iRobot Fourth-Quarter and Full Year 2016 Conference Call

Operator:

Good day everyone and welcome to the iRobot fourth-quarter and full year 2016 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 2017 and for the fiscal quarters of 2017; the growth, performance, revenue impact and prospects of our business, including outside of the United States; our expectations regarding seasonality and predictability of our business; our expectations regarding profitability; our expectations regarding revenue, the rate of revenue growth, gross margins, operating income, operating expenses, operating margin, marketing expenses, research and development expenses, general and administrative expenses, restructuring charges, stock compensation expenses, depreciation and amortization expenses, inventory, tax rate, diluted share count and earnings per share; the timing, and the impact on our financial results of, our previously-announced acquisition of our Japanese distributor; our ability to penetrate further the robotic vacuum cleaner and wet floor care markets; our intent to make, and the impact on our financial results of, strategic investments; the impact of our continued investments in sales and marketing and in R&D and technology; domestic and international demand for our robots; demand for, availability of and revenue and revenue growth opportunities associated with our wet floor care robots; our ability to support connected robots and develop connected robot and mapping technologies; our plans for expansion; our intent regarding the introduction and delivery of new products, applications and product capabilities and functionality, and the timing thereof; our competitive position; 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 will 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 expenses, restructuring expenses, 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 fourth quarter and full year 2016 earnings press release issued last evening, which is available on our websitehttp://investor.irobot.com/phoenix.zhtml?c=193096&p=irol-EventDetails&EventId=5242673.

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 February 16, 2017 and can be accessed by dialing **404-537-3406**, access code **15399077.**

On today's call, iRobot Chairman & CEO Colin Angle will provide a review of the company's operations and achievements for the fourth quarter and full year 2016 as well as our outlook on the business for 2017; Alison Dean, Chief Financial Officer, will review our financial results for the fourth quarter and full year 2016; and, Colin and Alison will also provide our business and financial expectations for fiscal 2017. 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.

2016 was a fantastic year for iRobot. Our Q4 and full year 2016 results exceeded our increased expectations. Record Q4 revenue was driven by very strong sales in the United States despite the steepest competitive environment we've ever seen. Higher revenue coupled with continued improvement in gross margin, allowed us to increase investment and capitalize on our momentum executing on our business strategy, while returning additional profit to shareholders, and setting a strong foundation for 2017 and beyond.

2016 was a pivotal year for the company as we:

- Firmly positioned iRobot as a consumer technology company;
- Took more direct control over our international distribution with a bifurcated model in China and the announcement of our planned distributor acquisition in Japan;
- Diversified our revenue through the establishment of the wet floor care category; and,
- Expanded our portfolio of connected products, better positioning us as an emerging strategic player in the Smart Home.

As a result of these efforts, Consumer revenue grew more than **20%** in the fourth quarter, and **17%** for the full year, driven by sales in the U.S. which for the fourth quarter were up more than **45%** for year-over-year and the full year were up more than **35%** over a record 2015. For the full-year 2016, total company revenue of **$661** million was up **7%** over the prior year. Keep in mind that full-year 2015 and 2016 revenue included **$57** million and **$5** million respectively of D&S and other revenue. Net income was **$42** million for the year, down **5%** from the prior year. Earnings per share were **$1.48,** including a negative **($0.10)** impact from the Defense & Security business divestiture, and Adjusted EBITDA of **$94** million, or **14%** of revenue.

In 2017 we will:

- Drive revenue growth through deeper household penetration of Roomba® in the U.S.;
- Accelerate growth in international markets: China, Japan and EMEA;
- Capitalize on our first mover advantage in the wet floor care category, particularly in Asia where Braava® and Braava jet™ have been enthusiastically received;
- Expand gross margin through improved operating efficiencies and scale; and,
- Continue to extend connectivity across more of our products, allowing us to offer more robots with mapping capabilities and cloud connectivity at more accessible price points, growing our role in the emerging Smart Home.

In 2017, we are expecting revenue of **$770** to **$785** million, which is year-over-year growth of **17%** to **19%**, EPS of **$1.35** to **$1.65** and operating income of **$57** to **$70** million. These expectations include the anticipated financial impact of our Japanese distributor acquisition, targeted to close at the beginning of Q2 2017. In November of 2016, we issued a press release, announcing our signed definitive agreement, and stated that for 2017 we expected a positive revenue impact of **$20** to **$25** million and a one-time negative impact to earnings per share of **$0.25** - **$0.35**. Alison will provide additional details.

To execute our 2017 plan and continue on our successful path to achieve our 3-year financial targets, we need to continue to strategically invest in a number of areas to:

- Establish unambiguous brand and product leadership in robotic vacuum cleaners, a category we created **15** years ago;
- Establish ourselves as the category leader for robotic floor care in China through both our Roomba and Braava products;
- Continue to build our wet floor care business globally to generate a material, secondary revenue stream;
- Explore, develop and grow adjacent, non-floor care Consumer products that can generate meaningful diversified revenue streams; and

- Make continued operational improvements that can reduce product and operating costs.

Now I'll take you through some of the highlights of 2016, and our business expectations for 2017.

When we talked to you in February last year, we expected our Consumer revenue to grow **12-13%** in 2016 over 2015 driven by the U.S. and China. We anticipated that U.S. retailers would make room for competitors' products during the holiday season and we were uncertain how those products would impact our sales. As the year progressed and our proven Roomba marketing programs in the U.S. continued to drive accelerating demand for our products, we increased our full-year financial expectations in July. As new competitors began debuting their products in the U.S. and failed to deliver the premium value proposition offered by Roomba, retailers increased their iRobot orders to ensure that they had sufficient inventory to meet consumer demand. As our full-year visibility continued to improve, we shared our further increased financial expectations on the third quarter call.

Following the exceptional performance we delivered in the fourth quarter, we are more confident than ever that the robotic vacuum cleaner segment is at an inflection point; that is, in the explosion stage on the maturity curve. It didn't happen overnight. In fact, it has taken us more than a decade to develop the right mix of appropriate messaging to reach the addressable market and deliver quality products that delight our customers. It is critical that we not cede our hard-won global market-leadership to would-be competitors who recognize this enormous opportunity. We need to continue investing in technology that provides the features and functionality we know consumers will buy as well as investing in patents to protect that technology and marketing. Robotic vacuum cleaner household penetration in the U.S. is roughly **8** million households, or less than **10%,** and this is the most deeply penetrated market. Capitalizing on the holiday momentum where we were the clear category winner, and building on it in 2017, will help us reach the next segment of immediately addressable **25** million households.

While the U.S. grew substantially in 2016, our overseas distributors were hampered by macros, currency weakness and competition exiting 2015. We performed an in-depth analysis of the major regions and markets to better understand why growth rates had slowed and what it would take to accelerate them in 2017 and beyond. While it differs by market, it is clear that where we have executed our marketing programs, with consistent global branding, we have seen positive results. Japan is a good example of how our investments in 2015 resulted in 2016 growth. We also expanded our programs into several western European countries in 2016 and saw accelerated sell through in the second half of the year. Based on the impact of our programs we are confident that the slower growth in EMEA and Japan was not due to market maturity or saturation but rather the absence of optimal marketing programs. We expect EMEA to return to low double-digit growth in 2017, up from single-digit in 2016.

In Japan, revenue grew from a year-over-year decline in 2015 to low single-digit growth in 2016 as anticipated. Sell through momentum increased throughout 2016 and we expect **30+%** growth in 2017 in part because of our distributor acquisition. As our largest international market, Japan is estimated to comprise roughly **15%** of this year's total revenue.

As we discussed in 2016, we had a slower than expected ramp up of our new China distributor. Demand for our products continued to be strong but sell-through on 11/11/16, which was up **17%** year-over-year from 11/11/15, fell short of our expectations. It is our understanding from Tmall, our primary ecommerce channel in China, that all of their retailers had similar experiences. Sales of our premium Roomba 800 actually exceeded our expectations, thus supporting our optimism for the launch of our Roomba 900 in China this year.

As we enter 2017, China is well-positioned for a growth year, following a decline in 2016, but will it comprise less than **10%** of total revenue. It took longer than we thought for us to understand the operating model of our new distributor, such as inventory management, and for the distributor to fully understand the most optimal mix and positioning of our products. We remain committed to the significant opportunity in China and with our Shanghai team in full control of the operation coming into the year, we are confident about delivering **30%** year-over-year growth in that market this year and further accelerating growth beyond 2017.

In 2016, Braava and Braava jet revenue grew roughly **75%**. This is significant given that Braava jet was only introduced in Asia in third quarter. As we have said, the predominantly hard floor surfaces in the region, coupled with the need for daily mopping, particularly in China, make the product ideal for those households. The wet floor care products comprised approximately **15%** and **50%** of 2016 revenue in Japan and China respectively and we expect that category to grow in 2017 with a full year of distribution in those regions. Consumables comprised roughly **5%** of total wet floor care revenue for the year. As we continue to build the installed base of robots, we expect that revenue to grow as well.

We continue to see a growth opportunity for the wet floor care market worldwide as we improve its positioning and better articulate its value proposition. In 2016 we made our first marketing investments to introduce and promote the wet floor category following the introduction of Braava jet. The television program was rolled out in Q4 in limited U.S. markets and the response was very positive. It not only built awareness of our latest product but of the wet floor category, which resulted in higher than expected Braava sales. We have also had great success with bundling a Roomba with a Braava, especially in Asian markets. In total, wet floor care comprised **9%** of 2016 Consumer revenue. We expect that revenue to grow in 2017 at a pace consistent with Roomba revenue growth.

We **DO NOT** plan to launch a new Consumer product **CATEGORY** in 2017. We have talked for several years about the potential for our developing a robotic lawn mower. We engaged in rigorous market analysis, including the addressable market and competitive landscape. The assessment has remained favorable and therefore we will continue our investment in this category. We continue to see the biggest barrier to entry in the U.S. market as the navigation systems used by current products. We are focusing our efforts on addressing this challenge. I am not going to provide any additional information on launch timing.

While we won't be launching a new category this year, we will be driving connectivity down through our products and rolling out the new functionality to view mission maps via our app that I previewed at our analyst day. Today our robots create maps that reside on the robot and aren't visible to the user. In the first quarter, we will push out an update to our app that will enable the user to see a completed map of the cleaned area once the Roomba is finished cleaning. This will not only improve the cleaning efficacy of the robot but help sceptics become believers by allowing them to see that Roomba really is vacuuming the area it's supposed to. It also puts us one step closer to our goal of becoming a strategically important player in the Smart Home.

A year ago, we provided you with 3-year targets beginning with 2016, when we expected Consumer revenue growth accelerating to **12-13%;** we delivered **17%** growth in 2016. We remain committed, to organic revenue growth of mid-teens this year accelerating to high-teen growth in 2018, and to increasing profitability. Beginning in 2017 we are shifting our profitability metric as Alison will explain. Growth from our acquisition of the Japanese distributor will be additive to the organic revenue growth in 2017 and 2018.

The business has developed from one in which we established the robotic vacuum as a category and became the market leader with first mover advantage. It is critical that at this inflection point of the category, we establish unambiguous brand and product leadership in robotic vacuum cleaners. We must also continue to build on our initial success in wet floor care products and not let the competition get a foothold in this category. We will be laser-focused on moving the ball forward in China and Japan. They are fast-moving markets that hold tremendous potential for our products and with our in-market presence we are well-positioned to capture an increasing piece of the growing pie.

There is a lot of be excited about. 2016 was a pivotal year for iRobot as we exited non-consumer businesses to focus solely on products for the home. We did so while delivering outstanding financial results for the year. Q4 was a record quarter for us and it was driven from the successful investments we made leading up to 2016 and during the year, as we responded well to increasingly competitive market conditions.

2017 will be our first full year as a consumer technology company and we plan to capitalize on the investments we began making in 2016. Overseas, we expect revenue growth to accelerate in all regions as we anniversary our China distribution transition, acquire and integrate our Japanese distributor, and continue to evolve our proven sales and marketing initiatives in European markets. In the U.S. we expect continued strong sales following our **30+%** growth in 2016.

I will now turn the call over to Alison to review our fourth quarter and full year results in more detail.

Alison

Our fourth quarter and full-year revenue, net income, EPS and Adjusted EBITDA exceeded expectations due to better than anticipated domestic Consumer performance. Total quarterly revenue of **$213** million increased **3%** from Q4 last year. Keep in mind that Q4 2015 revenue included **$31** million from our defense business which we sold at the end of Q1 2016. Consumer revenue of **$212** million was up **21%** from record Q4 2015 revenue. Net income for Q4 was **$14** million compared with **$19** million for Q4 2015. EPS was **$0.49** for the quarter, compared with **$0.65** in Q4 2015**.** Note that Q4 2016 EPS included a **$0.03** benefit associated with a change in accounting treatment of an equity investment and a **$0.01** contribution from D&S. Q4 2015 included a fourth quarter gain on the sale of an investment we made several years ago and a positive contribution from our D&S business of **$0.06** and **$0.23** per share respectively. Q4 2016 Adjusted EBITDA was **$29** million or **13%** of revenue compared with **$35** million, or **17%** last year.

Domestic Consumer revenue growth was **47%** for Q4 and **36%** for the year, reflecting the positive impacts of our marketing programs and our successful positioning against competitors. Q4 domestic revenue was partially impacted by a favorable adjustment to the product return accrual of **$1.2** million. This compares with a **$1.9** million favorable adjustment in Q4 2015. International revenue grew **4%** for the full year with EMEA growing roughly **5%** and APAC up **2%**.

In Q4 2016, we established a small reserve for pricing adjustments, recognizing the need to respond to rapidly changing market conditions in some of our overseas markets. During the fourth quarter we recorded a **$5.0** million revenue reduction for pricing support. Of that amount, **$3.5** million was for specific support and **$1.5** million was a general reserve for potential future pricing actions. Going forward we will review the reserve quarterly, to assess its adequacy based on our view of market conditions at that time.

Gross margin was **50%** for the fourth quarter and **48%** for the full year 2016.

Q4 operating expenses were **41%** of revenue, up from **35%** in Q4 last year as we invested to capitalize on the positive momentum created by our successful marketing programs. For the full year, opex was **40%** of revenue compared with **37%** last year, consistent with our expectations. Sales and marketing was **17%** of 2016 revenue, up from **16%** last year. As we have discussed throughout the year, higher 2016 sales and marketing expenses are due to increased investment to drive adoption of Roomba, establishing our new office in Shanghai supporting our evolving China go-to-market strategy and directly promoting our wet floor care products.

Net income for the full year was **$42** million, compared with **$44** million for 2015. Adjusted EBITDA for the full year was **$94** million or **14%**, compared with **$92** million or **15%** last year. Full-year EPS was **$1.48**, relatively flat with 2015.

We ended the year with **$254** million in cash, up from **$213** million a year ago. During the year, we repurchased approximately **2.3** million shares and returned **$97** million of cash to shareholders, while investing to grow the business to enhance shareholder value.

2016 year-end inventory was **$50** million or **42** days compared with **$62** million or **51** days last year. The improvement in year-over-year DII was due to significantly higher Q4 Consumer revenue, the sale of the defense business and the shutdown of Remote Presence.

Now I'd like to provide you with additional detail and some of the underlying assumptions for our full-year 2017 financial expectations and our 3-year targets. As we have previously discussed, we manage our business from a full-year perspective. To better align that practice with our investor communication, we will be providing only annual expectations going forward.

For 2017 we expect full year revenue of **$770** to **$785** million. These expectations assume the acquisition of our Japanese distributor closes at the beginning of Q2 2017 and contributes **$20** to **$25** million in incremental revenue as disclosed in our November 2016 announcement of the pending acquisition. As in the past several years, revenue will be more heavily weighted in the second half of the year when we expect to deliver roughly **57%** of the year's revenue. In addition to the traditional second-half seasonality of the business, 2017 will be positively impacted by the inclusion of incremental revenue from the acquisition.

We expect double digit year-over-year Consumer revenue growth in each quarter and for revenue to increase sequentially throughout 2017 as it did in 2016. The year-over-year growth rate is expected to be the highest in Q1 as U.S. retailers replenish inventory following a record Q4. Also, keep in mind that Q1 2016 included **$3** million of defense revenue. As Colin discussed, growth will be driven by accelerated growth overseas, continued growth in the U.S. through further market penetration of our Roomba robots and increased momentum in our wet floor care product adoption. Overall, we expect Consumer revenue to grow **17-19%** in 2017, including the impact of the Japanese distributor acquisition. Excluding the **3%**-**4%** impact of the acquisition on revenue growth, we expect Consumer revenue growth of **14%** to **15%.** The incremental revenue from the acquisition will come entirely in the second half of the year.

We expect full-year EPS of **$1.35** to **$1.65,** including a negative (**$0.25** to **$0.35**) impact from the acquisition. We expect operating income of **$57** to **$70** million or roughly **8%** of revenue. This expectation includes a (**$10** to **$15** million) negative impact from the acquisition. This year-one impact is driven by the initial acquisition accounting adjustments required and one-time costs associated with making the actual acquisition. As previously announced, we anticipate that the acquisition will be fully accretive to revenue, gross margin and profit in 2018 and beyond on an operational basis.

Note that for full-year 2017, we have included a schedule in the earnings release showing the anticipated quarterly year-over-year impact of the acquisition.

We expect to fund the investments outlined by Colin, by improving our gross margin by **200** basis points to **50%** in 2017 while maintaining our base opex at **40%.** Including operating expenses associated with the acquisition, both ongoing and one-time, operating expenses are expected to increase to **42%** for 2017. On a quarterly basis, opex in the second quarter is expected to increase significantly due to our seasonal sales and marketing programs coupled with acquisition expenses, both non-recurring and ongoing. In addition, we anticipate the gross margin to decline to roughly **45%** for that quarter as we begin to sell through inventory acquired from our Japanese distributor. As a result, we expect to report an operating loss and negative EPS in the quarter before accelerating profitability sequentially through the third and fourth quarters.

We are also assuming:

- Stock comp expense of roughly **$18** million;
- Depreciation and amortization expense of approximately **$15** million; and,
- Diluted share count of approximately **29** million shares

We are estimating a tax rate of **32%** for 2017 inclusive of the investment tax credit.

Building from our 2017 expectations, we are adjusting our financial targets through 2018 for the Japan acquisition as follows:

  - Consumer revenue growth of **17-19%,** inclusive of the Japanese distributor acquisition in 2017 is expected to accelerate in 2018; and,
  - Our EPS growth of 2017 over 2016 is expected to accelerate in 2018 as we anniversary year-one impacts of the acquisition and integration of our Japanese distributor; and,
  - We had previously provided Adjusted EBITDA margin expectations for 2017 and 2018 and those expectations remain intact organically. For

2017, and going forward, we will be measuring our operating profitability using GAAP operating margin. For 2017, we expect an **8%** operating margin due to the dilutive impact of our acquisition. In 2018, we expect improved operating margin in the range of high single digit to low double digits**.**

At this point we haven't implemented a stock repurchase plan for 2017 despite our cash level exiting 2016. Given current global uncertainty, the board and management are taking time to consider different alternatives for returning cash to investors.

I'll now turn the call back to Colin.

Colin

We expect our Consumer business to deliver strong financial performance in 2017 that will in turn fund critical investments in future technologies, and marketing, to solidify our position as the unambiguous leader in robotic floor care and our increasing importance as strategic player in the Smart Home to drive enhanced long term shareholder value. With that we'll take your questions.

Following Q&A

Colin

That concludes our fourth quarter and full year 2016 earnings call. We appreciate your support and look forward to talking with you again in April to discuss our Q1 results.

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