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**Kelsey Turcotte**

## PRESENTATION

**Operator**

Good day, everyone, and welcome to the Kornit Digital Ltd. Fourth Quarter 2019 Earnings Conference Call. (Operator Instructions). At this time, I'd like to turn the conference over to Kelsey Turcotte of the Blueshirt Group. Please go ahead.

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**Kelsey Turcotte**

Thank you, operator. Good afternoon, everyone, and welcome to Kornit Digital's Fourth Quarter and Full Year 2019 Earnings Conference Call. Before we begin, I would like to remind you that forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and other U.S. securities laws will be made on this call. These forward-looking statements include, but are not limited to, statements relating to the company's objectives, plans, strategies, statements of preliminary or projected results of operations or our financial condition, and all statements that address activities, events or developments the company intends, expects, projects, believes or anticipates, will or may occur in the future.

Forward-looking statements are subject to known and unknown risks and uncertainties and are based potentially on inaccurate assumptions that could cause results to differ materially from those expected or implied by the forward-looking statements. The company's actual results could differ materially from those anticipated for many reasons, and I encourage you to review the company's filings with the Security and Exchange Commission, including the company's annual report on Form 20-F filed March 26, 2019, which identifies specific risk factors that may cause actual results or events to differ materially. Any forward-looking statements are made as of this call hereof, and the company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

Additionally, the company will be making reference to certain non-GAAP financial measures on this call. The reconciliation of these non-GAAP measures to the most directly comparable GAAP measures can be found in the company's earnings release published today, which is posted on the company's Investor Relations site.

On the call today, we have Ronen Samuel, Kornit's Chief Executive Officer; and Guy Avidan, Kornit's Chief Financial Officer. At this time, I would now like to turn the call over to Ronen. Ronen?

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**Ronen Samuel** *- Kornit Digital Ltd. - CEO & Director*

Thank you, Kelsey. Good evening, and thank you for joining us on this afternoon's earning call. I'm very pleased to report that we delivered a strong fourth quarter 2019, which capped off a year of outstanding growth and progress for Kornit. It also marks completion of the first year of our 5-year journey to become a $500 million revenue run rate business, an objective we are very much on track to achieve.

The industry we serve is undergoing a perfect storm into on-demand textile manufacturing in a sustainable way. As I look at everything the team accomplished in 2019, I believe that our leadership position to capture this opportunity continues to widen. 2020 outlook looks very promising, and I believe it is time for us to continue investing and accelerate our efforts across the board in order to execute on the huge market opportunity ahead of us.

Before we continue with our Q4 results, I would like to highlight a few key achievements of this remarkable execution year for Kornit. We delivered extremely strong financial results, driving both growth and profitability. We successfully launched the innovative Atlas, Polypore and Presto systems. All are experiencing great momentum and opened new market for us. We made significantly progress with some of the world's leading brands. We significantly grew our business with strategic accounts, while penetrating many net new customers. We accelerated our DTF business. We scaled and professionalized our go-to-market across regions, and we executed successfully on our go-direct sales model in North America.

Turning to Q4, we finished 2019 on a very strong note, delivering revenue of $48.7 million, net of $1.1 million of warrants related to a global strategic account. Overall, it was a very strong close to the year as business volume grew 27% during the period, driven by outstanding system sales, growing momentum in direct-to-fabric business and a very robust peak season for strategic and regional accounts. We continue to experience strong adoption across our HD platforms, the Atlas and the Polypore. As many of you know, the introduction of the Presto represents an important step in Kornit's direct-to-fabric strategy, and I'm very pleased with the strong results this quarter and the phenomenal feedback we continue to receive from our customers. The DTF market represents a very large opportunity for Kornit. And with only a very small percent of current volume produced by digital technology, there is a significant opportunity for disruption.

During the quarter, we continued to expand our footprint in strategic accounts and engaged with large and medium-sized fashion and sports brands. Our recent announcement that Hanesbrands company, GEAR for Sports, has added our Avalanche Poly Pro to its installation of 3 Kornit DTG print systems already in production, is yet another example of the great progress which we are making on helping brands expand the sustainable on-demand digital textile manufacturing capabilities.

Turning to our regional performance. We had a strong finish across the board, particularly when you look at the business excluding the influence of a large contribution by global strategic accounts in Q4 last year. This was particularly the case in North America with its strongest system sales quarter ever, where we can see the momentum continuing well into the new year. The regions are firing on all cylinders, and there is great excitement about the pipeline for 2020. I'm also pleased to update you that effective March 10, Chuck Mayo will be joining my staff as Regional President for the Americas. Chuck is a seasoned executive with tremendous experience and track record of driving sales growth and operational excellence, and we look forward to his contribution.

Naturally, we are closely monitoring the situation in China and ensuring our teams and their families have all the assistance they require to remain protected and in well-being. This is very unfortunate situation, and we send all impacted a message of strength and hope. As it comes to our business, we don't anticipate any material negative impact to our top line should the situation continue. While China is a future growth opportunity for us, its contribution to our current and near-term business remain immaterial. As it comes to our ability to deliver products, none of our products are manufactured in China, and our only supply chain dependency is in the area of certain raw material and dryers. We feel comfortable that if needed, this could be reasonably mitigated.

Consistent with our finish to 2019, we started 2020 on an extremely strong note with ISS Long Beach in California. Our booth was packed with attendees excited about our brand-new product introductions, the Vulcan Plus and the Storm Lite, as well as last year's portfolio NPIs, including the Atlas and the Polypore. We are starting the year with a very strong pipeline, which we expect will translate into Q1 business volume that will be in the range of Q4. This is a material and exciting deviation from our typical Q4 to Q1 seasonality.

Beyond that, we have very good visibility for the rest of the year. And we are currently engaged in big expansion projects with some strategic accounts. While Guy will provide guidance in more detail, we are investing in the business to realize these expansions. As such, we anticipate that during the first half of the year, we will show modest operating margin, offset by operating margin improvements in the second half of the year that will result in overall operating margin expansion for the full year 2020. I have never felt better about our ability to meet our $500 million run rate objective. And as today's guidance indicates, I believe if we execute and make the right investments, we can even accelerate our growth on the path to that goal. I want to thank all our customers and investors for the confidence and loyalty to Kornit and our global workforce for their hard work and dedication to our collective success.

Before I turn the call over to Guy, I would like to personally invite you to our Business Unusual event on April 21 to 24 in Israel, where we'll be hosting hundreds of customers, partners and investors at first-of-its-kind conference. This unique event will allow you to hear from and speak with mega sports and fashion brands, industry experts and visionaries in the apparel industry. You will have the opportunity to meet with our executive team, see our technology in action and visit our facilities in Israel. Most importantly, this event will be incredibly relevant for current prospective customers as we showcase Kornit and its powerful ecosystems that we believe will create an even stronger business funnel for the rest of the year. Now I will turn the call over to Guy for a closer look to the numbers and our guidance.

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**Guy Avidan** - *Kornit Digital Ltd. - CFO*

Thanks, Ronen, and good evening, everyone. Before beginning the financial overview, I would like to remind you that the following discussion will include GAAP financial measures as well as non-GAAP pro forma results.

Our fourth quarter non-GAAP pro forma results reflect adjustments for the following items: stock-based compensation expenses, which totaled $2 million; amortization expenses relating to the acquisitions of intangible assets in previous years in the amount of $108,000; taxes on income in the amount of $331,000; and $376,000 for expenses relating to acquisition in 2019.

The company has significant operating lease liability in foreign currencies and incur foreign exchange gain or losses from the reevaluation of these liabilities. These gains and losses may vary from period-to-period and do not reflect the true financial performance of the company. For the fourth quarter, foreign exchange income associated with ASC 842 were $530,000. A full reconciliation of our results on GAAP and non-GAAP basis for the quarter and for the year is available in the earnings press release issued earlier today and on the Investors section of our website. On November 11, 2019, the FASB issued ASU 2019-08, which clarifies the accounting for share-based payments issued to a global customer that are not in exchange for distinct goods or services.

Under the new guidance, entities should use a fair value-based measure to calculate such incentive on the grant date rather than upon the vesting date. We early adopted the new guidance as of January 1, 2019, and will use the fair value of the unvested warrants on the adoption date rather than upon the later vesting date in order to determine the reduction of the transaction price. The adoption of ASU 2019-08 resulted in adjustment of $4.6 million to increase our Q1 to Q3 revenues. We are restating the first 3 quarters of 2019, which will be presented as comparative figures in the 2020 results. The annual financial statements for 2017 and 2018 will not be affected from the adoption of ASU 2019-08. And we will compare the fourth quarter of 2019 with the year ago quarter. We will use Q4 2018 figures based on the old standard.

Fourth quarter GAAP revenue, net of $1.1 million attributed to the noncash impact of warrants issued to Amazon, increased by 28.8% to $48.7 million, compared to $37.8 million in the prior year and increased by 2.9% versus the prior quarter. You can find the new accounting treatment impact on the warrants on 2019 results by quarters in the earnings supporting slides. Fourth quarter business grew 27.1% year-over-year and 0.1% sequentially.

Revenues grew this quarter versus the previous year period, thanks to strong momentum of new printing systems and service business, partially offset by lower growth of our ink and consumables due to transitioning of our system installed base to HD technology. Services revenues for the fourth quarter were $6.4 million, net of $114,000 attributable to the noncash impact of warrants, accounting for 13.2% of total revenues, an increase of 50.2% over the prior year period, an increase of 61% sequentially. The amount attributed to the noncash impact of warrants in the fourth quarter was $1.1 million or 2.3% of revenues, compared to $2.4 million in the previous quarter and $1.4 million in the fourth quarter of 2018.

By geography, 64% of our fourth quarter of 2019 sales were from the Americas, 25% from Europe, the Middle East and Africa, and 11% from the Asia Pacific region, compared to 57%, 30% and 13%, respectively, in Q4 2018. Our growth in the Americas was based on very strong demand for our printing systems.

Moving to customer concentration. A global customer contributed 9.1% of our overall revenue this quarter, compared to 11.2% in the previous year. Our top 10 customers accounted for 42% of our overall revenues, compared to 59% in the fourth quarter of 2018. Our strategy to go-direct in the U.S. as well as increase in customer diversification contributed to the decrease in customer concentration. For the year, our annual revenues for 2019 was $179.9 million, net of $5.1 million attributable to the noncash impact of warrants, representing an increase of 26.3% versus $142.4 million, net of $4.6 million attributable to the noncash impact of warrants in 2018.

The annual increase in revenues is in line with our 5-year plan. For the year, 61% of our sales were from the Americas, 27% from Europe, the Middle East and Africa, and 5% from the Asia Pacific region. Our global customer contributed 12.3% of our overall revenues, compared to 17.1% in the previous year. Year-over-year growth by geography without our global account was: Americas, 33%; EMEA, 8%; and Asia Pacific, 42%. This year, 3.3% of our sales came from China versus 4.2% in the previous year.

To align with our previous year's revenue presentation for 2019, revenues from printing systems contributed 50.8% revenues, from ink and other consumables contributed 36.3%, and revenues from services contributed 12.9%, compared to 46.2%, 42.1% and 11.7% in 2018, respectively. Revenues from printing systems grew by 38.8%, while revenues from ink and other consumables grew by only 8.9% due to transition of our installed base to HD technology.

Looking forward, the rapid growth in printing systems revenue reflects accelerated growth of our installed base that it is expected to generate more demand for ink in the coming years. In addition, we believe the most HD upgrades were completed during both 2018 and 2019. As a result, for 2020, we expect strong double-digit growth for our consumable business. We expect continued momentum in printing system growth in 2020 and the related year-over-year growth rate to be higher than consumable growth.

Moving to profitability. Non-GAAP gross margin in the quarter came in at 50.2%, compared to 48.8% in the fourth quarter of 2018 and an increase from 47.7% in the previous quarter. Margin improvement this quarter versus the year ago quarter was the result of 68 basis point net decrease after noncash warrant. The increase in gross margin versus the previous quarter was attributed to improvement in product mix. On a GAAP basis, gross margin was 49.4% versus 48% in the prior year period and 47% in the previous quarter. For the year, our annual non-GAAP gross margin decreased to 47.9%, compared to 49.8% in the prior year due to less favorable product mix. Warrants impact on non-GAAP gross margin was 144 basis points for 2019 versus 156 basis points in the prior year. On a GAAP basis, our annual gross margin decreased to 45.6%, compared to 49.1% in the prior year.

Moving to our OpEx item. I'll discuss this item on a non-GAAP basis, which exclude nonoperating charges previously mentioned and highlighted in our GAAP to non-GAAP reconciliation in our press release. Research and development expenses for the fourth quarter was $5.7 million or 11.6% of revenues, compared to $5.9 million or 15.6% of revenues in the prior year. The year-over-year decrease in R&D expenses as a percentage of revenue reflects robust top line growth. This quarter, we had $380,000 of software capitalization.

For the year, research and development expenses were $21.1 million or 11.7% of sales, compared to $20.9 million or 14.7% of sales in the prior year. Sales and marketing expenses in the quarter were $8.5 million or 17.4% of sales, compared to $6.2 million or 16.5% of sales in the prior year. For the year, sales and marketing expenses were $31.1 million or 17.3% of sales, compared to $23.4 million or 16.4% of sales in the prior year. Higher sales and marketing expenses, both for the fourth quarter and the year, were the result of an increase in headcount and marketing activities related to our go-to-market transition to direct model and penetrating of new markets.

General and administrative expenses in the fourth quarter were $4.5 million or 9.2% of sales, compared to $3.4 million or 8.9% in 2018. For the year, general and administrative expenses were $15.7 million or 8.8% of sales, compared to $13.9 million or 9.7% of sales in the prior year. Higher G&A expenses for the fourth quarter and the year were the result of increase in headcount, corporate development activities and an increase in D&O insurance cost. Headcount as of December 31 was 547 employees versus 444 employees at the end of 2018. The 23% increase in personnel was predominantly attributed to sales and marketing and service activities.

Non-GAAP net income for the fourth quarter was $7.1 million, net of $1.1 million noncash impact of warrants, or $0.17 per diluted share, compared to $3 million, net of the $1.4 million noncash impact of warrants, or $0.08 per diluted share in the prior year period.

Non-GAAP net income for 2019, net of $5.1 million noncash impact of warrants, was $19.6 million or $0.49 per diluted share, compared to $13.1 million, net of $4.6 million noncash impact of warrants, or $0.37 per diluted share in the prior year. GAAP net profit was $4.8 million, net of $1.1 million noncash impact of warrants, or $0.11 per share on a diluted basis, compared with net income of $7 million, net of $1.4 million noncash impact of warrants, or $0.19 per share for the prior year period.

For the quarter, the warrants impact was 113 basis points on gross margin, 200 basis points on operating margin, 194 basis points on the net margin and $0.02 on a diluted basis. For the year 2019, the warrants impact was 144 basis points on gross margin, 248 basis points on operating margin, 245 basis points on net margin and $0.13 on a diluted basis. Our non-GAAP financial income this quarter was $1.7 million, an increase of $1.3 million compared to prior year period, and $3.6 million for this year compared to $1.4 million in 2018.

Next, I'll discuss our adjusted EBITDA. For the fourth quarter 2019, adjusted EBITDA was $8.2 million or 16.4%, compared to $5.2 million or 13.4% for the 3 months ended December 31, 2018, an increase of $3 million or 55.7%. Net cash provided by operating activities was $14.9 million this quarter, compared to $8 million yield in the third quarter and net cash provided by operating activities of $15.7 million in the prior year period. This increase in cash from previous quarter in cash was mainly a result of a decrease in accounts receivable and an increase in trade payable. For the year, we generated $11 million of cash from operating activities versus $33.4 million in 2018. During 2019, we used $4.3 million to invest in our new ink factory. We expect an additional $10 million investment in the first half of 2020 to complete the ink factory.

Now I'll discuss company's cash position at December 31, 2019. Cash balances, including long-term marketable securities and short-term deposits at year-end, were $263.7 million, compared to $127.7 million as of December 31, 2018. The growth is attributed to $129.7 million net proceeds from secondary offering and $11.0 million cash from operations, driven from profit, partially offset by $5.4 million investment activities, including ink factory and other equipment.

Before we move to our guidance for the first quarter 2020, I'd like to talk a bit about the opportunities in front of Kornit. As Ronen has discussed, we have a great deal of momentum as we enter 2020 and are well on our way to achieve our $500 million run rate revenue objective. The market is ripe for disruption and performance of our newly introduced product has been very strong. As a result, we think now is the time to accelerate investment in the business and expand our product portfolio to capitalize on the opportunities in front of us and further accelerate our ability to take market share. Investment across the organization will predominantly include an increase in customer-facing personnel, an additional $1.2 million of expenses for our marketing event in the second quarter of 2020. We expect this accelerated OpEx investment to continue throughout the first half of 2020. And as a result, we do not expect an increase in operating margin in the first half of the year. However, we are expecting an annual growth in our operating margin in 2020.

Now moving to our guidance for the first quarter 2020. We expect revenues to be in the range of $47 million to $51 million and non-GAAP operating income to be in the range of 2% of revenues to 6% of revenues. As has been our practice in the past, these numbers assume no impact of fair value of issued warrants in the first quarter of 2020. The fair value of issued warrants depend on future revenues from single customer whose expected purchase cannot be predicted with certainty and are reflected as part of our overall guidance since we do not provide guidance for a specific customer. I will now transfer the call back to Ronen.

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**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

Thank you, Guy. With that, we are ready to open the call for questions.

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## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) We'll take our first question from Patrick Ho with Stifel.

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**J. Ho** - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD of Technology Sector*

Congrats on a nice 2019. Ronen, first, can you provide a little more color on the new products traction? And whether you're seeing a greater existing customer base leveraging the new products into additional markets, or are you seeing more new customer adoption of these solutions? And maybe just kind of a follow-up. On the existing customer end, given that they've been Kornit's customers for some time, how quickly can you turn those, I guess, new product adoptions into volume orders?

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**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

Okay. Good question. So regarding the momentum, we see actually great traction or momentum on all new product introduction. Starting with the Atlas, we already mentioned that we sold more than 70 units in -- during 2019. We see the momentum continue very, very strong into Q1 and the rest of the year. So Atlas is really, really looking very strongly followed by the Polypore that opened for us totally new market, getting into many, many net new customers that we couldn't reach before. Now with the Polypore, really a unique solution, not only compared to digital, but even better than the conventional solution in the market. The Presto is really hot. We had a very strong Q4. We are starting with a very strong Q1 on the Presto. We are entering into a totally new market. Mainstream fashion manufacturers are using it. Brands are behind it. We see really accelerated goals. We have a very unique solution, best-in-class. This is really on-demand manufacturing in a sustainable way, and we see a huge acceleration on this front.

As for the mix, we see our customers adopting the new products, some existing customers adding on top of the Avalanche -- HD Avalanche, they're adding the Atlases and also the Polypores. We have customers that prefer to stay with the Avalanche HD. So we continue to see also growth on the Avalanche HD. So overall, we see a very, very nice mix of products turning to more the high end side of the products.

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**J. Ho** - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD of Technology Sector*

Great. Maybe as my follow-up question in terms of the services business. You talked about the consumables growth on the call in terms of growth as you get more systems into the marketplace. How do you look at the services growth, given that services typically follows on about a year after warranties fall off? How do you see that business growing in 2020 and beyond?

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**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

So we have changed our policy regarding the contract -- service contract starting -- beginning of 2019 and actually, we are selling all our products with a contract. So it's a bundled contract into every sales of new units, and we see a major increase in contracts -- service contracts in the field also for installed base that are using our systems are moving into service contracts. By that, we have much better view on recurring revenues that will come from the service. And as you can see, you can see the growth over the whole year-over-year on the service side. And as we mentioned, we believe that 2020 will be the year that we will end breakeven on the service side overall.

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**Operator**

Next, we'll move on to Peter Zdebski with Barclays.

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**Peter A. Zdebski** - *Barclays Bank PLC, Research Division - Research Analyst*

This is Peter, on for Tavy Rosner. I wanted to ask about some of the product traction on the [Poly Pro]. You did disclose the number of Atlas shipments that you've delivered. Can you give us a sense of how well the Poly Pro has been tracking compared to that? And then I have a follow-up.

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**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

Yes, we did not disclose the number of units we sold on the Polypore. I can say that we sold more than we planned during 2019. We expect to see a major acceleration during 2020. We are dealing with few major brands fashion, but also sports and athleisure brands, but starting to adopt the Polypore and will accelerate the adoption and the business during 2020. So we expect this business to grow. Plus, we are putting a lot of effort to penetrate faster in this market. We believe, as I mentioned, we have a unique solution. There are hardly any competitors, definitely not on the digital side, but also we believe that we have a very strong value proposition versus the analog side. And due to the margin advantage that we have on this product, we are pushing it very strongly to the market. And we have focused into continue to grow the market with existing customers, but we're working very closely with many brands to accelerate the growth.

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**Peter A. Zdebski** - *Barclays Bank PLC, Research Division - Research Analyst*

And then I have a follow-up on services, just specific to the fourth quarter. It looks like you had a record quarter in sales there. But would you attribute that to the new plans? Or is it more service on the more industrial systems that you're selling? And how would you account for that?

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**Guy Avidan** - *Kornit Digital Ltd. - CFO*

It's actually all of the above. One, there is an ongoing growth in services. We -- obviously 3 or 4 years ago, we started to sell services. So there's a lot of catch-up on the installed base. And what Ronen mentioned before, it's a bundle. You cannot really buy a high throughput Kornit machine today without committing for a service contract.

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**Operator**

We will next take Brian Drab with William Blair.

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**Brian Paul Drab** - *William Blair & Company L.L.C., Research Division - Partner & Analyst*

First, on the hiring. So you hired about 100 people in 2019. Can you just break that down, roughly give us the rough number of hires by function, marketing, service, et cetera?

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**Guy Avidan** - *Kornit Digital Ltd. - CFO*

The number of 103, this is actually net. We're not really breaking it down to department, but we can say that predominantly, most of the new -- or most of the increase in headcount is related to customer-facing and services activities. So you can see it both, and if you look at P&L, you can attach it both to OpEx and COGS.

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**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

Yes. I would just add that we have managed during 2019 to attract really strong talent to our organization. Kornit is becoming really a company that's attracting many, many experienced people into the company. And we are very, very pleased with the growth and the type of people we've managed to hire doing this.

**Brian Paul Drab** - *William Blair & Company L.L.C., Research Division - Partner & Analyst*

Okay. And what percentage of revenue would you estimate DTF might account for in 2020? Maybe of system revenue or total revenues...

**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

We are not breaking it down. We are not breaking it down between DTG to DTF at this stage. We -- as I mentioned, we can see as very strong growth on the DTF, but DTG, by far, is a bigger business, and we can see also a very, very strong growth in the DTG. So it's great to have another pillar, of course, but the DTG has continued to grow very fast. So I don't think that the mix overall in terms of revenue will change much.

**Brian Paul Drab** - *William Blair & Company L.L.C., Research Division - Partner & Analyst*

Okay. Is it fair to say though that DTF wasn't really material to overall results in 2019, but would be in 2020 then?

**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

So DTF was very material for Q4 results. As for 2020, it -- overall, it will be material.

**Brian Paul Drab** - *William Blair & Company L.L.C., Research Division - Partner & Analyst*

Okay. Okay. And then maybe just one last question for now. You mentioned that you have some good visibility for 2020 through discussions with some of the larger strategic customers. Do you expect that you'll have any lumpiness in your revenue as you move through 2020? Are there any quarters that you can already tell are going to be bigger quarters than others in terms of revenue? Or does it kind of increase sequentially throughout the year?

**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

No. At this stage, we -- as I've mentioned, we have a very good visibility. We are working with few of our strategic accounts on a major expansion globally, and we started production on those systems. So we really have a clear direction when we need to deliver them. We feel very, very, very good about 2020, about the growth. And no, we don't see any lumpiness during the quarter -- between the quarters.

**Operator**

Next, we'll move on to Jim Suva with Citigroup.

**Michael Anthony Cadiz** - *Citigroup Inc, Research Division - Research Analyst*

Ronen and Guy, this is Michael Cadiz for Jim Suva with Citi. As we look into 2020, would you mind giving us some color on the depth of your brand pipeline with which you were talking with or you'd like to work with? And any expectations that you may have in converting those conversations?

**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

Yes. So we are working with many top-tier brands, both on the DTG and DTF. We see engagement also for midsized brands across the board, across the world. We see growth there. A few of those big brands already using our systems, few of them in trials and few of them are scaling up their businesses. I recommend you to come to our event in April, in Israel. You will have the opportunity to see those brands and to understand who is behind it, and I'm sure that they will share much more information when -- during the event. So it will be a great opportunity to have much more color on what's going on.

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**Operator**

We'll move next to Jim Ricchiuti with Needham & Company.

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**James Andrew Ricchiuti** - *Needham & Company, LLC, Research Division - Senior Analyst*

So I'm trying to get a little better understanding of how we should be thinking about the investments you're going to be making in 2020? You're clearly starting the year at a much higher level, and you ended 2019, I think, at a higher level than some of us were expecting. As we think about the investments you're making, maybe, Guy, can you give us any color as to how that is comprised in R&D and sales and marketing? Where should we be thinking the heavier investments are going to be made? In sales and marketing, mainly?

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**Guy Avidan** - *Kornit Digital Ltd. - CFO*

So as mentioned before, across-the-board. So it starts even higher. So we mentioned before that we're growing very fast. And as a result, we're growing our services personnel. So that will impact cost of goods sold. And then in terms of priority, we mentioned that before. So the #1 priority for us is customer-facing. So it will impact sales and marketing and then R&D and then G&A. So we do expect to see more and sooner leverage on G&A, then R&D and only later on sales and marketing.

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**James Andrew Ricchiuti** - *Needham & Company, LLC, Research Division - Senior Analyst*

Okay. And the support that you're providing prospective customers, as you go after these bigger brands, is that requiring more intensive support that's driving some of this OpEx? Or are you adding -- making these investments with the objective of just expanding the broader customer base? What I'm trying to find out is -- as you go after these brands, is the investment higher and support higher and more intensive than what is normally required?

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**Guy Avidan** - *Kornit Digital Ltd. - CFO*

Absolutely, yes. I mean they are much more demanding in terms of machines operation. And as a result, we are investing more efforts before the sales and during the first phase of the sales.

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**James Andrew Ricchiuti** - *Needham & Company, LLC, Research Division - Senior Analyst*

And in that first phase, is that -- should we assume that some of that payback starts to flow through in the second half of the year? Or are these investments really being made with the idea that you're looking for a much stronger return in 2021.

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**Guy Avidan** - *Kornit Digital Ltd. - CFO*

So we also mentioned in the prepared commentary that we will see, let's say, a lower operating margin in the first half. But we expect to catch up the year, we expect increase in operating margin year-over-year. Obviously, we expect 2021 to see more profits from the investments that we did in 2019, and we will continue to do in 2020.

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**James Andrew Ricchiuti** - *Needham & Company, LLC, Research Division - Senior Analyst*

So the investments then sounds like begins to taper off in 2021, where you get some of the benefits -- a greater benefit from these investments that you're making this year?

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**Guy Avidan** - *Kornit Digital Ltd. - CFO*

Yes. Normally, we're guiding for one quarter only. But when we said 5 years, 5 $500 million, we also said that we expect to expand margin, including gross and operating margins, and that still is the plan.

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**Operator**

Next, we'll take Greg Palm with Craig-Hallum Capital Group.

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**Gregory William Palm** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Guy and Ronen, congrats on the good end of the year here. So I guess following up on the Q1 guidance, I'm curious, are you assuming a higher level of contribution from shipments from your larger customers here? I mean I think, normal seasonality or, I guess, buying patterns is kind of that Q2, Q3 time frame. But I'm trying to reconcile, Ronen, your earlier comments about global expansion and some of these units that are already in production.

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**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

The Q1 will be mixed between, first of all, DTG and DTF. But we will see another strong quarter for DTF. But it also will be a mix between regional accounts and strategic accounts. So we already have a few expansion -- biggest expansion during Q1 with strategic accounts, but many of the growth in Q1 is coming from regional accounts and net new accounts.

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**Gregory William Palm** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. Understood. And then just following up on the commentary around China and associated supply chain risks. I mean are you assuming any related impacts here in Q1? I don't know whether that's increased lead times or higher component pricing. I guess what's the risk if factory production of some of these components remains delayed here for the near future?

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**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

Yes. So first of all, we are monitoring very closely the situation in China. We have a small team in China and bigger team in Hong Kong. We are working very closely with them, making sure that they are safe. We're providing them all the masks and other things that they need to protect themselves. So this is the first priority for us. As for the business, we do not anticipate any impacts in Q1. As you know, China, we see China as a growth region for us, very important longer term. But short term and midterm, we don't see China contributing materially to our revenues. So we don't see an impact on -- major impact on long term in China. Manufacturing is being done in Israel for the systems and the inks. So we don't have any manufacturing in China.

And as for the supply chain, we are monitoring it very, very closely. There are some components that have been made in China, some material. We are looking for all kinds of mitigation. But this is more midterm into Q2 and Q3. And we feel we are reasonably assured that we will be able to mitigate all those supply coming from China.

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**Gregory William Palm** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay, great. And last one, going back to the commentary on your kind of large global customer. So if my math was correct, revenue in Q4 looks like it was down year-over-year quite a bit actually, given a much higher installed base now versus a year ago. I am having trouble reconciling that. I don't know, maybe there was some modest contribution from systems a year ago, but if there wasn't, what am I missing here?

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**Guy Avidan** - *Kornit Digital Ltd. - CFO*

Well, yes, your assumption is right. When you do Q4 with Q4 last year, Q4 included printing system as well. And that's actually the reason for the decline year-over-year.

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**Gregory William Palm** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. Fair to assume that excluding those systems, so just looking at consumables, it would have been up on a year-over-year basis?

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**Guy Avidan** - *Kornit Digital Ltd. - CFO*

A good assumption.

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**Operator**

(Operator Instructions) We'll move next to Chris Moore with CJS Securities.

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**Christopher Paul Moore** - *CJS Securities, Inc. - Senior Research Analyst*

Just a question on the ink sales. Guy, you had talked about kind of the expectations on consumable growth in 2020. This HD transitioning slowed things down a little bit. Can you just repeat that? I wasn't able to -- wasn't writing quick enough.

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**Guy Avidan** - *Kornit Digital Ltd. - CFO*

Yes. So we actually discussed this issue only on an annual basis. So what we've said in terms of ballpark numbers, that printing system grew very nicely year-over-year, close to 40% in terms of business and ink, and other consumables grew close to 10%. And the reason was during 2018 and 2019, we shifted most of the installed base, but the installed base in terms of throughput, not number of machines, to HD technology. Meaning, at the end of the day, the machines are more efficient. And as a result, we saw, dollar-wise, less growth in revenues from ink and other consumables. That said, because we believe that most of the upgrades were done already, we will see a much stronger growth in 2020. At the same sentence, we also said it's going to be a strong double-digit growth, but we also expect printing system to grow even faster than that.

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**Operator**

We'll take a follow-up from Jim Ricchiuti with Needham & Company.

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**James Andrew Ricchiuti** - *Needham & Company, LLC, Research Division - Senior Analyst*

Just a question on the M&A pipeline. You've talked in the past, more recently, about an acquisition pipeline, some acquisitions you may be looking at. It looks like there may have also been some expense in the quarter associated with some M&A work you're doing. How does that impact your overall commentary regarding the improvement in operating margins that you're looking at for the full year 2020 over 2019?

**Guy Avidan** - *Kornit Digital Ltd. - CFO*

Well, Jim, we cannot really comment about that right now.

**James Andrew Ricchiuti** - *Needham & Company, LLC, Research Division - Senior Analyst*

Can you talk at all about how active the pipeline is?

**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

Yes. So on the pipeline, we have a very strong pipeline. Our team was working for the last few months on building the pipeline. We feel very good about what we have right now. And we are progressing very well. And I hope in the next few months that we will be able to disclose the direction that we are taking. As we mentioned in the past, our focus is mainly around workflow solution in the market. We believe that workflow is superimportant for brands and connecting brands with consumer, work related to providing the production, the on-demand production in a sustainable way.

**James Andrew Ricchiuti** - *Needham & Company, LLC, Research Division - Senior Analyst*

And Ronen, I think you had also talked about potentially something, and it sounds like more in the automation area. Are there 2 tracks you're looking at in terms of M&A?

**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

So there are a few tracks. One of them is workflow, another one is in the go-to-market. And another one, as we've mentioned in the past, ancillaries, automation, color management. So in this direction as well. We have good coverage that -- what we are looking into.

**James Andrew Ricchiuti** - *Needham & Company, LLC, Research Division - Senior Analyst*

Sounds like it's pretty active one.

**Operator**

That does conclude our question-and-answer session at this time. I'll turn the call back over to Ronen Samuel for any closing remarks.

**Ronen Samuel** - *Kornit Digital Ltd. - CEO & Director*

Okay. Thank you very much. Thank you for joining today's call, and we appreciate your continued interest in Kornit. We are very pleased with our progress until today, and I want to thank our employees for their hard work, for their dedication throughout this exciting time for Kornit. I want to thank all of you, and I look forward to speaking with all of you and to see you in Israel in the event in April, which is going to be very important for all of us together. So looking forward to see you. Thank you very much.

**Operator**

That does conclude today's call. We do thank you for your participation. You may now disconnect.