iRobot Second-Quarter 2017 Conference Call Script

Operator:

Good day everyone and welcome to the iRobot second - 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 and for the fiscal quarters of 2017; the growth, performance, revenue impact and prospects of our business, including outside of the United States; our expectations regarding profitability; our expectations regarding revenue, the rate of revenue growth, gross margins, operating income, operating expenses, operating margin, marketing expenses, research and development expenses, general and administrative expenses, restructuring charges, stock compensation expenses, depreciation and amortization expenses, inventory, tax rate, diluted share count and earnings per share; our expectations regarding the timing, and the impact on our financial results, of our acquisition of our European distributor (that we announced last night); our ability to penetrate further the robotic vacuum cleaner and wet floor care markets; our intent to make, and the impact on our financial results of, strategic investments; the impact of our continued investments in sales and marketing and in R&D and technology; domestic and international demand for our robots; demand for and revenue and revenue growth opportunities associated with our wet floor care robots; our intent regarding the introduction and delivery of new products, applications and product capabilities and functionality, and the timing thereof; our expectations regarding the International Trade Commission (ITC) action that we filed; our competitive position; our market share and opportunity; and business conditions.

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

During this conference call, we may also disclose non-GAAP financial measures as defined by SEC Regulation G, including Adjusted EBITDA, which we define as earnings before interest, taxes, depreciation, amortization, merger, acquisition and divestiture expense, 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 second-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 August 2, 2017 and can be accessed by dialing **404-537-3406**, access code **15405594.**

On today's call, iRobot Chairman & CEO Colin Angle will provide a review of the company's operations and achievements for the Second 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 second 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.

I am very excited to report that we delivered another outstanding quarter in which revenue grew **23%** over Q2 last year. Based upon this and our latest view of the second half, I am equally excited that we are increasing our core business 2017 full-year revenue and profit expectations.

And last, but not least, I am very happy to report that we announced a signed definitive agreement to acquire our largest European distributor, Robopolis. The transaction is expected to close at the beginning of Q4 this year. This represents another element of our strategy to gain more direct control over our go-to-market execution in international markets. When completed, the acquisition will extend iRobot's overseas control of market activities, including consistent global messaging, that will help drive greater adoption of robotic vacuum cleaners and affirm iRobot's segment leadership.

Before discussing the acquisition of Robopolis, let's look at our second-quarter results. In Q2, total year-over-year revenue growth was **23%** driven by continued momentum in the United States, where revenue grew **46%** over Q2 2016. For the full year 2017, we now expect revenue in the U.S. to increase roughly **30%** compared with our April estimate of **18%** to **20%.**

Based on our Q2 results and our outlook for the rest of 2017, we are increasing our financial expectations. We now expect 2017 revenue of **$815** to **$825** million, which equates to year-over-year consumer revenue growth of **24 - 26%**, operating income of **$67** to **$75** million and EPS of between **$1.80** and **$2.00** before the impact of the European distributor acquisition**.**

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

In EMEA, where second quarter revenue was up **10%** from Q2 2016, strong consumer demand for iRobot products, particularly Roomba 800 and 900, fueled increased year-over-year sell through of more than **15%** over the second quarter 2016. Throughout Europe in the second quarter, the Roomba 900 was the #1 selling sku. Our full-year 2017 EMEA revenue growth outlook, before any expected positive revenue impact of our Robopolis acquisition, has improved from mid-teens to high-teens over 2016. In April, we expected year-over-year growth in EMEA to be the strongest in the first and third quarters. Given the positive expected impact of the Robopolis acquisition, which Alison will discuss in more detail, we expect strong year-over-year EMEA revenue growth in the fourth quarter as well.

Revenue in China for the second quarter increased **38%** compared with Q2 2016 due to the launch of the Roomba 900 in that market and the more favorable year-over-year comparison resulting from the dynamics of last year's distributor transition that we have previously discussed. We featured our Roomba 800 on the 6/18 selling holiday and it performed very well.

Second quarter 2017 revenue in Japan decreased **21%** from Q2 2016 as expected. As Alison said on last quarter's call, inventory at retailers in Japan at the end of Q1 was higher than we would typically like to see. While we are pleased with the sell-through activity generated from our incremental S&M investments, we would like retail channel inventories to be even lower. Similar to the actions we took in the U.S. a number of years ago, we expect leaner inventory levels to provide us maximum leverage with our Japanese retailers. As a result, we now expect full-year 2017 revenue growth in Japan of **20 – 25%**.

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

In the U.S. we continue to see very strong growth momentum for both iRobot and the robotic vacuum cleaner segment. Our investments in sales and marketing programs to build awareness and articulate the value proposition of our Roomba products are generating substantial results. On 7/11/17, Amazon Prime Day and the biggest selling day in Amazon's history, we sold more than twice the volume sold on Prime Day in 2016 which was twice what was sold in 2015. The Roomba 652 was ranked #1 in robotic vacuum cleaners, #1 in all floor care and #2 in all home & kitchen for Prime Day. That is particularly significant when considered in the context of the increasing availability of cheaper, lower quality competition.

Our performance on Amazon Prime Day is an important gauge for second-half expectations in the U.S. While we expect the competitive landscape to be similar to last year's, <u>especially</u> at the lower end of the market, we have a high level of confidence in our increased expectations for full-year U.S. revenue growth.

With respect to domestic competition, I reported on last quarter's call that we had filed a legal action against several well-known appliance brands and Chinese manufacturers with the International Trade Commission (ITC) in the U.S. The ITC issued a decision to hear the case, the first step in affirming the validity of our claims. Since then, discovery has been ongoing. We have been informed that a trial date has been set for March 2018. We would expect an initial decision to be handed down in June 2018 and finalized in October 2018. That is all the information we can provide at this time.

As we promised on our last call, we introduced the Roomba 890 and Roomba 690 Wi-Fi connected vacuuming robots in the U.S., EMEA and China, extending the benefits of cloud-connected cleaning at lower price points. These robots 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 can enjoy the benefits of smart home solutions, like our connected Roomba vacuuming robots. In addition, U.S. consumers are able to voice activate their Wi-Fi connected Roombas through Amazon Alexa™ and Google Home Assistant devices.

I think it's important to remind you about a component of our product development and launch strategy. Based on feedback from the tens of millions of Roomba customers, we have developed a prioritization of technology-enabled features and functionality that we plan to integrate into future generations. As we have done in the past, we will introduce new capabilities into our most premium product, our "best" at our highest price points. Through a combination of product reengineering and scale efficiencies, we cascade some of the capabilities into lower-cost "better" or "good" product offerings at lower price points while maintaining or improving gross margins. A good example of this is the Roomba 980 to Roomba 960 transition. By removing the carpet boost feature from the 960, we were able to offer a lower-priced, similar-margin version of our premium product for those consumers for whom carpets were not a priority.

While Roomba is driving overall revenue growth this year, we continue to be pleased with the performance of our wet floor care robots, Braava and Braava jet™. We are seeing continued adoption of the category and expect high-teen growth for the year vs 2016.

Now I'd like to provide you with additional information about our announcement to acquire Robopolis, our largest European distributor. As we have matured as a company, we have assessed our global markets to identify opportunities for potential forward integration or more direct control. As with our Japanese distributor, we felt the timing was right to acquire our largest European distributor. We have seen continued momentum and accelerated growth in Western Europe over the past couple of quarters as we have previously discussed. This has been driven by a number of factors including the improving macro environment and positive consumer sentiment as well as the implementation of iRobot's successful U.S. marketing programs in this region.

This acquisition provides iRobot with an opportunity to capitalize on the market momentum driving accelerated adoption of robotic floor cleaners. It will further expand the company's direct control of distribution, in an environment of ever-increasing competition, while ensuring global brand consistency and better serving the needs of

European consumers. Robopolis has been an exclusive distributor of iRobot products since 2006 and sells across eleven markets in Western Europe through operations in Germany, Spain, France, Belgium, Austria, the Netherlands, and Portugal.

EMEA is a key strategic region for iRobot, comprising approximately **25%** of our 2016 consumer revenue, and sales of our robots to Robopolis represented roughly half of our EMEA revenues last year. The Robopolis team has been instrumental in establishing iRobot as the leading consumer robotics brand in Western Europe, and we look forward to them formally joining iRobot.

Turning now to China, we had very strong year-over-year growth in Q2 2017. Demand for our premium products, the R800 during last year's holiday season and the R900 following its launch in Q2, is strong and supports our premium product and market positioning. Sell through doubled on the 6/18 holiday this year over 6/18 in 2016. We did see more aggressive moves by our competition at the low end of our target market during Q2. As a result, we are adjusting our expectations regarding the growth in full-year 2017 China revenue. We now expect nominal full-year 2017 revenue growth following the decline in 2016.

In Japan, where our integration effort has been underway since early this year, we are progressing well against our short and long term integration goals. We have hired additional finance and accounting staff to implement policies, procedures and reporting consistent with those in the U.S. and are on track to deliver very strong year-over-year revenue growth of **20 – 25%**.

With our increased expectations for total company full-year 2017 revenue, we plan to reinvest some of the incremental profitability to ensure our continued product leadership in a rapidly growing, competitive marketplace and capitalize on the strong U.S. and EMEA momentum, while still increasing profit expectations. We will make additional investments in R&D to accelerate our product roadmap in anticipation of new product launches in

2018. In addition, we will make incremental S&M investments to further promote our Braava family of robots building on the momentum we have seen over the past couple of quarters.

We are firmly committed to improving profitability as we drive adoption and revenue growth and are pursuing a disciplined strategy of balancing our incremental investment with increased profit.

In summary, it has been an exciting first half and we are very optimistic about the outlook for the rest of the year:

- In the second quarter, we saw the positive impact of our targeted marketing programs, especially in the U.S., as revenue in that market grew **46%** year over year driving total Q2 Consumer revenue growth of **24%;**
- We successfully launched Roomba 890 and Roomba 690 Wi-Fi connected vacuuming robots, extending the benefits of cloud-connected cleaning at lower price points while maintaining margins, and;
- We announced the planned acquisition of our largest European distributor which we expect will enable us to capitalize on the current market momentum and drive robotic floor care adoption in EMEA.

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

Alison

As I begin my comments**,** I will first discuss Q2 results and full year expectations before the Robopolis acquisition, and then I will explain the impact expected from the acquisition.

We delivered record second quarter revenue, slightly ahead of our expectations. Revenue of **$183** million increased **23%** from Q2 last year, driven primarily by growth in the U.S. and China. Operating income was **$4.1** million in the second quarter compared with **$5.9** million in Q2 last year and EPS was **$0.27** this quarter compared with **$0.17** for the same period last year. **Q2 2017** included a **$0.15** tax benefit relating to the new 2017 stock compensation accounting standard. As a reminder, given the difficulty with projecting the size and direction of the stock compensation tax impact, we communicated in Q1 that our guidance reflected our tax rate expectations, prior to discrete items for future periods.

For the first half, revenue was **$352** million compared with **$280** million in 2016; operating income was **$25.7** million compared with **$11.4** million last year; EPS was **$0.85** compared with **$0.30** last year. Keep in mind that 2016 first half results include, Defense & Security revenue of **$3** million versus **$0** in the first half of 2017. Divestiture of the Defense & Security business negatively impacted first-half 2016 operating income by **$5.6** million and EPS by **($0.11)**.

Operating income and earnings per share were significantly higher in the quarter than our outlook in April driven by several factors, the largest of which were the timing of Japan impacts, and the significant favorability in the Q2 effective tax rate, as just discussed. Incremental revenue, delayed S&M spend, favorable gross margin and another earn out on an investment were also factors.

With respect to the Japan accounting impact, the total 2017 effect of all Japan accounting requirements is in line with our previous expectations. However, due to the types of the final accounting adjustments, the timing of the quarterly impact will be different. We will have longer amortization periods on some intangible assets and as a result, there was a lower impact to Q2 results, but the impact to Q3 and Q4 will be higher. To be clear, the impact for the year is expected to be the same.

As we said on our first quarter call, we adopted the new accounting standard for 2017 related to the accounting for stock compensation. Windfalls and shortfalls are now accounted for in the quarterly effective tax rate rather than running through additional paid in capital as they had been previously. The impact in either direction is highly dependent on the company's stock price. We have seen favorable discrete benefits in both Q1 and Q2 from this new accounting guidance, but the amount in Q2 was significantly higher than it was in Q1, primarily as a result of the higher stock price during the quarter. Our Q2 effective tax rate before discrete items was **35.7%**.

As Colin discussed, Consumer revenue grew **24%** in Q2 over last year as we continue to see tremendous momentum at U.S. retailers. In the US, net revenue from life-to-date returns adjustments was **$500** thousand in Q2 2017, compared with **$1.2** million last year.

In EMEA, we saw continued market momentum in the second quarter resulting in year-over-year revenue growth of **10%.** On last quarter's call we said that we expected 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. As the second quarter progressed, we saw momentum driving annual growth of high-teens over 2016, with similar quarterly timing, prior to the impact of the Robopolis acquisition.

Year-over-year Q2 growth of roughly **38%** in China compares with a **45%** revenue decline in Q2 2016 as we worked down channel inventory ahead of our transition to a new distributor model at the end of Q2 2016. As Colin has discussed, our full-year 2017 revenue growth expectations have changed due to the quickly changing competitive environment at the low end of our product offering in China. We are now planning for nominal year-over-year growth in China this year, compared with the decline in 2016.

In Q2, revenue declined roughly **20%** in Japan from Q2 2016 as expected, as we began selling through the inventory acquired from the distributor in the acquisition and allowed retail channel inventory to decline. During the quarter, we made significant progress on reducing the retailer inventory and we expect further reductions in Q3 and Q4. Year-over-year revenue growth in Japan is expected to resume in the third and fourth quarters, as we expected, resulting in full-year revenue growth of **20 – 25%** in 2017, in part due to the higher price points we receive having eliminated a tier in the distribution model. As Colin mentioned, the full year revenue has been reduced a bit, as we look to target more aggressive retailer inventory levels. We are pleased that our stronger performance in the US and EMEA more than offset this impact and still allow us to increase our overall revenue guidance.

Gross margin was **49.1%** for the second quarter of 2017, up **2.3** points from the same quarter last year. The gross margin was higher than we anticipated in April primarily due to the timing and P&L classification of the final accounting impacts for the Japanese distributor acquisition that I mentioned previously. In total, Q2 was impacted by approximately **$7** million of inventory profit adjustments and amortization of intangible assets. Not related to the acquisition, we also saw better-than-expected gross margin, driven mostly by COGS savings and regional mix. In Q3 and Q4, we expect gross margin percent to be roughly the same level as Q2, before any impact of the Robopolis acquisition.

Q2 operating expenses were **47%** of revenue, compared with **43%** in Q2 last year driven largely by the acquisition of the Japanese distributor at the beginning of the quarter and additional R&D spending. This was better than anticipated due to higher revenue and the timing of some planned expenses that were postponed until the second half of the year. Opex is expected to decrease as a percent of revenue in Q3 and Q4 Q4 before the impact of the Robopolis acquisition. For the full year, we continue to expect operating expenses to total roughly **42%** of revenues consistent with the expectations we have provided throughout the year, and again, prior to the Robopolis acquisition.

We ended the quarter with **$260** million in cash, up from **$173** million a year ago. Inventory at quarter-end was **$83** million or **81** days compared with **$47** million or **54** days last year. This increase in inventory and DII was largely driven by our Japan acquisition in Q2 and the inventory we now hold in Japan to serve this region under our direct model. Looking forward to Q3 and Q4, we expect DII to increase further in Q3 as we build inventory for holiday season, and then come down significantly in Q4, before any impact from the Robopolis acquisition.

Our full-year 2017 financial expectations, before the impact of the acquisition, are for revenue of **$815** to **$825** million, operating income of **$67** to **$75** million and EPS of between **$1.80** and **$2.00.** Revenue is expected to grow sequentially in the third and fourth quarters and most significantly in Q4. Third-quarter year-over-year growth is expected in all regions except China due to a difficult quarterly comparison. As a reminder, we received an **$11** million order in the third quarter of 2016 that we had expected to receive in Q4 last year.

Finally, I'd like to comment on the expected impact of the acquisition of Robopolis, which is detailed in our earnings release. We have signed a definitive agreement to acquire the company for cash in the amount of **$141** million, or approximately **.9** times the Robopolis twelve month trailing revenue ended June 2017, consistent with revenue multiples for comparable transactions, and subject to customary purchase price and working capital adjustments. We expect the acquisition to close at the beginning of Q4 2017 and to contribute incremental revenue of approximately **$25 - 35** million, all in the fourth quarter. Our gross margin is expected to be negatively impacted by roughly 500 basis points in Q4 and **200** basis points for full-year 2017, as a result of the acquisition. We expect the acquisition to be between **$0.30 - $0.45** dilutive in 2017, the vast majority of which will be incurred in Q4. We have included a schedule in the earnings release showing the anticipated 2017 impact of the acquisition. For 2018, we expect the transaction to generate incremental revenue, and higher earnings per share.

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 second quarter 2017 earnings call. We appreciate your support and look forward to talking with you again in October to discuss our Q3 results.

Operator

That concludes the call. Participants may now disconnect.