iRobot Third-Quarter 2018 Conference Call

Operator:

Good day everyone and welcome to the iRobot third-quarter financial results conference call. This call is being recorded. At this time for opening remarks and introductions, I would like to turn the call over to Elise Caffrey of iRobot Investor Relations. Please go ahead.

Elise:

Thank you and good morning. Before I introduce the iRobot management team, I would like to note that statements made on today's call that are not based on historical information are forward-looking statements made pursuant to the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995.

This conference call may contain express or implied forward-looking statements relating to the company's financial results, operations and performance for fiscal 2018 and the fourth quarter of 2018; the growth, performance, revenue impact and prospects of our business, including in the United States, EMEA, Japan and China; our expectations regarding profitability; our expectations regarding revenue, the rate of revenue growth, gross margins, operating income, operating expenses, operating margin, sales & marketing expenses, research and development expenses, general and administrative expenses, restructuring charges, stock compensation expenses, depreciation and amortization expenses, inventory, tax rate, earnings per share and cash; the seasonality and predictability of our business; the imposition of tariffs on goods imported into the United States, including the impact thereof; our expectations regarding currency exchange rates; our expectations regarding our ability to penetrate further the robotic vacuum cleaner and wet floor care markets; the impact and timing of our continued investments in sales & marketing and in R&D, technology and innovation; the impact of our efforts to increase consistency and awareness of our brand and to protect our IP; domestic and international demand for robotic vacuum cleaners (RVC) and our RVC products; demand for and revenue and revenue growth opportunities associated with, our wet floor care products, including our Braava family of floor mopping robots; our intent to make, and the impact on our financial results of, strategic investments; our intent regarding the introduction and delivery of new products, applications, and product capabilities and functionality, and the timing and impact thereof; the impact on our financial results and operations of our acquisitions of our European and Japanese distributors; our market share and opportunity; and business conditions**.**

These statements are neither promises nor guarantees, but are subject to a variety of risks and uncertainties, many of which are beyond our control, which could cause actual results to differ materially from those contemplated in the forward-looking statements. In particular, the risks and uncertainties include those contained in our public filings with the Securities and Exchange Commission. Investors are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. iRobot undertakes no obligation to update or revise these forward-looking statements, whether as a result of new information, future events or circumstances or otherwise.

During this conference call, we may also disclose non-GAAP financial measures as defined by SEC Regulation G, including Adjusted EBITDA, which we define as earnings before interest, taxes, depreciation, amortization, merger, acquisition and divestiture (income) expense, restructuring expense, net intellectual property litigation (income) expense, and non-cash stock compensation expense. A reconciliation between Adjusted EBITDA and net income – the GAAP measure most directly comparable to Adjusted EBITDA is provided in the financial tables at the end of the third-quarter 2018 earnings press release issued last evening, which is available on our website http://investor.irobot.com/news-releases?field_nir_news_date_value%5Bmin%5D=2018#views-exposed-form-widget-news-widget-news-ul.

A live audio broadcast of this conference call is also available on the Investor Relations page of our website and an archived version of the broadcast will be available on the same Web page following the call. In addition, a replay of this conference call will be available through October 31, 2018 and can be accessed by dialing **404-537-3406**, access code **2997885.**

On today's call, iRobot Chairman & CEO Colin Angle will review the company's operations and achievements for the third quarter of 2018 and Alison Dean, Chief Financial Officer, will review our financial results for the third quarter of 2018. Colin and Alison will also provide our business and financial expectations for fiscal 2018. Then we'll open the call for questions.

At this point I'll turn the call over to Colin Angle.

Colin:
Good morning and thank you for joining us.

We delivered third-quarter revenue growth of **29%** over Q3 2017, driven by a very successful launch of two new products in the United States, where revenue grew **45%** over Q3 2017. Sales of our game-changing Roomba i7+ were so robust we were challenged to keep the product in stock. As we roll out our premium product through additional domestic and overseas channels over the next year, we anticipate a similar response across the markets. The premium features we've introduced in our new Roomba e5, make it an affordable, highly-featured product to add to our lineup and one that we believe will stand up very well against competitors' products. Third-quarter profit was higher than we anticipated due to the higher than expected revenue, along with some delayed marketing expense and a slightly higher gross margin.

Given our Q3 results and our outlook for the holiday season, we are increasing our 2018 full-year financial expectations. We now anticipate full-year 2018 revenue of **1.08** to **1.09** billion dollars, which is year-over-year growth of **22 to 23%**. As we said on last quarter's call, our full-year financial expectations at that time did not include any impact from the proposed tariffs. The imposition of **10%** tariffs went into effect on September 24th. We made the decision NOT to pass on those additional costs to U.S. retailers or consumers in 2018 and as a result, we expect lower gross margins in Q4 resulting from the tariff, with full year gross margin of approximately **50%**. We have increased our full-year 2018 operating income expectation to **92** to **96** million dollars, despite the previously un-forecasted **5** million dollar tariff impact, and our expectations for full-year 2018 EPS have increased to **$2.55** to **$2.75** reflecting Q3 performance and the incremental Q3 EPS associated with stock compensation windfall benefit we received.

Now I'll take you through some of the highlights of Q3 2018, and our business expectations for the rest of the year.

The most important event of the third quarter was the introduction of our i7/i7+ Roomba. This is the product I've been working towards for the past decade. What makes it game-changing is that it delivers a dramatically new kind of customer experience. Imagine coming home every day for up to a year and having freshly clean floors while never touching your robot. If you do make a mess while cooking, for example, just being able to say "Alexa, tell Roomba to clean the kitchen" and have Roomba drive to the kitchen, clean it, and return. What makes this new experience possible is the new CleanBase accessory which empties Roomba's full bin 30 time. The i7 also has the ability, based on new home understanding algorithms, to build a map of the home, segment that map into rooms, allow you to adjust and label those rooms, while keeping track of its location, even if you start it in a random location. And no virtual walls required.

Why is this so critical to iRobot's future? Beyond extending our leadership in the RVC segment, it extends our ecosystem. These maps can be shared with other robots in the home and the opportunity for robots working together is expected to be significant. Today, the smart home is a collection of robots and devices that don't understand the home. Our mapping robots will make the smart home work better. The larger our installed base, the more IoT companies will want their products to work with our products. Today, consumers can already use Google Assistant and Amazon Alexa to operate Roomba.

In addition, earlier this month, Google's Sr. Director, Smart Home Ecosystem and I demonstrated our shared vision of the smart home at HUBweek in Boston. We showed how our iRobot/Google collaboration can integrate robotic and smart home technologies that will advance the next-generation smart home. Working together, we will seek additional ways to integrate Google's platforms, providing customers with the choice to opt in to new innovative smart home experiences that leverage a broader understanding of the home's space enabled through Roomba's spatial awareness of the home. This is a significant step forward towards the realization of the smart home possibilities and many of these future advancements will be delivered over-the-air and will not require the purchase of a new Roomba.

Not to be overlooked in its importance, the launch of our Roomba e5 during the third quarter, further solidified the value proposition of our Roomba line. Our strategy of introducing new features and functionality in our premium-level robot, and then flowing the innovation to lower price points has been successfully executed again through the e5. Pet owners comprise a significant percentage of our customers and they don't like cleaning pet hair out of their robots. We equipped the robot with debris extractors, previously only available in our high-end robots and redesigned the dirt bin so it could be removed and rinsed with water. The customer can now have a cleaner home AND a cleaner robot that requires minimal maintenance.

We are very excited about our Roomba competitive position with products across a broad range of features, functionality and prices; but we're not done yet! As exciting as these two new products are, you should expect the pace of new product introductions to continue into 2019.

In addition to Roomba, our focus on growing Braava awareness and adoption continued in Q3. Our Q3 Braava family revenue grew **9%** year-over-year and we will run the planned exclusive Braava television advertisements in the fourth quarter in both the U.S. and Japan to further drive broader awareness of the category.

And finally, a comment about tariffs. As I mentioned, we are not increasing our prices in 2018 as a result of the **10%** tariff imposed in September on all vacuum cleaners manufactured in China. As currently proposed, these tariffs are scheduled to increase to **25%** on January 1, 2019. We expect the increased tariffs to put moderate pressure on the strong RVC category, but we are working to align our product mix and pricing with key retailers to maintain momentum in the segment in the short term. Longer term, we will continue to look for cost reduction opportunities to help mitigate the impact on prices, margin and the long-term growth of the market segment.

In summary, I am very excited about:

- Our game-changing new products;
- Our articulated vision of the smart home and iRobot's role in it; and,
- The pipeline of new products on the horizon.

I will now turn the call over to Alison to review our third quarter results in more detail.

Alison

Our third quarter performance was ahead of our expectations. We delivered record third-quarter revenue of **$265** million, an increase of **29%** from Q3 last year. Operating income for Q3 was **$37** million compared with **$24** million for Q3 2017. EPS was **$1.12** for the quarter, compared with **$0.76** in Q3 2017**.** **$0.13** of Q3 2018 EPS was attributable to the impact of stock compensation tax windfall compared with **$0.16** in Q3 2017. In addition, there was a positive impact from the timing of roughly **$6.0** million of sales and marketing and R&D expenditures that we expect to incur in the fourth quarter of 2018 versus Q3. As a reminder, Q3 2017 EPS also included **$0.08** from a non-taxable gain on the Japanese distributor acquisition.

Revenue growth of **29%** for Q3, included domestic growth of **45%**, EMEA growth of **19%,** and growth in Japan of **13%**. Keep in mind that year-over-year revenue growth varies by region on a quarterly basis. In Q3, the U.S. benefitted from the launch of our new products and their availability only in that region. As we continue to roll out distribution of these products in other markets over the next **12** months, you should expect similar fluctuations. We manage our global business on an annual basis, provide annual financial expectations and encourage investors to view us accordingly.

The gross margin of **51%** in the third quarter was slightly ahead of our expectations driven by less than planned promotional activities. We saw a **100** basis point increase year-over-year in Q3 due primarily to revenue uplift associated with the Robopolis acquisition. Keep in mind that quarterly gross margin can fluctuate widely based on mix, seasonality and promotional activity, among other things. We expect our Q4 gross margin to be negatively impacted by roughly **$5.0** million from the **10%** tariff on U.S. imports as well as the typically heavy promotional activity due to the seasonal holidays.

Q3 operating expenses were **37%** of revenue, compared with **38**% in Q3 last year and slightly below our expectations. Q3 G&A was in line with our expectations, but as I just mentioned, there was roughly **$6.0** million of other operating expenses originally planned for Q3 that is now planned for Q4.

Our Q3 actual effective tax rate (ETR) before discrete items was **25%** versus our Q3 2017 rate of **37%,** largely driven by the US Tax Reform as well as the implementation of our UK principal company in July. After discrete items, the ETR for Q3 was **15**%, including the impact of the **$4** million stock compensation tax windfall. The ETR after discrete items in Q3 2017 was **17%** and included a **$5** million benefit from stock compensation tax windfall. We still expect our full year ETR before discrete items to be between **24-26%.**

We ended Q3 with **$135** million in cash, up slightly from **$127** million at the end of Q2. We expect to end the year with approximately **$160** million of cash.

Q3 ending inventory was **$161** million or **113** days, compared with **$93** million or **82** days last year. In addition to the typical higher U.S. inventory for the holidays, the need to hold inventory for direct-to-retail sales in Japan and more than **50%** of EMEA following our distributor acquisitions also contributed to the higher Q3 2018 inventory level, as expected. As we have previously said, due to this structural change in our business model for direct to retail sales, we expect DII to be approximately **100** days **+/-** on average in 2018. We still expect Q4 inventory to decline sequentially, and we anticipate exiting the year with DII well below our **100**-day average as is typical.

Now for additional color on our financial expectations. We are expecting another strong fourth quarter coming off a record Q3, driven by double digit year-over-year growth in all major regions. Keep in mind that we will anniversary the acquisition of our European distributor in Q4 so our total year-over-year revenue growth rate will be lower in Q4 than in each of the previous three quarters where we benefitted from the revenue uplift associated with the acquisition.

In the fourth quarter, sales & marketing, as a percent of revenue, is expected to peak as we continue to roll out i7/i7+, promote Braava family robots and run our holiday advertising campaigns, which have already begun. We still expect full-year R&D of **13%** of revenue and operating expenses to total roughly **42%** of revenue.

We are increasing our full-year operating income to **$92** to **$96** million, despite the **$5** million of unplanned tariffs, and our EPS to **$2.55** to **$2.75**.

We are very pleased with our year-to-date results and our ability to increase our expectations for the year again, especially in light of the tariff impact. As Colin mentioned we will discuss the 2019 increased tariff impact we expect on our Q4 and full-year earnings call in February.

I'll now turn the call back to Colin.

Colin

We have delivered strong results thus far this year. I am very excited about our positioning for the upcoming holiday season and confident in our ability to deliver our increased 2018 financial expectations.

In summary:

- We launched game-changing products that will reinforce our leadership in consumer robotics;
- We demonstrated the power of Artificial Intelligence coupled with home mapping, in collaboration with Google, in advancing the usability of the smart home; and,
- We will launch significant Braava family promotions during the holiday season to promote the category and further develop our revenue diversification.

We believe that consistent execution of this strategy is the most effective way to drive sustainable growth and shareholder value.

With that we'll take your questions.

Following Q&A

Colin

That concludes our third quarter 2018 earnings call. We appreciate your support and look forward to talking with you again in February to discuss our Q4 results.

Operator: That concludes the call. Participants may now disconnect.