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Q4 2017 Garmin Ltd Earnings Call

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CORPORATE PARTICIPANTS

Clifton Albert Pemble *Garmin Ltd. - CEO, President & Director*
Douglas Gerard Boessen *Garmin Ltd. - CFO and Treasurer*
Teri Seck -

CONFERENCE CALL PARTICIPANTS

Benjamin James Bollin *Cleveland Research Company - Senior Research Analyst*
Bradley D. Erickson *KeyBanc Capital Markets Inc., Research Division - Research Analyst*
Charles Lowell Anderson *Dougherty & Company LLC, Research Division - VP & Senior Research Analyst of Mobile Computing*
Douglas Clark *Goldman Sachs Group Inc., Research Division - Research Analyst*
Ivan Philip Feinseth *Tigress Financial Partners LLC, Research Division - Director of Research*
Joseph Helmut Wittine *Longbow Research LLC - Research Analyst*
Kristine Tan Liwag *BofA Merrill Lynch, Research Division - VP*
Robert Michael Spingarn *Crédit Suisse AG, Research Division - Aerospace and Defense Analyst*
William Verity Power *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*
Yuuji P. Anderson *Morgan Stanley, Research Division - Research Associate*

PRESENTATION

Operator
Good day, ladies and gentlemen, and welcome to the Garmin Fourth Quarter 2017 Earnings Call. (Operator Instructions) As a reminder, this call is being recorded. I would now like to turn the call over to Teri Seck. You may begin.

Teri Seck -
Good morning. We would like to welcome you to Garmin Ltd. Fourth Quarter 2017 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 and operating margins and future dividends, 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 the 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 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. - CEO, President & Director***
Thanks, Teri, and good morning, everyone. As we announced earlier today, we delivered another quarter of revenue and profit growth. Revenue grew 3% on a consolidated basis. Combined revenue from outdoor, aviation, marine and fitness increased 9% and represented 78% of our revenue in the holiday peak quarter. Gross margin improved year-over-year to 56% due to favorable shifts in both segment and product mix. Operating margin improved to 20%, resulting in operating income growth of 12%. These strong results generated a GAAP EPS of $0.73 and pro forma EPS of $0.79 in the quarter.

Looking briefly at our full year performance. 2017 was our second consecutive year of revenue and operating income growth. I believe this is a remarkable achievement considering the challenges that we faced. The PND market continued its decline as it has done for nearly a decade. In addition, the basic activity tracker market rapidly matured and left additional gaps to fill. We filled these gaps and more because of the strength and diversity of our business.

Revenue increased 2% over 2016 to nearly $3.1 billion. Combined revenue from outdoor, aviation, marine and fitness increased 9% and generated 90% of our operating income. Gross and operating margins improved to 58% and 22%, respectively, while operating income grew 7%. This resulted in GAAP EPS of $3.68 and pro forma EPS of $2.94. Pro forma EPS grew 4% over the prior year.

Doug will discuss our financial results in greater detail in a few minutes, but first, I want to highlight that Garmin was recently included in the Forbes Global 2000 World's Best Employers list, placing 430th out of more than 300,000 companies that were surveyed. We also were ranked 41st in the Forbes Just 100: America's Best Corporate Citizens list. This ranking considered companies focused on 7 metrics, including producing quality goods, treating customers well, minimizing environmental impact, supporting the communities we operate in, commitment to ethical and diverse leadership and treating our workers well. We are honored by this recognition, and I want to thank all of our employees for your strong commitment to our mission and values, which made this recognition possible.

Next, I'll highlight 2017 performance and 2018 outlook for each of our 5 segments. Starting with outdoor. Revenue increased 28% on strong demand for outdoor wearables and growth in inReach subscription services. The segment posted gross and operating margins of 64% and 36%, respectively, resulting in operating income growth of 36% over the prior year.

Looking back on 2017, our fenix line of adventure watches continued to show strong momentum, driven by the new fenix 5 series. There are many positive things that we can say about this product line, but one I'd like to highlight is that the variety of sizes and styles offered in the fenix 5 family has successfully broadened our customer base. In particular, the majority of customers registering fenix 5S devices are women, which was a previously underrepresented demographic in our fenix customer base.

As we have mentioned in the past, our Connect IQ application platform has become an important differentiator for our smart wearables. Connect IQ now offers more than 3,500 apps, widgets and watch faces and has generated over 45 million downloads since inception, approximately half of which occurred in the last year. To further promote the power and utility of Connect IQ, we will host our second annual Developers Conference in mid-April, offering workshops and tools that our developers can use to leverage the Garmin wearable ecosystem.

Looking ahead, we anticipate revenue in the outdoor segment will increase approximately 13% in 2018. We anticipate that growth will be driven primarily by the fenix series and supported by growth in other product categories within the segment.

Turning next to aviation. We reported solid revenue growth of 14%, with revenues exceeding $500 million for the first time in our history. Growth was broad-based in both aftermarket and OEM product categories. Gross and operating margins were strong at 74% and 31%, respectively, resulting in operating income growth of 23% for the year.

In recent developments, Textron Aviation announced that the new Cessna Sky Courier aircraft will be equipped with the Garmin G1000 NXi system. We are excited to expand our partnership with Textron Aviation and look forward to supporting the certification and delivery of this new aircraft.

Last week, we announced that our D2 Charlie aviation watch was selected by the United States Air Force for use by pilots of the Lockheed U-2 aircraft. The D2 Charlie will provide unique benefits such as pressure alerts and classical navigation information on the wrist.

Our aviation team has a strong commitment to delivering quality and service to our customers. As evidence of that commitment, we received 2 Supplier of the Year Awards for technical support to operators and for electric and electronic systems at the recent 2017 Embraer Suppliers Conference. This is a significant accomplishment considering the scope and complexity of Embraer's operation and the high expectations that their suppliers must meet. Also, for the 14th consecutive year, Garmin was ranked #1 in avionic support by Professional Pilot Magazine and by Aviation International News. I congratulate our team on earning these awards, which are the testament to the quality of Garmin equipment and the amazing way our associates care for our customers.

Looking ahead, we anticipate revenue in the aviation segment will increase approximately 13% in 2018. We anticipate broad-based growth across both OEM and aftermarket product categories due to improving market conditions, contributions from new products and platforms and opportunities related to the ADS-B mandate.

Looking next at the marine segment. Revenue grew 13%, driven by growth in chartplotters, fishfinders and contributions from our recent Navionics acquisition. Gross margin improved to 57%, while operating margin declined to 13% due to litigation-related costs. At the Miami Boat Show, we announced that Sea Hunt Boat Company, one of the top-selling saltwater boat brands in the United States, is now offering Garmin electronics in their line of watercraft. We are excited by the opportunity to serve Sea Hunt and their customers.

We are entering 2018 with a broad portfolio of strong products and technologies. We anticipate revenue in the marine segment will increase approximately 18%, consisting of both organic growth as well as growth from our recent Navionics acquisition.

Turning next to fitness. Revenue declined 7%, driven by the rapidly maturing market for basic activity trackers, partially offset by growth in advanced wearables and our children's line of activity trackers. Gross and operating margins were 55% and 19%, respectively. Gross margin improved due to product mix, while operating margin declined from the prior year. In 2018, we are targeting revenue to be flat in the fitness segment as growth in advanced wearables, cycling and children's trackers is offset by further declines in basic activity trackers.

Looking finally at the auto segment. Revenues were down 15% 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 9%, respectively. While the downward trend of the consumer PND market is well understood, we see incremental growth opportunities in certain product categories, including trucking, RV and cameras. We are focused on maximizing profits in the segment while leveraging these opportunities.

Looking at 2018, we expect revenue to decline approximately 17%, driven by the ongoing decline of the PND market. We remain focused on disciplined execution to bring pragmatic innovation to the market and to maximize profitability in the segment.

In summary, we are entering 2018 with a strong product lineup, and we see many opportunities ahead. With this in mind, we are projecting revenue of approximately $3.2 billion, up 3% year-over-year, as growth in outdoor, aviation and marine is partially offset by ongoing declines in the auto segment. We are projecting improved gross margin of approximately 58.5%, operating margin of approximately 21% and full year pro forma effective tax rate of approximately 19%, resulting in pro forma earnings per share of approximately $3.05.

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

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

Thanks, Cliff. Good morning, everyone. I'll begin by reviewing our fourth quarter and full year financial results and move to comments on the balance sheet, cash flow statement, taxes, impact of new revenue recognition standard. We posted revenue of $888 million for the fourth quarter, representing 3%

increase year-over-year. Gross margin was 56.2%, 150 basis point increase from the prior year, driven by segment and product mix. Operating expense as a percentage of sales was 36%, consistent with the prior year. Operating income was $179 million, a 12% increase over the prior year. Operating margin was 20.2%, 160 basis point increase from the prior year. Our GAAP EPS was $0.73. Our pro forma EPS was $0.79.

Looking at full year results. We posted revenue of about $3.1 billion for the year, representing 2% increase year-over-year. Gross margin was 57.8%, a 220 basis point increase from the prior year. Operating expense as a percentage of sales was 36.1%, 110 basis point increase over the prior year. Operating income was $669 million, a 7% increase over the prior year. Operating margin was 21.7%, an increase of 100 basis points from the prior year, driven by the increase in gross margin. Our GAAP EPS was $3.68. Pro forma EPS was $2.94.

Next, we'll look at fourth quarter and full year revenue by segment. During the fourth quarter, we achieved double-digit growth in 3 of our 5 segments, led by marine segment with 24%. Fitness returned to growth in the fourth quarter. For the full year 2017, we achieved 2% consolidated growth, led by robust growth in our outdoor segment and solid double-digit growth in our aviation and marine segments.

Looking next at fourth quarter revenue and operating income. Collectively, the outdoor, aviation, marine and fitness segments contributed 78% of total revenue in fourth quarter 2017 compared to 74% in prior year quarter. Outdoor grew from 20% to 23%. You can see from the charts illustrating our profit mix by segment, the outdoor, aviation, marine and fitness segments collectively delivered 90% of operating income in fourth quarter 2017 compared to 88% in fourth quarter of 2016. Outdoor operating income as a percentage of total operating income increased from 36% to 41%.

Looking next to the full year charts. For the full year, the outdoor, aviation, marine and fitness segments made up 76% of total revenue compared to 71% in 2016. Similar shift occurred in operating income, with 90% of our 2017 operating income collectively coming from the outdoor, aviation, marine and fitness segments compared to 84% in 2016.

Looking next at operating expenses. Fourth quarter operating expenses increased by $9 million or basically flat as a percent of sales. Research and development increased $4 million year-over-year due to investments in engineering resources and Navionics acquisition, partially offset by the additional week of expense in 2016. Our advertising expense decreased $9 million from the prior year quarter, representing 6.6% of sales, a 130 basis points decrease. The decrease was due primarily to lower media spend in the fitness segment.

SG&A was up $15 million compared to the prior year quarter, an increase of 120 basis points as a percent of sales to 14.5%. This increase was primarily due to litigation-related costs and Navionics acquisition.

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 to $591 million due to holiday quarter, an increase year-over-year due to stronger sales and timing of cash receipts. Inventory balance decreased sequentially to $518 million as we exit the seasonally strong fourth quarter but increased year-over-year primarily due to raw material requirements.

During the fourth quarter 2017, we generated free cash flow of $144 million. Also during the quarter, we paid dividends of approximately $96 million. We announced that we plan to seek shareholder approval for an increased dividend beginning the June 2018 payment. The proposal is a cash dividend of $2.12 per share, $0.53 per share per quarter, 4% increase from our current quarterly dividend of $0.51 per share.

For full year 2017, we reported an income tax benefit of $13 million, which includes $157 million of pro forma net discrete items relating to a $180 million tax benefit related to the change in tax balance sheet accounts as a result of the Switzerland corporate tax election, partially offset by $23 million of tax expense resulting from the new accounting standard related to the expiration of share-based awards. Excluding these pro forma discrete tax items, the full year 2017 pro forma effective tax rate is 21.2% compared to 18.9% in the prior year. The increase in the pro forma effective tax rate is primarily due to the company's election to align certain Switzerland tax positions with evolving international tax initiatives. We expect our full year pro forma effective tax rate in 2018 to be approximately 19%. The decrease is primarily due to the U.S. tax reform.

Finally, I'd like to walk you through the impact of the new revenue recognition standard. We adopted the new standard in the first quarter 2018 and restated the prior year financials. The auto segment is the only segment impacted by the new revenue recognition standard. Impact to our 2017 financial statements is an increase in revenue of $35 million, which means we would have deferred less revenue compared to the new revenue standard. All 2018 guidance is calculated off the restated 2017 amounts, which are available in the appendix to earnings release.

This concludes our formal remarks. Michelle, could you please open the line for Q&A?