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GRMN - Q3 2015 Garmin Ltd Earnings Call

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OVERVIEW:

Co. reported 3Q15 revenue of $680m and pro forma net income of $97m and pro forma EPS of $0.51. Expects 2015 revenues to be approx. $2.8b and pro forma EPS to be approx. $2.25.

CORPORATE PARTICIPANTS

Teri Seck *Garmin Ltd. - Manager of IR*

Cliff Pemble *Garmin Ltd. - President & CEO*

Doug Boessen *Garmin Ltd. - CFO & Treasurer*

CONFERENCE CALL PARTICIPANTS

James Faucette *Morgan Stanley - Analyst*

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Garmin third quarter conference call.

(Operator Instructions)

As a reminder, today's program may be recorded. I would now like to introduce your host for today's program, [Teri Seck] Manager of Investor Relations. Please go ahead.

Teri Seck - ***Garmin Ltd. - Manager of IR***

Good morning. We would like to welcome to you Garmin Limited's third-quarter 2015 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/star. An archive of the webcast and relayed transcript will also be available on our website.

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 shares, product introduction, future demand for our product 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 which is filed with the Securities and Exchange Commission.

Presenting on behalf of Garmin Limited 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.

Cliff Pemble - ***Garmin Ltd. - President & CEO***

Thank you, Teri, and good morning, everyone. As previously announced, Garmin third quarter revenue decreased 4% year over year. Aviation, Fitness, Marine, and Outdoor contributed 61% of total revenues and 75% of the operating profit in the third quarter. We continue to see our revenue base diversify broadly across our business segments.

Gross margin was 53%, and operating margin came in at 18.5%. The reduction in margins from the prior year reflects a combination of factors, including downward pressure from unfavorable currency movements, a more competitive pricing environment, particularly in the fitness market, and continued investments in advertising and R&D. These factors, combined with a higher effective tax rate, resulted in pro forma EPS of $0.51 in the quarter.

Throughout the year we have highlighted that the strong US dollar created revenue headwinds in geographies with weaker currencies. In contrast, unit deliveries are up 4% for the quarter and 10% for the year, due to the contribution from growth segments. While our primary yardstick is financial performance, we are encouraged by the underlying trends reflected in unit growth.

Doug will discuss our financial results in greater detail in a few minutes, but first I'll provide a few comments on each business segment. Beginning with the Fitness segment, revenue grew 23% on a year-over-year basis, with the sequential acceleration driven by strength in activity trackers, multisport, and cycling products.

It's interesting to note that currency headwinds disproportionately impact the Fitness segment due to the geographical revenue mix. These headwinds have softened revenue growth while unit deliveries have remained strong. We believe this indicates that the underlying business case remains sound.

Gross and operating margins were 54% and 19% respectively. Gross margin was impacted by unfavorable currency movements and competitive dynamics in the market. Operating margin was impacted by increased spending in R&D and global advertising. We believe these investments are strategically important in order to maximize the opportunity in this high-growth segment.

We recently introduced a new family of Forerunner products which includes three models. The Forerunner 230, 235, and 630. Notably the Forerunner 235 is our first wearable to incorporate Garmin Elevate technology. Garmin Elevate is a wrist-based heart rate sensor we specifically developed to serve a broad range of use cases from all-day heart-rate tracking to intense workouts. All of the new Forerunners are compatible with our Connect IQ application framework enabling users to personalize their watches with a host of interesting watch faces, custom data fields, and useful applications developed by third parties. We also recently introduced an exciting new activity tracker called vivosmart HR, which also features Garmin Elevate technology for all-day heart-rate tracking and activity intensity monitoring. Garmin Elevate technology, combined with an always-on-display and smart notifications make the Vivosmart HR one of the most capable activity trackers available on the market.

To support these products and many others, we have released a major update of Garmin Connect mobile. This update features a completely new user interface, making it easy to view important activity information at a glance and providing even more customizations to fit individual needs. All of these new products are shipping now, and we will soon launch a major new advertising campaign to support sales during the upcoming holiday shopping season.

Looking at Outdoor, revenue declined 5% year over year as the revenue mix shifted to geographies with weaker currencies. Gross and operating margins were stable sequentially but declined year-over-year driven primarily by currency weakness and product mix. The fenix 3 has been an exciting success story this year. During the quarter we expanded the available choices for fenix 3 with new color and material options in time for the holiday shopping season.

Turning next to Aviation, revenue declined 5% as the industry has been impacted by lower oil prices and stock market volatility. Gross and operating margins remain strong at 74% and 25% respectively, though operating margin declined on a year-over-year basis due to R&D growth supporting future revenue opportunities. While the industry slowdown is disappointing, we remain confident in our improving position in the business jet category and look forward to completing development and certification of additional aircraft platforms as previously announced. We remain confident in our market position and the opportunities for long-term growth.

Looking next at Marine, revenue was flat in the third quarter as the boating season ended and we passed the first anniversary of the July 2014 acquisition of Fusion. Gross and operating margins improved as the mix shifted to new products with higher margin profiles. Our investment in innovation has resulted in increased market share and industrywide recognition.

Garmin was recently honored as a manufacturer of the year by the National Marine Electronics Association. We also won four product-specific awards in the auto pilot, multifunction display, and smartphone applications categories. We intend to build on this momentum in the coming year with additional innovation and market share gains.

In the Auto segment, revenues were down 14% in the quarter, driven by the secular decline of the PND market as expected. However, our worldwide market share remains stable and strong. The PND market is an important part of our business, and we remain focused on delivering a superior in-vehicle experience.

The most recent example is babyCam, which was announced earlier this month. BabyCam is a backseat monitoring system that streams wireless video to compatible Garmin PNDs. This system provides front seat passengers the ability to safely monitor the wellbeing of other passengers or cargo at a glance.

As previously announced, we have updated our full-year guidance and now anticipate revenues of approximately $2.8 billion, which includes approximately $185 million of negative currency impact due to the stronger US dollar. Our revenue outlook has been adjusted in Fitness, Outdoor, and Aviation, which are the segments most impacted by the economic and competitive factors mentioned previously. We expect gross margin to be approximately 53.5%, down slightly from previous guidance due to unfavorable geographic revenue mix and competitive pricing dynamics in the fitness segment. Due to the revenue and gross margin revisions, we now expect operating margin to be approximately 18.5%.

Finally, we anticipate pro forma EPS of approximately $2.25, which also reflects a higher anticipated tax rate for the full year. While it's disappointing to revise our guidance, we believe that the underlying business trends remain positive and our investments in R&D and advertising will create long-term opportunities.

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

Doug Boessen *- Garmin Ltd. - CFO & Treasurer*

Thanks, Cliff. Good morning, everyone. I would like to briefly review our financial results, then move to summary comments from the balance sheet and cash flow statement. We posted revenue of $680 million for the quarter, pro forma net income of $97 million. Pro forma EPS was $0.51 per share.

During the quarter we faced significant exposure to foreign currency fluctuations which resulted in a revenue headwind of $52 million or 7% of revenue. Gross margin declined to 53%, a 310-basis point decrease from prior year. Operating margin was 18.5%, a 640-basis point decrease from the prior year.

Finally, effective tax rate increased to 27.7% in the current quarter compared to a pro forma rate of 21% in the prior year. This created earnings pressure of $0.05 per share. We will discuss gross margin, operating expenses, and effective tax rate in more detail later.

Next, we will look at third quarter revenue by segment. The Auto segment represented 39% of our total Q3 2015 revenue compared to 44% in the third quarter 2014. We continue to diversify revenue base with Fitness increasing to 21% of our total Q3 2015 revenue.

Next, I would like to discuss gross margin. This decreased to 53.3%, driven largely by the currency headwind which reduced revenue by $52 million on a constant currency basis, as well as pricing dynamics in the Fitness segment. Total corporate operating margin was 18.5%, due to gross margin pressure and increased R&D investment.

Looking next at operating expenses, third-quarter operating expense increased by $14 million or 6%. This is a 330-basis-point increase as a percent of sales. Research and development increased $7 million year-over-year, or 150 basis points, to 15.6% of sales. We continue to invest in innovation, increasing resources focused primarily on Aviation, Fitness, and Outdoor where we see long-term growth opportunities.

Our advertising expense increased $4 million over the prior-year quarter and represented 5.4% of sales, a 70-basis-point increase. Additional spending was focused on Fitness with investments in media, point of sale presence with key retailers and cooperative advertising. SG&A was up $3 million compared to the prior quarter, increasing 100 basis points to percent of sales of 13.8%. Increased spending was driven primarily by IT expenses and product support costs as our customer base continues to grow rapidly.

Just a few quick highlights on the balance sheet and cash flow statement. We ended the quarter with cash and marketable securities of over $2.4 billion. Accounts receivable decreased both sequentially and year over year to $432 million. Our inventory balance increased to $503 million as we prepare for the fourth quarter and launch a number of new products simultaneously.

During the third quarter of 2015 we generated free cash flow of $124 million. Also in the quarter, we paid dividends of $97 million, repurchased $51 million of Company stock, with $192 million remaining for purchase through December 2016.

Finally, as I mentioned previously, our effective tax rate increased to 27.7% in the current quarter compared to a pro forma rate of 21% in the third quarter of 2014. Increased tax rate was primarily a result of forecasted income mix by tax jurisdiction, which is negatively impacted by the overall reduction in forecasted taxable income, and resulting catch-up expense for the first half of 2015. Our full-year effective tax rate is now expected to be approximately 21.5% due to the change in income mix by tax jurisdiction. Consistent with last year, the full-year effective tax rate forecast assumes the passage of the R&D tax credit.