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GRMN - Q4 2016 Garmin Ltd Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Garmin Ltd. fourth-quarter 2016 earnings conference call.

(Operator Instructions)

As a reminder, today's program may be recorded. I would now like to introduce your host for today's program, Teri Seck. Please go ahead.

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

Good morning. We would like to welcome you to Garmin Limited's fourth-quarter 2016 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 Limited and its business. Any statements regarding our future financial position, revenues, earnings, market shares, product introductions, future demand for our products, 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.

Presenting on behalf of Garmin Limited 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.

Cliff Pemble - ***Garmin Ltd. - President and CEO***

Thank you, Teri, and good morning, everyone. As announced earlier today, Garmin finished 2016 on a strong note. Revenue for the quarter increased 10% over the prior year to $861 million. Outdoor, fitness, marine, and aviation collectively increased 25% year over year, and contributed 74% of total revenues.

Gross margin improved year over year to 54.7%. Operating margin was essentially flat at 18.6%, while operating income increased 10%. These strong results generated GAAP EPS of $0.72, and pro forma EPS of $0.73 in the quarter.

Looking briefly at our full-year performance, 2016 was a remarkable year, as we delivered four consecutive quarters of revenue and profit growth. Revenue increased 7% over 2015, and exceeded $3 billion for the first time since 2008. Outdoor, fitness, marine, and aviation increased 21% on a combined basis, contributing over $2.1 billion in revenue for the year, or 71% of the total, and generated 84% of our operating income.

Gross and operating margins improved to 55.6% and 20.7%, respectively, while operating income grew 14%. This resulted in GAAP EPS of $2.70, and pro forma EPS of $2.83, both representing strong increases over the prior year. Unit deliveries increased 4% to 16.8 million, which was the second highest in our history, and brought our total units shipped to over 173 million since Garmin's inception.

Doug will discuss our financial results in greater detail in a few minutes, but first I'd like to highlight the 2016 performance and 2017 outlook for each of our five segments. Starting with outdoor, revenue increased 33% on strong demand for outdoor wearables, contributions from DeLorme, and growth in all other product categories. The segment generated strong gross and operating margins of 62% and 34%, respectively, while operating income grew 32% over the prior year. Looking back at 2016, our Fenix line of adventure watches continued to show strong momentum, while high-end Chronos variations are opening new retail channels at watch stores and specialty retailers.

Our Connect IQ application platform has become an important differentiator for our smart wearables. Connect IQ now features over 2,500 apps, widgets, and watch faces, and has generated more than 24 million downloads since inception. To further promote the power and utility of Connect IQ, we will host our first-ever developer conference in mid-April, offering workshops and tools that developers can use to leverage the Garmin wearable ecosystem.

Looking ahead, we anticipate revenue growth of approximately 10% in 2017. We anticipate that wearables will continue to be strong, led by the new Fenix 5 series. Fenix 5 comes in three different sizes, and features our new QuickFit band replacement system, allowing users to quickly change the style of their watch. We're also expanding our handheld device portfolio with inReach satellite communication technology, and we will introduce inReach devices into new geographic markets.

Looking next at fitness, we reported robust revenue growth of 24%, driven by strong demand for wearables with Garmin Elevate wrist heart rate technology. In addition, vivofit jr. was well received by retailers and customers during the holiday shopping season. Gross and operating margins were 53% and 20%, respectively. Gross margin was impacted by product mix, while operating margin was relatively flat to the prior year, resulting in operating income growth of 19%.

Much has been said recently about the momentum change in certain wearable categories, specifically basic activity trackers; however, demand for products with more advanced features, particularly those with GPS capability, was very strong in the holiday quarter. One possible explanation is that customers want more than just a basic activity tracker. We believe we are well positioned to capitalize on this trend, with the broadest portfolio of activity trackers, many of which include GPS capability. In 2017, we are targeting revenue growth of approximately 5% in the fitness segment, with strength in cycling and advanced wearables offsetting anticipated softness in basic activity trackers.

Looking next at the marine segment, revenue grew 16%, ahead of the overall market, pointing towards market share gains driven primarily by strong demand for fish finders and chart plotters. Gross margin was steady at 55%, while operating margin improved to 16%, resulting in operating income growth of 82% over the prior year.

The marine season is off to a great start, and we are ready to serve with a strong portfolio of products for every boating pursuit. For 2017, we are targeting revenue growth of approximately 10% for the marine segment.

Turning next to aviation, we reported solid revenue growth of 10%, driven by ADS-B and retrofit upgrades, as well as growth in our OEM categories. Gross and operating margin remained strong at 75% and 28%, respectively, resulting in operating income growth of 12% for the year.

In recent developments, Textron Airland announced that the Scorpion light attack aircraft will be equipped with Garmin avionics, expanding the addressable market for our commercial off-the-shelf equipment into military and government applications. We are excited about our expanding partnership with Textron, and we look forward to serving on the Scorpion aircraft.

I also want to mention that for the 13th consecutive year, Garmin was ranked number one in avionics support by Professional Pilot Magazine and by Aviation International News. I want to congratulate our team on earning this award once again, which is a testament to the quality of Garmin equipment, and the amazing way our associates care for our customers.

In 2017, we are targeting revenue growth of approximately 5% in the aviation segment. While industry dynamics remain a factor, market share gains, new platforms, and the ADS-B mandate provide opportunities for growth.

Looking finally at the auto segment, revenues were down 17% for the full year, as expected, due to the ongoing decline of the PND market; however, our global market share remains very strong. Gross and operating margins were 44% and 12%, respectively.

While the downward trend of the consumer PND market is well understood, we do see incremental growth opportunities in certain product categories, including trucking, RV, cameras, and in our OEM business. We're focused on maximizing profits in this segment, while leveraging these opportunities.

Earlier today we announced that BMW selected Garmin as a Tier 1 supplier of infotainment computing modules for future BMW models produced in China. This is a pivotal win for us, and validates the investments we have been making in the OEM category.

Looking at 2017, we expect revenue to decline approximately 17%, driven by the ongoing decline of the PND market. We remain focused on disciplined execution, in order to bring pragmatic innovation to the market, and to maximize profitability in the segment.

In summary, we see many opportunities ahead in each market we serve, and we are well positioned with a strong product lineup. With this in mind, we are projecting revenue of approximately $3.02 billion, flat year over year, as growth in fitness, outdoor, aviation, and marine is offset by anticipated declines in the auto segment. We are projecting steady gross margin of approximately 56%, and operating margin of approximately 20%. We expect a pro forma effective tax rate of approximately 22% for the year, resulting in pro forma earnings per share of approximately $2.65.

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

Doug Boessen - ***Garmin Ltd. - CFO and Treasurer***

Thanks, Cliff. Good morning, everyone. I will begin by reviewing our fourth-quarter and full-year financial results, then move to comments on the balance sheet, cash flow statement, and taxes.

We posted revenue of $861 million for the fourth quarter, representing a 10% increase year over year. Gross margin was 54.7%, a 180-basis-point increase from the prior year, driven by the shift towards segments with higher margin. Operating expense as a percentage of sales was 36.1%, a 200-basis-point increase from the prior year. Operating income was $160 million, a 10% increase over the prior year. Operating margin was 18.6%. Our GAAP EPS was $0.72, and our pro forma EPS was $0.73.

Looking at full-year results, we posted revenue over $3 billion for the year, representing a 7% increase year over year. Gross margin was 55.6%, a 100-basis-point increase from the prior year. Operating expense as a percentage of sales was 35%, consistent with prior year. Operating income was $624 million, a 14% increase over the prior year. Operating margin was 20.7%, an increase of 120 basis points from the prior year, driven by the gross margin increase.

Our GAAP EPS was $2.70, a 13% increase over the prior year. Pro forma EPS was $2.83, a 14% increase from the prior year. We will discuss gross margin and operating expenses in more detail later.

Next, we look at fourth-quarter and full-year revenue by segment. In the fourth quarter, we achieved double-digit growth in four of our five segments, led by the outdoor segment at 46%. Collectively, these four segments were up 25% compared to the prior-year quarter. For the full-year 2016, we achieved 7% consolidated growth, led by robust growth in our outdoor and fitness segments, and solid double-digit growth in our marine and aviation segments.

Looking next to fourth-quarter revenue charts, during the quarter, fitness grew to be our largest segment, as it grew to 32% of revenue in the current period, compared to 29% in the prior year. Outdoor grew from 16% to 20%. The auto segment represented 26% of our total fourth-quarter 2016 revenue, compared to 35% in the fourth quarter of 2015.

As you can see from the charts, we illustrate profit mix by segment. Outdoor, fitness, marine, and aviation collectively delivered 88% of operating income in fourth-quarter 2016, compared to 74% in fourth-quarter 2015. Outdoor operating income as a percentage of total operating income increased from 27% to 36%. Total corporate operating margin was relatively flat year over year, as gross margin improvement was offset by increased operating expenses.

Looking next at the full-year charts, for the full year, the non-auto segments made up 71% of total revenue compared to 62% in 2015. Similar shift occurred in operating income, with 84% of our 2016 operating income collectively coming from the outdoor, fitness, marine, and aviation segments, compared to 75% in 2015.

Looking next at operating expenses, fourth-quarter operating expense increased by $44 million or 16%. Research and development increased $23 million year over year, 140 basis points to 15% of sales. We continue to invest in innovation, increasing resources focused primarily on aviation, fitness, outdoor, and marine, where we see long-term growth opportunities. The fourth quarter of 2016 was also impacted by the additional week of expense from the addition of the DeLorme business.

Our advertising expense increased $11 million from the prior quarter, representing 7.9% of sales, a 60-basis-point increase. Additional spending was focused on the outdoor and fitness segments to support growth in wearables.

SG&A was up $9 million compared to the prior quarter, but decreased 10 basis points as a percent of sales to 13.3%. Increased spending in SG&A was driven primarily by the additional week of expense in the addition of the DeLorme business, partially offset by year-over-year decrease in litigation-related costs.

A few highlights on the balance sheet and cash flow statement: We ended the quarter with cash and marketable securities of approximately $2.3 billion. Accounts receivable increased sequentially due to the holiday quarter, and decreased year over year to $527 million. Our inventory balance decreased year over year to $485 million, through exit of the seasonally strong fourth quarter.

In the fourth quarter of 2016, we generated free cash flow of $165 million, a $34 million increase from the prior-year quarter. Also during the quarter, as a result of the additional week, we paid two quarterly dividends of approximately $96 million, for a total of $192 million. We purchased $28 million of Company stock. We extended the expiration date for share repurchase program to December 2017, and have approximately $75 million remaining for purchase. We expect to repurchase as business and marketing conditions warrant. Assuming our dividend payments were normalized before dividends totaling $385 million, we returned $478 million of cash to our shareholders through dividend payments and through share repurchases in 2016.

The effective tax rate was 19% in the current quarter, compared to 13.2% in the prior-year quarter. The increase was primarily due to the full-year impact of the US R&D tax credit being recorded in the fourth quarter of 2015, compared to being spread over all four quarters in 2016. Our full-year 2016 effective tax rate was 18.9%, a 70-basis-point decrease from the prior year, primarily due to income mix by tax jurisdiction. We expect our full-year 2017 pro forma tax rate to be approximately 22%.

Switzerland is in the process of aligning the corporate tax rules with evolving international tax initiatives. We've elected at this time to align certain Switzerland tax position with these initiatives, resulting in year-over-year increase in pro forma tax rate. The utilization of a deferred tax asset will reduce our cash tax liability, so we do not expect to pay any additional cash taxes in Switzerland in 2017.

We announced that we plan to seek shareholder approval for a dividend of $2.04 per share, payable in four installments of $0.51 per share per quarter, beginning with the June 2017 calendar quarter. This concludes our formal remarks. Jonathan, could you please open the line for Q&A?

Operator

Thank you. This does conclude the question-and-answer session of today's program. I'd like to have the program back to Teri Seck for any further remarks.

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

Thanks, everyone. Doug and I will be available for call backs. Have a great day.

Operator

Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.