MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the Garmin Limited Third Quarter 2013 Earnings Conference Call. Today's call is being recorded. And 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 third quarter 2013 earnings call. Please note that the earnings press release and the related slides are available at Garmin's Investor Relations site on the Internet. An archive of the webcast and a related transcript will also be available shortly after the call.

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, or future demand for our products 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 specific risk factors is contained in our Form 10-K for the year ended December 30, 2012, which is filed with the SEC.

Presenting on behalf of Garmin this morning are Cliff Pemble, President and CEO; and Kevin Rauckman, Chief Financial Officer and Treasurer.

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

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

Thank you, Kerri, and good morning, everyone. As announced earlier this morning, Garmin reported strong third quarter revenue and margin performance with revenue growth in fitness, marine and aviation largely offsetting declining revenues in PND. Consolidated revenues decreased 4% year-over-year. However, our non-automobile market segments grew 12% on a combined basis contributing 50% of the total revenue and 65% of the operating profit in the third quarter.

Gross margins improved year-over-year to 55% from 53% in 2012, as deferred revenue was less of a headwind and segment mix improved slightly.

Operating margins were 24%, consistent with the prior year as gross margin improvement was offset by growing research and development spending. These strong results allowed us to generate $205 million of free cash flow in the quarter and raise our EPS guidance for the full year. Kevin will discuss our financial results in greater detail in a few minutes.

But next, I'll walk through a review of our results segment-by-segment. Starting first with outdoor, revenues declined 4% as we faced a much stronger comparable in third quarter of 2012. Gross and operating margins remain very strong in the segment at 69% and 44% respectively.

During the quarter, we announced our entry into the action camera market with the VIRB and VIRB Elite. This new family of products delivers industry leading features to the action camera market, including sunlight readable color displays, GPS location awareness, extended battery life, integration with our broad range of fitness sensors and ability to control the camera via other Garmin devices.

We believe VIRB will be a catalyst for growth within the segment in 2014 and look forward to participating in this exciting new market. In the fourth quarter, we do not expect a significant change in revenue trajectory due to the late season launch of VIRB and due to the strong results in fourth quarter of 2012, when the segment delivered almost $120 million of revenue.

Turning next to the Fitness segment, revenue grew 25% on a year-over-year basis as our entire portfolio of products sold well in the summer season. Deliveries of Vector accelerated our cycling category contributing to the strong results in the segment. We delivered gross and operating margins of 61% and 33% respectively, and operating income grew 25% in the quarter.

We introduced a number of new products in the quarter, including the Forerunner 220 and 620. These watches deliver new features that have captured significant customer interest, including a high resolution and sunlight readable color display and real-time tracking through wireless connectivity with a smartphone. In addition, the Forerunner 620 offers an intuitive touch screen user interface and innovative running dynamics measurements that give runners powerful new tools to improve their performance. The form factor of the 220 and 620 establishes the new standard for running watches as they are lighter, thinner and more comfortable to wear for both running and everyday use.

In the cycling market, we launched the Edge Touring designed for casual and commuter cyclists, which is our first product line specifically targeting this growing subset of the cycling community.

Looking at 2014, we anticipate entering new adjacent markets and we will continue to make investments that position us for long-term growth opportunities.

In aviation, we experienced another quarter of strong revenue growth of 15% with both OEM and aftermarket product categories contributing to the improvement. Operating income grew 37% in the quarter, ahead of revenue growth due to the improvement in both gross and operating margins.

I'm very pleased to note Garmin received the AIN Avionics Support award for the 10th consecutive year during the quarter. I congratulate our aviation team on this amazing accomplishment and thank them for the passion and dedication to being the best. Outstanding customer supports, combined with superior products are key differentiators as we compete for new opportunities.

We've made significant progress in finalizing deliverables required for avionic certification on the Learjet and Cessna platforms. We are actively supporting our OEM partners, as they work to complete their respective aircraft certifications.

While our near-term results have been positive, the aviation market remains challenging and this has been further intensified by shutdown related furloughs at the FAA, causing short-term delays in certifications, field approvals and shipments. While this may create headwinds in the fourth quarter, we continue to believe in our long-term growth story in this segment.

Revenue in the marine segment grew 24% in the quarter, as we experienced stronger than expected demand across our range of new and existing products. While the segment was profitable in the third quarter, the margin structure remains challenged due to the product mix and the competitive pricing environment of the market. As we approach the winter months, we are already anticipating the beginning of the 2014 marine season. We have a full lineup of new products that will be announced in the coming weeks and delivered in time for the upcoming boating season. We are confident that an intensive focus on superior new products and innovation will lead to improved market share and profitability in this segment.

In our automobile segment, revenues were down 16% in the quarter with PND unit volumes declining at a global rate of approximately 20%, which is in line with our expectations. This decline was partially offset by growth in our OEM and mobile categories as well as the amortization of previously deferred revenues. The segment remains highly profitable with gross and operating margins or 46% and 17% respectively.

As we've previously mentioned, we expect the PND market to decline approximately 20% on a global basis. While the PND market development has been, and continues to be, a significant headwind, we feel confident with our execution in 2013, and we will continue to carefully manage the business going forward.

As a final note in the auto/mobile segment, OEM opportunities have been slow to develop, which is the nature of the automotive business. We remain optimistic as Garmin navigation begins to play a significant role in the 2014 Mercedes-Benz lineup, and we continued to pursue new opportunities for our software and hardware solutions.

Finally, as stated in our press release, we are updating our guidance for 2013. Due to our strong performance in the third quarter, we now anticipate pro forma EPS of $2.40 to $2.45 with improved gross and operating margins slightly offset by a higher anticipated tax rate. The PND market will continue to create headwinds for our top and bottom line. However, these headwinds will be partially offset by growth across our non auto/mobile market segments.

This concludes my remarks, and Kevin will walk through our Q3 financials in more detail. Kevin?

Kevin S. Rauckman, Chief Financial Officer & Treasurer

Thanks, Cliff and good morning, everyone. I'd like to begin by reviewing our income statement and segment results, then move to summary comments on the balance sheet, cash flow, taxes, and guidance.

We posted revenue of $644 million for the quarter with pro forma net income of $136 million. Our pro forma EPS was $0.69 per share excluding foreign currency loss, and a $52 million tax adjustment that I will discuss later. Our revenue represents a decrease of 4% year-over-year. Gross margin came in at 55%, a 140 basis point increase from the prior year, driven by segment mix and reduced impact from deferred revenues.

Our operating margin was 24%, down only 20 basis points from the prior year. The components were gross margin favorable by 140 basis points, and an unfavorable operating expense impact of 160 basis points. Total operating expenses increased by $2 million in the current quarter with reduced spending in advertising, offset by a $6 million increase in R&D. Each of the operating expense categories will be discussed in detail on a later slide.

Our pro forma EPS which is adjusted for the foreign currency loss and a tax adjustment was $0.69, representing a 7% decrease year-over-year. We shipped 3.3 million units during the quarter, which represents a 12% decrease year-over-year and our total company average selling price was $197 per unit, up from $182 in Q3 of 2012, driven primarily by segment mix and the amortization of previously deferred revenue.

Cliff has summarized revenue changes by segment, however, I would like to briefly highlight the chart on this page which illustrates the automobile segment representing 49% of our total revenue during Q3, as fitness, marine and aviation grew during the quarter.

Looking at profitability by segment, our non-automobile segments delivered 65% of operating income in the quarter, an increase from 59% in Q3 of 2012. Fitness and aviation, each contributed an increasing proportion of total operating profit in Q3 due to revenue growth.

I would like to briefly discuss year-over-year gross margin changes by segment. Total corporate gross margin increased by 140 basis points in the quarter, driven by improved margins in automobile and in aviation. The automobile gross margin increased to 46% from 43% in the prior year due primarily to amortization of previously deferred high margin revenues.

Marine and fitness gross margins declined in the current quarter due to product mix and pricing dynamics during the quarter. And our total corporate operating margin was steady at 24% with the increased gross margin offset by increased R&D spending of $6 million.

Looking briefly at year-to-date metrics, revenue contribution for 2013 is shifting toward our growth segments with aviation, fitness, and marine, each growing in contribution. And a similar shift is occurring in operating income as well, with 67% of our year-to-date operating income coming from our non-automobile segments.

As previously mentioned, Q3 operating expenses increased by $2 million on a year-over-year basis from $199 million in Q3 of 2012 to $201 million in Q3 of 2013, while increasing 170 basis points as a percent of sales.

R&D was the only expense category that increased with a $6 million year-over-year impact, and this represented a 150 basis point impact as R&D increased to 14% of sales. We continue to invest in innovation and grow our engineering workforce with a heavy emphasis on aviation.

Our advertising spend decreased $4 million over the year-ago quarter and decreased 40 basis points as a percent of sales to 4% in Q3 2013. Much of the decrease was related to declining volumes in PND as well as reduced promotional activity in fitness. We will continue to scale our advertising expense to match our revenue trends.

SG&A was flat compared to the year ago quarter increasing 60 basis points as a percent of sales to 13%. We are working diligently to manage these costs as our PND market declines.

We ended the quarter with cash and marketable securities of nearly $2.8 billion. Accounts receivable decreased sequentially to $476 million due to declining sales in the quarter. Accounts receivable accounted for 66 days of sales compared to 66 days of sales in the second quarter and 55 days of sales in the third quarter of 2012. Our inventory balance increased to $417 million on a sequential basis at the close of third quarter in preparation for the stronger holiday quarter. And our days of inventory were 124 days compared to 116 days in the second quarter of 2013, and 125 days in third quarter of 2012.

We continue to generate strong free cash flow across our business as cash from operations was $217 million during Q3. CapEx spending was $12 million during the third quarter. Therefore, we generated free cash flow of $205 million during Q3.

Our year-to-date free cash flow in on plan at $439 million. We didn't pay a dividend in the third quarter due to the timing of our fiscal versus calendar quarter. We will pay four quarterly installments in the 2013 fiscal year with three paid in the first half and a fourth dividend payment in the fourth quarter. And we repurchased $14 million of company stock and have $273 million still authorized through December of 2014.

And a few more items to discuss relative to our Q3 announcement. Our pro forma effective tax rate for Q3 of 2013 was 15.7% compared to 13.7% in Q3 of 2012. The increased rate was primarily driven by an unfavorable change in income mix by taxing jurisdiction and reduced tax holidays in Taiwan.

We did have a significant reserve release of $52 million in the quarter, which drove our GAAP effective tax rate negative. This represents expiration in the statute of limitations for uncertain tax reserves. We now expect our full year pro forma tax rate to be 16%, an increase from 13.1% in 2012 due to the geographic mix of income.

Finally, as Cliff previously discussed, we've updated our 2013 pro forma EPS guidance to be $2.40 to $2.45. Our current revenue forecast does anticipate that automobile will continue to be less than 50% for our total revenue in 2013.

This concludes our formal remarks.