Garmin Ltd.(Q3 2022 Earnings)

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Corporate Speakers:

- Teri Seck; Garmin; Manager of IR
- Clifton Pemble; Garmin; President, CEO & Director
- Doug Boessen; Garmin; CFO & Treasurer

Participants:

- Paul Chung; JPMorgan Chase; Analyst
- David MacGregor; Longbow Research; Analyst
- Ben Bollin; Cleveland Research; Analyst
- Ivan Feinseth; Tigers Financial Partners; Analyst
- Erik Woodring; Morgan Stanley; Analyst

PRESENTATION

Operator^ Thank you for standing by, and welcome to Garmin Ltd. Third Quarter 2022 Earnings Conference Call. (Operator Instructions) As a reminder, today's program is being recorded. And now I'd like to introduce your host for today's program, Teri Seck, Director of Investor Relations. Please go ahead.

Teri Seck^ Good morning. We would like to welcome you to Garmin Ltd.'s Third Quarter 2022 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. 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 the 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 Pemble^ Thank you, Teri, and good morning, everyone. As reported earlier today, consolidated third quarter revenue came in at $1.14 billion, down 4% from the prior year. Revenue was negatively impacted by approximately $70 million due to the strengthening of the U.S. dollar relative to other currencies. Excluding this impact, revenue would have increased about 2% over the prior year.

While the stronger dollar negatively impacted revenue cost of goods benefited due to the weakening of the Taiwan dollar. In addition, cost of freight came down as more products are being shipped by ocean and as rates decline due to excess capacity in the shipping industry. These, combined with favorable segment mix resulted in gross margin of 58.8%, an increase of 40 basis points over the prior year.

Expenses increased 4% as growth in R&D and SG&A was partially offset by advertising efficiency. This resulted in operating income of $239 million, which was down 15% from the prior year. Operating margin was solid at 21%. Considering our year-to-date performance, we are adjusting expectations for the remainder of the year. We now anticipate full year revenue of approximately $4.85 billion, a year-over-year decline of 3%. We are raising our full year EPS guidance to $4.95 on improving gross margins, increased efficiency in our expense structure and the lower full year effective tax rate. Doug will provide more details on our financial results and updated guidance in a moment but first, I'll provide highlights on the performance and outlook of each business segment.

Starting with Fitness, revenue decreased 18% and to $280 million, primarily due to lower sales of advanced wellness wearables and indoor cycling products. Gross and operating margins were 53% and 15%, respectively, resulting in operating income of $41 million. During the quarter, we launched the index BPM smart blood pressure monitor, which measures systolic and diastolic blood pressure at home or on the go. When paired with our Garmin Connect app, users can see their measurement history and trends alongside other health stats.

We also launched the Venu Sq 2 featuring a bright AMOLED display and up to 11 days of battery life, which is nearly double that of its predecessor. Considering year-to-date performance in the Fitness segment, we are maintaining our expectation that revenue will decline 25% for the year.

Moving to outdoor. Revenue increased 5% to $340 million, driven by growth in adventure watches and inReach devices and services, but partially offset by declines in other product lines. Gross and operating margins were strong at 65% and 36%, respectively, resulting in operating income of $121 million.

inReach remote communication devices and response coordination services have been a strong product category and unique differentiator for the Outdoor segment.

During the quarter, we launched the inReach Messenger, a versatile communication-focused device with global 2-way texting, location sharing and SOS capabilities. Whenever a customer presses the SOS button their communication is sent to our Garmin Response Center, which oversees and coordinates a unique response based on the situation. Since launching inReach Services in 2011, the Garmin Response Center has coordinated over 10,000 inReach SOS responses in more than 150 countries and on all 7 continents, for activities ranging from hiking and backpacking to roadside assistance in areas of poor cell phone coverage. Many customers claims that inReach products and services were instrumental in returning safely to family and friends.

Considering year-to-date performance in the Outdoor segment and current trends, we now expect revenue to grow 17% for the year. Looking next at Aviation, revenue increased 4% to $188 million, primarily driven by growth in aftermarket product lines. Demand for Aviation products remains strong, and we continue to experience higher-than-normal backlogs for our products. Supply chain constraints have improved, but continue to affect our ability to completely clear the backlog. Gross and operating margins were strong at 73% and 26%, respectively, resulting in operating income of $48 million. During the quarter, we announced that our G3000 integrated flight deck was selected by Tactical Air to modernize F5 fighter aircraft operated by the U.S. Navy and Marine Corps.

Our expanding role on the F5 demonstrates the capability and versatility of our integrated cockpit systems for use in demanding military applications. Additionally, a recent survey by Aviation International news ranked Garmin #1 in Avionics product support for the 19th consecutive year. This long period of recognition demonstrates an unwavering commitment to meet the needs of highly demanding markets from owner flown aircraft to large Part 135 commercial operators. I congratulate our team for once again earning this award, which is a testament to the quality of Garmin equipment and the amazing way our associates care for our customers. The Aviation segment has delivered solid performance so far, but supply chain constraints are affecting our ability to achieve our original plan by the end of the year. With this in mind, we are adjusting our revenue growth estimate to 7% for the year.

Turning to the Marine segment. Revenue decreased 5% to $197 million. The Marine business is highly seasonal and Q3 typically represents the lowest quarter of the year. For the past 2 years, these seasonal trends have been difficult to predict due to the influence of the pandemic. We believe the market is returning to more typical seasonal trends. Growth in operating margins were 56% and 23%, respectively, resulting in operating income of $45 million.

During the quarter, we began shipping the LiveScope XR system, which operates at greater depths and expands the addressable market for live action sonar to coastal and deep lake fishing applications. We also launched the LiveScope Plus ice fishing bundle with high-resolution real-time imaging, which creates the ultimate portable solution for winter fishing. And finally, we continue to be recognized for innovation and achievements in the Marine industry.

For the eighth consecutive year, the National Marine Electronics Association named Garmin Manufacturer of the Year, and we also received 5 Product of Excellence awards. I'm very proud of our accomplishments in the Marine market, and I congratulate our team on these achievements. Considering year-to-date performance in the Marine segment and the return of typical seasonality patterns, we are lowering our revenue growth estimate to 3% for the year.

Looking finally at Auto, revenue decreased 2% to $136 million as declines in consumer product lines more than offset growth in OEM programs. Gross margin was 40% and the operating loss driven by investments in auto OEM programs, narrowed significantly from the prior year to $16 million. During the quarter, we announced that our Tread Navigators have been selected by Arctic Cat as standard equipment on select side-by-side off-road vehicles beginning in model year 2023.

Considering year-to-date performance in the Automotive segment and current trends, we now expect revenue to decline 7% for the year. So that concludes my remarks. Next, Doug will walk you through additional details on our financial results. Doug?

Douglas Boessen^ Thanks, Cliff. Good morning, everyone. I begin by reviewing our third quarter financial results, provide comments on the balance sheet, cash flow statement, taxes or updated guidance. We posted revenue of $1.140 billion for the third quarter, representing a 4% decrease year-over-year. Gross margin was 58.8%, a 40 basis point increase compared to prior year quarter. The increase was primarily due to favorable segment mix in lower freight, partially offset by the net unfavorable impact of foreign exchange rates.

Operating expense as a percentage of sales was 37.8%, a 310 basis point increase from the prior quarter. Operating income was $239 million, a 15% decrease. Operating margin was 21%, 270 basis point decrease. Our GAAP EPS was $1.09, pro forma EPS was $1.24.

Next, look at our third quarter revenue by segment and geography. During the third quarter, growth in the Outdoor and Aviation segments were more than offset by declines in the Fitness, Marine and Auto segments. Our geography, the Americas region was down 2%. The EMEA region was negatively impacted by foreign exchange rates, excluding the impact of foreign exchange rates, EMEA sales performance put in more in line to America's sales performance.

APAC region was up 10% with the prior year. Excluding the approximate $16 million impact of foreign exchange rates, APAC region would have been up 19% with the prior year. Looking next, operating expenses. Third quarter operating expenses increased by $18 million or 4%. Research and development increased $10 million year-over-year primarily due to engineering personnel costs. SG&A increased $12 million to prior year quarter primarily due to increases in personnel-related expenses, information technology costs.

Advertising expense decreased approximately $4 million due to lower co-op advertising. A few highlights on the balance sheet, cash flow statement and taxes. Ended the quarter with cash and marketable securities of approximately $2.7 billion. Accounts receivable was relatively flat year-over-year and decreased sequentially to $641 million. Inventory balance increased year-over-year to approximately $1.5 billion. This increase was in line with our expectations. We've been executing our strategy to reduce freight costs through higher mix of ocean versus air shipments.

During the third quarter of 2022, we generated free cash flow of $104 million, $100 million decrease from the prior quarter, primarily due to lower operating income, increased working capital needs. Capital expenditures for the third quarter were $50 million. We expect full year 2022 free cash flow to be approximately $450 million, capital expenditures approximately $250 million. Also during the quarter, we paid dividends of $141 million purchased $83 million of the company's shares being $186 million remaining at the end of the quarter.

Share repurchase program authorized through December 2023. During the third quarter 2022 reported effective tax rate of 4.3% compared to 5.9% in the prior quarter. The increase in effective tax rate is primarily due to income mix by tax jurisdiction, an increase in U.S. tax deductions and credits.

Turning next to our full year guidance. We estimate revenue of approximately $4.85 billion compared to our previous guidance of $5 billion. We expect gross margin to be approximately 57.5%, higher than our previous guidance, 56.7%, primarily due to year-to-date performance, including favorable segment mix and lower costs. We expect an operating margin of approximately 20.7%. Also, we now expect the full year 2022 pro forma effective tax rate to be approximately 8% lower than our previous guidance of 8.5% to projected full year income mix for tax rejection, results in pro forma earnings per share of approximately $4.95.

That concludes our formal remarks. Jonathan, can you please open the line for Q&A?

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

Teri Seck^ Thanks, everyone, for your time today. Doug and I are available for callbacks this afternoon. Thank you. Bye.

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