iRobot First-Quarter 2017 Conference Call Script

Operator:

Good day everyone and welcome to the iRobot first-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 fiscal 2017, the growth, performance, revenue impact and prospects of our businesses including the international growth and revenue of our businesses, our expectations regarding seasonality and predictability of our businesses, our expectations regarding profitability; our expectations regarding revenue, the rate of revenue growth, gross margins, operating income, operating expenses, marketing expenses, research and development expenses, general and administrative expenses, restructuring charges, stock compensation expenses, depreciation and amortization expenses, inventory, earnings per share, the impact of our continued marketing investments, the impact of our continued investments in technology, domestic and international demand for our consumers, demand and revenue opportunity for our wet floor care robotics, the mix of product revenue, and the impact on operating margins, the impact of our presence in China, the impact of the acquisition of our Japanese distributor business that we closed on April 3, 2017, expenses related to the purchase of the Japanese distributor business, our plans for expansion, our introduction and delivery of new products and the timing thereof, our introduction and delivery of new product capabilities and functionality, 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 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 expense, 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 first quarter 2017 earnings press release issued last evening, which is available on our website http://investor.irobot.com/phoenix.zhtml?c=193096&p=irol-news&nyo=0. 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 May 4, 2017 and can be accessed by dialing **404-537-3406**, access code **15400565.**

On today's call, iRobot Chairman & CEO Colin Angle will provide a review of the company's operations and achievements for the first 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 first quarter of 2017; and, Colin and Alison will also provide 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.

Building off the strong momentum we experienced during the year-end holidays iRobot delivered first quarter 2017 consumer revenue growth of **32%** due to growth across all regions.

- Domestic Q1 2017 revenue was up **34%** over record growth in Q1 last year. Replenishment following exceptionally strong holiday sell-through at retailers, coupled with increasing demand for our category-leading robot vacuum cleaner, drove the growth;
- Revenue in China for the first quarter increased nearly **25%** compared with Q1 2016;
- Q1 2017 revenue in Japan grew **20%**, over the first quarter of 2016 and,
- The strong second-half 2016 sell-through in EMEA, that we discussed in February, coupled with selected investments in marketing programs in that region, drove year-over-year Q1 2017 EMEA revenue growth of more than **35%**.

As I said on last quarter's call, we are more confident than ever that the robotic vacuum cleaner segment is at an inflection point; that is, in the explosion stage on the maturity curve we've previously shared. For example, our entry level Roomba was the #1 selling vacuum cleaner in the U.S. last year based on total retail dollars spent. Our exceptional 2016 performance, followed by an outstanding first quarter in 2017, reaffirms our assertion.

Based on our Q1 results and our outlook for the rest of 2017, we are increasing our financial expectations. We now expect 2017 revenue of **$780** to **$790** million, which equates to year-over-year consumer revenue growth of **19-20%**, EPS of between **$1.45** and **$1.70** and operating income of **$60** to **$70** million**.**

These expectations reflect our confidence that strong domestic momentum will continue and 2017 revenue growth will accelerate over 2016 rates in the international markets we serve.

Now I'll take you through some of the details of the first quarter and our expectations for the rest of 2017.

Total year-over-year consumer revenue growth of **32%** in Q1 reflects significantly increased demand for our premium Roomba 900 products across all regions. These connected robots have been launched in all markets except China where they will be introduced in the second quarter.

Revenue in the U.S. increased **34%** in Q1 2017 over last year, while overseas revenue grew **29%** in the same period. Keep in mind that we expect quarterly year-over-year growth rates to vary throughout the year due to product launch and distribution timing as well as the impact of our Japanese distributor acquisition in Q2. For the full year we expect revenue in the U.S. to grow from **18%** to **20%**, China and Japan to grow approximately **30%** each, and EMEA to grow mid-teens over 2016.

While Roomba is driving overall revenue growth this year, we are very pleased with the accelerating adoption of our wet floor care robots, Braava and Braava jet™, and continue to believe these products will provide meaningful revenue diversification. In the first quarter, Braava family revenue nearly doubled over Q1 2016, and comprised roughly **10%** of total first quarter revenue compared with a year ago, when Braava robots generated just **7%** of total consumer revenue. In addition, we are seeing a positive growth trend in the portion of revenue coming from Braava jet pad sales, which portends well for our future consumables model as we build the installed base. In the U.S., where we have the best consumables data, we are selling at a rate of **2-2.5** boxes of pads per robot.

As we have previously said, the predominantly hard floor surfaces in Asian homes, coupled with the need for daily mopping, particularly in China, make the Braava robots ideal for those households. In Q1 2017, revenue from the sale of Braava robots comprised roughly **25%** of our revenue in Japan and **40%** of our revenue in China, compared with **10%** and **25%** respectively for Q1 2016. This growth as a percentage of revenue supports our enthusiasm for the potential of wet floor care in Asia.

We recently announced that the acquisition of our Japanese distributor closed on April 3, 2017 as expected. We are excited to begin a new chapter in Japan, a key strategic region for iRobot, and our second largest market. We also announced that we had named Hajime Hikino Vice President & General Manager, for Japan. Mr. Hikino comes to iRobot with a successful global track record of establishing and growing profitable consumer businesses in Japan, most recently at Bose and previously at Hewlett-Packard.

Through direct control of sales, marketing, branding, channel relationships and customer service, we will be better able to maintain our leadership position and accelerate the growth of our business in Japan. Mr. Hikino has responsibility for managing the highly successful existing team and all market activities in country. We are optimistic that with the business built by our Japanese distributor, coupled with our direct control over consistent global messaging we are well positioned to optimize the opportunities in the Japanese market.

On our last call I said that we wouldn’t be launching a new consumer robot category this year, but that we will be driving connectivity down through our products and rolling out the new functionality to view mission maps via our app. In the first quarter, we pushed out an update to our app that enables users who authorize the app to see a completed map of the cleaned area once the Roomba is finished cleaning. Not only does the map improve cleaning efficacy but it provides proof to skeptics who previously doubted Roomba’s total coverage. As of last count, **200** thousand connected Roomba 900 users were uploading maps at a rate of more than **75** thousand maps per day or more than **3.5** million total maps.

During the second quarter we will extend the benefits of cloud-connected cleaning with the launch of additional Wi-Fi connected vacuuming robots at lower price points. This will give consumers a variety of connected Roomba vacuum options to choose from, at price points that best meet their budget and cleaning needs. More people will be able to enjoy the benefits of smart home solutions, like our connected Roomba vacuuming robots. In addition, consumers in the U.S. will be able to voice activate their Wi-Fi connected Roombas through Amazon Alexa™ devices.

As we have grown the robotic vacuum category as well as our share of it, we have seen an increasing number of entrants in the market. Given that we invest nearly **$100** million annually in R&D to out-innovate the competition and widen our competitive moat, it is critical for us to protect our robust intellectual property portfolio comprised of **1,000** worldwide patents. That is why we recently filed a legal action against several well-known appliance brands and Chinese manufacturers with the International Trade Commission in the U.S. After careful assessment of their products, we determined that each had infringed on numerous iRobot patents and felt that the time was appropriate to enforce our rights. As competition has increased in this fast-growing and lucrative market, we have seen greater instances of infringement on our patents and while we would rather innovate than litigate, we will vigorously defend our intellectual property. Note that the anticipated 2017 costs of this litigation are included in our financial expectations.

In summary, we are off to an excellent start in 2017:

- In the first quarter, we continued to see the positive impact of our targeted marketing programs as Consumer revenue grew **32%** year over year following record Q4 revenue**;**
- We continue to invest in key technologies and successfully launched our Clean Map™ update to our iRobot Home App enabling customers to view the job once complete;
- We closed the acquisition of our Japanese distributor enabling us to expand our global footprint and capitalize on the tech-savvy Japanese consumer market, and;

- Took a significant step to validate the strength of our IP and widen our competitive moat;

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

Alison

We delivered record first quarter revenue slightly ahead of our expectations. Revenue of **$169** million increased **29%** from Q1 last year driven by growth in all regions. EPS was **$0.58** for the quarter compared with **$0.13** for the same period last year. Keep in mind that the divestiture of the defense business negatively impacted Q1 2016 EPS by **($0.12)**. In addition, in Q1 2017, we adopted the new accounting standard related to stock compensation expense. As a result, we recorded a **$1.7** million or **$0.06** discrete tax benefit in the quarter. Our effective tax rate in Q1 before discrete items was **31.4%**. Q1 operating income was **$22** million or **13%** of revenue.

As Colin discussed, domestic Consumer revenue grew more than **30%** in Q1 over last year. This growth was driven primarily by strong inventory replenishment by U.S. retailers. Net revenue from life-to-date returns adjustments was negligible in Q1 2017 compared with **$1.0** million last year. International revenue increased **29%** as expected.

Year-over-year Q1 growth of roughly **25%** in China compares with a **30%** revenue decline in Q1 2016 as we worked down channel inventory ahead of our transition to a new distributor model at the end of Q2 2016. We remain optimistic about the significant opportunity in China. With our Shanghai team fully ramped coming into the year, we are confident about delivering **30%** year-over-year growth in China this year and further accelerating growth beyond 2017.

In Q1, we had revenue growth of 20% in Japan over Q1 2016. As a reminder, we expect Q2 Japan revenue to decline year-over-year as we sell through the inventory acquired from the distributor in the acquisition. We expect year-over-year revenue acceleration in

Japan in the third and fourth quarters, after selling through the inventory we acquired, and approximately **30%** revenue growth overall in 2017, in part due to the higher price points we receive having eliminated a tier in the distribution model.

In EMEA, we saw continued strong sell through and replenishment during the first quarter resulting in EMEA revenue growth of **36%.** Due to expectations about product launch timing, we expect year-over-year growth in EMEA to be the strongest in the first and third quarters and full-year EMEA revenue growth of mid-teens over 2016, which is slightly higher than our original expectations.

Gross margin was **51.8%** for the first quarter of 2017, up **4.4** points from the same quarter last year. The increase was primarily due to region and product mix, as well as COGS improvements. We continue to expect gross margin percent to decline in Q2 to the low **40's**, or approximately **10** percentage points, due to the various accounting impacts of the Japanese distributor acquisition. Q3 and Q4 gross margins are expected to return to normal levels and full-year gross margin is expected to be approximately **50%.**

Q1 operating expenses were **39%** of revenue, down from **43%** in Q1 last year reflecting overall leverage. In Q2, opex will increase to roughly **50%** of revenue before returning to normal levels in the second half of the year. In addition to the typical Q2 increase in Sales & Marketing expense to promote Mothers' Day and Fathers' Day sales, Q2 17 opex will also include our investments in China which were much smaller last year, expenses associated with the patent litigation that Colin discussed, as well as the costs associated with the Japanese business we just acquired. For the full year we continue to expect operating expenses to total roughly **42%** of revenues consistent with the expectations we provided on the February earnings call.

Net income for the first quarter was **$16.4** million, compared with **$4.0** million for 2016. Operating income was **$21.6** million or **13%** of revenue and Adjusted EBITDA was **$30.3** million or **18%** of revenue. Q1 2017 EPS was **$0.58**, compared with **$0.13** last year. As mentioned previously, our effective tax rate before discrete items was **31.4%** in Q1 and we expect a similar rate for the remainder of the year. Although we received a **$0.06** tax benefit in Q1 relating to the new stock compensation accounting treatment, it is difficult to predict the impact, if any, in future quarters, and therefore we are not providing an estimate for it.

We ended the quarter with **$275** million in cash, up from **$247** million a year ago. Inventory at quarter-end was **$57** million or **64** days compared with **$53** million or **86** days last year.

Finally, I'd like to comment on our current financial expectations relative to the impact of the acquisition of our Japanese distributor which are detailed in our earnings release. We have reduced our Japan expectations versus those provided in February due to our analysis of inventory at retailers in Japan at the end of Q1, which was higher than we would typically like to see. We have lowered the level of incremental revenue post acquisition, as we work through this channel inventory. We have additionally planned to increase Japan related marketing expense to assist in driving sell through in 2017. And, as with all acquisitions, we have a **45** day window to make all final purchase price adjustments. We still expect the acquisition to be accretive in the second half – most likely in Q4. To summarize our current view, we now expect incremental Japan revenue of **$10-12** million for the year, with a likely negative EPS impact of **($0.50-0.60)**, the majority of which, we expect in Q2. We continue to expect the Japan acquisition will be fully accretive in 2018 at a revenue, gross margin and EPS level.

We are pleased that the momentum in the remainder of the business indicates we will be able to offset the changes in Japan, and to increase our full year total company expectations.

I'll now turn the call back to Colin.

Colin

We are off to an excellent start in 2017 as we focus our efforts on extending our position as the world's leading global consumer robotics company.

With our efforts solely focused on robots for the home we are confident that we can accelerate the company's growth in the near term by seizing the tremendous opportunities we see in driving further worldwide adoption of robotic floor care products. Leveraging our robust portfolio of mapping and navigation software will enable us to further develop and grow significant adjacent consumer product categories longer term.

With that we'll take your questions.

Following Q&A

Colin

That concludes our first quarter 2017 earnings call. We appreciate your support and look forward to talking with you again in July to discuss our Q2 results.

Operator

That concludes the call. Participants may now disconnect.