iRobot Fourth-Quarter and Full Year 2017 Conference Call

Operator:

Good day everyone and welcome to the iRobot fourth-quarter and full year 2017 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 each quarter thereof; the company's three-year financial targets for fiscal 2018, 2019 and 2020; 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 and 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; seasonality and predictability of our business; our expectations regarding our ability to penetrate further the robotic vacuum cleaner and wet floor care markets; the impact of our continued investments in sales and marketing and in R&D, technology and innovation; the impact of our efforts to increase consistency and awareness of our brand; 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 case products; our intent to make, and

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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 of our acquistions 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 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 fourth quarter and full year 2017 earnings press release issued last evening, which is available on our website http://investor.irobot.com/news-releases?_ga=2.192054377.2105878468.1516124487-142556974.1506451862.

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

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available through February 15, 2018 and can be accessed by dialing **404-537-3406**, access code **4995868.**

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 2017, as well as our outlook on the business for 2018; Alison Dean, Chief Financial Officer, will review our financial results for the fourth quarter and full year 2017. Colin and Alison will also provide our business and financial expectations for fiscal 2018 and our three-year financial targets for 2018 through 2020. 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.

2017, our first full year as a consumer-only focused business, was a fantastic one for iRobot. Our highly successful strategic decision to focus on the "consumer-as-our-customer" drove 2017 revenue growth that was **4** times 2016 revenue growth.

And we've only just begun.

We increased our expectations three times during 2017 and our Q4 and full year 2017 revenue exceeded those increased expectations. Record Q4 revenue was driven by very strong sales in the United States and in EMEA, as the overall category continued to grow at an accelerating rate. Higher revenue coupled with continued improvement in gross margin, allowed us to increase investment in R&D and sales and marketing to capitalize on our momentum, while returning additional profit to shareholders, and setting a strong foundation for 2018 and beyond.

During the year, we:
- Maintained unambiguous global product and brand leadership in the robotic vacuum cleaner category;
- Acquired two of our major distributors in Japan and Europe giving us more direct control of **75%** of our global revenue;
- Initiated marketing efforts to drive awareness of our mopping products; and,
- Continued 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.

These achievements resulted in full-year 2017 revenue growth of **34%**, operating income of **$73** million, or **8%** of revenue, and earnings per share of **$1.77** including a **($0.41)** negative impact from the tax law change.

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In 2018, we expect to:

- Drive revenue growth of **19% - 22%** through deeper household penetration of Roomba® globally;

- Deliver double-digit growth in the U.S. and overseas;

- Expand gross margin due to distributor acquisitions;

- Drive greater global iRobot brand consistency and awareness;

- Continue investment in innovation to extend our technology and product leadership in the category; and,

- Deliver several new products in the second-half of the year.

What are the factors supporting our confidence in our revenue growth rate?

- Global household penetration of robotic vacuum cleaners is still extremely low, in the single digits. In the U.S. where penetration is the highest, it is still at roughly **11%**. That landscape provides us with a tremendous opportunity for growth.

- iRobot's relentless focus on building robots that deliver world-leading system performance for our customers, not just features listed on a box, combined with our strong technology and product pipelines, position us for continued category leadership.

- Strong economic conditions world-wide are fueling overall global growth and positive consumer sentiment.

- We have demonstrated that in regions where we have run marketing programs to educate prospective customers about Roomba, we have increased our market share. Our recent distributor acquisitions enable us to extend our strategic marketing programs to Japan and many western European countries.

- The RVC category grew at more than **25%** in 2017, and we expect category growth to continue as we and competitors invest to drive awareness.

- We have seen retailers in the U.S. embracing and promoting the category through national advertising programs featuring RVCs, allocating increased shelf space and investing in high-visibility displays.

In addition to these growth drivers for Roomba, we see a tremendous opportunity to drive adoption of Braava products through campaigns targeted at our millions of Roomba customers.

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In 2018, we expect to cross the billion-dollar revenue threshold delivering **$1.05** to **$1.08** billion in revenue, which is year-over-year growth of **19%** to **22%**, operating income of **$86** to **$96** million, and EPS of **$2.10** to **$2.35**.

Continued investment in both sales and marketing and R&D is essential to meet 2018 expectations and successfully achieve our new three-year financial targets.

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Now I'll take you through some of the highlights of 2017, and our business expectations for 2018.

Our initial view last February was that we would grow 2017 revenue **17-19%,** excluding the impact of any acquisitions, over the previous year. As the year progressed, our outlook for the U.S. and EMEA markets became more bullish, despite increased competition, while addressing a rapidly shifting landscape in China. The final result was full-year organic revenue growth that far exceeded our initial expectations along with the incremental revenue we achieved through acquisition.

Each year, we go through a very comprehensive, bottoms-up analysis with input from retailers and distributors, while keeping in mind any planned product introductions and transitions. As the category grows and retail dynamics change, we see new indicators develop that provide us with better visibility into potential consumer demand. The most significant indicator in the past two years was Amazon Prime day in July, which has become an important metric for retailers planning their orders for the year-end holiday season in the U.S. We provide a range of financial expectations at top and bottom lines intended to capture the opportunities and risks we see at different times of the year. Our view in February can change dramatically throughout the year, as it did again in 2017.

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Following the exceptional performance we delivered in the fourth quarter, we are more confident than ever that the outlook for robotic vacuum cleaner category growth remains strong. At the Consumer Electronics Show, CES, in January of this year, we met with U.S. retailers and overseas distributors to review their respective iRobot performance and outlook. We have been doing this for years and I have never heard such outright enthusiasm about robotic vacuum cleaners. They understand the category is expanding. During the holidays, the RVC segment was a major driver of store traffic at retailers.

While **our** continued investment in growing the category and brand through national TV campaigns clearly helped drive awareness, major retailers including, Target, Amazon, Best Buy, and Walmart all featured iRobot in **their** national commercials leading up to the holidays. Roomba is also currently being shown in Verizon's connected home T.V. ad for their Fios internet service. In addition, new competition invested in TV advertising in the U.S. The end result? Market data shows RVC 2017 growth in the U.S., for products that cost more than **$200**, of more than **40%** compared with year-over-year category growth of **20%** in 2016. Growth of the category will enable **us** to continue to grow even as competitors enter the market. Based on the U.S. market momentum, we expect to drive U.S. revenue growth in the low **20's** in 2018.

We are often asked what differentiates our products from others because they "all look alike". While it's true that competitors have copied our external design and their products look like Roomba on the outside, that's where the similarities end.

On the inside, our 900 Series Roomba robots are sophisticated high-tech mobile mapping devices with more than **1 million** lines of code, making them:
- Smarter – by combining iRobot's proprietary iAdapt navigation with Visual Localization and Dirt Detect it systematically and efficiently navigates an entire level of a home, recharging as needed until the job is done;
- Simpler – the iRobot HOME App enables cleaning and scheduling conveniently; anytime, anywhere; and,

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- Better cleaning – Roomba's Aeroforce cleaning system with dual self-cleaning debris extractors provides leading performance without the need to maintain brushes.

We will continue to drive connectivity down through our product lines as well as continue our technology development of persistent mapping. In Q1 of 2017, we pushed out functionality to users, through our app, that enables them to see a completed map of the cleaned area once the Roomba robot is finished cleaning. Our maps not only improve the cleaning efficacy of the robot, but also help sceptics become believers by allowing them to see that Roomba really is vacuuming the area it's supposed to. We've talked about the importance of persistent maps that would allow the user to segment the map into specific rooms as well as enabling our robots to work together. These are just a couple of the critical capabilities we are working to develop that we believe will improve cleaning efficacy and autonomy, thus driving further adoption.

It is essential that we not cede our hard-won global market-leadership to competitors who recognize this enormous opportunity. We will continue focusing investment more deeply into the most important emerging technologies and integrate them into products that deliver the features and functionality that meet our customers' needs, as well as investing in patents to protect that technology.

Likewise, we must continue to invest in targeted marketing programs to drive awareness. Robotic vacuum cleaner household penetration in the U.S. is roughly **14** million households, or **11%,** 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 2018, will help us reach the next segment of immediately addressable **25** million U.S. households.

While U.S. revenue grew substantially in 2017, our overseas revenue grew an impressive **28%,** driven by **46%** year-over-year growth in EMEA and **25%** in Japan.

Our acquisition of Robopolis, our largest European distributor, at the beginning of the fourth quarter enabled us to implement our successful U.S. marketing programs in parts of Europe, going into the important holiday season, and deliver results that exceeded our expectations. Going forward, our efforts in that region will focus on improving our brand awareness across Europe as the adoption of robotic vacuum cleaners is growing. The RVC category itself grew roughly **22%** in 2017 up from roughly **19%** in 2016. In 2018, we expect EMEA to grow **25 – 30%** over record 2017 growth.

Three-quarters after acquiring our distributor in Japan, our largest market outside the United States, we have completed its integration and fully implemented channel inventory management practices consistent with those in the U.S. We exited the year with historically low channel inventory levels and improved retailer relationships. We are optimistic about further extending our targeted marketing programs in this region and driving consistent double-digit revenue growth.

And finally, China. China represented less than **5%** of total company revenue in 2017, as competition, particularly at the low end of the premium RVC segment, remained intense and we don't see that changing materially in the next few years. We continue to execute against our premium-brand strategy, albeit at a scaled back level. With real-time market information available through our office in Shanghai, we continue to modify our go-to-market model, but at this point, don't see China as a growth driver in the next three years.

In 2017, Braava family revenue grew **26%** and comprised roughly **9%** of total company revenue.   We continue to see a growth opportunity for the wet floor care market as we improve its positioning and better articulate its value proposition. In Q4 2017 we launched our first ever Braava national television program in the U.S. following a very positive reaction to our limited television roll out in 2016, and Braava family revenue grew **65%** in 2017 over full-year 2016. We have promoted this category unevenly across the globe, however, where we **have** made advertising investments, as we did in Q4 2017 in the U.S., demand has been very strong. We began our television campaigns for Roomba first in

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the U.S. where we had been selling the product the longest and had the strongest brand recognition and market share. Since then, we have selectively expanded them into overseas markets with positive results. We are confident that putting additional investment to support Braava promotions globally will help drive awareness and adoption of this category too.

As I mentioned, we plan to launch several new products in the second half of 2018. As with all our new products, I will not provide any additional details about the products or the timing of their launch other than to say that we expect 2018 revenue contribution of roughly **20 – 25%** and further strengthening our RVC leadership.

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This year we kick off a new set of three-year financial targets for 2018 through 2020 inclusive of the distributor acquisitions we made in 2017. These will replace those we set for 2016 through 2018 which did not include any acquisitions.
Over the three-year period we expect:

- Annual revenue growth of roughly **20%**;
- Gross margin in the range of **50 - 51%**; and,
- Operating margin growing to **10%** by 2020.

It is critical that at this point in the accelerating adoption of the category, we maintain unambiguous brand and product leadership in robotic vacuum cleaners through continued focused investment in R&D as well as expanding our successful U.S. sales & marketing programs into overseas regions. 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.

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There is a lot of be excited about. 2017 was a critical year for iRobot as the first full year focused solely on developing and delivering products for the home. We delivered outstanding financial results for the year while successfully executing the acquisition of

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two major distributors in key markets and extending our control over **75%** of our global revenue.

In 2018, we plan to capitalize on the incremental investments we made in 2017 with the introduction of new products in the second half of the year. We expect double-digit revenue growth in the U.S. and overseas as we continue to evolve and extend our proven sales and marketing initiatives in overseas markets. In the U.S. we expect continued strong sales following our **40+%** growth in 2017.

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, operating income, and EPS exceeded expectations, before the impact of tax reform, due to better than anticipated performance in the U.S. and EMEA. Record quarterly revenue of **$327** million increased **54%** from Q4 last year. Operating income for Q4 was **$23** million compared with **$19** million for Q4 2016. EPS was **$0.16** for the quarter, compared with **$0.49** in Q4 2016**.** Q4 2017 EPS included a negative (**$0.41)** impact from the new tax reform which included the remeasurement of our net deferred tax assets and a provisional repatriation toll charge totaling roughly **$12** million. In addition, quarterly EPS included approximately **$0.03** of tax benefit relating to the new 2017 stock compensation accounting standard. As a reminder, given the difficulty with projecting the size and direction of the stock compensation tax impact, we communicated in Q1 that our financial expectations at the time reflected our tax rate expectations, prior to discrete items for future periods. Our Q4 effective tax rate before discrete items was **34%**. In 2018, we expect the tax law change to result in an effective tax rate, before discrete items, of between **25 – 27%.**

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Revenue growth of **54%** for Q4 and **34%** for the year, reflects the positive impacts of our marketing programs, acquisition of Robopolis at the beginning of the fourth quarter and

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our successful positioning against competitors. International revenue grew **28%** for the full year, with EMEA growing **46%,** Japan up **25%** and China down **27%**. We are very pleased with our two acquisitions and their performance to date. Incremental revenue was ahead of our expectations of **$25 - $35** million for Robopolis, and in line with **$10 - $12** million expected contribution from SODC. Our full-year 2017 organic growth rate was roughly **25%.** Because both acquired companies have been fully consolidated into iRobot, 2018 expectations and results will be provided in total.

Gross margin was **47%** for the fourth quarter, compared with **50%** in Q4 2016, and **49%** for full-year 2017. On our Q3 call, we said that we expected gross margin to be roughly **500** basis points lower in Q4 than Q3 primarily due to the impact of the Robopolis acquisition, and the Robopolis impact was in line with that. The quarter-on-quarter expected decline from Robopolis accounting adjustments was partially offset by favorability from higher revenue and COGS improvements, driven by product cost reductions, and lower warranty expense across the global business.

Q4 operating expenses were **40%** of revenue, down from **41**% in Q4 last year due to higher revenue. For the full year, opex was **41%** of revenue compared with **40%** last year, consistent with the low end of our range. Sales and marketing was **18%** of 2017 revenue, up from **17%** last year and included approximately **150** new employees from our distributor acquisitions as well as the first-time national marketing campaign for Braava and the China brand program.

Full-year EPS was **$1.77**, compared with **$1.48** in 2016. As a result of the tax reform act we took a discrete charge of **$12** million for the remeasurement of our net deferred tax assets and a provisional repatriation toll charge in the fourth quarter, negatively impacting Q4 and full-year EPS by **($0.41)**. Full-year 2017 EPS was also negatively impacted by approximately **($0.30)** from the year-one SODC accounting adjustments which will not impact 2018. In addition, the negative effect in 2017, from the acquired inventory from Robopolis, will also not carry into 2018. This will not translate into year-on-year gross

margin improvement, however, due to increased amortization of Robopolis intangibles in 2018.

We ended the year with **$166** million in cash, down from **$254** million a year ago, reflecting net cash payments of **$149** million to acquire the distributors. We plan to rebuild our cash position to more than **$200** million by the end of 2018.

2017 year-end inventory was **$107** million or **56** days compared with **$50** million or **42** days last year, driven by the acquisitions and the need to hold inventory for direct-to-retail sales in Japan and more than **50%** of EMEA.   Due to this structural change in our business model, you should expect DII to be approximately **100** days **+/-** on average in 2018, with our typical quarterly fluctuations.

Now I'd like to provide you with additional detail and some of the underlying assumptions for our full-year 2018 financial expectations and our 3-year targets. As we have previously discussed, we manage our business from a full-year perspective. Likewise, our 2018 financial expectations should be viewed on full-year basis as quarterly year-over-year revenue growth rates will vary greatly by region due to a number of factors including the impact of acquisitions we made in 2017.

For 2018 we expect full year revenue of **$1.05** to **$1.08** billion, which is year-over-year growth of **19%** to **22%**. As in the past several years, we expect revenue will be more heavily weighted in the second half of the year when we expect to deliver roughly **60%** of the year's revenue. In addition to the traditional second-half seasonality of the business, 2018 will be positively impacted by the inclusion of incremental revenue from the European acquisition through the third quarter. Our revenue expectations contemplate Yen and Euro exchange rates roughly in line with current rates, **+/- 5%**.

We expect double digit year-over-year growth in each quarter and for revenue to increase sequentially throughout 2018 as it did in 2017. The year-over-year growth rate is expected

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to be the highest in Q1 as U.S. retailers replenish inventory following a record Q4 and we will also benefit from revenue due to the inclusion of the two distributors in the first quarter. Profitability will be lowest in Q2 as our sales and marketing expense increases over Q1 to support Q2 seasonal selling.

We expect our gross margin to be **50 - 51%, 1** to **2** percentage points up from 2017 which included the negative impact of acquisition related intangible asset amortization and lower margin from acquired inventory, the latter of which is completely behind us coming into 2018. We sold through all the acquired inventory from both SODC and Robopolis, as expected, during 2017. Beginning in 2018, we will recognize margin on products sold to retailers in Japan and the Robopolis countries on a basis consistent with our direct-to-retailer margins in the U.S. As we previously disclosed, however, this positive impact on margins will be partially offset by the amortization of intangible assets associated with the Robo acquisition which will continue through 2019. The charges are front-end loaded and will be higher in 2018 than 2019.

We expect full-year opex to increase **100** basis points to **42%** of revenue as we are proactively reinvesting the incremental gross margin provided by our forward integration primarily into higher sales & marketing spend. Higher sales & marketing expenses in 2018 include a full year of expense associated with our two acquisitions, as well as marketing expenses associated with our 2018 product launches. Additionally, we will make continued investments in the Roomba and Braava awareness campaigns to drive continued worldwide household adoption. Our R&D investment is expected to remain at **13%** of revenue, as we continue to invest in innovation to ensure Roomba maintains its market leading position while we develop new product offerings for the future.

We expect full-year operating income of **$86** to **$96** million and EPS of **$2.10** to **$2.35**.

We are also assuming:
- Stock comp expense of roughly **$24** million;
- Depreciation and amortization expense of approximately **$27** million;

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- Diluted share count of approximately **30** million shares; and,
- Capital expenditures of approximately **$30** million driven largely by tooling for new products, facility expansions and the related leasehold improvements, and system implementations for our newly acquired entities.

We are estimating a tax rate, before discrete items, of between **25 - 27%** for 2018 reflecting the new tax law.

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Building from our 2017 results, we are providing our three-year financial targets through 2020 as follows:

- **20%** revenue CAGR;
- Gross margin in the range of **50 - 51%**; and,
- Operating margin growing to **10%** by 2020.

Global revenue growth is expected to be driven primarily by further adoption and greater household penetration of Roomba, as well as adoption of our Braava family of mopping robots. We believe at this critical point in the accelerating adoption of household robots, driving higher top line growth and maintaining dominant segment share is essential.

I'll now turn the call back to Colin.

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Colin

We have a tremendous opportunity to drive **20%** revenue growth over the next three years due to:
- Single-digit global household penetration of robotic vacuum cleaners
- Our successful marketing programs that have driven consistent global market share of more than **60%**;
- The global RVC category grew more than **25%** in 2017, and we expect category growth to continue as we and competitors invest to drive awareness;
- Retailers in the U.S. embracing and promoting the category; and,
- Our delivering world-leading performance products.

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We expect our global business to deliver strong financial performance in 2018 that will in turn fund critical investments in future technologies, and marketing, to further solidify our position as the unambiguous leader in robotic floor care and our increasing importance as a 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 2017 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.