iRobot Second-Quarter 2019 Conference Call

Operator:

Good day everyone and welcome to the iRobot second-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 Elise Caffrey of iRobot Investor Relations. Please go ahead.

Elise:

Thank you and good morning. As many of you know, today is my last earnings call at iRobot. My successor, Andy Kramer, joined the company about a month ago and we have been working together to ensure a smooth transition. I greatly value the relationships I've built with our analysts and investors over the years. I will turn the call over to Andy at this point.

Andy:

Thank you Elise, and thanks for all your help since starting at the company. 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 2019 and for the second half and third and fourth quarters; 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, 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 of tariffs on goods imported into the United States; our expectations regarding our ability to penetrate further the robotic vacuum cleaner and wet floor care markets, and regarding sales of connected robots; 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; our plans relating to tariffs on goods imported into the United States; demand for and revenue and revenue growth opportunities associated with our wet floor care products, including our Braava family of floor mopping robots; our intent to make, and the impact on our financial results of, strategic investments; our intent 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; our collaboration with Amazon; 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 second-quarter 2019 earnings press release issued last evening, which is available on our website: http://investor.irobot.com/news-releases?field_nir_news_date_value%5Bmin%5D=2019#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 July 30, 2019 and can be accessed by dialing **404-537-3406**, access code **8832179.**

On today's call, iRobot Chairman & CEO Colin Angle will review the company's operations and achievements for the second quarter of 2019 and Alison Dean, Chief Financial Officer, will review our financial results for the second quarter of 2019. Colin and Alison will also provide our business and financial expectations for fiscal 2019. 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 had another strong quarter with revenue growing 15% over Q2 2018. Our growth was led by Japan with more than 25% growth, followed by EMEA with 18% growth and 12% growth in the United States. Our Q2 operating income and EPS results were higher than anticipated in large part due to our efforts to carefully manage spending.

Year-to-date segment[1] growth in EMEA and Japan was generally in line with our expectations. The U.S. segment growth did not accelerate in the second quarter as we had expected, but we have maintained our segment share in this region and are not seeing any share erosion due to the competition. We are, however, navigating a U.S. market segment that is growing slower than we had originally anticipated, driven by the direct and indirect impacts of the ongoing U.S.-China trade war and related tariffs. So, although we achieved our Q2 U.S. revenue target, we are lowering our second-half expectations for this region. Nevertheless, we view tariffs as a short-term impediment to more robust U.S. segment expansion. We remain optimistic that the category will ultimately return to stronger growth over the medium to longer term, and that iRobot will be well positioned to benefit whenever that occurs.

As a reminder, in February, our expectations for 2019 were based on 10% tariffs that we didn't think would materially impact segment growth. In April, we reaffirmed those expectations. Today, following the implementation of increased tariffs to 25% on May 10th and the resulting slower-than-expected segment growth in the U.S., which represents roughly half of our revenue, we now expect full-year 2019 revenue of 1.2 to 1.25 billion dollars, or year-over-year growth of 10% to 14%. To mitigate the impact of lower-than-expected revenue and increasing gross margin pressure, we have begun to recalibrate spending in ways that we believe will help preserve near-term profitability without compromising our ability to innovate, expand our business and create long-term value for

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

all of our stakeholders. We now anticipate operating income of 75 to 100 million dollars, and EPS of $2.40 to $3.15 in 2019.

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

In May, we successfully launched two revolutionary new cleaning robots in the U.S., the Roomba s9/s9+, the most intelligent, powerful, deepest cleaning Roomba to date, and the Braava jet m6 robot mop, which can tackle multiple rooms and large spaces with advanced navigation and mapping capabilities. Together, these two robots can use Imprint Link Technology to talk to each other, automatically vacuuming and then mopping without any effort from the user. We have talked for some time about robots working together in your home, leveraging our mapping and navigating intelligent technology as the next step toward realizing the dream of the smart home.

Following the launch, I was a keynote speaker at re:MARS, Amazon's AI and robotics event, where I presented our vision for robotic automation in the home. The s9+ and m6, as well as our-soon-to-be-launched robot mower, Terra, were working in conjunction with other smart home products in the Alexa & iRobot Smart Home.

We are continuing to demonstrate how our digital product architecture is increasingly a differentiator. The proprietary software on our robots is the key to enabling spatial understanding that is fundamental for harnessing the full power of the smart home ecosystem. The re:MARS event raised our visibility as part of the smart home ecosystem and the support we're getting from partners like Amazon in making the smart home a reality is very gratifying. I will share some details about our Amazon Prime Day success in a moment, but it's worth noting that Amazon sold millions of smart home devices that day and specifically cited the Roomba as one of the event's top-selling deals in the smart home category. By the end of 2019, we expect to have sold over 9 million connected robots and we have begun a developer program that enables third parties to leverage iRobot's home understanding with the homeowner's permission. This progress demonstrates that we are building a strong foundation for our growing role in the smart home.

Now turning to our second-quarter performance by region, we delivered 12% year-over-year revenue growth in the U.S. while international revenue increased 18%. In the United States, we believe that we've maintained segment share year-to-date that is comparable to last year, even as the category's estimated growth did not increase at the rate we had expected. We believe that higher tariffs, compounded by a lack of competitive investment – rather than market saturation – are creating a speed bump in the category's growth trajectory.

Our 5th consecutive invitation into and performance on Amazon Prime Day earlier this month helps validate our perspective. Amazon included 3 SKUS for this year's Prime Day versus only 1 entry level SKU in prior years. For the U.S. Prime Day event, our Roomba 980, the most expensive SKU we've ever promoted on Prime Day, sold out on the first day, which we believe demonstrates continued consumer interest in and demand for our premium-priced Roomba robots. In total, the U.S. event yielded a 90% increase in retail revenue with a 50% increase in units versus last year's Prime Day. Internationally, where it was our second consecutive invitation into Prime Day, retail revenue grew by 35% with units increasing by nearly 45%. We are thrilled with these results, but it's still too early in the year to know how this performance may influence current retailers' holiday buying expectations. Nevertheless, our success on Prime Day illustrates that underlying demand for RVCs remains quite vibrant – similar to how it was before tariffs.

In other news, we remain on track to begin our closely-controlled U.S. beta program for Terra, our robot mower, in Q3. The timing is expected to coincide with the limited launch program for Terra in Germany. Interest from potential beta participants and buyers has been overwhelming and we are very excited to be launching this new category of robots for the home.

In EMEA, revenue grew 18% year-over-year in the second quarter driven primarily by enthusiasm for the i7/i7+. The RVC segment is growing robustly in the region which is attracting more competition. We are responding to this shifting landscape with more pricing and promotional programs. Looking ahead, the s9/s9+ and m6 robots are launching in EMEA this quarter, which we believe will further increase our product differentiation.

And in Japan, we delivered another strong growth quarter with revenue up versus Q218 by more than 25%, driven by the i7/i7+ and the e5, all of which are performing better than expected. The m6 is launching in July and the s9/s9+ are scheduled for introduction early next year. iRobot continues to gain share in this market segment, and we believe that our upcoming launches can help us build on our momentum.

Globally, we continue to expect full-year double digit revenue growth domestically and overseas. New products, which includes the i7 and i7+ in international markets, are on track with our target of 15% of total 2019 revenue.

A couple of additional notes about tariffs. As some of you may have seen, iRobot has formally applied for exclusion from the tariffs, and I have appeared in Washington several times to present our case. We believe that our position to gain an exemption from the tariffs is compelling. However, given the nature of the process, it is unclear when a decision on our application will be forthcoming. We raised prices on select products earlier this week to partially offset the impact of higher tariffs. Higher tariffs are also impacting order timing from certain retailers and Alison will provide some further detail on that front.

We are also making excellent progress with our 2019 manufacturing initiatives. We continue to diversify manufacturing in China across our various contract manufacturers. We are also tracking well against our plans to move our initial line of robots to Malaysia, where we expect to be manufacturing product by the end of 2019.

In summary, although we are experiencing more impact from the worsening tariff situation than we originally anticipated in the U.S., 2019 is still shaping up to be a remarkable year. With our new product launches proceeding on track, we are driving significant innovation that is resetting the bar for competition and laying another piece of our smart home foundation. And, even as we operate in a higher tariff environment, we still expect to generate very healthy, double-digit top-line growth for full year 2019 and fortify our substantial global segment leadership. Our progress and achievements over the coming quarters will pave the way for us to capitalize on the many exciting medium and longer-term opportunities for the company's products and role in the evolving smart home.

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

Alison

Our second-quarter performance was strong. Quarterly revenue of $260 million, an increase of 15% from Q2 last year, was driven by 18% growth overseas. Revenue was slightly below our quarterly expectations due to relatively small shortfalls in EMEA and Canada. Operating income for Q2 was $5 million compared with $13 million last year. EPS was $0.25 for the quarter, which included a net discrete tax benefit of $1.6 million, or $0.06, driven by the release of a tax reserve along with additional stock compensation windfall. This compares with EPS of $0.37 last year, which included a net discrete tax charge of $2.0 million, or $0.07. The charge last year was driven by an exit charge reserve in conjunction with the establishment of our UK principal company.

For the first half, revenue was $498 million, compared with $443 million in the first half of 2018; operating income was $28 million, compared with $39 million last year; and EPS was $1.03 compared with $1.08 last year.

Our Q2 2019 effective tax rate was a negative 6.3%, due to the $1.6M of discrete benefits. Our Q2 tax rate before discrete items was 18%, and we still expect our full-year tax rate before discrete items to be between 19% and 21%.

Revenue growth of 15% for Q2, included domestic growth of 12%, EMEA growth of 18% and Japan growth of more than 25%. We still anticipate roughly 60% of our annual revenue to be generated in the second half of the year. The reduction in our full-year revenue expectations is primarily driven by U.S. RVC segment growth that has not accelerated at the rate we originally expected. As a result, we now anticipate that revenue growth in the U.S. is likely to be in the low double-digit range versus the high teens we previously expected.

The initial launches of the Roomba s9/s9+ and Braava jet m6 are going well and are consistent with our previous expectations. However, the slower-than-anticipated growth of the U.S. segment overall is weighing on the Braava category – the 380t in particular – such that we now expect to fall short of the 10% of total company revenue target for the Braava family in 2019. Nevertheless, we still expect significant year-over-year growth in the range of 20% to 25% for the Braava category globally driven by the m6, which we believe can take our mopping category to the next level.

Gross margin was 45% for the second quarter, compared with 52% in Q2 2018. The 600-basis point decrease from last year was due primarily to pricing and promotional activity as well as the impact from the tariffs we did not have last year. Due to our increased pricing and promotional activity in EMEA that Colin discussed, coupled with the increased tariffs to 25% for the second half of the year, we now expect gross margin for the year to be approximately 45% to 46%. Due to the tariff increase, we now expect that the direct tariff cost for the full year will be in the range of $35 to $40 million, versus our previous estimate of $20 to $25 million. The price increases that went into effect on July 22 in the U.S. are expected to only partially offset the incremental tariff cost.

Q2 operating expenses were 43% of revenue, down from 46% in Q2 last year primarily due to the actions we began implementing to recalibrate our spending.

We ended Q2 with $157 million in cash, down from $162 million at year-end as we built inventory to support our 2019 product launches as planned.

Q2 ending inventory was $192 million, or 123 days, compared with $115 million, or 97 days last year. Recall that our U.S. inventory value now includes the impact of tariffs and we expect that the May increase of tariffs to 25% will further increase U.S. inventory value in the second half. Given our global roll-out cadence for new products and our supply chain diversification strategy, we expect elevated inventory levels for the next quarter before declining at year end as we discussed on the April conference call. We still expect that average DII for 2019 will be higher than the previous 100-day average.

Now I'd like to provide you with additional detail and some of the underlying assumptions for our full-year 2019 financial expectations and some quarterly color. As Colin has discussed, we are experiencing a disruption of our U.S. market that is resulting in slower growth for 2019 than we anticipated. The tariff situation remains fluid and while it's possible that we could see some positive impact from continuing trade talks or an iRobot exclusion, neither is assumed in our revised expectations.

For 2019, we now expect full-year revenue of 1.2 billion to 1.25 billion dollars, which is year-over-year growth of 10% to 14%. Consistent with top-line trends during the past several years, we expect revenue will be more heavily weighted in the second half of the year. Our revenue expectations contemplate Yen and Euro exchange rates roughly in line with current rates, +/- 5%.

For the full year, we now expect operating expenses to total roughly 38% of revenue, a 300-basis point improvement over 2018 as we scale back spending to mitigate the impact of lower revenue and gross margin.

We now expect full-year operating income of $75 to $100 million and EPS of $2.40 to $3.15.

As we have discussed on prior calls, we manage our business with a full-year perspective. Likewise, our annual financial expectations should be viewed on a full-year basis as quarterly year-over-year revenue growth rates, and overall results, can vary greatly by region due to a number of factors including new product introductions and product transitions. The changing tariff environment is exacerbating this further, and our current financial expectations reflect our best estimate today of the impact of tariffs, as well as the costs of our manufacturing diversification plans.

From a quarterly perspective, the anticipated second-half order activity from certain retailers, most notably Amazon, is shifting as part of their efforts to navigate potential tariff exposure. For example, last year, approximately two-thirds of Amazon's domestic second-half revenue came in the third quarter with a large percentage of those orders being directly shipped to, and imported by Amazon, from our contract manufacturer. This year, we expect just 20% of second-half revenue from Amazon's U.S. operations to be generated in the third quarter as the timing and sourcing of second-half orders have been further complicated by tariffs concerns.

As a result of these shifts, we expect Q3 revenue to show a slight year-over-year decline. Since substantially more of Amazon's expected second-half orders are now expected to ship in the fourth quarter of this year, we now expect Q4 year-over-year revenue growth to be more substantial than in prior years.

Gross margin in Q3 is expected to be comparable to Q2 as we continue to roll out our new products and respond to competitive pressures overseas. We now expect Q4 to be our lowest gross-margin quarter at approximately 44%, which would result in a full-year gross margin between 45% and 46%.

As it relates to our longer-term 2020 targets, it is important to point out that those were last updated in a 10% tariff environment. Due to the recent tariff increase to 25% and our updated 2019 expectations, those targets are no longer current and will be updated in conjunction with reporting our full-year 2019 results early next year.

In summary, all regions delivered double-digit Q2 revenue growth and are expected to do so for the full year as well. Our new product rollouts continue, as does our strategic initiative to diversify our supply chain and we are pulling the levers within our control to deliver continued profitable growth. Outside of the uncertain U.S. market, we continue to execute well against our 2019 plan.

I'll now turn the call back to Colin.

Colin

I am very excited about the year ahead as we address the current challenges in the U.S. market. Our strategy to:

- Strengthen Roomba leadership;
- Extend the portfolio beyond vacuuming;
- Widen the competitive moat;
- Diversify our supply chain; and
- Advance our smart home goals

continues to drive our planning and decision-making processes. As we navigate choppier market conditions, we believe that consistent execution of this strategy is the most effective way to drive sustainable growth and shareholder value. Although the playing field isn't as optimal today as we would otherwise prefer, we remain confident in our strategic direction and believe 2019 will be another successful year for iRobot.

Finally, on behalf of Alison and all of us at iRobot, I'd like to publicly thank Elise for her hard work and many contributions to the Company over the past 13 years and wish her well in her post-iRobot endeavors.

With that said, we'll now take your questions.

Following Q&A

Andy

That concludes our second-quarter 2019 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.