<u>iRobot Second-Quarter 2018 Conference Call</u>

Operator:

Good day everyone and welcome to the iRobot second-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, the second half and third and fourth quarters thereof; 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; 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; our expectations regarding the timing of the final determination of the International Trade Commissions (ITC) related to the ITC action that we filed; 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; the impact on our financial results and tax rate of our U.K. principal company; 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 of our acquisitions of our European and Japanese distributors; our market share and opportunity; the imposition of tariffs on goods imported into the United States; 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 second-quarter 2018 earnings press release issued last evening, which is available on our website http://investor.irobot.com/newsreleases?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 August 1, 2018 and can be accessed by dialing **404-537-3406**, access code **8376338.**

On today's call, iRobot Chairman & CEO Colin Angle will review the company's operations and achievements for the second quarter of 2018 and Alison Dean, Chief Financial Officer, will review our financial results for the second 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 second quarter revenue growth of **24%** over Q2 2017, slightly ahead of our expectations. EMEA and Japan saw significant year-over-year growth of **51%** and **31%,** respectively. EMEA growth was in part driven by the revenue uplift from the acquisition, which was closed at the beginning of Q4 2017. Shipments to support Q2 holidays in the United States drove domestic revenue growth of **15%** over last year. Second-quarter profit was higher than we anticipated due primarily to the higher revenue, a slightly higher gross margin and some delayed marketing expense.

Given our Q2 results and our outlook for the rest of the year, including our second-half product launches, we are increasing our 2018 full-year expectations. We now anticipate full-year 2018 revenue of **1.06** to **1.08** billion dollars, which is year-over-year growth of **20 – 22%,** full-year 2018 operating income of **90** to **96** million dollars, and full-year EPS of **$2.30** to **$2.50**. The anticipated EPS increase reflects several factors favorably impacting our tax rate, in addition to the core business upside reflected in the revenue and operating income increases. Alison will discuss these items in more detail later.

Now I'll take you through some of the highlights of Q2 2018, and our business expectations for the rest of the year.

We were excited to be selected, once again, for the fourth straight year, as a featured product for the U.S. Amazon Prime Day. We, once again, sold out, doubling our prime day sales volume as we have each year since the event began in 2015. The Roomba 671 was ranked **#1** in robotic vacuum cleaners, **#1** in all floor care and **#3** in all home & kitchen for the U.S. Prime Day event. That is particularly significant when considered in the context of the increasing availability of cheaper, lower quality competition.

While our performance on Amazon Prime Day in the U.S. isn't material to our Q2 results, it has become an important gauge for second-half expectations in the U.S. We expect the competitive landscape to be similar to last year's landscape and have a high level of confidence in meeting our expectations for full-year U.S. revenue growth.

Building upon our relationship with Amazon in the U.S., we were featured on Prime Day in EMEA and Japan this year, for the first time, and the results in those regions were great. An element of our rationale for acquiring our overseas distributors was to optimize the ecommerce channel in those regions, beginning with a strengthening of the relationship with Amazon. We were very pleased to be included in the events in EMEA and Japan and look forward to further expanding our relationship with this key partner. Our coordinated, global Amazon Prime Day further strengthened our global brand.

During Q2 we announced a favorable initial determination from the International Trade Commission (ITC) regarding our patent infringement claims. The finding recommended an exclusion order to bar the importation, into the United States, of certain robotic vacuum cleaners made, and/or sold by iLife, bObsweep and Hoover. The initial determination and recommended remedy are now before the ITC Commissioners, who are expected to issue a final recommendation by October 25, 2018. If approved, the exclusion order will go into effect immediately upon publication regardless of further appeals.

We are very pleased with the initial results and will be carefully considering next steps with respect to our IP litigation strategy.

I know you are all as excited about our second-half product launches as we are! Although I can't give you any specifics, what I can tell you is that we are planning multiple launch activities. The first, which will be happening in a few weeks, will be a soft launch, for limited stores initially, where we will introduce our next offering of high end innovation at lower price points. Our next launch event will take place later in Q3. Stay tuned!

Braava growth momentum continued through the second quarter driven by international demand where Braava revenue grew roughly **50%** over Q2 2017. As we've commented previously, growth of the category has suffered at the expense of investment in Roomba awareness campaigns. Therefore, additional advertising investment in Braava, is critical. Lack of awareness and articulation of the products' value propositions are the hurdles we will overcome to drive this growth.

One of the components of our 2018 incremental sales & marketing investment we discussed in February is executing Braava marketing programs for all major markets. In the U.S in Q4 we will run a national TV campaign similar to the one we ran last year at the same time. In addition, there is a TV campaign planned for Japan later this year and additional digital marketing campaigns in EMEA

Now turning to our second-quarter performance by region, we delivered **15%** year-over-year revenue growth in the U.S. while international revenue increased **34%**. In the US, sales were robust through the Mother's Day and Father's Day holidays as consumers continued to appreciate the value proposition of our products. In EMEA, revenue grew **51**% where we saw strong demand while also benefiting from the revenue uplift associated with sales in the EMEA countries where we now sell direct. Japan revenue grew **31%** in Q2 over 2017, without any benefit from the revenue uplift from SODC, which we completed at the beginning of Q2 2017. We still expect full-year 2018 growth of low **20%** for the U.S., and mid-teen growth in Japan, while our growth outlook for EMEA has increased to **30 – 35%**.

And finally, a comment about the most recent round of proposed tariffs, announced a couple weeks ago, which included Roomba and other RVCs. We are currently exploring our options and the potential implications if these tariffs are enacted. Our current full-year 2018 financial expectations do not reflect any impact from the proposed tariffs.

In summary, with half of the year behind us, and a very successful global Amazon Prime Day just completed, we are well on our way to meeting our increased full-year financial expectations.

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

Alison

Our second quarter performance was ahead of our expectations. Quarterly revenue of **$226** million, an increase of **24%** from Q2 last year, was driven primarily by growth of our Roomba 900 and Roomba 600 robots. Operating income for Q2 was **$13** million compared with **$4** million for Q2 2017. EPS was **$0.37** for the quarter, compared with **$0.27** in Q2 2017**.**

For the first half, revenue was **$443** million compared with **$352** million in first-half 2017; operating income was **$39** million compared with **$26** million last year and EPS was **$1.08** compared with **$0.85** last year.

Revenue growth of **24%** for Q2, included domestic growth of **15%**, EMEA growth of **51%,** driven by stronger demand and ASP uplift from the Robopolis acquisition, and Japan growth of **31%**.

The gross margin of **52%** in the second quarter was slightly ahead of our expectations, driven primarily by favorable promotional expenses and returns. We now expect gross margin for the year to be at the high end of our previously provided range of **50%** - **51%**.

The **300** basis point year-over-year increase in Q2 was due to higher margins in Japan, this year compared with last year due to the SODC acquisition, and COGS improvements, partially offset by the Robopolis intangible asset amortization. Keep in mind that quarterly gross margin can fluctuate widely based on mix, seasonality and promotional activity among other things.

Q2 operating expenses were **46%** of revenue, compared with **47**% in Q2 last year and slightly below our expectations. Q2 R&D and G&A were in line with our expectations, but as Colin mentioned we had **$2** million of marketing expense originally planned for Q2 that is now planned for Q3. We also benefitted in Q2 from an earnout from one of our investments, of **$0.6** million, recorded as non-operating income.

Relative to tax, I am excited to announce that we implemented a U.K. principal company, effective July 1, 2018. As you may recall, at our 2015 Analyst Day, I said we were exploring the establishment of an international principal company to optimize our global operating structure. We recognized then that our U.S.-based operating model would likely change as we increased our international business operations. During 2016, we assessed various operating models and set plans in place to establish our global operating structure centered around our London office. This entity will now be responsible for managing all of our EMEA direct business and as such, some of our operating profit will shift into the U.K., which currently imposes a lower statutory tax rate than the U.S. Our 2018 tax rate was already benefiting from the U.S. tax reform, and now we are further benefitting from this operational change.

Our Q2 actual effective tax rate (ETR) before discrete items was **16%** versus our Q1 rate of **27%**, benefitting from the implementation of our new U.K. structure, regional profit shifts and a higher estimated R&D tax credit. Additionally, we booked a discrete charge for exit charges associated with the establishment of our U.K. principal company, partially offset by a small discrete stock compensation windfall benefit, resulting in an overall ETR for Q2 of **30%** versus **21%** last quarter. Our second half and full year ETR before discrete items is expected to be between **24-26%**. We expect to more fully benefit from the U.K. principal company in 2019 and beyond.

Comparing Q2 2018 EPS to Q2 2017 EPS is challenging. The Q2 2018 EPS of **$0.37** was a **$0.10** increase versus Q2 2017. Key items in the Q2 2017 EPS were the **$7** million of acquisition-related adjustments for SODC, which had a negative **$0.16** impact, stock compensation windfalls which had a benefit of **$0.15**, and the higher effective tax rate, before discrete items, of **32%**, which was prior to the U.S. tax reform.

We have included a schedule to the financial statements providing the actual first and second quarter 2018 tax rates before and after discrete items, and the anticipated effective tax rates for the third and fourth quarters as well as full-year 2018 before discrete items for your reference. We can't forecast the discrete items until the end of the quarter so we don't provide any estimates for those in the schedule.

We ended Q2 with **$127** million in cash, down from **$184** million at the end of Q1. During the quarter, we completed the previously announced stock repurchase program authorizing the purchase of up to **$50** million of our common stock. The plan became effective on March 28th and we repurchased a total of **800** thousand shares at an average price of **$62.57**. In addition, we announced an increase in our revolving credit facility to **$150** million and an extension of the term to 2023. This facility gives us additional flexibility to execute on our growth strategy. We expect to end the year with approximately **$150** million of cash.

Q2 ending inventory was **$115** million or **97** days, as expected, compared with **$83** million or **81** 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. As we have previously said, due to this structural change in our business model, we expect DII to be approximately **100** days **+/-** on average in 2018, with our typical quarterly fluctuations. In Q3, we expect inventory to increase well over the **100**-day average in support of the Q4 holiday season before declining well below **100** days by year end. We continue working to identify operating efficiencies to improve working capital and reduce DII over time.

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

For 2018 we now expect full year revenue of **$1.06** to **$1.08** billion with roughly **60%** of the year's revenue being delivered in the second half of the year. In addition to the traditional second-half seasonality of the business, 2018 will be positively impacted by the inclusion of revenue uplift from the European acquisition through the third quarter. Our revenue expectation range contemplates Yen and Euro exchange rates roughly in line with current rates, **+/- 5%**.

We continue to expect double digit year-over-year growth in each quarter and for revenue to increase sequentially throughout 2018 with the highest year-over-year growth rate in Q1. The smallest sequential quarterly increase is expected between the first and second quarters, and the largest sequential quarterly increase between Q3 and Q4.

In the third quarter, sales & marketing, as a percent of revenue, is expected to decline from Q2 but not as significantly as in prior years due to our third-quarter product launches and the expense that moved from Q2 into Q3. We still expect full year R&D of **13%** of revenue, but Q3, like Q2, will be closer to **15%** of revenue, before declining as a percent of revenue in the fourth quarter.

Profitability will be the lowest in Q2 driven by our sales & marketing expense increase over Q1, as is typical, to support the Q2 seasonal selling. Q3 profitability will be higher than Q2 but only modestly.

For the full year, we continue to expect operating expenses to total roughly **42%** of revenue. Our full year guidance still assumes reinvesting the incremental gross margin provided by our forward integration primarily into higher sales & marketing spend. One-third of the incremental spending is a full year of expense associated with our two acquisitions and the remaining two-thirds for marketing expenses associated with our 2018 product launches and continued investments in the Roomba and Braava awareness campaigns to drive continued worldwide household adoption.

As a result of all of these items, we now expect full-year operating income of **$90** to **$96** million and EPS of **$2.30** to **$2.50**.

We are very pleased with our first half results and our ability to increase our expectations for the year. I am also very excited about having delivered an improved global operating structure that will benefit iRobot and its shareholders in the future.

I'll now turn the call back to Colin.

Colin

We have delivered the strong first-half we expected and I am very excited about the rest of the year ahead.

In the second half:

- We will launch products that will reinforce our leadership in consumer robotics;
- With the positive initial ruling from the ITC, we validated the strength of our technology and IP portfolio which will further widen our competitive moat; and,
- We will leverage the Braava family growth momentum of the first half to build 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 second quarter 2018 earnings call. We appreciate your support and look forward to talking with you again in October to discuss our Q3 results.

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