THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

IRBT - Q4 2016 iRobot Corp Earnings Call

EVENT DATE/TIME: FEBRUARY 09, 2017 / 1:30PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Elise Caffrey *iRobot - IR*

Colin Angle *iRobot - Chairman and CEO*

Alison Dean *iRobot - CFO*

CONFERENCE CALL PARTICIPANTS

Bobby Burleson *Canaccord Genuity - Analyst*

Jim Ricchiuti *Needham - Analyst*

Frank Camma *Sidoti - Analyst*

Austin Bohlig *Piper Jaffray - Analyst*

Mark Strouse *JPMorgan - Analyst*

Bill Baker *GARP Research - Analyst*

Ben Rose *Battle Road Research - Analyst*

PRESENTATION

Operator

Good day everyone and welcome to the iRobot fourth quarter 2016 and full year 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 Caffrey - *iRobot - IR*

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. These forward-looking statements are subject to risks and uncertainties and involve a number of factors that could cause actual results to differ materially from those expressed or implied by such statements. Additional information on these risks and uncertainties can be found in our public filings with the Securities and Exchange Commission. iRobot undertakes no obligation to update or revise these forward-looking statements, whether as a result of new information or circumstances.

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, net merger, acquisition and divestiture expenses, restructuring expenses, net intellectual property litigation expenses, and non-cash stock compensation expense. A reconciliation of GAAP and non-GAAP metrics can be found in the financial tables at the end of the fourth quarter and full year 2016 earnings press release issued last evening, which is available on our website.

On today's call, iRobot Chairman and CEO, Colin Angle, will provide a review of the company's operations and achievements for the fourth quarter and full year 2016, as well as our outlook on the business for 2017. Alison Dean, Chief Financial Officer, will review our financial results for the fourth quarter and full year 2016, and Colin and Alison will also provide our financial expectations for the full year ending December 30, 2017. Then we'll open the call for questions.

At this point, I'll turn the call over to Colin Angle.

Colin Angle *- iRobot - Chairman and CEO*

Good morning and thank you for joining us. 2016 was a fantastic year for iRobot. Our Q4 and full year 2016 results exceeded our increased expectations. Record Q4 revenue was driven by very strong sales in the United States, despite the steepest competitive environment we've seen. Higher revenue coupled with continued improvement in gross margin allowed us to increase investment and capitalize on our momentum, executing on our business strategy, while returning additional profit to shareholders and setting a strong foundation for 2017 and beyond.

2016 was a pivotal year for the company, as we firmly positioned iRobot as a consumer technology company, took more direct control over our international distribution with a bifurcated model in China, and the announcement of our planned distributor acquisition in Japan. We diversified our revenue through the establishment of the wet floor care category and expanded our portfolio of connected products better positioning us as an emerging strategic player in the smart home. As a result of these efforts, consumer revenue grew more than 20% in the fourth quarter and 17% for the full year, driven by sales in the United States, which for the fourth quarter were up more than 45% for year-over-year, and for the full year we were up more than 35% over our record 2015.

For the full year 2016, total company revenue of $661 million was up 7% over prior year. Keep in mind that full year 2015 and 2016 revenue included $57 million and $5 million respectively of the DNS and other revenues. Net income was $42 million for the year, down 5% from the prior year. Earnings per share were $1.48, including a negative $0.10 impact from the defense and security business divestiture, and adjusted EBITDA of $94 million or 14% of revenue.

In 2017, we will drive revenue growth through deeper household penetration of Roomba in the United States, accelerate growth in international markets including China, Japan, and EMEA. We will capitalize on our first mover advantage in the wet floor care category, particularly in Asia where Brava and Brava Jet have been enthusiastically received. We will expand gross margin through improved operating efficiencies and scale, and continue to extend connectivity across more of our products, allowing us to offer more robots with mapping capabilities and cloud connectivity at more accessible price points, growing our role in the emerging smart home.

In 2017, we are expecting revenue of $770 million to $785 million, which is year-over-year growth of 17% to 19%, EPS of $1.35 to $1.65 and operating income of $57 million to $70 million. These expectations include the anticipated financial impact of our Japanese distributor acquisition, targeted to close at the beginning of Q2 2017. In November of 2016, we issued a press release announcing our signed definitive agreement, and stated that for 2017 we expected a positive revenue impact of $20 million to $25 million, and a one-time negative impact to earnings per share of $0.25 to $0.35. Alison will provide additional details.

To execute our 2017 plan and continue on our successful path to achieve our three-year financial targets, we will need to continue to strategically invest in a number of areas, including establishing unambiguous brand and product leadership in the robot vacuum cleaning category which we created 15 years ago.

We will establish ourselves as the category leader for robotic floor care in China through both our Roomba and Braava products. We will continue to build our wet floor care business globally to generate a material secondary revenue stream. We will explore, develop, and grow adjacent non-floor care consumer products that can generate meaningful diversified revenue streams, and make continued operational improvements that can reduce product and operating costs.

Now I will take you through some of the highlights of 2016 and our business expectations for 2017. When we talked to you in February last year, we expected our consumer revenue to grow 12% to 13% in 2016 over 2015, driven by the US and China. We anticipated that US retailers would make room for competitors' products during the holiday season and we were uncertain how these products would impact our sales. As the year progressed and our proven Roomba marketing programs in the United States continued to drive accelerating demand for our products, we increased our full year financial expectations in July.

As new competitors began debuting their products in the United States and failed to deliver the premium value proposition offered by Roomba, retailers increased their iRobot orders to ensure they had sufficient inventory to meet consumer demand. As our full year visibility continued to improve, we shared our further increased financial expectations on the third quarter call.

Following the exceptional performance we delivered in the fourth quarter, we are more confident than ever that the robotic vacuum cleaning segment is at an inflection point. That is, it is in the explosion stage on the maturity curve. It didn't happen overnight, in fact it has taken us more than a decade to develop the right mix of appropriate messaging to reach the addressable market and deliver quality products that delight our customers.

It is critical that we not cede our hard-won global market leadership to would be competitors who recognize this enormous opportunity. We need to continue investing in technology to provide the feature and functionality we know consumers will buy as well as investing in patents to protect the technology and our marketing.

Robotic vacuum cleaner household penetration in the US is roughly 8 million households, or less than 10%. And this is the most deeply penetrated market, capitalizing on holiday momentum, where we were the clear category winner, and building on it in 2017 will help us reach the next segment of immediately-addressable 25 million households.

While the US grew substantially in 2016, our overseas distributors were hampered by macros, currency weakness, and competition exiting 2015. We performed an in-depth analysis at the major regions and markets to better understand why growth rates had slowed and what it would take to accelerate them in 2017 and beyond.

While it differs by market, it is clear that where we have executed our marketing programs with consistent global branding, we have seen positive results. Japan is a good example of how our investments in 2015 resulted in 2016 growth. We also expanded our programs in to several western European countries in 2016 and saw accelerated sell-through in the second half of the year. Based on the impact of our programs, we are confident that the slower growth in EMEA and Japan was not due to the market maturity or saturation, but rather the absence of optable marketing programs. We expect EMEA to return to low double-digit growth in 2017, up from single digit in 2016.

In Japan, revenue grew from a year-over-year decline in 2015 to low single-digit growth in 2016 as anticipated. Sell-through momentum increased throughout 2016, and we expect greater than 30% growth in 2017, in part because of our distributor acquisition. As our largest international market, Japan is estimated to comprise roughly 15% of this year's total revenue.

As we discussed in 2016, we had a slower than anticipated ramp up of our new China distributor. Demand for our products continue to be strong, but sell-through on 11/11/16 which was up 17% year-over-year from 11/11/15 fell short of expectations. It is our understanding from Tmall, our primary ecommerce channel in China, that most of their retailers had similar experiences. Sales of our premium Roomba 800 actually exceeded our expectations, thus supporting our optimism for the launch of our Roomba 900 in China this year.

As we enter 2017, China is well positioned for a growth year following the decline in 2016. But it will comprise less than 10% of total revenue. It took longer than we thought for us to understand the operating model of our new distributor, such as inventory management, and for the distributor to fully understand the optimal mix in positioning of our products. We remain committed to the significant opportunity in China and with our Shanghai team in full control of the operation coming in to the year, we are confident about delivering 30% year-over-year in that market this year, and further accelerating growth beyond 2017.

In 2016, Braava and Braava Jet revenue grew roughly 75%. This is significant given that Braava jet was only introduced in Asia in the third quarter. As we have said, the predominantly hard floor surfaces in the region coupled with a need for daily mopping, particularly in China, makes the product ideal for these households. The wet floor care products comprised approximately 15% and 50% of 2016 revenue in Japan and China respectively, and we expect that category to grow in 2017 with a full year of distribution in those regions. Consumables comprised roughly 5% of total wet floor revenue for the year. As we continue to build the installed base of robots, we expect that revenue to grow as well.

We continue to see growth opportunity for wet floor care markets world-wide, as we improve its positioning and better articulate its value position. In 2016, we made our first marketing investments to introduce and promote the wet floor category following the introduction of Braava Jet. The television program was rolled out in Q4 in limited US markets and the response was very positive. It not only built awareness of our latest product, but also of the wet floor category which resulted in higher than expected Braava sales. We've also had great success in bundling a Roomba with a

Braava especially in Asian markets. In total, wet floor care comprised 9% of 2016 consumer revenue. We expect that revenue to grow in 2017 at a pace consistent with Roomba revenue growth.

We do not plan to launch a new consumer product category in 2017. We have talked for several years about the potential for developing a robotic lawn mower. We are engaged in rigorous market analysis, including the addressable market and competitive landscape. The assessment has remained favorable and therefore we will continue our investment in this category. We continue to see the largest barrier to entry in the US market as the navigation system used by current products, and we are focusing our efforts on addressing this challenge. I am not going to provide any additional information on launch timing.

While we won't be launching a new category this year, we will be driving connectivity down through our products and rolling out the new functionality to view mission maps via our app that I previewed at our analyst day. Today our robots create maps that reside on the robots and aren't visible to the user. In the first quarter, we will push out an update to our app that will enable the user to see a completed map of the cleaned area once the Roomba is finished cleaning. This will not only improve the cleaning efficacy of the robot, but helps skeptics become believers by allowing them to see that Roomba really is vacuuming the area it's supposed to. It also puts us one step closer to our goal of becoming a strategically important player in the smart home.

A year ago, we provided you with three year targets beginning with 2016, when we expected consumer revenue growth accelerating to 12% to 13%. We delivered 17% growth in 2016. We remain committed to organic revenue growth in mid-teens this year, accelerating to high-teen growth in 2018 and also to increasing our profitability. Beginning in 2017, we are shifting our profitability matric, as Alison will explain. Growth from our acquisitions of the Japanese distributor will be additive to the organic revenue growth in 2017, 2018 and beyond.

The business has developed from one in which we establish the robotic vacuum as a category and became the market leader with first mover advantage. It is critical that at this inflection point in the category we establish unambiguous brand and product leadership in robot vacuum cleaners. 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. We will be laser focused on moving the ball forward in China and Japan. They are fast-moving markets that hold tremendous potential for our products. And with our in-market presence, we are well-positioned to capture in increasing piece of the growing pie.

There's a lot to be excited about. 2016 was a pivotal year for iRobot as we exited non-consumer businesses to focus solely on products for the home. We did so while delivering outstanding financial results for the year. Q4 was a record quarter for us, and it was driven from the successful investments we made leading up to 2016 and during the year as we responded well to increasingly competitive market conditions.

2017 will be first full year as a consumer technology company and we plan to capitalize on the investments we began making in 2016. Overseas, we expect revenue growth to accelerate in all regions, as we anniversary our China distribution transition, acquire and integrate our Japanese distributor, and continue to evolve our proven sales and marketing initiatives in European markets. In the US, we expect continued strong sales, following our greater than 30% growth in 2016.

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

Alison Dean - *iRobot - CFO*

Thanks Colin. Our fourth quarter and full year revenue, net income, EPS, and adjusted EBITDA exceeded expectations due to better than anticipated domestic consumer performance. Total quarterly revenue of $213 million increased 3% from Q4 last year. Keep in mind that Q4 2015 revenue included $31 million from our defense business, which we sold at the end of Q1 2016.

Consumer revenue of $212 million was up 21% from record Q4 2015 revenue. Net income for Q4 was $14 million compared with $19 million for Q4 2015. EPS was $0.49 for the quarter, compared with $0.65 in Q4 2015. Note that Q4 2016 EPS included a $0.03 benefit associated with a change in accounting treatment of an equity investment, and a $0.01 contribution from DNS. Q4 2015 included a fourth quarter gain on the sale of an investment we made several years ago, and a positive contribution from our DNS business of $0.06 and $0.23 per share respectively. Q4 2016 adjusted EBITDA was $29 million or 13% of revenue compared with $35 million or 17% last year.

Domestic consumer revenue growth was 47% for Q4 and 36% for the year, reflecting the positive impacts of our marketing programs and our successful positioning against competitors. Q4 domestic revenue was partially impacted by a favorable adjustment to the product return accrual of $1.2 million. This compares with a $1.9 million favorable adjustment in Q4 2015. International revenue grew 4% for the full year, with EMEA growing roughly 5% and APAC up 2%.

In Q4 2016, we established a small reserve for pricing adjustments, recognizing the need to respond to rapidly changing market conditions in some of our overseas markets. During the fourth quarter, we reported a $5 million revenue reduction for pricing support. Of that amount, $3.5 million was for specific support and $1.5 million was a general reserve for potential future pricing actions. Going forward, we will review the reserve quarterly to access its adequacy based on our view of marketing conditions at that time.

Gross margin was 50% for the fourth quarter and 48% for the full year 2016. Q4 operating expenses were 41% of revenue, up from 35% in Q4 last year as we invested, capitalized on the positive momentum created by our successful marketing programs. For the full year, OpEx was 40% of revenue compared with 37% last year, consistent with our expectations.

Sales and marketing was 17% of 2016 revenue, up from 16% last year. As we have discussed throughout the year, higher 2016 sales and marketing expenses are due to increased investment to drive adoption of Roomba, establishing our new office in Shanghai supporting our revolving China go-to-market strategy, and directly promoting our wet floor care products.

Net income for the full year was $42 million compared with $44 million for 2015. Adjusted EBITDA for the full year was $94 million or 14% of revenue compared with $92 million or 15% last year. Full year EPS was $1.48, relatively flat with 2015.

We ended the year with $254 million in cash, up from $213 million a year ago. During the year, we repurchased approximately 2.3 million shares and returned $97 million of cash to shareholders while investing to grow the business to enhance shareholder value.

2016 year end inventory was $50 million or 42 days, compared with $62 million or 51 days last year. The improvement in year-over-year DII was due to significantly higher Q4 consumer revenue, the sale of the defense business, and the shutdown of Remote Presence.

Now I'd like to provide you with additional detail and some of the underlying assumptions for our full year 2017 financial expectations and our three-year targets. As we have previously discussed, we manage our business from a full-year perspective. To better align that practice with our investor communication, we will be providing only annual expectations going forward.

For 2017, we expect full year revenue of $770 million to $785 million. These expectations assume the acquisition of our Japanese distributor closes at the beginning of Q2 2017 and contributes $20 million to $25 million in incremental revenue as disclosed in our November 2016 announcement of the pending acquisition.

As in the past several years, revenue will be more heavily weighted in the second half of the year, when we expect to deliver roughly 57% of the year's revenue. In addition to the traditional second half seasonality of the business, the 2017 second half will be positively impacted by the inclusion of incremental revenue from the acquisition.

We expect double-digit year-over-year consumer revenue growth in each quarter and for revenue to increase sequentially throughout 2017 as it did in 2016. The year-over-year growth rate is expected to be the highest in Q1 as US retailers replenish inventory following a record Q4. Also keep in mind, Q1 2016 included $3 million of defense revenue.

As Colin discussed, growth will be driven by accelerated growth overseas, continued growth in the US through further market penetration of our Roomba robots, and increased momentum in our wet floor care product adoption.

Overall, we expect consumer revenue to grow 17% to 19% in 2017, including the impact of the Japanese distributor acquisition. Excluding the 3% to 4% impact of the acquisition on revenue growth, we expect consumer revenue growth of 14% to 15%. The incremental revenue from the acquisition will come entirely in the second half of the year.

We expect full year EPS of $1.35 to $1.65, including a negative $0.25 to $0.35 impact from the acquisition. We expect operating income of $57 million to $70 million, or roughly 8% of revenue. This expectation includes a $10 million to $15 million negative impact from the acquisition. This year one impact is driven by the initial acquisition accounting adjustments required and one-time cost associated with making the actual acquisition.

As previously announced, we anticipate that the acquisition will be fully accretive to revenue, gross margin, and profit in 2018 and beyond on an operational basis. Note that for 2017, we've included a schedule in the earnings release showing the anticipated quarterly year-over-year impact of the acquisition.

We expect to fund the investments outlined by Colin by improving our gross margin by 200 basis points to 50% in 2017, while maintaining our organic OpEx at 40%. Including operating expenses associated with the acquisition, both ongoing and one-time, operating expenses are expected to increase to 42% for 2017.

On a quarterly basis, OpEx in the second quarter is expected to increase significantly due to our seasonal sales and marketing programs, coupled with acquisition expenses, both non-recurring and ongoing. In addition, we anticipate the gross margin to decline to roughly 45% for that quarter as we begin to sell through inventory acquired from our Japanese distributor.

As a result, we expect to report an operating loss and negative EPS in the quarter before accelerating profitability sequentially through the third and fourth quarters. We are also assuming stock comp expense of roughly $18 million, depreciation and amortization expense of approximately $15 million, and diluted share count of approximately 29 million shares. We are estimating a tax rate of 32% for 2017, inclusive of the investment tax credit.

Building from our 2017 expectations, we are adjusting our financial targets through 2018 for the Japan acquisition as follows -- consumer revenue growth of 17% to 19% inclusive of the Japanese distributor acquisition in 2017 and is expected to accelerate in 2018. Our EPS growth of 2017 over 2016 is expected to accelerate in 2018 as we anniversary year one impact of the acquisition and integration of our Japanese distributor, and we had previously provided adjusted EBITDA margin expectations for 2017 and 2018 and those expectations remain intact organically.

For 2017 and going forward, we will be measuring our operating profitability using GAAP operating margin. For 2017, we expect an 8% operating margin due to the dilutive impact of our acquisition. In 2018, we expect improved operating margin in the range of high single-digit to low double-digit as a percent of revenue.

At this time point, we haven't implemented a stock repurchase plan for 2017, despite our cash level exiting 2016. Given the current global uncertainty, the Board and management are taking time to consider different alternatives for returning cash to investors.

I'll now turn the call back to Colin.

Colin Angle - *iRobot - Chairman and CEO*

Thank you. We expect our business to deliver strong financial performance in 2017 that will in turn fund critical investments in future technologies and marketing to solidify our position as the unambiguous leader in robotic floor care, and our increasing importance as a strategic player in the smart home, which will drive enhanced, long term shareholder value.

With that, we'll take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). And our first question comes from the line of Bobby Burleson from Canaccord Genuity. Your line is now open.

Bobby Burleson - *Canaccord Genuity - Analyst*

Hey, good morning. Congratulations on the strong 2016.

Colin Angle - *iRobot - Chairman and CEO*

Thank you.

Bobby Burleson - *Canaccord Genuity - Analyst*

I hope everybody is okay with the storm.

Colin Angle - *iRobot - Chairman and CEO*

Hey, we're doing okay here in Boston. It's a little bit of white-out, but it's good.

Bobby Burleson - *Canaccord Genuity - Analyst*

Just a couple of quick ones, I know that China -- International in general is supposed to accelerate, but yet China is supposed to have a nice uptick, but I'm wondering how do you kind of reconcile the disappointing your 11/11 performance with your ability to get visibility into accelerating growth in that market this year?

Colin Angle - *iRobot - Chairman and CEO*

Sure. It was an interesting performance. We gave you sort of the high level, I can go a little bit deeper. Traditionally, the growth that we were seeing in China was driven by our entry level price point robots, the Roomba 600, and we had banked on that being the main driver of 11/11 and had built up some inventory to support that thesis. What happened was there was more competition than at the low end and the growing appreciation for the category drove increased demand for the 800 series. So we were actually out of stock on the 800 series. We worked to try to address that shortage, but saw sort of an inversion of the demand curve, and that was at the heart of the problem of Q4 in China.

So that effect is giving us a lot of comfort around why the introduction of the 900 series that's upcoming soon is China is going to be very successful for us, and we are adjusting our strategy to again do what we do best, dominate the premium categories in the market place, the premium price points in the market place.

Bobby Burleson - *Canaccord Genuity - Analyst*

So it sounds like you kind of shifted your expectations there on the ASP as well there in the beginning?

Colin Angle - *iRobot - Chairman and CEO*

We're certainly going to see a shift, but remember we're also seeing tremendous growth in the wet floor care category, which carries with it lower ASPs. So we're going to see a couple offsetting trends but growth in the China market is going to be driven by premium price point Roombas and our wet floor care robots predominantly.

Bobby Burleson - *Canaccord Genuity - Analyst*

Okay. And then just one more quick one -- just trying to understand the cadence of innovation this year. You guys are talking about driving connectivity into more SKUs. And then I guess in Q1 there is the upgrading of the mapping capability. Should we expect kind of throughout the first half of the year enhancements to the portfolio or is most of this happening in Q1? What's the timing and what we can hear about upgrades to the product in terms of connectivity and how far in the portfolio does that go?

Colin Angle - *iRobot - Chairman and CEO*

Great question, and I'm not going to give you a fully satisfying answer because we are not going to talk about new product launches within our current categories on this call other than suggesting that we are in fact working to drive connectivity deeper into our line. It is our intent to give customers who have purchased connected robots periodic upgrades that will add functionality without adding or asking for any additional investment on our customer side. So the example of adding visibility to map the robot is creating in the first quarter is a concrete example of a complimentary feature enhancement that we're giving to our customers. And that's something that will continuously be happening on an ongoing basis as we move forward.

Bobby Burleson - *Canaccord Genuity - Analyst*

Okay, great. Thank you.

Colin Angle - *iRobot - Chairman and CEO*

Okay.

Operator

Thank you. And our next question comes from the line of Jim Ricchiuti with Needham & Company. Your line is now open.

Jim Ricchiuti - *Needham - Analyst*

Hi, thank you. Good morning. So it looks like your international revenues were down about 3% for the quarter. Alison, I am wondering if you could give us the year-over-year growth or decline in the quarter in constant currency in EMEA, Japan and China, just to get a little better sense as to where the markets are internationally for you.

Alison Dean - *iRobot - CFO*

Just to clarify Jim, our business in 2016 was US denominated, so there really isn't a constant currency metric for us. So again, we encourage everybody to look on an annualized basis versus any particular quarter, and EMEA was up year-on-year in mid-single digits around 5%. We did see some acceleration in the second half of the year that drove that year-over-year gain. China, as we talked about, was slightly down year-over-year on a full year basis and Japan was slightly up. But that's all US-denominated business.

Jim Ricchiuti - *Needham - Analyst*

Okay. But it sounds like EMEA for the quarter, was it a little bit stronger? I understand to get a sense in the quarter and I know you look at it on an annual basis, but I'm just trying to get a sense exiting the year what you were seeing.

Alison Dean - *iRobot - CFO*

On a year-over-year basis EMEA was [up 20% from] (corrected by company after the call) Q4 of last year.

Jim Ricchiuti - *Needham - Analyst*

Okay. And the other question I had was, you alluded -- I wonder if you could just elaborate on this small reserve that you talked about for pricing adjustments relative to some activities in the overseas market. Can you expand a little bit more on that?

Alison Dean - *iRobot - CFO*

Sure. And based on some of the mix changes that Colin was addressing in China, for example, we decided to put some reserves aside to help drive through some of that inventory that we sold in 2016 and the early part of 2017, that was both of the reserve of $3 million plus of the reserve. And we thought it would be prudent to take a little bit more of a reserve to have a general reserve for any other pricing actions we might see as things like our mix profile continued to evolve in the overseas market.

Jim Ricchiuti - *Needham - Analyst*

Okay, got it. Now your consumer margins, gross margins were actually I think just a little above 52%, is that right? And you're looking for a pretty healthy improvement in gross margins in 2017. And I'm just wondering if you could talk a little bit about what some of the major components could be as it relates to that improvement? Is it going to be mix related primarily?

Alison Dean - *iRobot - CFO*

There was actually -- we've made significant progress in 2016 on several cost reduction initiatives. Some of those are design-related, some of those are supply chain related leveraging a lot of our dual sourcing of product as well as components. So we definitely had some favorable impact contributing to 2016 and that will also be the largest driver to continue the gross margin expansion for us in 2017.

Jim Ricchiuti - *Needham - Analyst*

Got it. And the last question, just with respect to the US market, are you guys seeing any change in the competitive environment either in Q4 or just as you're looking out at in the early part of 2017? Seems like the market is at least from a competitive standpoint no major changes, but I wonder if you could just talk a little bit about that in the US? Thank you.

Colin Angle - *iRobot - Chairman and CEO*

Sure. What we saw heading in to the fourth quarter was a lot of retailers talking about the potential of two competitors entering the marketplace, which led to some of our conservative estimates earlier in 2016. And while there was some new product launches in the back half of 2016, they did not meet expectations and failed to get any momentum. So we are definitely very optimistic coming out of 2016 as to the competitive set in North America. There is some activity down at the lower price points that we're tracking carefully, some growth in sort of the below $300 robot range, below $200 robot range, and I would say that would be the only area that we definitely are paying attention to.

Jim Ricchiuti - *Needham - Analyst*

Got it. Thanks a lot. Congrats on the year.

Colin Angle - *iRobot - Chairman and CEO*

Thank you so much.

Operator

Thank you. And our next question comes from the line of Frank Camma with Sidoti. Your line is now open.

Frank Camma - *Sidoti - Analyst*

Good morning.

Colin Angle - *iRobot - Chairman and CEO*

Good morning.

Frank Camma - *Sidoti - Analyst*

Just a couple of quick questions. One is just a clarification on Japanese distributors, just want to make sure that I understand. It sounds like the dilution is really principally from the purchase accounting, is that an accurate statement, like a step up in the inventory?

Alison Dean - *iRobot - CFO*

Yes.

Frank Camma - *Sidoti - Analyst*

Okay, all right. Great. The other thing is more in to sort of customer experience specifically in the US since that's so far been your greatest penetration, Colin, as you mentioned. What do you fine is sort of like the number one reason why either someone -- well I guess it's a two-part question, why someone repurchases your brand and why maybe they don't step up for a new unit, sort of reluctance to do that when it outlives its useful life?

Colin Angle - *iRobot - Chairman and CEO*

Let me answer the first half, I didn't fully understand the second half. I think that the promise of robot vacuum cleaning is buy the robot, bring it home, plug it in and never have to worry about vacuuming again. And iRobot has focused very, very strongly on delivering that experience so that both our cleaning efficacy but also the intelligence and reliability with which our robot begins, traverses the home thoroughly and gets back to recharge again is one of the hallmarks that sets iRobot apart, and the reason why at the end of the day our customer reviews are so high and our competitors are often challenged.

So it's quite simple. It's not making your robot talk, it's making your robot do the job. And things that we can do to give the customer more control over what gets cleaned, give the customer more confidence that what they thought got cleaned actually got cleaned, we think are strategically important features to add.

We do see a pattern where people come in, have an experience with some of our entry level robots and then when it comes time to step up, they go and step up to the more expensive models. So there's definitely a strong and observable pattern that demonstrates that effect. And we definitely also see repurchase as something that is happening very strongly. We estimate based on data about two-thirds of our purchases come from new customers, one-third purchases come from repeat customers and we think that's a very good and strong and healthy ratio.

Frank Camma - *Sidoti - Analyst*

Sure, I get that, and based on your market share that definitely makes sense. But in the case where somebody -- because the vacuum basically lasts three to four years is that an accurate statement roughly?

Colin Angle - *iRobot - Chairman and CEO*

Yes, more or less its designed for that. Yes.

Frank Camma - *Sidoti - Analyst*

Yes, I'm just curious like when someone doesn't re-up, like they don't come back to you, is there a general trend as to why they might not? And that's not just you just sort of why they don't do a robotic vacuum again, that's really where I'm going with that. Is it convenience?

Colin Angle - *iRobot - Chairman and CEO*

At the end of the day, if they've had a bad experience they might not come back. But our statistics are showing very, very strong repurchase intent and so that if someone didn't do it, it might be because their robot, maybe it had an issue with it that wasn't handled properly or you do have to actually pick the pizza boxes off the floor in order for the Roomba to work, and so people have expectations that the robot is going to change them from messy behavior to non-messy behavior and that doesn't always happen.

But those are outliers. The vast, vast majority -- and we're very pleased with our customer reviews and the feedback we get back from our customers -- are saying that we are meeting and exceeding expectations and people are excited to trade up for these new features.

Frank Camma - *Sidoti - Analyst*

Great. Thanks guys.

Colin Angle - *iRobot - Chairman and CEO*

You bet.

Operator

And our next question comes from the line of Austin Bohlig with Piper Jaffray. Your line is now open.

Austin Bohlig - *Piper Jaffray - Analyst*

Thanks for taking my questions and congratulations on the nice results guys.

Colin Angle - *iRobot - Chairman and CEO*

Thank you.

Austin Bohlig - *Piper Jaffray - Analyst*

And just quickly before you gave what the quarterly growth rate looked in EMEA, any chance you could give us what that was in APAC or in Japan and China specifically for just Q4?

Alison Dean - *iRobot - CFO*

Give me one second. Can you ask your next question and then we'll circle back?

Austin Bohlig - *Piper Jaffray - Analyst*

Yes, absolutely. And then I just wanted to ask another question on the gross margin and now with the acquisition of the Japanese distributor, could you quantify maybe how much that could be benefiting margins, maybe not in 2017, but looking long term since we'll be going more direct?

Alison Dean - *iRobot - CFO*

We haven't given specifics beyond 2017 at this point, but there probably would be at least 1 point to maybe a 1.5 point expansion in gross margin due to the acquisition of our Japanese distributor.

Austin Bohlig - *Piper Jaffray - Analyst*

Okay. Okay, perfect. And then just looking, I was wondering -- is this a strategy you guys look to maybe continue as you make your way further by acquiring more distributors or that was just an opportunity that presented itself and you guys didn't want to turn it down?

Alison Dean - *iRobot - CFO*

This was a particularly compelling opportunity for us due to a lot of different circumstances. We will address the evolution of our distributors on a case-by-case basis and if it makes sense to forward integrating with another one based on the economics, the market expectations et cetera, we would do that. But there were a lot of unique circumstances that had us move to a more hybrid model in China this year as well as go all the way forward to integrate with our Japan distributor this year.

Alison Dean - *iRobot - CFO*

And then just one last one from me. In the prepared remarks, you highlighted just a super competitive environment -- was that primarily just to United States or did you also see that globally in other regions?

Colin Angle - *iRobot - Chairman and CEO*

We did see it globally, and I think that the United States was emblematic of the success that we had. I think that in Europe and in Japan and China we have more active competitors who are on-shelf. We have very strong market share in Europe, up over 60% in Europe, 70% in Japan, and in China it's less because we're newer in the marketplace. And this is in the robotic floor cleaning segment or vacuuming to be clear. But we're certainly in Europe and Japan very strongly leading and we feel confident that in China we're on a good path.

Austin Bohlig - *Piper Jaffray - Analyst*

Okay, (inaudible). And good luck into 2017.

Alison Dean - *iRobot - CFO*

Austin just to circle back on your initial question on Japan and China in the fourth quarter, so without getting too specific, Japan was [down 17%] (corrected by company after the call) in the fourth quarter year-on-year [because we wanted to make sure the channels were clear ahead of our acquisition and China was down 50% from Q4 last year as expected. As you may recall we received an $11M order in Q3 2016 from China that we were expecting in Q4 so China was up 140% in Q3 and then down year-over-year in Q4] (corrected by company after the call). But again we encourage everybody to really focus on the full year growth rates for all of those regions versus Q4 specifically.

Austin Bohlig - *Piper Jaffray - Analyst*

Okay, perfect. Thank you very much.

Alison Dean - *iRobot - CFO*

You're welcome.

Operator

And our next question comes from the line of Mark Strouse with JPMorgan. Your line is now open.

Mark Strouse - *JPMorgan - Analyst*

Hey, good morning guys. Thanks for taking our questions. Just wanted to focus on Japan if we can. Excluding the acquisition and backing into kind of an organic growth rate that's a bit below the corporate average, can you just give color on that? Is that just conservatism ahead of the acquisition, is that FX related, is there something else going on there that we should be aware of?

Alison Dean - *iRobot - CFO*

So Mark as we look at 2017, the growth before the acquisition was in line with our long term targets for the year which called for mid-teen growth. So I'm not really sure about your comment about corporate average, but in our view it was in line with our expectations we had for 2017 and those that we had committed to the Street with our long term targets.

Mark Strouse - *JPMorgan - Analyst*

Okay, that's helpful. I apologize for that. My rough math was off. And then for the marketing expenses this year, you talked about increasing investment in some of the areas that didn't have as much marketing before. But the total OpEx guidance for the year is relatively flat organically. So does that mean that you're starting to see leverage in some of the areas that you have been investing in and so you're essentially scaling back in some areas and then ramping up in others, is that how we should think about marketing?

Alison Dean - *iRobot - CFO*

Well we definitely look at the mix every year of the spend. There are certain areas which are emphasized in one year and maybe deemphasized in the next year. We are constantly doing a refresh to look at exactly what we're trying to drive and achieve as well as to assess the performance of different programs that were successful in one year and either look to augment them in another year or bring them to another region. So it really is a fresh look that determines what our priorities are and there's certainly a little bit of a shift in the priorities we would have in 2017 versus those we had in 2016.

Colin Angle - *iRobot - Chairman and CEO*

And of course with a 17% to 19% growth rate, holding our percentage invest in sales and marketing flat is giving us significant additional dollars to put to work. So as far as minutes on television globally that will go up significantly and you're definitely going to see increased dollars spent internationally in 2017 versus 2016.

Mark Strouse - *JPMorgan - Analyst*

Okay, thanks. And then just real quick lastly, this split of international business EMEA versus APAC, it used to be about a third/a third, but how should we think about it or I guess what was that number in 2016?

Alison Dean - *iRobot - CFO*

EMEA and APAC were actually fairly close. EMEA is still the larger of the regions between APAC and EMEA for 2016.

Mark Strouse - *JPMorgan - Analyst*

Okay.

Alison Dean - *iRobot - CFO*

Not by far, but they're still a little bit ahead.

Mark Strouse - *JPMorgan - Analyst*

Thanks very much.

Colin Angle - *iRobot - Chairman and CEO*

We gave a -- okay.

Operator

Thank you. And our next question comes from the line of Bill Baker with GARP Research. Your line is now open.

Bill Baker - *GARP Research - Analyst*

Hi, thank you. What have you learned from your marketing in 2016? After that sort of rush of initial success and making some breakthroughs, it seemed to be mostly television related. Just wondering how that's evolved in other mediums -- ecommerce, social media, that sort of thing? And if you could also touch upon how that changes when you start looking at China and Japan?

And in the context of China I'm curious, you talked about the low-end being where you were concentrating, but then you found that the demand was out there on the high-end. So I'm wondering were you marketing in the low-end and it wasn't effective because of the intense competition or were you marketing in the high-end and you sold out, but your distributor didn't have any inventory? Give me a little color on that tell me what you learned in 2016 in the US and internationally.

Colin Angle - *iRobot - Chairman and CEO*

First off, in the United States as a percentage of investment, we are having substantial success with our social and online marketing investments, so that you will see us continuing to shift on a percentage basis dollars towards social and online medium. So it's quite effective for us. We're very, very quantitatively oriented, and the amount of high quality social investments that we have in front of us, that will actually have good return is limited. So we can't just do a 180 degree instantaneously and put money in bears. But given the discipline of finding high quality social opportunities -- as a category that's working well for us, so that it wanted to add a little color. It is definitely not just put more money into television in North America, it's far more rich and trending towards online.

The marketing strategy in China is tremendously oriented towards online channels. The vast majority of products sold in China are online. And while it's important to support retail and we do have good sell-through in our retail channels, we are moving towards a reality in China where retailers to some extent are showrooms for online sales channels. And so that's a very different reality in that market than anywhere else in the world.

And our marketing strategy understands and is adapting to that. Part of the reason why we wanted to invest in having boots on the ground having an iRobot China office located in China was to be closer to that market and be able to respond more quickly to trends that we saw in the marketplace.

You asked for a little more color on Q4 in China. As I described that we did see a shift in demand away from the 600 towards the 800 to our premium SKUs and we believe that will continue. And it does mean that iRobot -- how we represent the brand and ensuring that iRobot is viewed as the premium in how we structure our online demand generation activities, needs to make sure that it's consistent with our premium positioning.

So I think we validated that premium was important and that represented a bit of a change in local strategy which to-date had been focused on driving the lower price point unit. So you will see a different mix of channel and spend driven to drive that premium positioning in China.

Bill Baker - *GARP Research - Analyst*

Okay. Can I just ask another follow-on? In the wet floor care, what's your long-term target for the percentage that'd be coming from consumables and are you seeing the sell-through after the initial placement of these machines behave well?

Colin Angle - *iRobot - Chairman and CEO*

It's too early to give you a number as to what we are targeting, but we definitely believe that wet floor care can be a substantial and very material addition to our Roomba sales, particularly in Asia where the de facto cleaning is mopping and particularly in China where mopping is a daily and very time consuming activity. We think that Braava and Braava Jet will be a very important augmentation to Roomba.

I'd mentioned in the script that in China today it was -- 50% of the revenue in China came from our wet floor care robots, and I don't know whether that's steady state, whether that will go down a little bit as we recommit ourselves to premium strategy around Roomba, but it's going to be very,

very important. 15% in Japan where the Roomba is much more well established, I could imagine that will grow up from 15% to what I'm not quite sure. And I think that in the rest of the world including North America where the percentages are lower than that, we think that there's an opportunity for wet floor care to grow quite nicely.

We're going to learn a lot in 2017. We've got results from marketing programs that we trialed in 2016 that have come back favorably and so we'll be doing some scaling there. And we think that there's a lot of runway in front of wet. That said, Roomba is not slowing down. It's accelerating and so that wet is going to have to work really hard to gain share against Roomba.

Bill Baker - *GARP Research - Analyst*

Thank you. That's all my questions.

Colin Angle - *iRobot - Chairman and CEO*

Okay.

Operator

Thank you. And our next question comes from the line of Ben Rose with Battle Road Research. Your line is now open.

Ben Rose - *Battle Road Research - Analyst*

Excuse me -- a few questions, it's interesting you called out within the prepared remarks the next 25 million household opportunity in the US, could you talk a little bit, Colin, about perhaps what the demographics are of the [inaudible] iRobot customers and did they differ demographically at all from previous that you've have sold to so far.

Colin Angle - *iRobot - Chairman and CEO*

They are not materially different from the first, the main differentiation is their need to see the product recommended by someone they knew, as opposed to being willing to lean forward and independently make that purchase decision. The inflection point we referred to is the effect that happens when word of mouth becomes material on a daily basis, where they just hear from someone they respect that, "Why don't you have Roomba they are great?" And hear that enough that it gives them confidence. So it's more on the early adapter versus early majority spectrum rather than we're breaking through from one socio-economic class to the next or from one gender to the next. Those are holding steady.

Ben Rose - *Battle Road Research - Analyst*

Okay. And related to the US market you called out the impact noticing more of the, sort of $200 and below robotic vacuum cleaners in the US. Are you rethinking plans at this point to potentially enter that particular price segment?

Colin Angle - *iRobot - Chairman and CEO*

We are committed strongly to performance in the high end of the premium strategy. We think that the value proposition that an iRobot Roomba can deliver to a customer is something that we want to protect and so that we are not interested in lower performing inexpensive products interest the market place. If we found an opportunity to go deliver something with our level of performance at lower prices, that could be interesting. But we are very committed to our brand, very committed to the confidence that it gives our consumers. And so I would aggressively avoid being seen as having a cheap discounted product in the market.

Ben Rose - *Battle Road Research - Analyst*

Okay. And just turning to Asia, you had mentioned that there was success with bundling Roomba and Braava products. Was that a significant portion of the sales anywhere in Asia and could we see similar types of marketing or promotional efforts in the US?

Colin Angle - *iRobot - Chairman and CEO*

It was absolutely a significant revenue driver. It was materially quite successful. It was successful in 2016, it was quite successful in 2015. We think that there are opportunities especially as the wet floor care category gets more credibility and there is more demand for it. I think that it worked best earliest in Asia because there's a natural affinity for mopping and for the rest of the world as the Braava product become more recognized, I'm sure that we will give it some attention.

Ben Rose - *Battle Road Research - Analyst*

Okay. And in terms of the, if I may, on the robotic lawnmower front, in terms of the competitive analysis that you've done in terms of examining different markets and regions, do have a working hypothesis as to why Europe has taken off much quicker than the US in this particular category?

Colin Angle - *iRobot - Chairman and CEO*

Absolutely, their lawns are simpler. They are small and well-ordered and they don't have islands and so a more simplistic navigation system can be quite successful. And when those same products go to the United States, they have done very poorly. So that's why we are working very hard to ensure that our strategy is going to be a successful and differentiated strategy. And there also in Europe a very different channel to market which supports buying a lawnmower from a channel partner that can also install it for you and bury the wire, which is not typically the case in the United States. So a number of very understandable reasons and we remain as I said very optimistic and excited about this. But at this moment in time, we believe that investing in 2017 in wet and driving Roomba makes the most sense.

Ben Rose - *Battle Road Research - Analyst*

Sure. And finally just a quick question for Al in terms of looking at the cash position and what you might do, could we assume that something like a dividend is on the table for consideration?

Alison Dean - *iRobot - CFO*

I wouldn't assume that now. As we said, the Board and the management are considering various options as to either investments for the cash or potentially returning it to shareholders. But I wouldn't make any particular assumptions at this point.

Ben Rose - *Battle Road Research - Analyst*

Okay. And is it still reasonable to know that the channel strategy is to offset stock issuance through share repurchases?

Alison Dean - *iRobot - CFO*

We had said at a minimum, those are the type of programs we'd like to have. Again, as we've said, we haven't announced that type of a program yet for 2017. There's still time within the year where we could take that action if we decide to do so.

Ben Rose - *Battle Road Research - Analyst*

Okay. Great. Thanks so much for answering my questions.

Alison Dean - *iRobot - CFO*

No problem.

Colin Angle - *iRobot - Chairman and CEO*

Okay. That concludes our fourth quarter and full year 2016 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.