iRobot Fourth-Quarter and Full Year 2018 Conference Call

Operator:

Good day everyone and welcome to the iRobot fourth-quarter and full year 2018 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 2019 and each quarter thereof; the company's updated three-year financial targets through fiscal 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, the rate of revenue growth, gross margins, operating income, operating expenses, operating margin, sales and marketing expenses, research and development expenses, general and administrative expenses, restructuring charges, stock compensation expenses, depreciation and amortization expenses, capital expenditures, inventory, tax rate, diluted share count, earnings per share and cash; the seasonality and predictability of our business; the imposition of tariffs on goods imported into the United States, including the impact thereof and actions we may take in response thereto; out expectations regarding currency exchange rates; 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 and marketing and in R&D, technology and innovation; the impact of our efforts to increase awareness of our brand and our products; 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; our intent to make, and the impact on our financial results of, strategic investments; our intent regarding the introduction and delivery of new products (including, without limitation, the introduction of Terra), new applications, and new product capabilities and functionality, and the timing and impacts thereof; our intent to diversify our supply chain and manufacturing capabilities (including, without limitation, establishing new manufacturing capabilities outside of China), and the impact thereof on our financial results; the impact on our financial results of our acquisitions of our European and Japanese distributors; 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. 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 income before income taxes, 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 fourth quarter and full-year 2018 earnings press release issued last evening, which is available on our website http://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 this conference call will be available through February 14, 2019 and can be accessed by dialing **404-537-3406**, access code **6399788.**

On today's call, iRobot Chairman & CEO Colin Angle will provide a review of the company's operations and achievements for the fourth quarter and full-year 2018, as well as our outlook on the business for 2019; Alison Dean, Chief Financial Officer, will review our financial results for the fourth quarter and full year 2018. Colin and Alison will also provide our business and financial expectations for fiscal 2019 and our updated three-year financial targets through 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.

We had a phenomenal finish to 2018, exceeding both our fourth-quarter and full-year expectations for revenue growth and profitability AFTER raising our expectations twice during the year. Revenue grew **24%**, crossing the billion-dollar revenue threshold, in an increasingly competitive market and we delivered an operating margin of nearly **10%** after absorbing the impact of tariffs in Q4. Substantial demand for our game-changing Roomba i7 and i7+ robots drove strong holiday performance domestically. Overseas, overperformance in Japan was driven by robust Q4 demand supported by our sales and marketing programs in that region.

In 2019, we will continue on a growth diversification journey, focusing on driving growth of non-Roomba products, as well as supply chain and manufacturing diversification for longer term production stability. Our financial performance is expected to be driven by our continued transformation to a global consumer robot company.
In 2019, we expect to:

- Drive revenue growth of **17% - 20%** through
    - Deeper household penetration of Roomba® globally;
    - Broader roll out of the Roomba i7/i7+ and e5, which were launched in the United States in 2018, and;
    - Further adoption of Braava through marketing campaigns targeted at Roomba customers to drive Braava revenue of **10%** of total company revenue;
- Introduce a new category of robot, the iRobot Terra, our revolutionary autonomous lawn mower;
- Engage a contract manufacturer outside of China for partial production beginning in 2019;
- Continue investment in innovation to extend our technology and product leadership; and,
- Introduce additional new products mid-year.

Before discussing our 2019 financial expectations, I'd like to note that commentary has been written about our providing "conservative" expectations in February only to increase those expectations through the year. Given that roughly **60%** of our annual revenue is generated in the second half of the year, the competitive landscape continues to change, and we are operating in an unprecedented environment with the imposition of tariffs for which there are no historical trends on which to base future growth, we are providing you with the best visibility we have today on our annual expectations.

That said, in 2019, we expect revenue of **1.28** billion to **1.31** billion dollars, which is year-over-year growth of **17%** to **20%**, operating income of **$108** to **$118** million, and EPS of **$3.00** to **$3.25,** excluding discrete items.

Now I'll take you through some of the highlights of 2018, and our business expectations for 2019.

In 2018, the U.S., EMEA and Japan, grew **24%, 29%** and **25%**, respectively year over year. These results advance our transformation to a global consumer robot company and make us less susceptible to macro impacts in any one country.

In the U.S. we successfully launched two new products during the third quarter, the Roomba e5, our core product, offering premium features at a lower price point, and our game-changing premium Roomba i7 and i7+ robots. Both contributed to the **24%** year-over-year 2018 domestic revenue growth. In the U.S. we continued to see new competitive products selling through Amazon marketplace but not on the shelves of retailers, where we still generate **~60%** of our domestic revenue. The overall category, for RVCs priced at more than **$200**, grew **27%** in 2018 over 2017 in the U.S. As we saw in 2017, competition ran an ad campaign throughout the 4th quarter which we believe helped the category growth. Our U.S. estimates for 2018, show a **3**-point share loss overall but we firmly believe that with low household penetration providing an opportunity for substantial category growth, we are well positioned to continue our growth trajectory in this market.

Overseas, we began to harvest the fruits from our targeted sales and marketing program investments in Europe and Japan, as we completed our post-acquisition integration efforts in both regions. International revenue growth of **23%** was driven by growth of Roomba 900, our 2018 premium robot. This strong demand bodes well for our 2019 global roll out of our i7 and i7+ robots.

In 2018, Braava family revenue grew **9%** and comprised roughly **8%** of total company revenue. We continue to see a growth opportunity for the wet floor care market as we improve its positioning and better articulate its value proposition. In Japan, where we ran a national television program in Q4, Braava revenue grew **25%** in the fourth quarter year-over-year. Our goal in 2019 is to drive total Braava revenue to **10%** of total company revenue and we are confident that putting additional investment to support Braava promotions globally will help drive awareness and adoption of this category.

It is critical that at this point in the accelerating adoption of the category, we maintain unambiguous brand and product leadership in robotic vacuum cleaners through continued focused investment in R&D as well as expanding our successful U.S. sales & marketing programs into overseas regions. We must also continue to build on our initial success in wet floor care products and not let the competition get a foothold in this category.

In 2019, we plan to capitalize on the incremental investments we made in 2017 and 2018 with the introduction of Terra, **AND** additional new products midyear.

Terra, our revolutionary robotic lawnmower, is unique because it learns its environment using iRobot's Imprint™ Smart Mapping technology. It will mow like a human, intelligently navigating the yard and cutting efficiently in systematic rows. Terra will remember what it has cut and where it still needs to mow. If the robot's battery runs low, it will return to its base to recharge and then resume mowing until the yard is complete.

Terra will offer consumers a welcome alternative to existing robotic lawnmower technology by eliminating the need for costly and labor-intensive boundary wires. Combining Imprint™ Smart Mapping technology and a newly developed wireless communications system, including standalone beacons. Users will place the wireless beacons around their yard, drive the robot once around the perimeter, and schedule Terra to mow. Users have total control over where the robot goes and where it doesn't go, so it will stay on the lawn and out of the flowers.

Because Terra will be connected, users will be able to use the iRobot HOME App to customize their robot – from adjusting the height of the grass to controlling precisely when the lawn is cut, day or night. The robot is designed with rugged features to help it operate in inclement weather and navigate tough outdoor terrain.

I am very excited that we are moving from talking about "working on a robotic lawnmower" to launching a new product, in a new category, that complements our growing ecosystem of robots for the home.

With the launch of the i7 in the 3rd quarter, we unveiled the next phase of our smart home strategy. It is our goal for our robots to disappear into the background of your home, require little to no interaction, consistently deliver routine services, and always be ready for on demand requests. All while gathering and maintaining, in partnership with the user, an understanding of the home, enabling a new generation of home intelligence.

The i7 runs every day, empties its own bin, and if you make a mess in the kitchen while cooking, just say "Google/Alexa, tell Roomba to clean the kitchen" and the right thing will happen.

This is all enabled by iRobot's Imprint Smart Mapping Technology, which brings actionable and valuable understanding of the consumers home, including location and identity of rooms. We are pleased to see our customers already actively engaging with their SmartMaps with a significant percentage of connected i7 users viewing, customizing and launching directed room cleaning missions.

We are planning to extend this functionality through collaborations with companies including Google and Amazon to deliver the most intuitive control of your iRobot robot possible. And developing a growing array of new ways that our Imprint Smart Mapping can bring real intelligence to the smart home.

Beginning with the i7, all the premium robots we launch are, and will be, platforms that will be continuously upgraded with the latest features and capabilities, allowing your iRobot robots to get smarter, and do more for you every month.

Last year we introduced a new set of three-year financial targets for 2018 through 2020 before the tariffs were announced and imposed. We are providing updated targets that assume a **10%** tariff for the balance of 2019 and 2020.

For 2020 we are targeting:

- Revenue growth of mid-high teens; a 3-year CAGR of roughly **19%**;
- Gross margin of approximately **48%**; and,
- Operating margin increasing to **10%**.

Alison will speak to the specific impacts from tariffs on gross margin and our 2019 financial expectations, but I want to spend a minute addressing the supply chain and manufacturing diversification initiative we are taking in 2019. While manufacturing solely in China has made economic sense for iRobot since we began to produce consumer robots in 2002, as a matter of good corporate hygiene, we have undertaken an annual review of alternative manufacturing sites. The pressure brought to bear by rising labor costs, forced technology transfers and intellectual-property theft, coupled with the imposition of tariffs and potential for them to increase, has changed our view and accelerated our plan for supply chain and manufacturing diversification. This initiative is expected to negatively impact our gross margin in 2019, during the initial investment phase and 2020, when we start production, until we reach scale in the new facility as well as identify lower-cost component suppliers outside China.

Overseas and expanded U.S. distribution of the new Roomba robots we launched in 2018 will be the primary revenue growth driver for 2019. We expect revenue from Terra's limited availability to be nominal, however, we will be launching new products in 2019, beyond Terra. We expect revenue from the new products, including the i7 and i7+ overseas, to comprise approximately **15%** of total 2019 revenue. We anticipate double-digit revenue growth in the U.S. and overseas as we continue to evolve and extend our proven sales and marketing initiatives.

I will now turn the call over to Alison to review our fourth-quarter and full-year results in more detail.

Alison

Our fourth quarter and full-year revenue, operating income, and EPS exceeded expectations, due to better than anticipated performance in the U.S. and Japan. Record quarterly revenue of **$385** million increased **18%** from Q4 last year. Operating income for Q4 was **$30** million compared with **$23** million for Q4 2017. EPS was **$0.88** for the quarter, compared with **$0.16** in Q4 2017**.** Q4 2017 EPS included a negative (**$0.41)** impact from the new tax reform which included the remeasurement of our net deferred tax assets and a provisional repatriation toll charge totaling roughly **$12** million. In addition, Q4 2017 EPS included approximately **$0.03** of tax benefit relating to stock compensation windfall compared with approximately **$0.04** in Q4 2018 EPS. Our Q4 2018 effective tax rate before discrete items was **23%**. In 2019, we expect an annual effective tax rate, before discrete items, of **19% - 21%**, driven by the benefits of our new UK Principal company as well as the further impact of the U.S. Tax Reform Act.

Revenue growth of **18%** for Q4 and **24%** for the year, reflects the positive impacts of our marketing programs in the U.S. and overseas and our successful positioning against competitors. International revenue grew **23%** for the full year, with EMEA growing **29%,** and Japan up **25%**. We are very pleased with our two acquisitions and the growth we've delivered as a result of implementing our U.S. sales and marketing programs and optimizing ecommerce channels in those regions.

Gross margin was **48%** for the fourth quarter, compared with **47%** in Q4 2017, and **51%** for full-year 2018, slightly higher than we expected. Total P&L impact to gross margin from the tariffs was approximately **$3** million versus the **$5** million we estimated last quarter.

Fourth quarter operating expenses were **41%** of revenue, up from **40**% in Q4 last year. This was lower than our expectations due to slower R&D hiring than planned. For the full year, opex was **41%** of revenue also unchanged from **41%** last year. Sales and marketing expense was **19%** of 2018 revenue, up from **18%** last year and included a full year of approximately **150** new employees from our distributor acquisitions in 2017 as well as support for new 2018 product launches in the U.S. and a marketing campaign for Braava in Japan.

Full-year EPS was **$3.07**, compared with **$1.77** in 2017. As a result of the tax reform act we booked a discrete charge of **$12** million for the remeasurement of our net deferred tax assets and a provisional repatriation toll charge in the fourth quarter of 2017, negatively impacting Q4 and full-year 2017 EPS by **($0.41)**. Full-year 2017 EPS was also negatively impacted by approximately **($0.30)** from the year-one SODC accounting adjustments which did not impact 2018.

We ended the year with **$162** million in cash, consistent with the expectations we provided last quarter, down from **$166** million a year ago. Recall that we completed a **$50** million share repurchase program in 2018.

2018 year-end inventory was **$165** million or **76** days compared with **$107** million, or **56** days last year, and **$161** million or **113** days at the end of Q3 2018. Inventory was slightly higher than planned due to the purchase of some additional robots for the U.S. market at the **10%** tariff level, ahead of the anticipated tariff increase to **25%** on January 1, 2019.

Now I'd like to provide you with additional detail and some of the underlying assumptions for our full-year 2019 financial expectations and our updated 3-year targets. As we have previously discussed, we manage our business from a full-year perspective. Likewise, our 2019 financial expectations should be viewed on full-year basis as quarterly year-over-year revenue growth rates will vary greatly by region, due to a number of factors including new product introductions.

For 2019 we expect full year revenue of **1.28** billion to **1.31** billion dollars, which is year-over-year growth of **17%** to **20%**. As in the past several years, we expect revenue will be more heavily weighted in the second half of the year when we expect to deliver roughly **60%** of the year's revenue. Our revenue expectations contemplate Yen and Euro exchange rates roughly in line with current rates, **+/- 5%**.

We expect year-over-year revenue growth rates to be the highest in Q2 and Q4 due in part to the anticipated timing of new product introductions and distribution rollout. Profitability will be lowest in Q1 and Q2 as our sales and marketing expense is expected to increase in those quarters to support new product introductions.

We expect our gross margin to be roughly **48%,** down **3** percentage points from 2018, driven by many factors including pricing and promotion assumptions, product mix, costs associated with our supply chain diversification strategy, as well as the impact of a handful of favorable items in 2018 that aren't forecasted to repeat in 2019. Positively offsetting these factors, is the lower amortization of intangible assets associated with the Robo acquisition from **$15** million in 2018 to **$9** million through 2019.

The biggest driver of the year-on-year gross margin decline is from the mix of products, as well as pricing and promotion expectations. As our product mix moves away from our cost-optimized Roomba 900 and 800 robots, to our new products, which do not yet have the scale and maturity, we will see a decline in our gross margin. Through manufacturing scale, operating efficiencies, engineering adjustments and component changes, we expect to improve the margins on these products over time. We have also planned additional pricing and promotional activity as we anticipate the competitive environment to remain strong, particularly at the low end.

As it relates to tariffs, on January 1, 2019, we increased prices on our premium i7 and i7+ robots sold in the U.S. to help offset the impact of the **10%** we are incurring on all Roomba imports into the US. At the **10%** level, we anticipate **$20-25** million of tariff costs to be incurred in 2019. As currently structured, the U.S. government plans to increase tariffs to **25%** on March 1, 2019. If that happens, we would likely increase our prices again to offset the incremental tariff costs incurred. Should the tariffs be lifted altogether, we would expect to lower prices to their pre-tariff levels. Any change in tariffs would take time to implement as we and our retailers work through channel inventory and we provide any contractual price change notifications to our partners.

Also, as Colin mentioned, we plan to incur incremental costs in 2019 associated with the supply chain/manufacturing diversification program, both within China and outside China. We expect these costs, which include tooling for new lines and the addition of sourcing expertise outside of China, among other things, to negatively impact gross margin in 2019 and 2020. Manufacturing outside China will be more expensive in the near term, as lower labor rates are more than offset by higher logistics costs, given that the vast majority of our current component and material supply base is in China. We feel diversifying our supply chain outside of China is a long-term strategic imperative, whether or not tariffs remain. We will pursue this diversification regardless of tariffs.

We expect full-year opex of **40%** of revenue, a **100** basis point improvement from 2018 as we continue to leverage G&A and begin to see some leverage in R&D. Higher sales

& marketing expenses in 2019 include marketing expenses associated with our multiple 2019 product launches. Additionally, we will make continued investments in the Roomba and Braava awareness campaigns to drive further worldwide household adoption.

We expect full-year operating income of **$108** to **$118** million and EPS of **$3.00** to **$3.25** before discrete items which we can't estimate.

We are also assuming:

- Stock comp expense of roughly **$32** million;
- Depreciation and amortization expense of approximately **$37** million;
- Diluted share count of approximately **29** million shares; and,
- Capital expenditures of approximately **$40** million driven largely by expansion of our manufacturing capacity and our manufacturing diversification program.

We are estimating a tax rate, before discrete items, of roughly **19 -21%** for 2019.

Building from our 2017 results, we are updating our three-year financial targets through 2020 as follows to include the expected impact from tariffs. For 2020 we are targeting:

- Revenue growth of mid-high teens; a 3-year revenue CAGR of roughly **19%**;
- Gross margin of approximately **48%**; and,
- Operating margin increasing to **10%**.

Global revenue growth is expected to be driven primarily by further adoption and greater household penetration of Roomba, as well as adoption of our Braava family of mopping robots. We believe at this critical point in the accelerating adoption of household robots, driving higher top line growth and maintaining dominant segment share is essential.

As a last housekeeping item, beginning with our 2018 results, we are introducing additional non-GAAP actual metrics that we think provide additional clarity into iRobot's true operating performance and potential. We have historically provided actual quarterly non-GAAP Adjusted EBITDA in our financial statements along with a reconciliation of this metric to GAAP net income. In a supplemental schedule to our Q4 and full-year 2018 financial statements, we have provided full-year 2018 non-GAAP gross profit, non-GAAP income before income taxes, non-GAAP income tax expense, non-GAAP net income and non-GAAP net income per share, as well as reconciliations of each to the respective most directly comparable GAAP measure. We have also provided definitions of each and why we think they provide more clarity for investors. Beginning with our Q1 2019 results, we will provide this information on a quarterly basis.

I'll now turn the call back to Colin.

Colin

2019 will be an important step in our growth diversification journey. We see plenty of runway for continued Roomba household penetration and you should expect continued performance enhancements enabled both over-the-air and through new platforms. But it is incumbent upon us at this stage to more aggressively develop revenue diversification. We have started to see the positive impact from our Braava awareness campaigns and we expect our mopping robots to grow to **10%** of total revenue in 2019. In addition, we are launching our long-anticipated robotic lawnmower, Terra, that we believe will revolutionize the way people mow their lawns. While it won't contribute to revenue diversification in 2019, we believe that it can be a meaningful third leg on our revenue stool in the future. Its introduction should also put to rest any doubts about iRobot's prowess as a technology company as we leverage our navigation and mapping expertise to solve a previously unsolved challenge.

While we are navigating uncharted waters with the current tariff uncertainty, we expect our global business to deliver strong financial performance in 2019 that will in turn fund critical investments in future technologies, and marketing, to further solidify our position as the unambiguous leader in robotic floor care, definitively establish a diversified revenue stream, introduce a new robotic category and demonstrate our increasing importance as a strategic player in the Smart Home to drive enhanced long-term shareholder value.

With that we'll take your questions.

Following Q&A

Colin

That concludes our fourth quarter and full-year 2018 earnings call. We appreciate your support and look forward to talking with you again in April to discuss our Q1 results.

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