Brunswick Earnings Conference Call Q1, 2014 – April 24, 2014

Bruce Byots – Vice President, Corporate and Investor Relations

Good morning, and thank you for joining us. On the call this morning is Dusty McCoy, Brunswick's Chairman and CEO, and Bill Metzger, CFO.

Before we begin with our prepared remarks, I would like to remind everyone that during this call our comments will include certain forward-looking statements about future results. Please keep in mind that our actual results could differ materially from these expectations.

For the details on the factors to consider, please refer to our recent SEC filings and today's press release. All of these documents are available on our website at Brunswick.com.

During our presentation today, we are using certain non-GAAP financial information. Reconciliations of GAAP to non-GAAP financial measures are provided in this presentation, as well as in the supplemental information sections of the consolidated financial statements accompanying today's release.

I would also like to remind you that the figures in this presentation reflect continuing operations only, unless otherwise noted.

I would now like to turn the call over to Dusty.

Dusty McCoy – Chairman and CEO

Thank you, Bruce and good morning everyone. I'll start with an overview of our first quarter results.

As we pre-announced on April 8, revenue in the quarter decreased 3 percent. We experienced growth in fitness equipment and outboard boats, which was more than offset by declines in outboard and sterndrive engines, fiberglass sterndrive/inboard boats and in our bowling and billiards businesses. It is our view that harsh weather conditions throughout the quarter had an adverse effect on our marine and bowling segments. Bill will provide more color on these trends in his remarks.

Our gross margin increased by 110 basis points compared to the prior year. This outstanding improvement was largely driven by our fitness and boat segments. We do not, however, anticipate this trend in consolidated gross margin to continue in the second quarter. We will explain why later in the call.

Operating expenses increased by 2 percent, including an 8 percent increase in R&D expenses, as we continue to invest in numerous strategic initiatives. If we exclude a $5.5 million gain on sale of real estate in 2013, operating expenses were down by one percent compared to 2013.

Adjusted operating earnings decreased by one percent versus prior year.

Continuing down the P&L, net interest expense was reduced by $5.7 million, reflecting our prior year debt reduction activities, which were enabled by our strong free cash flow performance.

Adjusted pretax earnings increased by 6 percent, and diluted EPS, as adjusted, decreased by $0.16 to $0.60. If we apply our 2014 tax rate and shares outstanding to our 2013 results, EPS, as adjusted, would be up slightly.

Our Life Fitness segment reported strong top-line improvement of 6 percent in the quarter, while our combined Marine and Bowling & Billiards segments declined by 4 percent.

From a geographic perspective, consolidated U.S. sales decreased by 2 percent.

Sales to Europe increased by 1 percent, which includes a slight favorable impact from foreign currency.

Rest-of-World sales declined by 6 percent versus the prior year period, with foreign currency accounting for more than one-half of the decline.

Adjusted operating earnings were $94.7 million for the quarter, a decrease of 800 thousand dollars compared to 2013.

Operating margins, excluding charges, increased by 20 basis points to 9.8 percent.

The increase in our operating margin includes the impact of an expansion in gross margin, partially offset by the increase in operating expenses.

We are forecasting that operating expenses will increase in the second quarter as we fund various strategic initiatives, with a meaningful portion related to second-half product launches. I will discuss a few of our new product introductions in my concluding remarks.

Given our relatively flat adjusted operating earnings performance, combined with lower net interest expense, adjusted pretax earnings increased by approximately $5 million, or 6 percent.

Net earnings for the quarter equaled $0.60 per share on both a GAAP and an adjusted basis.

This compares to net earnings, as adjusted, of $0.76 per share in the prior year. As a reminder, our current EPS reflects a significant increase in our effective book tax rate.

Now, I'll turn the call over to Bill for a closer look at our segment results and financials.

Bill Metzger – CFO

Thanks Dusty. I'll start with the Marine Engine segment, where sales were down by 3 percent in the quarter. From a geographic perspective, sales to the U.S. markets were down 5 percent, reflecting a slight increase in parts and accessories, which was more than offset by lower engine revenues.

Sales to Mercury's European customers decreased 1 percent as growth in parts and accessories and diesel sterndrive/inboard engines was more than offset by a decrease in outboard engines.

Rest-of-World sales decreased 6 percent, reflecting an increase in diesel sterndrive/inboard engines, which was more than offset by lower outboard engines and parts and accessories. Currency also had an unfavorable impact on Rest-of-World sales during the quarter.

On a product category basis, our outboard engine business reported sales declines in most major markets in the first quarter of 2014.

I should point out, that system-wide outboard inventory levels entering 2014, along with backlogs, were much better aligned with anticipated market demand than in 2013, which also contributed to the year-over-year wholesale demand dollar declines.

Our outlook for the outboard engine business continues to reflect favorable retail demand in most markets and boat categories.

Sterndrive engine sales continued to be affected by unfavorable global retail demand trends. We are realizing some modest diesel engine growth, particularly in international markets, as we pursue our objective of expanding our presence in this market.

We believe harsh weather conditions in many North American markets were a major contributor to the decrease in engine sales.

Sales for Mercury's parts and accessories businesses were flat compared to the prior year, with growth in both Europe and the U.S., offset by declines in Rest-of-World.

Revenue benefited from new product launches and market share gains.

The product launches included new MotorGuide trolling motor products, and Land 'N' Sea continued to grow market share through service delivery improvements, rapid product availability, broader product offerings and some additional new products.

Weather was also a negative factor for these businesses in many North American markets, causing early seasonal activity to be below normal patterns.

Mercury's operating earnings declined compared to last year's first quarter and operating margins were at 12.2 percent, 150 basis points lower than the prior year quarter.

Lower operating earnings resulted from the absence of a $5.5 million gain on the sale of real estate that occurred in Q1, 2013, the decline in sales and increased spending on growth initiatives.

In our Boat segment, first quarter revenues decreased by 2 percent.

In the U.S., which comprises about two-thirds of the segment, sales declined by 4 percent. This included continued sales growth in our outboard boats. However, these gains were more than offset by reductions in fiberglass sterndrive/inboard boats.

In the quarter, our European sales increased by approximately $9 million, or 38 percent versus the prior year. This performance resulted from improvements in our European outboard brands, as well as gains in our U.S. fiberglass brands.

Rest-of-World sales decreased by 11 percent, which reflected lower sales in all major markets and the unfavorable impact of currency.

Once again, we believe harsh weather conditions in many North American markets were a major contributor to the decrease in segment sales.

Before we discuss U.S. Powerboat Industry statistics, let's briefly review some weather trends that were influencing retail sales activity in the first quarter.

As these charts clearly depict, colder-than-normal conditions affected the eastern two thirds of the U.S. in 2014, and were more widespread than 2013, which was also a difficult year.

Looking at data for the top 20 boating states provides some additional insights into the impact of the weather. First, states that experienced average temperatures of more than 5 degrees colder than normal, reported on average double-digit declines at retail and second, states having more favorable conditions, for the most part, reported results that were more consistent with our full-year expectations. For example, Florida and Texas reported first quarter increases of 9 and 4 percent, respectively.

I would also like to point out that a number of upper Midwestern states included in this summary have NOT fully reported their first quarter sales, including Minnesota, Wisconsin and Illinois.

Weather conditions have continued to be adverse in certain key boating states and may consequently affect April retail comparisons as well.

At this early point in the marine season, we believe that retail sales could be deferred to later months.

As you can see from the preliminary SSI data, retail demand for the first quarters of both 2013 and 2014 was weak, and not consistent with prior quarterly trends.

Fiberglass outboard boat markets continue to demonstrate solid growth, while the aluminum category - - the most vulnerable to cold and ice - - was down modestly.

The fiberglass sterndrive/inboard boat category also declined in the quarter. This decline most likely reflects the weather's impact, but also continues to be challenged by ongoing economic headwinds and consumer shifts to other boat types - - factors that we have been discussing with you over the past few years.

The NMMA will soon be releasing their final 2013 U.S. retail powerboat market data. Our estimate reflects that the U.S. market grew by approximately 3 1/2 percent in 2013, and totaled 158,100 units.

Brunswick's global retail unit sales were flat in the first quarter versus prior year.

Our global wholesale unit shipments decreased by 4 percent. This compares to the Boat group sales decline of 2 percent, as the segment benefited from a higher average selling price.

Regarding our pipelines, dealers ended the quarter with 40 weeks of boats-on-hand on a trailing 12-month retail basis, which is comparable to the prior year level.

Pipelines for aluminum and fiberglass outboard products are up compared to the last year, while fiberglass sterndrive/inboard pipelines are down versus the prior year.

Our current pipeline levels are consistent with our annual growth expectations in the various boat categories and we continue to be comfortable with these overall levels.

The Boat segment's first quarter adjusted operating earnings improved by $1.1 million, when compared to the prior year.

This improvement resulted from a higher gross margin, which included benefits from cost reduction actions - - including plant consolidation activities initiated in 2012 and 2013 - - and improved net operating efficiencies. Partially offsetting these factors were lower sales and increased investment spending, primarily related to the introduction of new models.

Now let's turn our attention to our two recreational segments.

Sales at Life Fitness increased by 6 percent resulting from strong growth in the U.S. to health clubs, local and federal governments and hospitality customers.

Partially offsetting the U.S. growth was slightly lower international sales, including an unfavorable impact of currency in Rest-of-World markets.

We anticipate new products to benefit sales in all markets over the next several quarters.

Segment operating earnings in the quarter increased by approximately $5 million.

This strong earnings performance reflected higher sales and improved gross margin, which included favorable warranty expense comparisons, partially offset by the absence of a favorable prior year insurance settlement. Continued increases in investment in growth initiatives also negatively affected year-over-year comparisons.

Sales for our Bowling & Billiards business decreased by 8 percent.

Revenues declined in each major business category, with weather being a negative factor in many regions for our retail bowling centers.

As a reminder, our bowling organization completed the divestiture of its European bowling center portfolio in the second half of 2013. Excluding the impact of this divesture, the segment's sales were down 3 percent.

Operating earnings in the quarter decreased by about $2 million, reflecting declines in sales and operating inefficiencies, including higher utility expenses.

Foreign currency had a slight net unfavorable impact on total consolidated sales, however, Rest-of-World sales were unfavorably affected to a greater degree in our Marine Engine, Fitness and Boat segments.

Foreign currency had a minimal net favorable impact on operating earnings comparisons for the quarter, reflecting a mix of favorable and unfavorable exchange rate movements, including the impact of hedging activity.

For the full-year 2014 versus 2013 comparisons, we currently estimate that exchange rates will have a slight net unfavorable impact on sales and operating earnings. This assumes that rates remain consistent with current levels for the remainder of the year.

Now, I would like to provide some brief comments on our tax provision:

Our effective book tax rate, on an adjusted basis, was 34.3 percent. This rate excludes the tax impact of any non-recurring special tax adjustments.

Our anticipated full-year effective book tax rate for 2014, as adjusted, continues to be approximately 34 percent. We are, however, lowering our estimated effective cash tax rate to a low double digit percent level due to a revised assumption on our domestic tax liabilities.

I also would like to note that our effective book tax rates for 2014 exclude any potential benefit from an extension of the U.S. R&D tax credit.

Turning to a review of our cash flow statement. Cash used for operating activities was $108.2 million, an increase of $14.4 million versus the prior year.

Normal seasonal changes in balances, combined with the impact of lower than expected demand for our marine products, resulted in a use of cash in our primary working capital accounts and totaled approximately $210 million. The biggest changes occurred in:

- Accounts and notes receivable, which increased by $111 million,
- Inventory increased by $81 million,
- Accrued expenses decreased by $84 million, and
- Accounts payable increased by $68 million.

Given the seasonality of sales in our marine businesses, we anticipate the liquidation of working capital over the balance of the year.

Total free cash flow amounted to a negative $130 million versus approximately $109 million in the prior year, a difference of $21 million.

Capital spending in the quarter was approximately $22 million, which included investments in new products in all businesses, along with capacity expansion projects.

Our business units continue to remain focused on generating strong free cash flow, which will allow us to continue to fund future investments in growth.

Cash and marketable securities totaled $227 million at the end of the quarter. The decline from year-end 2013 reflects the seasonal free cash flow usage of $130 million, as well as our quarterly dividend payment of $9 million.

Let me conclude with some comments on certain items that will impact our P&L and cash flow for 2014.

Our estimate for depreciation and amortization is approximately $95 million to $100 million.

We expect our 2014 pension expense to be approximately $15 million, which is a decrease of $4 million from 2013.

Net interest expense is expected to be in the range of $30 million to $32 million, a decrease of $10 million to $12 million for the year.

We anticipate that our restructuring charges will be nominal in 2014 - - relating to activities initiated in 2013.

And, we expect our diluted shares outstanding to be approximately 95 million to 96 million.

As you can see, all of these items are unchanged from our previous outlook statements.

On the cash flow side, the Company plans to make cash contributions to its qualified defined benefit pension plans of approximately $50 million in 2014.

Our working capital performance in 2014 will primarily be a function of our revenue assumptions. Our current plan anticipates working capital changes to result in a usage of cash in the range of $40 million to $60 million.

Our plan continues to reflect capital expenditures that approximate 4 percent of projected sales, with a substantial portion directed at growth and profit enhancing projects.

Despite higher investment spending levels and a modest usage of cash for working capital, we plan to generate strong free cash flow for the full-year in the range of $165 million to $190 million. This represents an increase from our previous guidance due to a lower estimate of tax payments.

I will now turn the call back to Dusty to continue our outlook comments.

Dusty McCoy – Chairman and CEO

Thanks, Bill. As we stated in our earnings release, weather conditions in certain marine markets have masked the underlying consumer demand for our boat and engine products. However, at this very early point in the marine season, our operating plans for the full-year remain fairly consistent with the planning assumptions we communicated at the outset of the year.

We continue to target 2014 to be another year of strong earnings growth with outstanding cash flow generation.

Our plan reflects 5 to 6 percent sales growth, which is supported by our increasing investment in growth initiatives and by the continuation of the solid growth demonstrated in 2013.

We continue to anticipate a solid improvement in gross margin levels.

Our organic growth platform will continue to benefit from increased investments in capital projects and research and development programs, along with the SG&A to support them. As a result of these ongoing initiatives, full-year operating expenses will increase, but as a percentage of sales, are expected to be slightly lower than 2013 levels - - approximately in the range of 17.3 percent to 17.6 percent.

As a result, our adjusted operating and pretax earnings should continue to demonstrate strong double-digit growth rates. Further, we expect our adjusted diluted earnings per common share to be in the range of $2.40 to $2.55, which would translate to a 20 percent to 28 percent growth rate, assuming a 34 percent tax rate applied to 2013 earnings.

Regarding our outlook for the second quarter, assuming weather conditions in May and June are more normal, we are anticipating solid top-line growth in our marine segments, as well as in our fitness segments. The bowling and billiards' performance is expected to be comparable to 2013.

However, we do anticipate some near-term pressures on our gross and operating margins.

Specifically, we expect our second quarter gross margin to be slightly lower than we reported in the prior year. In addition, Q2 planned operating expenses reflect low-teens percent growth, as we fund various strategic initiatives during the quarter, particularly in connection with new product launches. The second quarter operating expense growth represents a significant portion of our planned annual increase in operating expenses.

We will continue to benefit from lower interest expenses and, therefore, we estimate a slight increase in our adjusted pretax earnings.

As we look at our 2014 first half, our operating earnings will be down slightly compared with 2013's first-half. Thus, our view of the 2014 results reflects strong second-half growth in sales driven by an extensive array of new products along with year-over-year improvements in gross margin and more normal operating expense trends.

This slide we have up now gives you an example of some of the new products in our Marine businesses that we have introduced or will be launching in the upcoming quarters.

At the recent Boat shows, Sea Ray introduced at top left, a new product in the large boat category, the 650 Fly, which debuted in Miami. This is the first of Sea Ray's new L-Class family of yachts. The L-Class family marries style and substance as only Sea Ray can, and will change the way boaters look at luxury.

As we continue clockwise on the chart, Sea Ray also introduced its new 510 Flybridge, which has expanded Sea Ray's re-entry into large motoryachts.

At the bottom right is the popular new 350 SLX bowrider, which was also in Miami. Demand is already substantially higher than what we originally expected for 2014.

And Mercury's outboard product line will continue to be comprehensively upgraded with new, more cost-efficient architectures and product-refresh programs.

New products entering the marketplace from Life Fitness include, beginning at the top left on this chart, the company's first in its history, step climber. Another addition to the Elevation Series – and also available in Life Fitness Integrity Series – the PowerMill Climber uses proven Life Fitness technology to create a powerhouse, perfect for high-intensity, low-impact training.

Continuing clockwise on the chart, available in summer 2014, Insignia Series weight system will replace the successful Life Fitness Signature Series selectorized line with a new look, improved feel and enhanced features.

At the bottom right, Hammer Strength Select features a 22-piece line of selectorized equipment with new technology integrations enabling exercisers to tailor the equipment experience to suit their needs.

And finally, bottom left, SYNRGY BlueSky is an extension of the groundbreaking SYNRGY360, and is Life Fitness' first small training system designed specifically for outdoor use.

The full-year financial targets in our four operating segments remain largely unchanged. Our overall plan is based on full-year revenue and operating earnings growth in our Marine Engine segment.

Specifically, we are planning for full-year revenue growth in the mid-single digit range with a solid improvement in operating margins.

We will continue to make significant investments at Mercury, including projects to further increase outboard manufacturing capacity and support new product introductions.

Regarding the second quarter of 2014, we are currently expecting a lower operating margin compared to the second quarter of 2013, due to the absence of favorable insurance settlements and warranty adjustments in the second quarter of 2013, as well as investment spending increases.

Looking at our Boat segment, our plan is based on four key areas of execution (1) our large fiberglass boat strategy should begin to generate growth in the second half of the year, as an increasing number of new products are shipped into the market; (2) continued solid performance in outboard boats; (3) contributions from our Brazil operations will continue and (4) small fiberglass boats should also provide growth during the year, as we continue to extend our day boat offerings.

Year-over-year growth anticipates modest improvements in global industry demand, market share gains and new product introductions.

As a result, we are targeting revenue growth in the high-single digit range with a solid improvement in operating earnings.

As we look at the second quarter of 2014, we will continue to execute our plan to curtail the production and sale of certain existing models of large fiberglass boats as we transition to the production of several additional new models of large fiberglass boats, which will begin to reach the market later this year. We will reach full production of these new models in 2015.

Further, we anticipate lower operating margins and earnings compared to Q2, 2013, due to increases in operating expenses, including heavier investment spending, and the absence of favorable warranty expense in Q2, 2013 - - offsetting benefits from increasing sales.

In our Life Fitness segment, our plan is based on continued revenue growth and maintaining strong operating margins.

Our 2014 and 3-year plans are targeting revenue growth in mid-single to high-single digit range.

We will continue to make significant investments at Life Fitness - -aggressively leveraging innovation in order to achieve competitive differentiation in our products and services, which should continue to enable market share growth and create business opportunities beyond their core business model.

And, although Life Fitness' margins could decline slightly in 2014 as a result of these investments, our plan continues to reflect very healthy margins in this business.

As we look at the second quarter, we expect a lower operating margin compared to the second quarter 2013, as benefits from sales growth are more than offset by investment spending increases related to new products and business opportunities.

Finally, in our Bowling and Billiards segment, our 3-year plan reflects revenue growth and an improvement in operating margin. However, as a result of the unfavorable weather conditions and the resulting "lost" Q1 sales, we are now targeting 2014 revenue for the segment to be flat with the prior year, however, we still believe we can achieve a solid second-half improvement in both operating earnings and margin.

I would like to remind everyone that revenue comparisons for the first three quarters of 2014 will be unfavorably affected due to the divestiture of the European bowling centers last year.

To conclude, we are planning for 2014 to be the fifth consecutive year of strong improvements in operating and pretax earnings, and excellent free cash flow. And, we plan to accomplish these results while increasing investments to enable product and innovation leadership in every segment and as the foundation for our top-line growth.

Thanks, and now I would like to turn the call back to the operator for your questions.