarter product launches, increased levels of indoor cycling products, expansion of our global manufacturing footprint and executing our strategy to increase supply to support our increasingly diversified product lines.

During 2022, we expect our inventory balance to continue to grow to work to optimize the mix of ocean versus air freight shipments, produce efficient level of safety stock to mitigate increased lead times and generally manage the supply of raw materials.

During the fourth quarter of 2021, we generated free cash flow of $49 million. For the full year 2021, we generated free cash flow of approximately $705 million, a $245 million decrease from the prior year, primarily due to increased inventory levels and higher capital expenditures.

In 2022, we expect free cash flow to be approximately $725 million with approximately $310 million of capital expenditures. For 2022, we expect to continue to make investments, platforms for growth, including our Taiwan manufacturing facilities, continued renovation of our Olathe facilities to increase work space capacity and IT-related projects. Also, we announced our plans to seek share approval for an increase in our dividend beginning with the June 2022 payment, proposal of a cash dividend of $2.92 per share or $0.73 per share per quarter. This is a 9% increase from our current quarterly dividend of [$0.67] (corrected by company after the call) per share. For full year 2021, we report an effective tax rate of 10.3%.

Turning next to our full year guidance. We estimate revenue of approximately $5.5 billion, an increase of 10% over the prior year, with double-digit growth in 3 of our 5 segments. We expect gross margin to be approximately 57.5%, which is lower than our full year 2021 gross margin, primarily due to higher supply chain costs and less favorable foreign exchange rates, partially offset by increases in selling prices. We expect an operating margin of approximately 22.8%. The full year pro forma effective tax rate is expected to be approximately 10.5%. This results in expected pro forma earnings per share of approximately $5.90.

Finally, I've discussed the changes in our methodology for classification of certain expenses and allocation of certain expenses among the segments. We plan to reflect these changes in our reporting for the first quarter of 2022, and prior periods will be recast to conform to revised presentation. The new expense classification result in less indirect SG&A costs being classified as R&D expense, which we believe will provide a more meaningful representation of the cost incurred to support R&D activities, consistent with the way management will use the information in decision-making. We estimated approximately $61 million expense as classified as R&D in 2021 will be reclassed as SG&A.

Future reports will also reflect a refined methodology to allocate certain SG&A expenses to the segments in a more direct manner, based on analysis of activity supported by the expenses. We believe this refined allocation approach result in a more meaningful representation of segment operating income. We estimate that fitness and outdoor will be allocated more S&A expenses, resulting in lower operating margin while other segments will be allocated less SG&A expenses, resulting in higher operating margin. These changes have no impact on our consolidated operating income or net income.

This concludes our formal remarks. Valerie, please open the line for Q&A.

Teri Seck ***Garmin Ltd. - Manager of IR***

Thanks, everyone. As always, Doug and I are available for callbacks throughout the day. Have a good one. Bye.

Operator

Thank you. Ladies and gentlemen, this does conclude today's conference. Thank you all for participating. You may now disconnect. Have a great day.