iRobot Third-Quarter 2019 Conference Call

Operator:

Good day everyone and welcome to the iRobot third-quarter 2019 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 Andrew Kramer of iRobot Investor Relations. Please go ahead.

Andrew:

Thank you operator, and good morning everybody. 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 the fourth quarter and full fiscal year 2019 and fiscal year 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 (and the components thereof), 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, other income, tax rate, earnings per share and cash; the seasonality and predictability of our business; our expectations regarding currency exchange rates; our expectations regarding the impact on us, our expectations for, an our plans relating to, tariffs on goods imported into the United States from China, as well as our efforts to pursue an exemption from those tariffs ; 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 & marketing and in R&D, technology and innovation; the impact of our efforts to increase consistency and awareness of our brand and to protect our IP; domestic and international demand for robotic vacuum cleaners (RVC) and our RVC products; demand for and revenue and revenue growth opportunities associated with our wet floor care products, including our Braava family of floor mopping robots; our expectations regarding our 2020 strategic priorities; our intent and timing expectations regarding the introduction and delivery of new products (such as Terra lawn mowing robots), applications and product capabilities and functionality, and the timing and impact thereof; our intent to diversify our supply chain and manufacturing capabilities, and the timing of our manufacturing diversification efforts; 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, non-GAAP gross profit, non-GAAP operating income, non-GAAP income tax expense, non-GAAP net income and non-GAAP net income per share. Our definitions of these non-GAAP financial measures, and reconciliations of each of these non-GAAP financial measures to the most directly comparable GAAP measure, are provided in the financial tables at the end of the third-quarter 2019 earnings press release issued last evening, which is available on our website: https://investor.irobot.com/news-releases

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 the telephone conference call will be available through October 30, and can be accessed by dialing 404-537-3406, passcode 9667109.

On today's call, iRobot Chairman & CEO Colin Angle will briefly review the company's performance the third quarter of 2019, highlight major accomplishments and offer his perspective on our outlook for the full year. Alison Dean, Chief Financial Officer, will detail our financial results for the third quarter of 2019 and review our updated expectations for 2019. Colin will wrap up our prepared remarks with his thoughts on our preliminary plans for 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.

Despite challenging market conditions in the United States, we reported a good quarter with both revenue and EPS surpassing our plans. Revenue of $289 million grew 9% due to strong international growth and the large Amazon shipment we previously expected to occur in the fourth quarter. Our top-line growth was driven by 25% international growth due primarily to a 27% increase in EMEA and 40% growth in Japan. This more than offset a 7% decline in the U.S. While we believe that our growth overseas exemplifies the category's overall health and vitality, U.S. category growth[1] has remained subdued as the direct and indirect impacts from rising tariffs on Chinese imports weigh heavily on consumers, retailers and suppliers. From a bottom-line perspective, the combination of higher revenue, better-than-anticipated gross margins and disciplined spending resulted in a 15% operating margin and EPS of $1.24. Given our results and accomplishments to date, our plans going forward and current market conditions, we have narrowed the range on our full-year 2019 expectations, which we'll discuss later on the call.

Q319 Highlights

We executed well across many fronts during the third quarter and I'd like to briefly highlight those important accomplishments.

Our growth in EMEA demonstrates our ability to participate in the category's robust expansion despite aggressive price competition. During the third quarter, we launched the Roomba s9/s9+ and the Braava jet m6 robots in EMEA, further differentiating us in the premium segment. Our accomplishments in this region also included progress with the beta trial of our Terra robotic lawnmower in Germany, which will be ending shortly in conjunction with the end of the mowing season. We expect to commence online sales in Germany next year. I'll provide some additional color on Terra in a few moments.

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[1] iRobot defines category (also referred to as segment) as robot vacuum cleaners priced at or above $200.

In the Asia-Pacific region, we enjoyed low double-digit revenue growth thanks in large part to an outstanding performance in Japan. Our top-line growth and market share expansion in Japan reflects solid execution of our go-to-market plans. Sell-through activity remained very strong through the third quarter in advance of an increase in Japan's consumption tax earlier this month. During the quarter, we successfully launched the Braava jet m6 in Japan and plan to introduce the s9/s9+ in early 2020.

With the launch of the Braava jet m6, consumers worldwide are now benefitting from a mainstream mopping robot that offers a powerful combination of coverage, cleaning capability and spatial awareness. Thanks in part to the m6's early traction and our expectation for a strong Q4, we anticipate that our Braava category will surpass 100 million dollars in annual revenue on at least 20% year-over-year growth. We believe the sales ramp of the m6 is an important step forward in making Braava the second pillar of our growth engine and in diversifying our business beyond vacuuming.

Terra represents a third, emerging pillar for future growth. In addition to the previously mentioned activities in Germany, we also commenced a smaller, closely controlled beta trial in the U.S. that will run until the end of October. We are now putting the sales, marketing and operational plans in place to support limited U.S. online sales of Terra next year. We are focusing development on further enhancing Terra's software, thereby elevating overall performance, including mission completion rates and system installation. We believe that our learnings over the coming quarters and related software enhancements will set the stage for larger-scale commercial launches in the spring of 2021.

In addition to our third-quarter international product launches, our investment in digital features is delivering tangible value to consumers worldwide. Our newest robots were designed as software-centric product platforms, which enables us to incrementally improve performance and deliver completely new features and functionality through over the air updates. For example, we recently added new features like Keep Out Zones, which allows owners to designate areas that our robots are prohibited from entering; Smart

Charge & Resume, which enables Roomba to charge only enough to resume and complete its mission; and we added ImprintLink technology to our Roomba 900 fleet, which supports pairing with the m6 to coordinate vacuuming and mopping missions.

These new capabilities demonstrate the spatial awareness of our robots. We believe that our robots' understanding of their environment will enable them to play an increasingly important role in making the smart home smarter. We are working closely with select smart home development partners who plan to leverage certain data sets collected by our robots with the consumer's approval. Additionally, we are advancing activities that will enable our products to work seamlessly with other smart home devices. We believe that further progress in this area will increase our competitive differentiation, thereby further building consumer loyalty and driving sales in the process. We expect to shed more light on these efforts over the coming quarters.

U.S. Market Conditions & Tariffs

I'd like to now turn my comments to the U.S. marketplace, where category growth has been muted by rising tariffs on Chinese imports. Last year at this time, tariffs were 10% on List 3 goods, which include robot vacuum cleaners. However, this tariff increased to 25% in May 2019. Through August, U.S. category growth had moderated well below the 30%-plus CAGR experienced over the past several years. However, during this period, we gained share in the category.

To partially offset the higher costs associated with the 25% tariff rate, we raised prices on most of our RVC lineup in late July. Most competitors, however, opted to absorb the tariffs and kept prices static. Subsequently, we experienced greater demand elasticity than we expected, which resulted in suboptimal sell-through in August and September. To drive consumer demand and defend our category leadership, we rolled back prices to pre-tariff levels earlier this month on most of our SKUs. Based on preliminary data, it appears that this tactic has helped improve sell-through levels and we are optimistic that our marketing and promotional plans will facilitate further progress.

We understand that prioritizing growth through lower prices while incurring higher tariffs will increase pressure on gross margins and overall profitability in the fourth quarter and into 2020. Accordingly, we are taking steps to get out from under these tariffs while operating as efficiently as possible as long as these severe tariffs persist.

- First, we are aggressively pursuing an exemption from List 3 tariffs and submitted our application for an exemption at the beginning of July. We believe that our position has strong merit but with over 30,000 applications now awaiting review, it could take several more quarters before we learn whether our request for an exemption will be granted.
- Second, we have made great progress with our efforts to diversify manufacturing outside of China. Products from our contract manufacturer's new line in Malaysia were successfully qualified during the third quarter, and we are ahead of schedule to support volume production to begin 2020. While we are still finalizing 2020 volumes for Malaysia, our current plan is to produce one entry-level SKU in this country and add additional SKUs as needed.
- Finally, we continue to control operating costs by curbing discretionary spending, and carefully managing the timing and pacing of hiring. These actions are expected to help us keep operating costs relatively flat in the fourth quarter versus the same quarter one year ago, and will help limit expense growth in 2020.

Before I conclude my comments, I'd like to offer my thoughts on our recent patent litigation. As many of you know, during the past decade, iRobot has withstood many competitive forays into our category. During this time, we've invested aggressively to widen our competitive moat by innovating and protecting our intellectual property with over 1,000 patents. In 2017, we undertook substantial legal action against multiple competitors that ultimately resulted in a favorable ITC ruling and related settlements. Last week, we took legal action to gain a preliminary injunction to order one of our competitors, SharkNinja[2], to halt all sales and distribution of its newest robot based on infringement of

[2] Refers to SharkNinja Operating LLC and its related entities

certain iRobot patents related to features launched in our i7+ robot. Our engineers have worked tirelessly over many years to perfect our auto-evacuation technology along with our smart mapping capabilities. We will not stand by and watch any competitor try to tilt the playing field in their favor by misappropriating our intellectual property and we are taking these actions to protect our innovations. Given that this litigation is ongoing, we will refrain from commenting further, and we appreciate your understanding in this regard.

Summary

In summary, we expect to deliver revenue and operating income at the lower end of the revised 2019 financial targets that we set in July with EPS near the midpoint. Category growth outside the U.S. remains very robust and the success of our new product launches in EMEA and Japan are helping us fortify our leadership position. In the U.S., market conditions remain challenging, but we have taken decisive steps to defend our technology and market leadership. At the same time, we will continue to diligently manage our costs while funding initiatives that are crucial to long-term success.

iRobot has pushed the boundaries of what’s possible in consumer robotics by refusing to rest on its laurels, and by setting and achieving ambitious goals. We’re excited for what we believe is in store over the coming years, and we are prioritizing accordingly to drive success in 2020 and beyond. I will now turn the call over to Alison to review our third-quarter results in more detail. After that, I will return to offer some closing thoughts on our plans for 2020. Alison …

Alison

Thanks Colin. I'd like to preface my comments by reminding investors that all comparisons for the third quarter and the first nine months of 2019 will be against the comparable period of 2018 unless otherwise noted.

Our third-quarter results exceeded our plans for revenue, operating income and EPS. Quarterly revenue increased 9% to $289 million thanks to strong 25% growth overseas fueled by a 27% increase in EMEA and 40% growth in Japan, which more than offset a 7% decline in the U.S. In July, we had expected third-quarter revenue would be slightly down versus last year in part because we expected a large shipment for Amazon to occur in the fourth quarter. Amazon subsequently adjusted its plans once again and requested the shipment in the third quarter.

Our 47% gross margin for the third quarter was better than expected but down 400-basis points year-on-year due primarily to pricing and promotional activity, and the impact of tariffs. With that said, the impact of these items on Q3 gross margin was partially offset by progress in our ongoing effort to reduce COGs.

Operating income for Q3 was $43 million. Q3 operating expenses decreased by 4% to $94 million, representing 33% of revenue versus 37% last year. The decrease in spending in absolute dollars reflects ongoing fiscal discipline across each major functional area, as well as lower short-term and long-term incentive compensation expenses. The combination of higher revenue and lower operating costs more than offset the gross margin decline, enabling us to deliver 15% operating income, up from 14% in the same quarter one year ago.

Our Q3 2019 effective tax rate was 18.2%, including $0.2 million of discrete benefits. Our Q3 tax rate before discrete items was 18.6%, driven by higher-than-expected R&D tax credits. EPS was $1.24 for the quarter, which included just one penny of a net discrete tax benefit related to the impact of stock-based compensation windfall. Last year's Q3 EPS of $1.12 included $0.13 related to stock compensation windfalls.

For the first nine months of 2019, our performance reflects revenue growth of 11% to $787 million; an operating income decline of 8% to $70 million; and EPS growth of 4% to $2.27.

We ended Q3 with $91 million in cash, down from $157 million at the end of Q2 and in line with our expectations as we built inventory for the heavy Q4 sales season.

Q3 ending inventory was $248 million, or 149 days, compared with $161 million, or 113 days last year. Recall that our U.S. inventory value at the end of September includes the impact of tariffs at the 25% level. Consistent with our commentary on prior calls, we believe that inventory levels have peaked in Q3 and will decline significantly at year end.

FY19 Outlook

Now I'd like to provide you with additional detail and some of the underlying assumptions for our full-year 2019 and fourth-quarter financial expectations.

We currently expect full-year revenue of 1.2 to 1.21 billion dollars, which equates to year-over-year growth of approximately 10% to 11%. This full-year target implies fourth-quarter revenue in the range of approximately 413 million to 423 million dollars on year-over-year growth of up to 10%. We expect high single-digit growth in the fourth quarter in the U.S. and internationally. Our revenue expectations contemplate Yen and Euro exchange rates roughly in line with current rates, +/- 5%.

As you know, 2019 has been a year of unprecedented new product launches. This was highlighted by the international introduction of the Roomba i7+, the domestic and EMEA introductions of the Roomba s9+, the launch of the Braava jet m6 in most major markets worldwide, and initial commercial activities for Terra. Overall, revenue from these new products is expected to exceed our 2019 target of having 15% of total 2019 revenue come from new products. As Colin noted, we expect the Braava family to deliver annual revenue growth in excess of 20%.

In terms of gross margin, we expect increased Q4 pressure primarily due to the combination of the recent price reductions, typical fourth-quarter promotional activity and the impact of the tariff costs. We anticipate full-year gross margin of approximately 45%, which is at the low end of our prior range. This implies Q4 gross margin of approximately 40%. We still expect that the direct tariff cost for the full year will be in the range of $35 to $40 million, which covers current tariff levels.

For the full year, we now expect operating expenses to total roughly 39% of revenue with only 3% year over year expense growth as we have curbed spending to mitigate the impact of the previously reduced revenue outlook and gross margin pressure. We now expect full-year operating income of approximately $75 million to $80 million with an operating margin between 6% and 7%.

We currently anticipate some favorable benefits to both other non-operating income and taxes. The acquisition of one of our investments closed earlier this month, which we expect will contribute other income of over $8 million. In terms of taxes, we now expect our full-year tax rate before discrete items to be approximately 19%, which is the low end of our prior range of 19% to 21% driven by the higher R&D tax credit. As a result, we expect our full-year EPS to be between $2.60 to $2.80 with Q4 EPS in the range of $0.33 to $0.53.

In summary, our performance in the third quarter exceeded our plans, reflecting positively on our execution around the globe. As we work to finalize our annual operating plan for 2020, we do so with the recognition that U.S. market conditions have changed profoundly during the past year. We have taken – and will continue to take – the actions that we believe will enable us to protect and advance our technology and category leadership, and ultimately emerge from this environment as a stronger company. Outside of the U.S., the growth dynamics remain vibrant. Although there is intense competition, we remain confident in our ability to capitalize on the opportunities we see to further expand our business overseas. At the same time, we plan to carefully manage our cost structure without impacting our ability to advance innovation and engage and support our retailers and consumers worldwide.

I'll now turn the call back to Colin for his preliminary thoughts on 2020.

Colin

Thanks Alison. As we move forward, our team is focused on executing on a variety of strategic priorities in 2020. These include:

- Keeping prices at pre-tariff levels to drive U.S. segment growth and protect our market share;
- Delivering on our roadmaps to delight the consumer across our product portfolio spanning RVCs, robotic mops and robotic lawn mowers;
- Driving Roomba sales globally by capitalizing on the efficiency of our working media spend for Roomba while tapping further into the strong brand loyalty we've built to further diversify beyond vacuuming; and
- Leveraging our substantial and ongoing investment in software to further differentiate our robots and elevate the user experience.

As Alison noted, we have not yet finalized our 2020 annual operating plan, and accordingly, are not yet prepared to share specific expectations. Nevertheless, we'd like to share some of the performance parameters that are guiding our planning, which we expect to further refine over the coming months.

- We see sufficient demand to support revenue growth in excess of 10% in 2020 as we expect to benefit from recent pricing adjustments, promotional programs and broader marketing activities.

  - In particular, we expect that Roomba and Braava will continue to be our primary growth engines next year and we plan to launch at least one new Roomba platform next year;
  - Although we do not anticipate material revenue from Terra next year, it will be an important year in Terra's maturation, which is critical for ensuring a strong commercial ramp in 2021.
- Gross margins will obviously be challenged next year due to the combination of current tariffs and aggressive pricing in certain markets.
  - Regarding tariffs, we believe that the current 25% tariff rate on Roomba represents a short-term phenomenon that has temporarily stunted top-line growth and eroded profitability. We remain optimistic about obtaining an exemption at some point in 2020 even as negotiations to end the trade war continue. The tariff environment continues to be very fluid, and, as a result, our preliminary view does not include the impact of possible List 3 or List 4 tariff increases nor does it reflect the potential benefits of an exemption.
  - Looking ahead, we plan to continue to limit our China exposure by moving production to Malaysia. While ramping production in Malaysia will help us mitigate some gross margin pressure, we currently expect 2020 gross margins to drop below 40% on a GAAP basis.
- We continue to assess our operating cost structure as we strive to strike a balance between limiting expense growth without handicapping our ability to fund short and long-term growth initiatives.
  - While we plan to throttle spending in certain areas, we remain committed to funding the programs, people and partnerships that we believe are critical to long-term value creation.
  - As a result, we anticipate relatively minimal operating expense leverage, which will only slightly offset the expected year-over-year gross margin decline on our 2020 operating profit margin.

That concludes our comments. Operator, we are now ready to take questions.

Following Q&A

Andy

That concludes our third-quarter 2019 financial results call. We appreciate your support and look forward to talking with you again in early 2020 to discuss our Q4 and full-year 2019 financial results.

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