

## **iRobot Fourth-Quarter and Full Year 2015 Conference Call**

### **Operator:**

Good day everyone and welcome to the iRobot fourth-quarter and full year 2015 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 2016 and the first quarter ending April 2, 2016, the growth and revenue impact of our businesses including the international growth and international revenue impact of our businesses, our expectations regarding the seasonality and predictability of our businesses, our expectations regarding profitability, our expectations regarding revenue, the rate of revenue growth, Adjusted EBITDA, Adjusted EBITDA margin, operating cash flow, operating expenses, gross margins, operating margins, restructuring charges, stock compensation expenses, depreciation and amortization expenses, tax rates, shares outstanding and earnings per share, the impact of the shift of our investments in research and development to software-based functionality in our home robots, strategic investments to diversify Home revenue, the impact of our continued investment in quality and improved operational performance, the impact of our continued investment in expanding the robotic vacuum cleaner category, our customer base, and our global marketing capabilities, demand for our home robots including our Roomba<sup>®</sup> 900, Roomba<sup>®</sup> 800 and Roomba<sup>®</sup> 600 robots, demand for wet floor care robots including our

Scooba<sup>®</sup> robot, the mix of product revenue and impact of operating margins, the timing impact of our Defense & Security business unit that we announced on February 4, 2016, our plans for expansion, our introduction and delivery of new products and new product capabilities and functionality, including the timing of new product launches, the availability, capabilities and functionality of new technologies, the impact of our related investments in technology development, our competitive position, our market share, 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 expenses 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 Q4 and full year 2015 earnings press release issued last evening, which is available on our website <http://investor.irobot.com/phoenix.zhtml?c=193096&p=irol-EventDetails&EventId=5206137>.

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 18, 2016 and can be accessed by dialing **630-652-3042**, access code **40924296#**.

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 2015 as well as our outlook on the business for 2016; Alison Dean, Chief Financial Officer, will review our financial results for the fourth quarter and full year 2015; and, Colin and Alison will also provide our financial expectations for the first quarter ending April 2, 2016 and fiscal 2016. 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.

2015 was another great year for iRobot. Last night, we reported a record Q4 that resulted in full year revenue and EPS that exceeded our expectations. These results were driven by strategic investments we made throughout the year in:

- Domestic demand generation;
- China “go to market” improvements;
- Technologies supporting connectivity, navigation and mapping
- Advancements in product quality;
- Exploring adjacent Home Robot markets; and,
- Supporting demand generation efforts of our overseas partners.

We also took steps to become more focused on the large Home market and to fuel future growth. We:

- Created better nuanced messaging of Roomba - driving sell thru and further adoption
- Successfully launched our first connected Roomba using vSLAM navigation to dynamically create and update a map;
- Reallocated R&D resources from a next generation Remote Presence platform to home opportunities;
- Began to reinvigorate overseas Home Robot revenue growth; and,
- Identified potential acquirers for our Defense and Security business.

As a result of these efforts, Home Robot revenue grew more than **30%** in the fourth quarter, driven by sales in the U.S. and China which were up **46%** and more than **70%** respectively, over Q4 2014. Likewise, our D&S business grew more than **25%** in the quarter, driving full year revenue to **\$55** million and a return to pro forma fully allocated profitability for the first time in many years. For the full-year 2015, company revenue

was up **11%** to **\$617** million. Earnings per share were **\$1.47**, including the positive **\$0.05** impact of the investment tax credit and Adjusted EBITDA was **\$92** million or **15%** of revenue.

We delivered this strong performance in the face of:

- Significant currency headwinds;
- Economic collapse in Russia;
- Recession in Japan, our largest international market; and,
- Increasing competition.

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Also during the year, we took the steps required to become more focused on our well established and substantial market opportunity in Home by identifying a buyer for our Defense and Security business. On February 4, 2016, after a very thorough process, we announced the anticipated sale of the business to Arlington Capital Partners for consideration of up to **\$45** million. Upon completion, this divestiture not only creates an additional opportunity to return capital to shareholders, but also allows the remainder of the business to become razor focused on the much larger opportunity the home market provides.

In 2016 our financial performance will be driven by our Home Robot business, which is expected to grow **12 - 13%**, as we expand worldwide distribution of Roomba 980, tap further into a growing market in China and build our wet floor care business.

To execute our 2016 plan and achieve our 3-year financial targets, we need to continue to strategically invest in a number of areas to:

- Strengthen our marketing capabilities globally and accelerate worldwide consumer adoption of Roomba to maintain our market-leading position in robotic vacuum cleaners;

- Better position ourselves in China to capture an even larger share of the rapidly growing market for robotic floor care;
- Develop our wet floor care business to generate a material, secondary revenue stream;
- Scale the infrastructure to support future connected products
- Explore, develop and grow adjacent non-floor care Home Robot products that can generate meaningful diversified revenue streams; and
- Make continued operational improvements that can reduce product and operating costs.

For 2016, we expect revenue of **\$630** to **\$642** million, EPS of **\$1.20** to **\$1.40** and adjusted EBITDA of **\$80** to **\$90** million. Expectations include the impact of a one quarter D&S stub period and one-time D&S divestiture costs, most of which will be recognized in Q1.

Growth is expected to be driven by:

- Expanded worldwide consumer adoption of Roomba supported by targeted marketing programs;
- Wider geographic distribution of the Roomba 980;
- Accelerated growth of wet floor care products;
- Regional growth in China and the U.S.; and,
- A new product introduction in the first half of the year.

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Now I'll take you through some of the details of 2015, and our expectations for 2016.

Our Home Robot business had a solid year despite the significant overseas macroeconomic headwinds. Exceptional domestic growth, of **46%** in Q4 and **25%** for the full year over 2014, was driven by investment in ad media, national promotions, launch of Roomba 980, and the addition of Target as a new channel in the fourth quarter.

Our Roomba marketing programs were highly successful in the U.S. and we saw a significant return on our investment. Sell through at our top five retailers in Q4 was up more than **70%** over Q4 2014 validating our marketing strategy. We ran similar programs in Q2 over Mothers' Day and Fathers' Day with equally positive results, but wanted to further evaluate them during the Q4 holidays before declaring victory. We are highly confident that we have the right formula to export overseas to accelerate growth in those markets. During 2016, we will focus our marketing efforts on the Japanese market where we have already kicked off several initiatives. If we are successful, we should start seeing impact on demand generation by the end of the year.

In 2015, wet floor care revenue grew roughly **5%** but, within the category, Braava grew more than **30%** over 2014. This growth is due largely to Braava's successful adoption in Japan and China where the product was first introduced in 2014. 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.

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 will invest in optimizing the positioning and go-to-market strategy of this category by reaching out to existing Roomba customers, creating advertising to build awareness of the products and functional differentiation from Roomba, and educating the U.S. retail in-store sales personnel about how to promote the category.

Growth in China was more than **70%** year-over-year in 2015. We first entered that market in 2012 and have continued to evolve our go-to-market strategy. In 2015, e-commerce was the growth driver, especially on the 11/11 and 12/12 holidays.

We have said that we thought China could grow to be our second largest market and are confident that, with 2016 investment to focus on further accelerating growth in the e-commerce channel, we can more quickly reach that goal.

We **DO** plan to launch a new Home Robot product in the first half of the year, but I am not going to provide any additional information on timing or product category.

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Regionally, we expect the United States and APAC, to deliver mid-high teen growth, and EMEA to deliver mid-single digit growth in 2016.

Japan's strong fourth quarter followed 3 quarters of year-over-year declines during 2015. We are cautiously optimistic that a positive trend will continue in 2016 resulting in mid-single digit growth for the year. APAC as a region is expected to grow in the mid-high teens up from **2%** in 2015, driven by another year of strong growth in China.

In EMEA, we are cautiously optimistic about a return to growth, with a mid-single digit revenue increase in 2016 from a flat year-over-year performance in 2015. We expect Russia to grow off a much reduced base and Western Europe countries to post gains.

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Turning now to our Defense & Security business, Q4 and full year results were in line with our expectations. With revenue up **21%** year-over-year in 2015, D&S reported its first growth since 2011. As we announced on February 4, 2016, we are divesting this business in a transaction expected to close in the next few months. The business opportunity and the leadership team are strong, making it the right time for this transaction.

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While worldwide macros still present a challenging backdrop in the near term, we are excited that on a global basis the Home business is still growing significantly. Looking out over a 3-year horizon, we anticipate Home Robot revenue growth accelerating to **12-13%** in 2016 and then further accelerating each year to reach high-teen annual growth by 2018. The business has developed from one in which we established the robotic vacuum cleaner category, became the market leader with first mover advantage, and increased ASPs as we incorporated features and functionality through technology.



Going forward, we will maintain Roomba's market-leadership while positioning it as a key component in the connected home. We must also build a second material revenue stream, which we expect to do with our wet floor care products. As we execute on these strategies, in 2016 we expect a small decline in Adjusted EBITDA margin as we invest in these revenue growth initiatives, but expect to return to mid-teen Adjusted EBITDA margins in 2017 and 2018.

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In 2015 we began to further monetize our navigation technologies, through the introduction of Roomba 980 with Visual Simultaneous Location and Mapping or vSLAM. In 2016 we are divesting our Defense and Security business and curtailing R&D investment in a next generation Remote Presence platform in order to solidify iRobot's position as the leader in diversified Home Robots and to focus on the key technologies, with a focus on software, that allow our robots to understand the homes in which they operate. It is our intent to continue investing in these critical technologies and the economic opportunities they unlock.

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There is a lot of be excited about. We had great results in 2015. Q4 was a record quarter for us and it was driven from the successful investments we made leading up to 2015 and during the year as we responded well to the changing market environment.

We expect even higher revenue growth in 2016, driven by strong performance again in the US and China, with Japan and EMEA starting to turn the corner. As we exit the Defense and Security business, we are more focused. Our confidence about the future is demonstrated by our decision to make significant capital allocation choices in 2016 that will drive future revenue diversification for our Home business and further revenue acceleration in 2017, 2018 and beyond.

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 and EPS results exceeded expectations due to better than anticipated domestic Home Robot performance. Adjusted EBITDA was in-line with our expectations. Revenue of **\$206** million increased **29%** from Q4 last year driven by growth in Home Robot revenue. EPS was **\$0.65** for the quarter, compared with **\$0.31** in Q4 2014. An investment tax credit positively impacted 2015 EPS by **\$0.05** and 2014 EPS by **\$0.04**. Q4 Adjusted EBITDA was **\$35** million or **15%** of revenue compared with **\$20** million or **12%** last year.

We also recorded a fourth quarter gain on investment of **\$0.06** per share, or **\$3** million in pre-tax income, from the sale of an investment we made several years ago. We noted this on last quarter's call and increased our expectations accordingly in October.

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Domestic Home Robot revenue growth was **46%** for Q4 and **25%** for the year, reflecting the positive impacts of our marketing programs and successful launch of Roomba 980 our first connected product. Q4 domestic revenue was partially impacted by a favorable adjustment to the product return accrual of **\$1.9** million. This compares with a **\$1.1** million favorable adjustment in 2014. International revenue grew **2%** for the full year with EMEA flat year-over-year and APAC up **2%**.

Defense & Security revenue of **\$31** million in Q4 was up **26%** year over year as expected. Roughly **65%** of this quarterly revenue was from PLR, and the balance was from robot sales.

For the total company, gross margin was **46%** for the fourth quarter and **47%** for the full year 2015.

Q4 operating expenses were **35%** of revenue, down from **40%** in Q4 last year. We said on our Q3 earnings call that we would curtail sales & marketing spending in Japan in Q4. That contributed to lower overall sales and marketing expenses for the quarter as a percent of revenue. For the full year, sales and marketing was **16%** of total revenue,

compared with **15%** in prior years, consistent with our expectations. Keep in mind that the higher full year expense reflects the overseas investments we made earlier in the year to support our international distributors. Opex for the full year was **37%**, unchanged from last year.

EBITDA for the quarter was **\$35** million compared with **\$20** million last year; with full year 2015 results of **\$92** million or **15%**, compared with **\$80** million or **14%** last year. EPS in Q4 was **\$0.65** and **\$1.47** for the full year. Full-year EPS was favorably impacted by **\$0.05** from the enactment of the 2015 investment tax credit in late December.

We ended the year with **\$213** million in cash, down from **\$222** million a year ago. During the year, we repurchased **1.26** million shares of our stock for **\$37** million under our buy-back programs. 2015 year-end inventory was **\$62** million or **51** days compared with **\$48** million or **53** days last year. The improvement in year-over-year DII was due to significantly higher Q4 Home robot revenue.

Now I'd like to provide you with additional detail and some of the underlying assumptions for our Q1 and full year 2016 financial expectations. The outlook for our Home Robot business remains strong with growth drivers identified for the next couple of years.

We expect full year revenue of **\$630** to **\$642** million comprised primarily of Home Robot revenue. These expectations assume the divestiture closes in Q1 2016. As in the past several years, revenue will be more heavily weighted in the second half of the year when we expect to deliver more than **50%** of the year's revenue. While we provide quarterly expectations, we manage our business from a full-year perspective. Keep in mind that it is difficult to predict precise order timing between quarters and especially between Q3 and Q4.

We anticipate total company Q1 2016 revenue to be up **6-14%** year-over-year to **\$125** to **\$135** million, including a quarter of D&S revenue. After Q1, we expect Home revenue to increase sequentially throughout 2016 as it did in 2015. As Colin discussed, Home Robot's growth will be driven by full year distribution of the Roomba 980, growth in China and promotion of our wet floor care products. Overall, we expect Home Robot revenue to grow **12-13%** in 2016, fueled by growth in the United States and China.

We expect Q1 EPS of **(\$0.03)** to **\$0.04** and full-year EPS of **\$1.20** to **\$1.40**. Adjusted EBITDA in Q1 is expected to be **\$8** to **\$11** million and for the full-year is expected to be **\$80** to **\$90** million. The Q1 and FY expectations include the impact of a one quarter D&S stub period and divestiture costs expected to be incurred primarily in Q1, in total approximately **\$0.10-\$0.12** cents of EPS loss for the quarter.

Note that for full-year 2016, we have included a schedule in the earnings release showing comparable year-over-year data to help you model the impact of the divestiture. When we provide Q1 2016 results in April, we will also provide a comparable view of Q1 2015 results.

Given the investments outlined by Colin, we expect opex to increase to between **38%** and **39%** of revenue for the full year before beginning to decline to lower levels in 2017 and 2018.

We are also assuming:

- Gross margin of **47% - 48%**
- Stock comp expense of roughly **\$16** million;
- Depreciation and amortization expense of approximately **\$14** million; and,
- Diluted share count of approximately **28.2** million shares, after the execution of the additional share repurchases

We are estimating a tax rate of **30%** for 2016 inclusive of an investment tax credit.

Building from our 2016 expectations, we are establishing our financial targets through 2018.

- Home Robot revenue growth of **12-13%** in 2016 is expected to accelerate annually to high teens by 2018;
- Our EPS of **\$1.20 to \$1.40** for 2016 is expected to grow more than **25%** in 2017 and 2018 as we anniversary one-time costs associated with D&S and the divestiture, lever operating expense and continue to offset growth in share count through buy-backs; and,
- 2016 Adjusted EBITDA margins of **13-14%** are expected to return to **14-15%** levels in 2017 and 2018.

When we announced the planned divestiture of the D&S business, we also announced a **\$65** million increase to our current share repurchase initiative, partially funded from the expected proceeds, bringing the total 2016 program to more than **\$100** million. We are evaluating several vehicles for this incremental share repurchase, including an Accelerated Share Repurchase program. We intend to initiate the incremental program in Q1 in conjunction with the deal closing. This initiative, coupled with our previous return of capital, effectively balances our interest to return cash to shareholders while maintaining sufficient cash to operate the business and make appropriate investments and acquisitions.

I'll now turn the call back to Colin.

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## **Colin**

We expect our Home Robot business to deliver strong financial performance in 2016 that will in turn fund critical investments in future technologies and marketing to solidify

our position as the leader in diversified Home Robots as well as to drive long term shareholder value.

With that we'll take your questions.

**Following Q&A**

**Colin**

That concludes our fourth quarter and full year 2015 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.