Brunswick Earnings Conference Call Q2, 2014 – July 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, 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 results.

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

On July 17, 2014, the Company announced (1) the signing of an agreement to sell its Retail Bowling business and (2) its intention to sell its Bowling Products business.

Beginning with the third quarter of 2014, Brunswick will report the results of its Bowling Retail and Products businesses, which were previously reported in the Bowling & Billiards segment, as discontinued operations. The historical and future results of the Billiards business will be reflected in the Company's Fitness segment.

The Company's second quarter and year-to-date financial statements include the bowling business results as continuing operations. Also, the Company's 2014 second-half and full-year outlook statements reflect the bowling businesses as discontinued operations.

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 second quarter results.

Revenue in the quarter increased 4 percent. We experienced growth in outboard boats and engines, parts and accessories, fitness equipment and bowling products, which was partially offset by revenue declines in fiberglass sterndrive boats and engines, as well as retail bowling. Bill will provide more color on the segment's performance in his remarks.

Our gross margin increased by 30 basis points compared to the prior year.

Operating expenses increased by 7 percent, as we continue to invest in numerous strategic initiatives.

Adjusted operating earnings increased by 3 percent versus prior year.

Net interest expense was reduced by $4.1 million, reflecting our prior year debt reduction activities, which were enabled by our strong free cash flow performance.

Adjusted pretax earnings increased by 8 percent, while diluted EPS, as adjusted, decreased by $0.28 to $0.95, reflecting a higher 2014 effective tax rate.

Our Fitness segment reported strong top-line growth of 6 percent in the quarter. This is the sixth consecutive quarter of solid revenue growth for this business. Sales in our combined Marine segments increased by 4 percent.

From a geographic perspective, consolidated U.S. sales increased by 5 percent.

Sales to Europe also increased by 5 percent, with a favorable impact from foreign currency accounting for a portion of that growth.

Rest-of-World sales declined by 2 percent versus the prior year period, due to weakness in marine markets and changes in foreign currency, offset by gains in Fitness.

In summary, sales outside of the U.S. increased by one percent.

In the first half, the Fitness segment reported strong top-line improvement of 6 percent. While sales in our combined Marine segments were flat – due to, as you will recall, the difficult first quarter for the engine and boat businesses.

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

Sales to Europe increased by 4 percent. A favorable impact from foreign currency accounted for more than half of the increase.

Rest-of-World sales declined by 4 percent versus the prior year period, due to weakness in marine markets and changes in foreign currency, offset by gains in Fitness.

In summary, sales outside of the U.S. declined by one percent for the first-half.

Adjusted operating earnings were $144.4 million for the quarter, an increase of $3.7 million compared to 2013.

Operating margins, excluding charges, decreased by 10 basis points to 12.7 percent.

The decrease in our operating margin includes the impact of the expansion in gross margin, offset by the increase in operating expenses of 7 percent, which was driven by increased investment spending.

We are forecasting that operating expenses in the third quarter will increase at a comparable rate, as we continue to fund various strategic initiatives. Note that a portion of the operating expenses planned for the second quarter has shifted into the third quarter.

For the first six months, adjusted operating earnings were $239.1 million, an increase of $2.9 million compared to 2013.

Our operating margin, excluding charges, of 11.3 percent is comparable to the prior year.

As a result of the modest improvement in our adjusted operating earnings performance, combined with lower net interest expense and higher other income, adjusted pretax earnings in the second quarter increased by approximately $10 million, or 8 percent.

For the six months, adjusted pretax earnings increased by approximately $15 million, or 7 percent.

Diluted EPS from continuing operations, as adjusted, for the quarter equaled $0.95 per share.

This compares to net earnings, as adjusted, of $1.23 per share in the prior year. As a reminder, our reported EPS for 2014 reflects a significant year-over-year increase in our effective book tax rate.

Diluted EPS from continuing operations, as adjusted, for the first half equaled $1.56 per share.

This compares to net earnings, as adjusted, of $1.99 per share in the prior year.

Before I turn the call over to Bill, I want to provide some perspectives on the global marine market.

The U.S. market is unfolding consistent with our annual expectations and continues to benefit from solid growth in outboard boat and engine products, as well as in parts and accessories.

Year-to-date, the U.S. powerboat industry is up approximately 3 percent. On a rolling 12-month basis the market has improved by more than 6 percent. In the fiberglass sterndrive/inboard boat category, which also affects sterndrive/inboard engine production, modest year-to-date unit growth in boats greater than 30 feet is being more than offset by declines in boats under 30 feet.

International markets, however, have experienced declines in retail sales, specifically in Canada and South America. In Canada, an unusually cold and wet spring led to a late start to the boating season and currency variability is causing some consumers to delay or defer purchases. In South America, weaker than expected economic conditions is the primary factor causing lower market demand in Brazil, Argentina and Venezuela.

Consequently, first-half global marine retail demand growth is below our annual expectations.

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 up 3 percent in the quarter. From a geographic perspective, sales to the U.S. were up 3 percent, reflecting an increase in outboard engines and parts and accessories, which was partially offset by the impact of lower sterndrive/inboard engine revenues.

Sales to Mercury's European customers increased 5 percent, as growth in parts and accessories was partially offset by lower outboard and sterndrive/inboard engine revenues.

Rest-of-World sales increased slightly, as gains in outboard engines exceeded reductions in parts and accessories, and sterndrive/inboard engine revenues.

On a product category basis, the outboard engine business reported solid overall sales growth in the second quarter of 2014. 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. Diesel engine sales were down modestly in the quarter, but are still up year-to-date.

Mercury's parts and accessories businesses delivered solid sales growth during the quarter, with gains in both the U.S. and Europe, partially offset by declines in Rest-of-World. Revenue benefited from new product launches and market share gains.

We again reported record sales in the second quarter at Land 'N' Sea and Attwood.

Mercury's operating earnings increased by 3 percent compared to last year's second quarter. Operating margins were at 18.8 percent, 10 basis points lower than the prior year quarter.

The improvement in operating earnings included the benefit from higher sales, as well as the impact of the absence of favorable insurance settlements in the second quarter of 2013 and investments in growth initiatives.

In our Boat segment, second quarter revenues increased by 4 percent.

In the U.S., which comprises about two-thirds of the segment, sales increased 7 percent. This included continued growth in sales of outboard boats, along with modest reductions in fiberglass sterndrive/inboard boats.

In the quarter, European sales increased by approximately $8 million, or 27 percent versus the prior year. This performance resulted from the introduction of new larger higher priced products by our European outboard boat brands.

Rest-of-World sales decreased by 9 percent, which reflected the weaker demand in Canada and South America referred to by Dusty earlier in the call.

Brunswick's global retail and wholesale unit shipments both decreased by 2 percent in the quarter. This compares to the Boat group dollar sales increase of 4 percent, as the segment benefited from a favorable shift in mix across most of its outboard boat lines, resulting in a higher average selling price.

Regarding our pipelines, dealers ended the quarter with 34 weeks of boats-on-hand measured on a trailing 12-month retail basis, which is 2 weeks higher than the prior year level.

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

Our plan assumes that the wholesale unit growth rate for the full-year will be consistent with our retail unit growth rate. Our current pipeline levels are appropriate given our annual growth expectations in the various boat categories and we continue to be comfortable with these <u>overall</u> levels.

The Boat segment's second quarter adjusted operating earnings improved by $3.2 million or 19 percent, when compared to the prior year.

This improvement resulted from higher sales, as well as gross margin, which included benefits from cost reduction actions and improved net operating efficiencies.

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, combined with modest net sales growth in international markets.

Segment operating earnings in the quarter decreased by approximately $2 million, as the impact from higher sales was more than offset by slightly lower gross margin and continued increases in investment in growth initiatives.

Sales for our Bowling & Billiards segment increased by 2 percent.

This reflects gains in bowling products, as well as in equivalent retail center sales, including increases at pilot centers. This growth was partially offset by a reduced retail center count, particularly in Europe, along with a decrease in billiards sales.

Operating earnings, as adjusted, increased slightly in the quarter.

Foreign currency had a slight net unfavorable impact on total consolidated sales, with Rest-of-World sales affected to the greatest degree.

Foreign currency had a minimal 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 minimal impact on 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 a GAAP and as adjusted basis, was 34.0 percent. Our plan does not contemplate a change to the as adjusted rate for the remainder of the year.

Our estimated effective cash tax rate continues to reflect a low double-digit percent level.

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 year-to-date cash flow statement. Cash provided by operating activities was $77.0 million, a decrease of $30.0 million versus the prior year.

Seasonal changes in our primary working capital accounts totaled approximately $172 million. The biggest changes occurred in:

- Accounts and notes receivable, which increased by $98 million,
- Inventory increased by $62 million,
- Accrued expenses decreased by $50 million, and
- Accounts payable increased by $40 million.

To date, working capital movements have been unfavorable versus the prior year due to the timing of receivable collections and changes in inventory movements due mostly to new product introductions. For the remainder of the year, we anticipate that working capital changes will be favorable versus 2013 and end the full-year with a net usage of $40 million to $60 million.

Total free cash flow amounted to $27 million versus approximately $54 million in the prior year, a difference of about $27 million.

Capital spending in the quarter was approximately $53 million, which included investments in new products in our marine and fitness businesses, as well as 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 $335 million at the end of the quarter. The decline from year-end 2013 mainly reflects the Whale acquisition made in the second quarter and cash used for dividend payments, partially offset by free cash flow.

Let me conclude with some comments on <u>certain</u> items that will impact our P&L and cash flow for 2014. As a reminder, all of our outlook statements have been adjusted to reflect the bowling businesses which will be reported as discontinued operations.

Our estimate for depreciation and amortization is approximately $80 million to $85 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 $28 million to $30 million.

We anticipate that our restructuring charges will be between $4 million and $5 million in 2014.

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

On the cash flow side, the Company plans to make cash contributions to its qualified defined benefit pension plans of approximately $75 million to $80 million in 2014. This increase from prior guidance includes an estimated amount which will be used to fund planned lump sum payouts to term-vested participants. Our restructuring charge estimate does not reflect any pension related settlement charges associated with this payout plan.

Our plan reflects capital expenditures of approximately $140 million, with a substantial portion directed at growth and profit enhancing projects, including meeting capacity expansion requirements at Life Fitness.

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 $100 million to $135 million. This represents a decrease from our previous guidance due to adjusting for the bowling businesses cash flow and the incremental pension funding.

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

Dusty McCoy – Chairman and CEO

Thanks, Bill. Our operating plans and assumptions for the full-year remain fairly consistent with those we communicated on our first quarter call after adjusting for the bowling divestitures. 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 increased investment in new products and by the continuation of the growth demonstrated in the U.S. in the second quarter of 2014 and growth in certain international markets.

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

As a result of ongoing growth investments, full-year operating expenses, adjusted for the divestitures, will increase, but as a percentage of sales, are expected to be lower than 2013 levels - - approximately in the range of 17.6 percent to 17.7 percent.

As a result, our pretax earnings should continue to demonstrate strong growth of 24 percent to 30 percent. On our last earnings call we established our 2014 EPS, as adjusted, guidance of

$2.40 to $2.55. With the announced divestitures of our bowling business and the corresponding discontinued operations accounting, our guidance was effectively reduced by $0.20 to $2.20 to $2.35. Today, we are changing our guidance to a range of $2.25 to $2.35

Regarding our outlook for the second half, we are anticipating strong top-line growth in our marine segments, as well as in our fitness segment. On a consolidated basis, we are planning for approximately 10 percent to 12 percent sales growth in the second half.

Some of the key drivers of the second half growth include: new products being introduced at Mercury, which I will elaborate more on the next slide. The Boat Group has several new products being introduced or that are reaching full production rates, including Sea Ray's 650, 470, 510 and 350 SLX. Bayliner's new Element XL will also contribute to second-half growth. And, Life Fitness will also have a strong line-up of new products hitting the marketplace in the third and fourth quarters, including its Insignia Strength, Powermill, Synergy Blue Sky and Flex Strider equipment.

Additionally, we expect the improvement in gross margin in the second half to be slightly higher than the first half. And, our planned second-half operating expenses, as a percent of sales, will be lower than prior year, with the third quarter's year-over-year growth rate comparable to the second quarter's rate.

As a result, our plan continues to reflect a strong improvement in adjusted pretax earnings.

Over the past several quarters, we have highlighted some of the new products that we have been introducing to the marketplace. For this call, we will focus on some of Mercury's new product offerings.

Mercury Marine, which is celebrating its 75th anniversary and was named "Wisconsin's "Manufacturer of the Year" earlier this year, has once again launched a strong line-up of new innovative products.

Mercury recently launched its new line of 75-90-115hp fourstroke engines. These new engines follow the success of the 150hp, which was introduced over 18 months ago. Reviews of these engines have been positive. Also the White Verado has been a huge hit with OEMs and consumers. The continued success of the Verado engines, combined with the new four stroke platform, as well as the progress being made with its joystick docking technology, has contributed to the growth currently being achieved in freshwater, saltwater and re-power segments. As we look at the saltwater market, we believe these product successes will enable Mercury to gain share in this sector over the next 3 years, from high teens percentage to a target in the mid-twenties.

Mercury's new high horsepower purpose built V6-250hp sterndrive engine is also scheduled to start production in the second half of this year.

The full-year financial targets in our three operating segments remain largely unchanged.

Our overall plan reflects continued 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, such as the ones that I just discussed.

Looking at our Boat segment, our plan continues to assume a successful execution of our large fiberglass boat strategy, which will help to accelerate growth in the second half of the year, as an increasing number of new products are shipped into the market. As a result, we should start to see the benefit from a more favorable sales mix and higher average-sale-prices.

Continued solid performance in outboard boats and contributions from our Brazil operations should also benefit the segment's growth in the back-half.

Year-over-year growth anticipates new product introductions, improved market share gains and global industry growth.

As a result, we are targeting 2014 annual revenue growth in the high-single digit range with a solid improvement in operating earnings.

Further, we anticipate significant year-over-year operating earnings improvement in the second half. The segment, however, is expected to have a modest seasonal operating loss in both the third and fourth quarter.

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

We will now take your questions.