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Q3 2018 Garmin Ltd Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Garmin Ltd. Third Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded. I would now like to introduce your host for today's call, Ms. Teri Seck, Manager of Investor Relations. Ma'am, you may begin.

Teri Seck -

Good morning. We would like to welcome you to Garmin Ltd. Third 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 transcripts will also be available on our website.

As a reminder, we adopted the new U.S. GAAP revenue standards 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 introduction, 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.

I'd like to begin by mentioning a couple of important milestones we recently celebrated. During the third quarter, we shipped our 200 millionth product, which is a testament to our ability to design, manufacture and sell unique applications and technology for active lifestyles. Equally as exciting, we started production in our new aviation manufacturing facility located in Olathe, Kansas. This new facility more than doubles our production capacity, allowing us to serve our growing aviation business for many years to come.

Moving now to the quarterly results. Earlier today, Garmin reported strong third quarter consolidated revenue of $810 million, up 8% over the prior year. Marine, aviation, fitness and outdoor collectively increased 16% year-over-year and contributed 80% of total revenues.

Gross margin improved to 59.4% compared to the prior year. Operating income improved to $196 million, up 13% over the prior year. This resulted in GAAP EPS of $0.97 and pro forma EPS of $1 in the quarter.

We are pleased with our performance in the first 3 quarters of 2018, and these strong results give us confidence to raise our full year EPS 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 marine segment. Revenue increased 28% as we saw strong sales continue well into the summer building season. Approximately half of the growth was organic, while the other half came from acquisitions. Gross and operating margins were 59% and 14%, respectively.

We recently announced our GPSMAP 8600 series of chartplotters. This is the first product line to use our new G3 maps, which combine the best of Garmin and Navionics content.

We've been very intentional about investing in our marine segment, and the industry is taking notice. For the fourth consecutive year, we were recognized by the National Marine Electronics Association as Manufacturer of the Year, and Panoptix LiveScope won their prestigious technology award. We are also recognized as one of the Top 10 Most Innovative Marine Companies in 2018 by Soundings Trade Only, which is a B2B news and information provider for the recreational building industry. It's an honor to be recognized by the marine industry, and we will continue to invest in the segment to maximize its potential.

Turning next to aviation. Revenue increased 17% driven by broad-based growth within the segment. Gross and operating margins increased to 76% and 35%, respectively, resulting in operating income growth of 49% over the prior year.

During the quarter, we completed the acquisition of FltPlan.com and have begun integrating these new services into Garmin's existing apps. Also, we recently announced that our ADS-B solution was selected by Gulfstream for the G280 aircraft. Finally, we announced the teaming agreement with Bell to supply avionics for on-demand mobility vehicles. While this project is in its early stages, it's an important first step towards creating a viable urban air transport system.

Turning next to the fitness segment. Revenue increased 14%, primarily driven by growth of our wearable products. Gross and operating margins were 54% and 20%, respectively, and operating income grew 12% over the prior year.

During the third quarter, we launched the vívosmart 4, a slim, smart activity tracker that includes a Pulse Ox sensor. In addition to providing blood oxygen saturation levels, this device also provides users with advanced sleep monitoring and a new Body Battery feature that helps individuals understand and manage their energy levels throughout the day. We also added Disney Princess and Marvel's Spider-Man bands to our popular vívofit jr. product line, along with new mobile app adventures.

Turning next to the outdoor segment. Revenue increased 13% on a year-over-year basis, driven primarily by growth in wearables. Gross and operating margins improved year-over-year to 65% and 38%, respectively, resulting in operating income growth of 16%.

We recently announced the integration of Spotify with fenix 5 Plus series. And just this morning, the Forerunner 645 Music was added to the list as Spotify compatible wearables. This gives our customers the ability to download Spotify playlist to the watch via the Spotify app, which is available from the Connect IQ store. The app is already proving to be very popular with our customers. During its first full day of availability, Spotify set a record for the most downloads of a new app from our Connect IQ store.

Finally, we recently announced Instinct, a rugged and reliable GPS smartwatch designed to expand the market for outdoor wearables.

Looking finally at the auto segment. Revenue decreased 16% due to the ongoing decline of the PND market. Gross and operating margins declined year-over-year to 43% and 9%, respectively. Our global market share position in the PND category remains very strong.

We recently announced that we've been selected by the Chinese auto group, Geely, to provide camera and driving recorder systems beginning in model year 2020. This award demonstrates the progress we are making as a Tier 1 auto supplier.

In summary, we are pleased with our results in the first 3 quarters of 2018. In light of the strong third quarter results, we are making some adjustments to our guidance. We anticipate our fourth quarter revenue to be relatively flat on a year-over-year basis, with full year revenue of approximately $3.3 billion and a gross margin of 58.5%. We are raising our full year operating margin to approximately 22% and lowering our full year pro forma effective tax rate to approximately 16%, resulting in pro forma earnings per share of approximately $3.45.

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 third quarter financial results and make comments on the balance sheet, cash flow statement and taxes.

We posted revenue of $810 million for the third quarter, representing 8% increase year-over-year. Gross margin was 59.4%, a 120 basis point increase from the prior year. Operating expense as a percentage of sales was 35.2%, consistent with the prior year. Operating income was $196 million, a 13% increase year-over-year. Operating margin was 24.2%, 110 basis points increase from the prior year. Our GAAP EPS was $0.97. Pro forma EPS was $1, 30% increase from the prior year.

Next, look at our third quarter revenue by segment. During the quarter, we achieved 8% consolidated growth led by double-digit growth in 4 of our 5 segments. This growth was partially offset by decline in our auto segment, which resulted in continued decline in auto PND business. Combined basis, marine, aviation, fitness and outdoor were up 16% compared to prior year quarter.

Looking next at third quarter revenue and operating income. On a combined basis, marine, aviation, fitness and outdoor segments contributed 80% to total revenue in the third quarter 2018 compared to 74% in the prior year quarter. Auto declined from 26% to 20%, while every other segment grew. Marine grew from 10% to 12%, and fitness grew from 22% to 24%. As you can see from the chart, it illustrates our profit mix by segment. Combined basis, the marine, aviation, fitness and outdoor segments delivered 92% of operating income in the third quarter 2018 compared to 89% in the third quarter of 2017. The aviation and outdoor segments had year-over-year increase in both operating income dollars and operating margin.

Looking next at operating expenses. Our third quarter operating expenses increased by $21 million or 8%. Research and development increased $9 million year-over-year due to investments in engineering resources and recent acquisitions. Our advertising expense was down $1 million from the prior year quarter. SG&A was up $13 million compared to prior quarter, an increase of 60 basis points 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 $2.5 billion. Accounts receivable decreased sequentially due to seasonal trends and increased year-over-year on stronger sales. Inventory balance increased on a sequential basis to $557 million to prepare for the seasonally strong fourth quarter. In the third quarter 2018, we generated free cash flow of $234 million, $81 million increase from the prior year quarter. Also during the quarter, we paid dividends of $100 million.

During the third quarter of 2018, we reported an effective tax rate of 8.5% compared to the effective tax rate of 20.5% in the prior year quarter. The decrease in effective tax rate was primarily due to benefits from U.S. tax reform and increased benefit from U.S. R&D tax credits. We expect our full year 2018 pro forma effective tax rate to be approximately 16%.

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

Teri Seck -

Thanks, everyone, and have a great day. Doug and I will be available for calls through the rest of the day. Thank you. Bye.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes the program. You may disconnect, and have a wonderful day.
