MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome at the Garmin Limited Second Quarter 2014 Earnings Conference Call. Today's conference is being recorded. At this time, I'd like to turn the call over to Kerri Thurston. Please go ahead, ma'am.

Kerri R. Thurston, Director-Investor Relations

Thank you. Good morning, everyone. We'd like to welcome you to Garmin Limited's second quarter 2014 earnings call. Please note that the earnings press release and the related slides are available on Garmin's IR site at www.garmin.com/stock. An archive of the webcast and the related transcript will also be available there.

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 share, 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 SEC.

Presenting on behalf of Garmin Limited this morning are Cliff Pemble, President and CEO; and Kevin Rauckman, CFO and Treasurer. Also joining us today is Doug Boessen, who will become CFO tomorrow. Doug has been with us since June 2, allowing for a smooth transition to-date. In addition, Kevin is committed to providing ongoing support if needed throughout 2014. Doug and I will be travelling periodically throughout the remainder of the year providing the opportunity to meet many of you.

At this time, I'll turn the call over to Cliff.

Clifton A. Pemble, President, Chief Executive Officer & Director

Thanks, Kerri and good morning, everyone. As announced earlier today, Garmin reported a second consecutive quarter of strong performance with growth in revenue, operating income, and pro forma EPS. Consolidated revenues increased 12% year-over-year with aviation, fitness, marine, and outdoor contributing 55% of total sales and 66% of the operating profit in the quarter.

Gross margins improved to 57% from 55% in the prior year due to the amortization of previously deferred revenue and improved segment mix. Operating margins were 28%, an increase from 24% in the prior year. This resulted in operating income growth of 29% on a consolidated basis. These strong results generated $1.02 of pro forma EPS in the quarter, representing an increase of 34% over 2013.

Before discussing segment results, I wanted to briefly mention the subsequent event that we announced this morning. Our board has approved an intercompany restructuring transaction that will result in greater access to historical earnings and will allow us to efficiently repatriate future earnings to fund dividends, share repurchases and acquisitions.

This restructuring will trigger onetime payments covering taxes on intercompany transactions and withholding taxes as we repatriate a portion of our cash to our Swiss parent company. Kevin will provide more context in his remarks.

Looking first at the fitness segment, revenue grew 79% on a year-over-year basis with growth driven by new products across multiple fitness categories. We delivered gross and operating margins of 65% and 42% respectively. This generated operating income growth of 112% in the quarter as operating margins expanded by over 650 basis points due to strong sales.

We have a host of new products that are performing well across a variety of categories and price points. These include the vívofit which has had a strong start and rapidly growing activity tracking category. In the running category, Forerunner 15, 220 and 620 are all contributing to strong growth. In the cycling category, the Edge Touring, Edge1000 and Vector are the primary growth drivers.

The diversity of features, form factors and price points that are driving growth affirms our strategy of innovating across a broad portfolio of offerings. With that in mind, we continue to invest aggressively in fitness R&D with commitments to explore, develop and deliver superior products and services that our customers desire.

In aviation, we posted revenue growth of 11% driven primarily by new and existing OEM relationships. Gross and operating margins improved to 74% and 29%, respectively, due to positive sales mix and improved operating margin leverage. Operating income grew 38% in the quarter ahead of revenue growth due to the margin improvement.

I'd like to highlight that the business yet shown on this slide is the recently-certified Citation X+ with the Garmin G5000 integrated flight deck. Cessna began deliveries of this aircraft in the second quarter and we are pleased to be the avionics provider for the fastest civilian aircraft available in the market today.

As we continue into the back half of 2014, we will focus on a number of additional certifications. These include the Cessna CJ3+ and the Alpine Edition CJ2+, which are expected to be certified in 2014. Longer term, we will see new revenue contribution from the Cessna Latitude, Bell 505 and the Bell 525. These are complex projects and necessitate a high level of R&D investment.

And finally I think it's important to note that we continue to face a challenging environment in the small business jet industry. Despite the soft market conditions, our innovative products and market share gains have allowed us to deliver ongoing growth.

Turning next to Marine, revenue grew 1% in the quarter due to the strong comparable from the second quarter of 2013. While we didn't achieve significant revenue growth, strong growth in operating margin improvement driven by new products allowed us to deliver 23% operating income growth.

As announced previously, we completed acquisition of Fusion Electronics in the third quarter. Fusion broadens our product portfolio generating additional synergies for our customers in both OEM and aftermarket applications.

We continue to face weak market conditions that are slowing the growth trajectory of our products. Long term, we believe there is upside potential for the industry and we will be well-positioned when the market improves.

Turning next to Outdoor, revenues declined 1% in the quarter compared to the strong performance in the second quarter of 2013. In addition, growth in operating margins declined in the quarter due to inventory reserves and increased advertising associated with our action cameras.

During the quarter, we introduced the Approach S6 for the golf enthusiast. This new golf watch delivers unique metrics and training features such as swing tempo and swing strength. We expect this product to be well-received by the golf community.

And finally on Outdoor, I want to mention that we are reducing our full year revenue guidance. This is the only segment in which we do not expect to meet or exceed our original forecast given at the beginning of the year. The change has been necessitated by slower than expected uptake of our VIRB action cameras. While our initial entry into the action camera market delivered less than we expected, we remain committed to growing our market share through advertising, improved retail presence and ongoing product innovation.

In the auto/mobile segment, revenues increased 2% in the quarter as PND volumes declined less than expected and were offset by amortization of previously deferred revenue and growing OEM revenues. In addition, gross and operating margins remain strong at 48% and 21% respectively, leading to a highly profitable segment in which we continue to build market share. As we've mentioned before, we expect the PND market to continue to decline at a rate of approximately 15% to 20% on a global basis, consistent with the guidance we issued at the beginning of the year. While we're not prepared to change this outlook, we are encouraged by market trends in some geographies. We will continue to manage the category appropriately to maximize long-term profits.

Finally, having passed halfway point for 2014, we're updating our full-year guidance. In light of our solid performance in the first half of the year, we are increasing our revenue range to $2.75 billion to $2.85 billion, representing full-year revenue growth in the mid- to high-single digits. We've raised our margin expectations for both gross and operating margins based on the targeted segment mix and leverage of operating expenses.

We also anticipate a reduction in our pro forma tax rate due primarily to a more favorable mix by tax jurisdiction. As a result, we are increasing our pro forma EPS guidance to $2.95 to $3.05 representing full-year growth in the mid-teens.

So, before wrapping up my comments, I want to note that this is Kevin's last conference call as the CFO of Garmin. We've communicated in the past that Doug Boessen will assume the CFO role tomorrow and Kevin will be onboard throughout the remainder of the year to assist with the transition. I want to thank Kevin again for all the many contributions he has made to Garmin over the years. All of our stakeholders, our customers, employees, our suppliers, and shareholders have been positively impacted by Kevin's contributions.

So, Kevin, we will miss you but we also wish you well as you move on to the next phase in your journey.

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

Kevin S. Rauckman, Chief Financial Officer & Treasurer

Well, thanks, Cliff and good morning, everyone. I'd like to begin by reviewing our financial results and move to summary comments on the balance sheet and then cash flow statement.

We posted revenue of $778 million for the quarter with pro forma net income of $200 million. Our pro forma EPS was $1.02 per share excluding the foreign currency loss. Our revenue represents an increase of 12%, year-over-year, as previously highlighted by Cliff.

Gross margin was strong at 57%, a 210-basis-point increase from prior year, driven by favorable segment mix and amortization of previously deferred revenues. Our operating margin was 28%, an increase of 370 basis points from the prior year. This is a result of the gross margin favorability of 210 basis points, as well as operating expense favorability of 160 basis points thought the total operating expenses increased by $12 million or 6%.

Our effective tax rate decreased to 12.8%, leading to pro forma EPS, which is adjusted for the foreign currency loss, of $1.02 per share, representing a 34% increase year-over-year. We shipped 3.8 million units during the quarter, up 6% from 3.6 million last year. And our total company average selling price was $203 per unit, up 6% from $192 in Q2 2013, driven primarily by segment mix and reduced revenue deferrals. Overall, our revenue and EPS performance exceeded expectations for the quarter.

Next, you can see how our second quarter revenue breaks down by segment. We experienced growth in four of our five segments with fitness and aviation leading the way.

I'd like to highlight the chart on this page which illustrates the auto/mobile segment representing 45% of our total revenues during Q2 2014 down from 50% in the prior year. Fitness grew to 19% of revenues in the current period compared to 12% of the prior year.

These charts illustrate our profitability mix by segment with our non-auto/mobile segments delivering 66% of our operating income in the quarter, up from 63% of the prior year. Looking next at year-over-year gross margin changes by segment are Auto/Mobile gross margin increase to 48% from 45% of the prior year due primarily to amortization of high margin deferred revenues.

In addition, we posted gross margin improvement in marine and aviation. Our marine margin improvement was primarily related to product mix shifting toward new products and increased ASP. Our aviation margin improvement was primarily due to increased software sales. And our fitness margin was stable at 65% in the quarter.

Outdoor gross margin declined to 61% driven primarily by inventory reserves. Our total operating margin improved to 28% due to the increased gross margin and revenue growth outpacing the 6% growth of operating expense, which I'll highlight next.

As previously mentioned, Q2 operating expense increased by $12 million or 6% on a year-over-year basis in Q2, while decreasing 160 basis points as a percentage of sales. R&D increased $2 million year-over-year while declining 120 basis points to 12.7% of sales. We continue to invest in innovation and grow our engineering workforce with increasing resources focused on compelling new aviation, fitness and outdoor products.

Our advertising spending increased to $5 million over the year ago quarter and represented 4.5% of sales, a 30-basis-point increase. The additional spending was focused in fitness and outdoor to support new product categories. And we will continue to manage operating expenses by segment to match the market opportunities presented by our diverse products. SG&A was up $4 million compared to the year-ago quarter, decreasing 80 basis points as a percent of sales to 11.9%. We continue to manage these costs to align with the changing dynamics of our business.

Next, moving to balance sheet and cash flow. We ended the quarter with cash and marketable securities of over $2.8 billion. Accounts receivable increased year-over-year and sequentially to $497 million due to our double-digit revenue growth. Our inventory balance decreased to $430 million on a sequential basis as we reduced the inventory slightly exiting the seasonally strong second quarter, yet we maintained inventory levels large enough to support key new product categories.

We continue to generate strong free cash flow across our businesses. Cash from operations was $164 million during Q2 and CapEx was $21 million. Our free cash flow generation was $143 million in the quarter. We also repurchased $129 million of company stocks during Q2 and still have $79 million authorized to repurchase for the remainder of 2014.

Our effective tax rate for Q2 2014 was 12.8% compared to 16.5% in Q2 of 2013. The decreased rate was primarily driven by favorable income mix, by taxing jurisdiction, partially offset by a reduced Taiwan tax incentives and the expired R&D credit. And we now expect our full year rate to be 15.2%.

And regarding restructuring, Cliff recently touched on our intention to move certain U.S. subsidiaries, out from underneath our Taiwan subsidiary. This restructuring will occur in the third quarter, resulting in cash tax payments of approximately $300 million over the next 12 months. We're performing this restructuring to allow for two primary benefits. First, it will allow us to repatriate some of our existing cash that's been permanently reinvested. Secondly, it will allow us to repatriate future US earnings to our Swiss parent at a rate that does not negatively affect our effective tax rate.

And finally, as Cliff mentioned, we're updating our full year 2014 guidance given current trends across our segments. Cliff reviewed the total company guidance, so here we provide additional detail on revenue by segment. At a high level, we have increased our expectations for automobile and fitness, while outdoor expectations have been reduced, and marine and aviation are unchanged.

The improvement in auto/mobile is a result of better than expected industry volumes in the first half as well as improved auto OEM revenues. Fitness revenue guidance is being raised due to the continued strength we are seeing across our product portfolio, but particularly with the vívofit activity tracker. Offsetting these positive trends we have reduced our outdoor forecast due primarily to VIRB underperforming our expectations to-date.

This concludes our formal remarks.