Logitech Q2 and First Half Fiscal Year 2014 Financial Results Management's Prepared Remarks (October 23, 2013)

Logitech is posting a copy of these prepared remarks, its press release and accompanying slides to its investor website. These prepared remarks will not be read on the call. We refer both to GAAP and non-GAAP financial measures herein. For full GAAP to non-GAAP reconciliation information and cautionary information regarding the use of non-GAAP measures, please refer to "Supplemental Financial Information" in our earnings press release or "Financial Statements only" posted to our website under "Quarterly Results" at http://ir.logitech.com. The live webcast or replay of the question and answer session is also available on our website.

COMPANY COMMENTARY

Following is a summary of the company's comments on key areas impacting Q2 Fiscal Year 2014 performance. Unless noted otherwise, the growth percentages that follow are in comparison to same period prior year.

OVERVIEW

Q2 FY 14 sales were $532M, down 3% with exchange rates having no impact. GAAP operating income was $17M, including $11M of costs related to restructuring. This is the second consecutive quarter of better-than-expected sales and profit. First half total retail sales grew by 1%. First half FY 14 non-GAAP operating income was $49M, 4.9% of sales, double the prior year. This first half performance confirms that our turnaround is on track.

RETAIL SALES BY PRODUCT CATEGORIES

For Q2, our retail sales decreased by 2% in USD to $465M. Units decreased by 4%. Our overall retail average selling price in Q2 increased by 8%, reflecting the strategic shift to higher price point products in categories such as Audio Wearables & Wireless, Remotes, and Video.

AUDIO – WEARABLES & WIRELESS

For Q2, sales increased by 34%. Units declined 35% as our average selling price in the category doubled as a result of our strategic shift to higher price points over the course of the last year. Sales of our mobile speakers more than doubled with units up 60%. This growth was driven by strong demand for two speakers, the UE BOOM and the Mobile Boombox. The sales growth was partially offset by a decline in sales of our earphones and headphones, which we have deemphasized.

TABLET ACCESSORIES

In Q2, our sales grew by 3% with units up by 26%. As expected, the stronger unit growth in the category reflects the lower average selling price inherent to expanding our lineup to include iPad cases without keyboards and products for the iPad mini. The low sales growth in the quarter was also due to the timing of our new product launches. We launched a number of new iPad accessories in the first quarter of the current fiscal year, which led to sales growth of over 100% in that quarter. We held back from a similar new product launch during Q2 due to the release date of the next-generation iPad. The stronger unit growth in the category reflects the broadening of our portfolio to address a larger portion of the tablet accessory market, including cases. For perspective, first half sales were up almost 50%, with units up by 70%.

GAMING

Q2 sales in the Gaming category decreased by 11%, with units down by 1%. While sales in the Americas and Asia Pacific both increased by roughly 15%, EMEA declined. The situation in EMEA primarily reflects poor sales execution in Germany, our largest market in the region, a situation we are rectifying now. For the first half, sales were up 10%.

POINTING DEVICES

In Q2, our sales increased by 7%, with units up by 3%. We achieved growth in both the high end and low end of the category. Sales grew in the Americas and Asia Pacific and were flat in EMEA. The overall growth in the category was driven primarily by cordless mice, where sales increased by 9%.

PC KEYBOARDS & DESKTOPS

Q2 sales increased by 8%, with units up by 3%. The increase in sales and units was driven by the low end of the category. We achieved growth in all regions, led by the Americas. It was a strong quarter for wireless standalone keyboards, with sales up by 33% and units up by 29%.

VIDEO

Q2 sales in Video fell by 17%, with units down by 31%. The steep drop in unit sales reflects our systematic shift away from the low end of the consumer webcam category. We continue to see sales and unit growth in the high end of the category. The Video category benefitted from strong sales of webcams targeted at Unified Communications applications. Q2 sales of our Digital Video Security products, a product category that we are in the process of transitioning out of during Fiscal Year 2014, were roughly $4M, down by 25%.

PC AUDIO

Q2 sales in our PC Audio category declined by 13%, with units down by 17%. Sales fell across our three retail regions. The decline in sales and units was similar for both PC speakers and PC headsets.

REMOTES

Our Q2 Harmony Remotes sales decreased by 19%, with units declining by 51% as we continued to exit the unprofitable low-end of the category, in line with our strategy. The average selling price in the Remotes category increased by 67%, reflecting our strategic focus on the high end of the category with products such as the Harmony Ultimate, which was launched in Q1 and was our best-selling remote year-to-date. We have made strong progress phasing out low-end remotes as we move toward profitability in this category by the end of the year.

RETAIL – OTHER

This category includes a variety of products that we already have or intend to transition out of by the end of Fiscal Year 2014 and is subject to change as we continually assess the strategic fit of the products in our portfolio. Sales declined by 61% to less than $6M, with units down by 59%. Sales of speaker docks declined by $9M.

RETAIL SALES BY REGION

RETAIL SALES – AMERICAS REGION

Q2 sales in the Americas increased by 7%, with units up by 2%. It was a very strong quarter for sales in the Audio Wearables & Wireless category, with sales up by 73% and mobile speaker sales nearly tripling. Tablet Accessories sales grew by 21% despite the channel fill associated with our new product launch in Q1 and the Q3 launch date of the next generation iPad. Gaming, Pointing Devices and Keyboards & Desktops were each up by approximately 16%.

RETAIL SALES – ASIA PACIFIC REGION

Q2 sales in Asia Pacific decreased by 4% in USD and were flat in local currency. Units were up by 4%. The decline was driven by weakness in PC Audio, Audio Wearables & Wireless, and Video as well as the categories we are currently in the process of exiting (reported under Retail – Other). Q2 Sales in China increased by 10%, with growth across a number of categories led by Tablet Accessories and Gaming.

RETAIL SALES – EMEA REGION

Q2 sales in EMEA were down by 10% in USD and by 13% in local currency, while units decreased by 14%. Weakness in Germany, our largest country within EMEA, was the cause of roughly one third of the region's sales decline. The weakness in Germany reflects execution challenges that we are in the process of addressing. The decline in the region’s sales was primarily related to weakness in the Gaming and Video categories, as well as the categories that we are in the process of exiting (reported under Retail – Other). Sales in the Pointing Devices and Keyboards & Desktops categories were essentially flat, while we achieved strong growth in the Audio Wearables & Wireless category driven by sales of wireless speakers.

OEM SALES

Q2 OEM sales grew by 2% primarily due to strong growth in Keyboards & Desktops as well as an opportunistic sale in the Gaming category. This improvement also reflects our change in strategy in OEM to create fewer, more significant partnering relationships. Pointing Devices sales declined by 6%, which reflects the weak market conditions for sales of new desktop PCs.

LIFESIZE SALES

Sales in Q2 were $30M, down by 14%, virtually unchanged from the two previous quarters, indicating that a degree of stability has been achieved in the business. During the quarter, we implemented a comprehensive restructuring at LifeSize as part of our efforts to reposition the business and achieve profitability by the end of Fiscal Year 2014. This restructuring included reduction in staffing as well as an exit from non-strategic product lines.

GROSS MARGIN

Our Q2 GAAP gross margin of 34.5% was down by 120 basis points and by 70 basis points sequentially. The primary factor in both the year-over-year and sequential declines was a $5.2M write-off of LifeSize inventory resulting from the restructuring implemented during Q2. The write-off reflects a rationalization of the LifeSize product portfolio. On a non-GAAP basis, our Q2 gross margin was 36.1%, down from 36.6% in the prior year due to shifts in the product mix.

OPERATING EXPENSES

Our Q2 GAAP operating expenses of $166M decreased by 3%, or 8% excluding restructuring from both periods. This decline includes savings resulting from the restructuring actions and the ongoing rationalization of marketing activities, partially offset by variable compensation costs related to the company's improved first half performance. Variable compensation costs were the primary driver of the increase in G&A spending.

Restructuring charges reported as operating expenses were $5.5M in Q2. These charges reflect headcount reductions in our LifeSize business as we reposition the business while focusing on achieving profitability by the end of the current fiscal year.

Q2 non-GAAP operating expenses amounted to $155M, down $9M year over year. Non-GAAP operating expenses were 29.1% of sales, down by 80 basis points, reflecting improved operating leverage.

OPERATING INCOME

GAAP operating income in Q2 was $17M, including $11M of costs related to restructuring, with an operating margin of 3.2%. Non-GAAP operating income for the quarter was $37M, with a non-GAAP operating margin of 7.0%.

For the first half, GAAP operating income was $17M, including $13M of costs related to restructuring, compared to a loss of $35M. Operating margin was 1.7%, up from -3.4%. First half non-GAAP operating income was $49M, up from $25M in the prior year. Non-GAAP operating margin was 4.9%, up from 2.5%.

BALANCE SHEET

Our quarter-ending cash position was $295M, an increase of $58M compared to September 2012. While our cash declined by $24M compared to June 2013, this was the result of paying a $36M dividend in September, the impact of which was partially offset by our generation of $15M in cash flow from operations in Q2.

Good inventory management led to a $29M decrease, or 9%, compared to September 2012 and a $3M decrease compared to June 2013. This was the first sequential decline in our Q2 inventory in many years. Inventory turns were 4.8, up by 0.4 turns.

Due to disciplined collection efforts, accounts receivable decreased by $26M, or 9%. As a result, DSO improved 3 days to 44 days.

Some of the cash generated from better inventory turns and DSO was consumed by the actions we took to reduce our DPO to a more reasonable level. Our DPO decreased by 16 days to 78 days.

Our cash conversion cycle in Q2 was 41 days, up by 6 days. The increase was due to the reduction in DPO, which was partially offset by the improvements related to inventory (7 days) and accounts receivable (3 days)

FISCAL YEAR 2014 OUTLOOK

For the full Fiscal Year 2014, we continue to expect sales of approximately $2 billion. Our outlook is based on the prudent assumption that the sales performance of our PC peripherals will not be sustainable in the face of a double-digit PC market decline.

The current outlook for GAAP full Fiscal Year 2014 operating income is approximately $50 million, compared to an operating loss in Fiscal Year 2013. The outlook for GAAP operating income now includes year-to-date charges of $13 million, related to restructuring, that were not anticipated when we originally provided the outlook in April 2013.

FORWARD LOOKING STATEMENTS

These remarks contain forward-looking statements within the meaning of the federal securities laws, including, without limitation, statements regarding: our turnaround, profitability, profitability in certain product categories, product categories which we intend to keep or out of which we intend to transition and the timing of those transitions, changes to our product portfolio and product pricing, sales execution in Germany, growth in certain product categories, and Fiscal Year 2014 sales, operating income, and restructuring-related charges. The forward-looking statements in these remarks involve risks and uncertainties that could cause Logitech's actual results and events to differ materially from those anticipated in these forward-looking statements, including, without limitation: if our product offerings, marketing activities and investment prioritization decisions do not result in the sales, profitability or profitability growth we expect, or when we expect it; the demand of our customers and our consumers for our products and our ability to accurately forecast it; if we fail to innovate and develop new products in a timely and cost-effective manner for our new and existing product categories; if we do not successfully execute on our growth opportunities in our new product categories and sales in emerging market geographies; if sales of PC peripherals in mature markets are less than we expect; the effect of pricing, product, marketing and other initiatives by our competitors; if our products and marketing strategies fail to separate our products from competitors' products; if our restructurings fail to produce the intended performance and cost savings results; if there is a deterioration of business and economic conditions in one or more of our sales regions or operating segments, or significant fluctuations in exchange rates. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in Logitech's periodic filings with the Securities and Exchange Commission, including our Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2013 and our Amended Annual Report on Form 10-K/A for the fiscal year ended March 31, 2013, available at www.sec.gov, under the caption Risk Factors and elsewhere. Logitech does not undertake any obligation to update any forward-looking statements to reflect new information or events or circumstances occurring after the date of these remarks.

USE OF NON-GAAP FINANCIAL INFORMATION

To facilitate comparisons to Logitech's historical results, Logitech has included non-GAAP adjusted measures which exclude share-based compensation expense, amortization of other intangible assets, restructuring charges (credits), other restructuring-related charges, investment impairment (recovery) and other items detailed under "Supplemental Financial Information" in our earnings press release or "Financial Statements only" posted to our website under "Quarterly Results" at http://ir.logitech.com. Historical GAAP and corresponding non-GAAP measures are provided under Financial History in the Investors section of our website.
Logitech believes this information, used together with the GAAP financial information, will help investors to evaluate its current period performance and trends in its business.

CHANNEL INVENTORY DATA

Estimates the inventory levels of our products held by or in-transit to our retailer and distributor customers. Includes data compiled by Logitech from data supplied by our customers, and our estimates of inventory in transit to our customers. Customers supplying data vary by geographic region and from period to period, but typically represent a majority of our retail sales. Data and our estimates are subject to limitations and possible error sources and may not be an entirely accurate indicator of actual customer channel inventory. Limitations and possible error sources include the following:

- Data supplied by our customers may not be indicative of inventory held by our customers as a whole
- Reliability of the data depends on accuracy and timeliness of information supplied to us by our customers, and the processes by which they collect their data is largely outside our control

- In the U.S., Canada, and to a lesser extent Asia Pacific, and a still lesser extent, EMEA, data is based on Point of Sale (POS) electronic data. Where POS data is not available, the data is collected largely through manual processes, including the exchange of spreadsheets or other non-automated methods of data transmission, which are subject to typical human errors, including errors in data entry, transmission and interpretation
- Our interpretation of the data, and our estimates of in-transit inventory, may be subject to errors in assumptions, calculations or other errors.