iRobot Third-quarter 2017 Conference Call Script

Operator:

Good day everyone and welcome to the iRobot third-quarter 2017 financial results conference call. This call is being recorded. At this time for opening remarks and introductions, I would like to turn the call over to Elise Caffrey of iRobot Investor Relations. Please go ahead.

Elise:

Thank you and good morning. Before I introduce the iRobot management team, I would like to note that statements made on today's call that are not based on historical information are forward-looking statements made pursuant to the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995.

This conference call may contain express or implied forward-looking statements relating to the company's financial results, operations and performance for the fourth quarter of 2017 and fiscal 2017; 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, marketing expenses, research and development expenses, general and administrative expenses, restructuring charges, stock compensation expenses, depreciation and amortization expenses, inventory, cash, tax rate, diluted share count and earnings per share;; our ability to penetrate further the robotic vacuum cleaner and wet floor care markets; the impact of our continued investments in sales and marketing and in R&D and technology; domestic and international demand for our robots; demand for and revenue and revenue growth opportunities associated with our wet floor care robots; our expectations regarding the International Trade Commission (ITC) action that we filed; 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 thereof; our competitive position; our market share and opportunity; and business conditions.

These statements are neither promises nor guarantees, but are subject to a variety of risks and uncertainties, many of which are beyond our control, which could cause actual results to differ materially from those contemplated in the forward-looking statements. In particular, the risks and uncertainties include those contained in our public filings with the Securities and Exchange Commission. Investors are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. iRobot undertakes no obligation to update or revise these forward-looking statements, whether as a result of new information, future events or circumstances or otherwise.

During this conference call, we may also disclose non-GAAP financial measures as defined by SEC Regulation G, including Adjusted EBITDA, which we define as earnings before interest, taxes, depreciation, amortization, merger, acquisition and divestiture expense, gain on business acquisition, restructuring expense, net intellectual property litigation 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 third-quarter 2017 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=2017. 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 November 1, 2017 and can be accessed by dialing **404-537-3406**, access code **15414375.**

On today's call, iRobot Chairman & CEO Colin Angle will provide a review of the company's operations and achievements for the third quarter of 2017 as well as our outlook on the business for 2017; Alison Dean, Chief Financial Officer, will review our financial results for the third quarter of 2017; and, Colin and Alison will also share our financial expectations for fiscal 2017. 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.

I am very excited to report that we delivered another outstanding quarter in which total revenue grew **22%** over Q3 last year. Continued strong demand in the United States, even with new competitive offerings in the market, as well as g momentum in Europe and Japan drove the quarterly year-over-year growth.

Based on our Q3 results and our outlook for the rest of 2017, we are increasing our full-year 2017 growth expectations in U.S. and EMEA, to **40%** and **45%** respectively, and increasing our total financial expectations for the year. We now expect 2017 revenue of **$870** to **$880** million, which equates to year-over-year consumer revenue growth of **33 - 34%**, operating income of **$55** to **$65** million and EPS of between **$1.65** and **$2.00**.

We successfully closed the acquisition of Robopolis, our largest European distributor, at the beginning of the fourth quarter as expected, and now control more than **75%** of our global revenue. That is critical to our building a global brand in regions where awareness of iRobot and Roomba is lower than in the U.S. The timing of our acquisition is particularly important, as it will allow us to implement our successful U.S. marketing programs and improve our brand awareness in several European countries as the adoption of robotic vacuum cleaners is accelerating.

With two quarters of ownership under our belts, we are already beginning to see the positive impact of our efforts in Japan. Revenue increased **65%** in the third quarter 2017 over Q3 last year and the region is on track to deliver **20 - 25%** annual growth over 2016 as previously discussed. Sell-through, driven by our focused marketing investments, remains strong and we expect to exit the year with retail channel inventory levels consistent with our targeted levels.

During the third quarter, net revenue in China declined year over year, as expected and previously discussed. The decline was higher than expected though, due to continued aggressive competitive pressure which resulted in the booking of additional promotional reserves to assist us in working through channel inventory. The China market data does show that during the first **8** months of 2017, sales to consumers of iRobot products grew approximately **20%**. This underlying demand keeps us optimistic about our ability to grow revenue in region, once we work through the inventory on hand.

Based upon Q3 actuals and the distributor plans for Q4, in conjunction with inventory on hand, we now anticipate full-year revenue to decline **25 - 30%** from last year. For the full year, China revenue is expected to be less than **5%** of total company revenue.

Our strategy in China continues to be driving adoption of our premium robots. In Q4, we began implementing the first consumer outreach marketing program since opening our Shanghai office. It is focused on driving awareness of the iRobot brand and the quality of our western product. We expect to have measurable results coming out of Q4 that will help inform our strategy going forward. With the recent addition of the Roomba 900, and the Roomba 800 introduced last year, we believe we can still achieve strong revenue growth at the higher end of the premium segment.

Now I'd like to provide you with several other highlights of the third quarter.

Last month we announced a settlement with Micro-Star International (MSI) relative to an action we took against several well-known appliance brands and Chinese manufacturers with the International Trade Commission (ITC) in the U.S. The agreement represents an early win in our multi-level ongoing effort to defend and protect our valuable intellectual property. MSI was a component supplier for certain respondents but not directly named in iRobot's action. MSI agreed to exit the robotic cleaning industry worldwide and will compensate iRobot with a confidential monetary payment. The remaining terms of the settlement are confidential.

The ITC process remains on track with a trial date set for March 2018 and final decision in October 2018. That is all the information we can provide at this time.

Demand from U.S. retailers for our robots increased during the last quarter. We continue to gain space, exposure, and momentum in the market driving higher full-year U.S. revenue expectations for the second time this year even with availability of new competitive products. We always expected a low-end U.S. market to emerge over time. This should be good for the RVC category because it will help drive awareness. Continuing to execute against our premium strategy will ensure ongoing growth for iRobot and robotic vacuum cleaners.

Keep in mind that in the U.S., the most highly penetrated market for robotic vacuum cleaners, household penetration is still less than **10%.** Accordingly, there is plenty of runway domestically and even more overseas. With more than **60%** global segment share, at a time when adoption is accelerating, we are in an excellent position to capitalize on the momentum to drive future growth.

While Roomba is driving overall revenue growth this year, we continue to be pleased with our revenue diversification progress and the performance of our wet floor care robots, Braava and Braava jet™. We are seeing continued adoption of the category and expect full-year revenue growth of **20 – 25%** versus the high-teens we communicated on our last call. The year-on-year growth is expected to be the highest in the US, more than **50%**, where the products have been available the longest and where the majority of our category marketing and advertising dollars have been spent.

One of the critical elements of our success is listening to our customers and then continuing to improve our products using that input. There is a consistent theme running through their feedback; continue to improve cleaning efficacy and autonomy. By focusing R&D investments to deliver these features and functionality, we have maintained the market-leading position of a category we created **15** years ago. By continuing to deliver these improvements while out innovating our own technology, we have also continued to improve gross margins.

In summary, it has been an exciting year thus far and we are very optimistic about finishing the year strong:

- In the third quarter, we saw the positive impact of our targeted marketing programs, in the U.S., EMEA and Japan driving year-over-year Q3 revenue growth of **22%**;
- We successfully completed the acquisition of our largest European distributor which we expect will enable us to capitalize on the current market momentum and drive robotic floor care adoption in EMEA; and,
- We announced an agreement with Micro-Star International Co. representing an early win in our ongoing effort to defend and protect our valuable intellectual property.

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

Alison

We delivered record third-quarter revenue of **$205** million, up **22%** from Q3 last year, driven by growth in the U.S., EMEA and Japan. Operating income was **$23.9** million in the third quarter compared with **$27.5** million in Q3 last year and EPS was **$0.76** this quarter compared with **$0.70** for the same period last year. Q3 2017 included a **$0.16** tax benefit relating to the new 2017 stock compensation accounting standard. As a reminder, given the difficulty with projecting the size and direction of the stock compensation tax impact, we communicated in Q1 that our financial expectations at the time reflected our tax rate expectations, prior to discrete items for future periods. Our Q3 effective tax rate before discrete items was **36%**.

Q3 also included **$0.08** from a non-taxable gain on the Japanese distributor acquisition. During the quarter, we finalized our purchase price accounting and made adjustments to the provisional amounts of the value of assets acquired at the end of Q2 2017. The purchase accounting adjustments were made based on additional information relating to channel inventory at time of acquisition and the potential for product returns, and resulted in a gain on business acquisition which is reported as non-operating income of **$2.2** million and **$0.08** of EPS. We view our Japan distributor purchase accounting as final.

As Colin discussed, consumer revenue grew **22%** in Q3 over last year, as we continued to see tremendous momentum in the U.S. where revenue increased **34%** year-over-year. U.S. net revenue was favorably impacted from a life-to-date returns adjustment of **$1.4** million in Q3 2017, compared with **$90** thousand last year.

In EMEA, we saw continued market momentum in the third quarter resulting in year-over-year revenue growth of **31%**. Our increased full-year growth expectations, to **45%** from high-teens without Robopolis, is based on Q3 results, the impact of Robopolis and our current sales expectations for the holiday season. We have only just begun to roll out our targeted marketing programs but are already seeing positive results in select markets in this region.

In Q3, revenue increased **65%** in Japan from Q3 last year as expected. During the quarter, we made significant progress on reducing the retailer inventory and we anticipate exiting 2017 at targeted levels. Year-over-year revenue growth in Japan is on track to grow **20 – 25%** in 2017 as Colin mentioned, consistent with our prior expectations.

Q3 revenue declined **68%** in China year over year. A decline was expected as you recall that Q3 last year was up **140%** over 2015 revenue as orders we expected to receive and ship in Q4 2016 were received and shipped in Q3 2016. In addition, due to the continued competitive pressure in the lower-end, we recorded approximately **$3** million in additional promotional reserves to support sell through. Based upon Q3 results and expected Q4 sell-in, we now anticipate net revenue to decline **25 - 30%** from 2016.

Gross margin was **49.8%** for the third quarter of 2017, up **1.7** points from the same quarter last year. The gross margin improvement was primarily due to COGS savings and product and regional mix partially offset by the Japan intangible asset amortization and the promotional reserves for China. In Q4, we expect gross margin percent to be roughly **500** basis points lower than Q3 primarily due to the impact of the Robopolis acquisition as discussed last quarter. The Robopolis impact is due to the profit elimination on acquired inventory and the amortization of intangible assets, similar to the types of impacts we saw with our Japan distributor acquisition. Full-year gross margin is still expected to be **48%.**

Q3 operating expenses were **38%** of revenue, compared with **32%** in Q3 last year driven largely by higher Sales & Marketing expenses, including the planned expenses of the Japanese distributor acquired at the beginning of Q2, the increased R&D investments we discussed last quarter, and higher G&A costs including litigation costs, other legal fees and other acquisition-related expenses associated with the Robopolis acquisition. Opex is expected to increase **3-4** percentage points in Q4 versus Q3 driven largely by our typical Q4 investment in Sales & Marketing to support the holiday season, the impact of the Robopolis acquisition and our continued investments in R&D. For the full year, we expect operating expenses to total roughly **41-42%** of revenues.

We ended the quarter with **$278** million in cash, up from **$203** million a year ago. We expect lower levels of cash exiting the year to reflect the preliminary purchase price of **$138** million for Robopolis. Inventory at quarter-end was **$93** million or **82** days compared with **$61** million or **64** days last year. This expected increase in inventory and DII was largely driven by our building of inventory for the holiday season along with the inventory we now hold in Japan as part of our direct selling strategy. We anticipate Q4 inventory to increase over Q3 as we add the expected Robopolis acquired inventory needed to support our direct to retail sales across **50%** of EMEA, but DII should be down meaningfully.

Our full-year 2017 financial expectations are for revenue of **$870** to **$880** million, operating income of **$55** to **$65** million and EPS of between **$1.65** and **$2.00.** Revenue is expected to grow significantly in Q4 year over year. Fourth-quarter year-over-year growth is expected in all regions.

On our Q4 2017 call in February, we will provide 2018 full-year expectations as well as our three-year financial targets for 2018 - 2020.

I'll now turn the call back to Colin.

Colin

2017 has been an exciting year thus far. We have been transitioning from a U.S. company, that also sells products through distributors overseas, to a truly global company. Our expectations for 2018 will not only reflect the positive financial impact from the distributor acquisitions we've made this year but also the optimization of our go-to-market strategy resulting from our ownership of more than **75%** of our global revenue.

In the U.S., which represents roughly **50%** of our revenue, we expect to grow **40%** this year;
In EMEA, which represents roughly **25%** of our revenue, we expect to grow **45%** this year; and,
In Japan, which represents roughly **15%** of our revenue, we expect to grow **20-25%** this year.

By creating a consistent global brand and driving awareness of both the category and iRobot's products beyond the U.S. we can capitalize on the tremendous opportunities we see in worldwide adoption of robotic floor care products. And by continuing to address consumer-driven products, we will capture our share of the growing robotic floor care category.

With that we'll take your questions.

Following Q&A

Colin

That concludes our third quarter 2017 earnings call. We appreciate your support and look forward to talking with you again in February 2018 to discuss our Q4 results.

Operator

That concludes the call. Participants may now disconnect.