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PRESENTATION

Operator

Good morning. My name is Julie, and I will be your conference operator today. At this time, I would like to welcome everyone to the Garmin Ltd. Second Quarter 2018 Earnings Conference Call. (Operator Instructions) And as a reminder, today's call is being recorded on August 1, 2018. Thank you. Teri Seck, you may begin.

Teri Seck -

Good morning. We would like to welcome you to Garmin Ltd. Second Quarter 2018 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.

As a reminder, we adopted the new U.S. GAAP revenue standard in the first quarter of 2018. The prior periods presented here have been restated to reflect adoption of this new standard. 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 dividend, 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.

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, Principal Operating Officer & Director***

Thank you, Teri, and good morning, everyone. As announced earlier today, Garmin reported strong second quarter consolidated revenue of $894 million, up 8% over the prior year.

Fitness, marine, aviation and outdoor collectively increased 17% year-over-year and contributed 80% of total revenues. Gross margin improved to 58.5% compared to the prior year due to segment mix. Operating income improved to $218 million, up 4% over the prior year. This resulted in GAAP EPS of $1 and pro forma EPS of $0.99 in the quarter.

We are pleased with our performance in the first half of 2018, and these strong results give us confidence to raise our full year guidance. Doug will discuss our financial results in greater detail in a few minutes. But first, I'd like to provide a few brief remarks on the performance of our business segments.

Starting with the fitness segment. Revenue increased 24%, driven by growth in advance wearables and in cycling. Gross and operating margins were 56% and 23%, respectively, and operating income grew 40% over the prior year.

During the second quarter, we launched the vívoactive 3 music, expanding our music offerings into the advanced wellness category. We also launched new Edge cycling computers and the next-generation Varia radars, targeting the cycling safety market.

The basic activity tracker category continued to decline during the first half of 2018. However, the impact on our fitness segment was more than offset by growth in other categories. Looking forward, we believe we are well positioned in the segment with a strong lineup of wearables and cycling products.

Looking next at marine. Revenue increased 24% as weather conditions improved and boats were brought out of storage for the season. Approximately half of the growth came from our recent acquisition of Navionics, while the other half was organic across multiple product categories. Gross and operating margins were 59% and 21%, respectively, and operating income grew 14% over the prior year.

During the quarter, we introduced Panoptix LiveScope, a sonar system that generates real-time images underwater. LiveScope was quickly recognized by the marine industry as a disruptive new technology. At the recent ICAST sportfishing trade show, LiveScope won the award for best new electronics and received the prestigious award for best of show. We believe LiveScope is a game-changer for the fishing market.

Also during the quarter, we announced Sportsman Boats selected Garmin as their exclusive marine electronic supplier beginning with their 2019 model year boats. Sportsman is one of the fastest-growing boat companies in the U.S. market, and it's an honor to be selected as their exclusive electronics provider. Looking forward, we are focused on product innovation and gaining share in the inland fishing category.

Turning next to aviation. Revenue increased 23%, driven by growth in both OEM and retrofit product categories. We experienced particularly strong growth in our ADS-B offerings and from recently introduced products such as the G5 indicator system, TXi displays and GFC autopilots.

Gross and operating margins remained strong at 74% and 34%, respectively, resulting in operating income growth of 34% over the prior year. We were recently selected by Tactical Air Support to provide an integrated flight deck to their fleet of supersonic F-5 fighter aircraft. We also introduced the G30000H integrated flight deck for the Part 27 turbine helicopter market.

As I mentioned earlier, ADS-B has been a significant driver of growth in our aviation business. With just under 18 months to go before the December 31, 2019, deadline, we wanted to provide an update on the market development and how we see things playing out as the deadline approaches. According to the FAA, as of July 1, 2018, approximately 59,000 aircraft have been equipped. The FAA has estimated that approximately 100,000 to 160,000 aircraft will eventually be equipped with ADS-B. Based on the more conservative estimate, the market is just past the halfway point in the ADS-B cycle.

There are a few key observations that we would like to share. First, significant opportunity remains in the ADS-B cycle. According to FAA estimates, anywhere from 40,000 to 100,000 aircraft remain to be equipped. Interest in ADS-B is increasing, and many customers are using the opportunity to refresh their panels with additional equipment. This enhances the growth opportunity for Garmin.

Second, shock capacity appears to be a limiting factor in ADS-B adoption. With a modest increase in shock capacity, it is possible to reach the low end of the FAA estimates by the December 31, 2019, deadline. If shock capacity does not increase or if the final equipage level increases above the more conservative estimate, the opportunity would continue past the deadline.

Finally, ADS-B is a significant opportunity that it is only one of many that we are pursuing. To prepare for the future beyond the ADS-B cycle, we are investing in long-term opportunities such as gaining share in the OEM market, establishing a position in government and defense markets and developing new product categories. In summary, we are pleased with the performance of our aviation business, and we are optimistic about its future.

Turning next to outdoor. Revenue increased 4% on a year-over-year basis, driven by growth across all product categories. While this growth rate is below recent trends, we feel it is a remarkable accomplishment considering the strong growth we experienced in Q2 of 2017, driven by the initial channel fill of the fenix 5 series. Gross and operating margins were 64% and 36%, respectively.

Late in the quarter, we launched the fenix 5 Plus series, adding music, color maps and mobile payments to all 3 watch sizes. In addition, we expanded our sensor technology with the addition of Pulse Ox to the fenix 5X Plus, providing blood oxygen saturation awareness for athletes and outdoor enthusiasts. We also launched the inReach Mini, a compact, versatile satellite communicator that can be used with other Garmin products paired with a smartphone or used as a stand-alone device. Looking forward, we are focused on opportunities in wearables and other product categories within the outdoor market.

Looking finally at the auto segment. Revenues decreased 19% due to the ongoing decline in the PND market. Gross and operating margins declined year-over-year to 42% and 7%, respectively. Our global market share position in the PND category remains very strong. Looking forward, we are focused on disciplined execution to bring the desired level of innovations in the market and to maximize profitability in the segment.

In summary, we are pleased with our results in the first half of 2018. In light of the strong performance, we are raising our projected revenue to $3.3 billion for the year, up about 6% over 2017. Gross margin is projected to be 58.5% for the year, which is unchanged from the previous estimate. Operating margin is projected to be 21.5%, which is a slight improvement over our previous guidance. Assuming a pro forma effective tax rate of approximately 17.5%, pro forma earnings per share is expected to be approximately $3.30.

Looking at our annual revenue outlook by segment. We have increased our growth expectations for the fitness segment to 10% and the aviation segment to 18%. Outdoor and auto are unchanged, while the outlook for marine has been revised down slightly to 15%.

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

Douglas Gerard Boessen ***Garmin Ltd. - CFO, Principal Accounting Officer & Treasurer***

Thanks, Cliff. Good morning, everyone. I'd like to begin by reviewing our second quarter financial results and make comments on the balance sheet, cash flow statement and taxes.

We posted revenue of $894 million for the second quarter, representing an 8% increase year-over-year. Gross margin was 58.5%, a 30 basis point increase from the prior year. Operating expense as a percentage of sales was 34.2%, 120 basis point increase from the prior year. Operating income was $218 million, a 4% increase year-over-year. Operating margin was 24.3%, a 90 basis point decrease from the prior year. Our GAAP EPS was $1, and pro forma EPS was $0.99, a 9% increase from the prior year.

Next, I'd like to look at our second quarter revenue by segment. During the quarter, we achieved 8% consolidated growth led by robust double-digit growth in our fitness, marine and aviation segments. This growth was partially offset by a decline in our auto segment, which is a result of the continued decline in the auto PND business. On a combined basis, fitness, marine, aviation and outdoor were up 17% compared to the prior year quarter.

Looking next at second quarter revenue and operating income. On a combined basis, fitness, marine, aviation and outdoor segments contributed 80% of total revenue to second quarter of 2018 compared to 73% in the prior year quarter. Fitness grew from 22% to 25%. Aviation grew from 15% to 17%. Marine grew from 13% to 15%.

As you can see from the charts that illustrate our profit mix by segment, on a combined basis, the fitness, marine, aviation and outdoor segments delivered 94% of operating income in the second quarter 2018 compared to 84% second quarter 2017. The fitness and aviation segments had year-over-year increase in both operating income dollars and operating margin.

Looking next at operating expenses. Second quarter operating expenses increased by $31 million or 11%. Research and development increased $15 million year-over-year due to investments in engineering resources and recent acquisitions. Advertising expense was up $2 million for the prior year quarter and was relatively flat as a percent of sales. SG&A was up $16 million compared to prior year quarter, relatively flat as a percentage of sales. The increase was primarily due to personnel-related expenses, incremental costs associated with recent acquisitions.

A few highlights on the balance sheet and cash flow statement. We ended the quarter with cash and marketable securities of approximately $2.4 billion. Accounts receivable increased sequentially and year-over-year to $533 million. Inventory balance decreased sequentially in year-over-year to $501 million as we exited the seasonally strong second quarter. For the second quarter of 2018, we generated free cash flow of $157 million, a $28 million increase from the prior year quarter. Also during the quarter, we paid dividends of $100 million.

During the second quarter 2018, we reported an effective tax rate of 19.4% compared to pro forma effective tax rate of 21.4% in the prior year quarter. The decrease in the effective tax rate was primarily due to the benefits from U.S. tax reform. We expect our full year 2018 pro forma effective tax rate to be approximately 17.5%.

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

Operator

And that concludes today's conference call. You may now disconnect.

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the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.