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TASR - Q3 2017 Axon Enterprise Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the third quarter Axon Enterprise earnings conference call. At this time, all participants are in a listen only mode. Later we will conduct a question and answer session and instructions will be given at that time. (Operator Instructions) I would now like to turn the call over to Luke Larson, President at Axon Enterprises.

Luke S. Larson *- Axon Enterprise, Inc. - President*

Thank you and good afternoon to everyone. Welcome to Axon's third quarter 2017 earnings conference call. Joining on today's call from management are Rick Smith, CEO and Founder, and Jawad Ahsan, our CFO.

Before we get started I'm going to turn the call over to Andrea James, our VP of Investor Relations to read the safe harbor statement.

Andrea Susan James *- Axon Enterprise, Inc. - VP of IR*

Thanks, Luke. Our earnings are available on the SEC website and our investor relations site. This call is being broadcast on the Internet and is available on the investor relations section of the Axon Enterprise website. Please note that the earning shareholder letter as well as supplemental materials including our key operating metrics are available on our website.

Today we will open the call with prepared remarks and we will follow the prepared remarks with our standard live question and answer session. Statements made on today's call include forward-looking statements, including statements regarding our expectations, beliefs, intentions or strategies regarding the future including statements around projected spending.

We intend that such forward-looking statements be subject to the safe harbor provided by the Private Securities Litigation Reform Act of 1995. The forward-looking information is based upon current information and expectations regarding Axon Enterprise Inc. These estimates and statements speak only as of the date on which and they are made, are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict.

All forward-looking statements that are made on today's call are subject to risks and uncertainties that could cause our actual results to differ materially. These risks are discussed in greater detail in our annual report on form 10K and quarterly reports on form 10-Q under the caption risk factors. You may find these filings as well as our other SEC filings on our website at www.axon.com.

With that I will now hand the call over to Rick Smith, our CEO and Founder.

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

Thank you, Andrea and good afternoon, everyone. Thanks for joining our call and thank you for your interest in Axon. In Q3 we executed against our long term plan of creating the end-to-end technology platform for policing and public safety. We are proud of our revenue and product milestone achievements in the quarter.

While we incurred some additional costs that were necessary for the long term success of our business we were also taking a harder look at our operating margin performance and improving rigor around operating expenses. Specifically, our domestic body camera business is now transitioning from the early market formation phase where growth is the dominant focus, to our scaling phase where we are now placing significant emphasis on operating leverage and building the foundations of long term profitability.

Our strong quarterly revenue is indicative of our product leadership across all categories. There is no doubt about our market leadership and our strong customer relationships. Our record revenue in the quarter was driven by strength across our product segments including strong international Weapons revenue growth. Our Weapons revenue growth is quality growth. Getting on a budget line item where Police Department grows the long term revenue stream from the customer by giving them a clear mechanism to be able to consistently upgrade every five years. Without these budget line items in place we estimate our historic upgrade cycle was closer to the 8 to 10-year range.

We believe we can shorten that cycle to five years for agencies with a budget line item in place. We also believe that service plans for the weapons will pave the way for us to add software, training and other software plans as upgrades to create additional customer value and revenue opportunities starting in 2018.

Our operating loss in the quarter was caused by three key factors, which we addressed in our shareholder letter in detail and which Jawad will cover in more detail. At a high level though let me offer a quick review.

First, when we enter a new market we usually do so with disruptive upfront discounting, which compresses initial ASPS and gross margins. We did this with the TASER Weapon 20 years ago, with the domestic body-worn cameras and EVIDENCE.com starting five years ago. This is the case today as we penetrate international greenfield markets with body-worn cameras as well as the introduction of our new Fleet product domestically, which began to scale in the third quarter.

We are displacing several competitors with our Fleet offering and we have shipped 1600 fleet units in Q3 at higher discounted pricing and higher implementation costs as we iron out the new deployment processes required with this new product segment. We are gaining an important foothold with our in-car video system. As many of you know, we've already converted several fleets onto our platform because Fleet was coming. But the cost and discounts did impact the profitability of both our Weapons and Software and Sensors segment due to how the accounting works, which Jawad will cover in more detail.

Under the Generally Accepted Accounting Principles, a discount on one element of these multielement deals must be proportionally applied across all of the elements, regardless of the appearance on the customer invoice. So this not only caused compressed margins in the Software and Sensors segment in the quarter but also compressed Weapons margins because of those Fleet contracts where we also sold a bundled weapon. This effect can be a bit exacerbated with deferred contingent hardware under the current accounting guidelines. While there are many challenging aspects of the new 606 guidelines coming next year, these new guidelines will much better match the economics of our signed deals to the accounting. And as a result, we expect to see significant improvement in body camera hardware economic starting in the first quarter of 2018.

The second factor, gross margins were also compressed by $1.4 million in data migration cost in the quarter as we performed the largest cloud data migration ever with about 16 PB of data migrating from AWS to Microsoft Azure. After this data migration is complete we will have a strong sales partner in Microsoft and can leverage their relationships with customers around the globe as we grow our own product offerings.

And the third factor we made the decision in Q3 to bring closer scrutiny to our financial control functions. Jawad will go over this in a few minutes, but I just wanted to point out that the investment in restructuring our international entities should yield a significant ROI going forward. We expect to see a reduction in our effective tax rate by over 10 percentage points as a result of these efforts.

Although we plan to continue investing in R&D for future growth areas such as Records Management, artificial intelligence and Fleet we have identified other areas that would benefit from greater cost control in our company and we are taking a magnifying glass to our discounting practices to identify areas for improvement.

Up until now we've been focused almost entirely on growth. Our key metrics including all the compensation metrics were focused primarily on growth and that's exactly what the organization has delivered. As part of our pivot toward profitability in the body camera segment we are adding profitability metrics to our compensation and long term performance equity plans for 2018 and beyond. While we believe the strategic investments, we made in Q3 were the right decisions to make for the long term management of the business, we also wanted to highlight to investors that we have internal plans in place regarding cost control and slowing many areas of spend growth.

We are committed to executing in this next phase of growth with a more rigorous focus on profitability. I'd like to conclude by reiterating that our focus to date has been on building the network of devices, apps and people so that we can create new, highly valuable services that are only possible because of that network and we've made tremendous progress to date. We have over 6000 agencies on the Axon internetwork utilizing EVIDENCE.com.

We've added over 200 prosecutors' offices and are adding the Crown Prosecution offices across the entire United Kingdom to enable highly valuable and secure information sharing services. We have 245,000 camera sensors in the field today and have ingested over 16 million GB of data or 16 PB, one of the largest datasets in the world. And we've added the industry's leading artificial intelligence research and engineering team to develop and manage AI services that will unlock the value in this data for our customers, enabling the automation of cumbersome business processes and creating high-value services.

In 2018 we expect to begin launching some of these premium services that are made possible by the network that we have built. These new services will create significant and unique value for our customers and will create high-margin services that will accelerate long term profitability. With that, I'd like to turn the call over to Luke.

Luke S. Larson - *Axon Enterprise, Inc. - President*

Thanks, Rick. We had exceptional bookings in Q3 of $78 million as we continue to lead the market. Bookings grew 36% or by $20 million from the prior year quarter. Similar to the 2017 second quarter, this quarter's strong bookings were not reliant on any one large order.

Fleet bookings made a more meaningful contribution representing over 10% of this quarter's bookings. Our customers see and appreciate the value in our end-to-end solutions which improve the workflow of everyone in the chain, from officers to prosecutors to defenders. This was evidenced by 12 wins in Q3 where our body-worn camera or our Fleet offering displaced competitors. This is on top of 12 win backs we announced in Q2.

It's not easy for an agency to switch body camera providers but the fact that they do and migrate to our platform speaks to the quality and value proposition of the solutions we are providing. We also saw four large customer expansions in Q3 for agencies including the Las Vegas Metropolitan Police Department chose to upsize their contracts and their reliance on the Axon network. Las Vegas was one of our earliest body-worn camera customers and in Q3 they decided to renew their contract early and sign on to our Officer Safety Plan.

We are pleased with the pace of our product development which is accelerating, and our Software and Sensor segment is seeing a rise in operational discipline in 2017 as we've seen improvement in hitting product development milestones compared with past years. I want to touch on four product development milestones or accomplishments in this quarter.

Artificial intelligence, EVIDENCE.com, Signal Sidearm and Axon Citizen. First, artificial intelligence. We are investing in AI and machine learnings that will deploy across their products for enhanced functionality. We see AI as a productivity multiplier and not an end product in itself, which differentiates us from competitors and offers us a clear path to monetization.

While our AI research investments are still pre-revenue we received a major validation of our approach in the quarter. We had a really big win with the Los Angeles Police Department choosing Axon over several competitors to be the AI technology supplier for a special video analytics project. A panel of reviewers evaluated each of the competitor's work via scientifically rigorous test.

We were evaluated against benchmarks such as categorizing the video, accuracy and workflow improvement speed up. LAPD received a federal grant to pay for the project and though it is not material to results, we believe the win points to our strategic advantage of specifically focusing on solutions for law enforcement.

Second, our software development teams rolled out three new EVIDENCE.com updates in Q3 as we mentioned in our shareholder letter. Not only does EVIDENCE.com eliminate pain points for officers in the field but it also solves problems in the back office at agencies helping departments to make the best use of their body camera investment.

For example, our update in the quarter to the device search feature now allows agencies to filter video by which camera recorded it. One of our customers said I use the device search feature and the first day it was available, it saved me hours of work. These are really meaningful features for our customers.

We also received encouraging feedback regarding a feature update that gives customers more granular control over who has access to evidence from an update that allows users to run advice summary report that brings together all of the various device related details into a single place. One of the customers wrote thank you, thank you, thank you, thank you for the device summary. Again, we are really connected to our customers and making VOC[ph] driven feature decisions. We take customer feedback very seriously. EVIDENCE.com is continuously improving as we roll out monthly updates to agency customers.

Third, Signal Sidearm. We continue to see strong interest from customers and our internal development is tracking to plan. We finished beta testing in October and the product is now available to ship for all Axon customers. Signal Sidearm is a smart sensor that attaches to most law enforcement firearm holsters. When a firearm is removed from its holster, a wireless alert is sent to all Axon cameras within range to begin recording and capture buffered video from before the firearm was drawn.

And forth, we recently released Axon Citizen, a public safety portal that allows community members to submit evidence directly to law enforcement agencies only for crimes under investigation. This is a specific product that was requested by our customers and has generated a lot of user interest.

Finally, I'd like to update you on RMS which is still pre-revenue and represents a large future opportunity. RMS remains on track to ship in 2018 to select agencies that are our early access partners. In Q3 we signed up one major agency and a number of smaller agencies as early access partners. We were really encouraged by the level of customer interest shown for our Axon developed RMS at the International Association of Chiefs of Police conference in October. And now I'll turn it over to Jawad who will discuss our financial results.

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

Great. Thanks, Luke. Before I begin my prepared remarks, we wanted to briefly address the SEC's comment letter. We have been working to address the SEC's questions and earlier today we received a letter from the SEC stating that they completed their review of our form 10K filing.

Turning back to the quarter, we had record revenue of $90.3 million in Q3 which represents 26% annual growth. On the Weapons side we continue to execute in domestic weapons penetrating deeper into agencies who are upgrading at a healthy pace. International Weapons was also pretty exciting as we drove a lot of growth there.

In Software and Sensors, we continued to add users to the Axon network and to ship hardware to new customers. That's what drove the 63% revenue growth for that segment in the quarter. Within Software and Sensors Axon Service grew 88% and hardware grew 42% as we shipped nearly 37,000 cameras in Q3.

This quarter's record camera unit volume was driven by continued strength in the domestic market, shipments to international customers and contractual upgrades on customers who have hit the 2-and-a-half-year mark in their five-year contracts. The third quarter also included $2 million in catch-up service revenue previously held pending fulfillment of contractual terms or milestones.

The 12% year-over-year increase in weapon segment revenue to $59.4 million was driven primarily by an increase in both international revenue and domestic revenue.

International revenue growth was driven by strong X2 smart weapon sales in the UK and some large orders outside our Tier 1 markets. For the first time this quarter we offer our Taser 60 payment plan in the UK. This helped drive our total Weapons orders on our payment plan to 43%. Total international revenues in the second quarter increased $5.7 million or 51% from the prior year to $17.1 million. The growth was driven primarily by an increase in weapons and cartridge revenue and a more than doubling of Software and Sensors service revenue.

In the UK this quarter we received continued benefit from the approval of sales of the weapon in the UK in the 2017 first quarter. Annual recurring revenue which captures the growth of our subscription-based business at the end of the third quarter was $63.7 million, doubling our Q3 2016 number and representing 16% or $9 million growth sequentially as we've converted approximately 17,000 domestic booked seats to paid seats.

Gross margins in the second quarter were 55.1% on a consolidated basis. Weapon segment gross margin was 67.6% and was unfavorably impacted by a greater mix of X2 weapons and the pricing impact of bundling with initial Axon Fleet customers. In the Software and Sensors segment we were impacted by several items leading to a 31.1% gross margin in the quarter, which is down 2.7% in the second quarter. Software and Sensors hardware margin was lower due to three items.

First, we were impacted by our early Fleet deals, some of which were booked more than a year ago where we offered both aggressive leader pricing and concessions on accessories such as the routers needed for data flows. Our recently signed Fleet deals do not have the same level of discounting and in fact, we now charge $99 a month for our Fleet unlimited package plus the cost of upfront hardware. Axon Fleet bookings are accelerating even at our full pricing, which is highly disruptive in the industry.

Second, we did not receive the full benefit we expected from standardizing the terms and conditions across our contracts, which would have allowed us to recognize all of the revenue allocated for the upfront camera at the time of shipment. We expect to see some uplift in margins in Q4 if we are able to ship on a larger percentage of contracts with the standardized language. As a reminder, this contract change is expected to partially accelerate the hardware gross margin improvement we expected in Q1 2018 under the new 606 accounting guidelines.

Lastly, we were unfavorably impacted by the pricing on certain large international beachhead accounts at levels that we do not expect in 2018. Software and Sensors service gross margin was 64% and was unfavorably impacted by $1.4 million of costs related to the previously disclosed migration from Amazon Web services to Microsoft Azure's governing cloud. As a reminder, this is the largest cloud data migration in history.

We completed the first phase of the migration in October and are on track to be entirely on Azure by the end of Q4. However, we still expect up to $1 million of cost related to the migration in the fourth quarter. Additionally, cost of services includes $520,000 of amortization related to the Misfit acquisition which was previously recorded in research and development expense but will now be classified as cost of goods sold as it is revenue-producing.

Total operating expense in the quarter was $50.6 million. Selling, general and administered expenses were $36.4 million, up from $31.8 million in the prior quarter. In the quarter we had about $1.5 million of professional fees and contractor expenses related to material weakness remediation in international tax restructuring, which we decided to prioritize in this quarter. After our last earnings call when we forecast Q2 as a low point in margins, we had to make the call to bring in outside help relative to three subsequent events.

We weren't satisfied with the pace at which we were remediating our material weaknesses, getting ready for the new ASC 606 accounting guidelines or addressing lingering issues in our back-office support capabilities. These are independent issues with different yet critical deadlines that are important to hit. We were making progress against these goals, but I felt it best to bring in outside consultants to help us ensure that we put these issues behind us definitively.

We could have solved for these items with internal resources, but it wouldn't have happened at the pace we needed it to. We are very excited about 2018 and made the call to deal with these items now so we can exit the year with a strong foundation on which we can execute with confidence and continue our great momentum. Overall, we have been working to bring our finance organization to world-class levels by bringing in new leadership and thought partners in key areas. This includes our new VP of Accounting, Jim Zito, critical hires and other important financial roles and a team at Ernst & Young led by Todd Stein that I previously worked with. A key focus of this team going forward will be to improve our expense and operating rigor to steadily drive up profitability.

Additionally, flowing through SG&A we had a sequential $1.4 million increase in expenses from increased commissions and selling expenses, both tied to revenue that beat our internal forecast. Research and development expenses were $14.2 million in Q3, up from $13 million in Q2. The increase was driven by a $2.4 million increase in headcount-related spend as we accelerated our investment in new lines of business including Fleet and RMS. The increase in headcount was partially offset by lower professional and consulting spend and the shift of Misfit amortization expense to cost of goods sold.

Below the operating line, other income of $1.4 million consisted of $1.1 million of gain related to foreign currency transaction adjustment and interest income, which includes interest on the TASER 60 program where GAAP rules require that we allocate a small portion of customer payments on the TASER 60 to interest income as we are essentially financing the hardware for our customers. We are executing on our inventory management plan. Total inventory in the quarter decreased by $8.1 million to $52.7 million putting us on track to meet or exceed our target of $50 million by year-end.

Turning to our outlook for the rest of the year as you have in our shareholder letter in front of you, we now expect full your revenue growth to exceed 25%, which surpasses our original guidance of 15% to 20% growth in 2017. We expect modest sequential gross margin improvement and a sequential increase in operating expenses of 5% to 8% in Q4.

We are actively working to adjust the trajectory of our operating expense growth rate to drive leverage as Rick stated at the beginning of this call. We look forward to providing an overview of our long term vision at our Investor and Analyst Day next week in New York. And with that we can now move to the question and answer portion of the call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Mark Strouse of JP Morgan. Your line is open.

Mark Wesley Strouse - *JP Morgan Chase & Co, Research Division - Alternative Energy and Applied and Emerging Technologies Analyst*

Hi, guys. Thanks for taking our questions. So, I just want to clarify something if I could. The one-time items that weighed down on gross margin this quarter it sounds like there is still some impact in 4Q but by the time we get to 1Q of 2018 it will be a much cleaner margin number. Is that accurate?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

Yes, that's exactly right. We have as we mentioned the data migration we had some of the leader pricing on the international beachhead accounts and we're expecting by Q1 that's going to be behind us.

Mark Wesley Strouse - *JP Morgan Chase & Co, Research Division - Alternative Energy and Applied and Emerging Technologies Analyst*

Okay, okay. And then so you mentioned transitioning into profitability phase here now for the market. In 2018 you're going to have a pretty easy year-over-year comp for operating margin. So I guess can you just kind of and maybe I'm stealing your thunder from next week but is there any more specific target you can give for operating margins next year?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

So that is absolutely something that we're going to discuss next week. I can tell you that as Rick mentioned, we are making this shift to profitability and we are going to be also as Rick mentioned, incentivizing our executive team and frankly all of our employees to be driving towards profitability.

Mark Wesley Strouse - *JP Morgan Chase & Co, Research Division - Alternative Energy and Applied and Emerging Technologies Analyst*

Got it. And if I can just sneak in one more if I can. Rick, just your high-level thoughts coming out of IACP on the competitive landscape, people getting more aggressive, any competitors exiting? And then your latest thoughts on where you see Axon's market share in the domestic body cam space? Thanks.

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

Yes, I mean we're feeling really good about it coming out of the show. We're continuing to see lots of win backs. We're having discussions with some significant customers that had gone on different platforms and are really struggling and hearing really positive things from the people that are on our platform.

I was particularly delighted at the feedback on Axon Fleet. That product took us a little longer to get to market than we initially expected as I think we talked about on previous calls the complexity of integrating into wireless networks and all of the hardware in the patrol cars turned out to be a bigger little lift than we thought when we first launched that product. But I was just delighted at the positive feedback. Every chief I talked to who had Axon Fleet was telling me that they were just sort of blown away by the experience, how the sort of connected nature of the cloud in their car was really compelling. The lightweight hardware approach that we've taken that makes it easy to maintain, as well as giving really great feedback on the overall experience with our customer service staff.

We've had to build a sort of new function of people to be handling the customer installs and professional services related to that. So that I think felt really good. We feel well positioned in the in-car space. I had a great meeting with a lot of state police colonels that are very interested in that product and then I think we're continuing to see a lot of customer excitement around our AI strategy.

You know, a year ago we sort of announced going into records management with the idea that really video records and text records should end up in one system and ultimately the text records should be meta-data that's extracted from the video records and, so we made a lot of progress towards that with the buildout of our AI capabilities in our team.

So, I think that was really resonating. I had a number of customers coming back and frankly telling us that they selected us for their body camera vendor because they believe that that vision is the right one, that it's much bigger than cameras. This is about a whole new way to collect and analyze information. So I think it was a really solid show for us and we're feeling I think better than ever about the overall competitive positioning.

Mark Wesley Strouse - *JP Morgan Chase & Co, Research Division - Alternative Energy and Applied and Emerging Technologies Analyst*

Okay, that's helpful. Thank you.

Operator

Our next question comes from Steve Dyer of Craig Hallam Capital. Your line is open.

Steven Lee Dyer - *Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst*

Thanks for taking my question. On the software and services side even if I exclude the one-time hits in the quarter for service revenue gross margin was still down year-over-year which sort of seems counterintuitive given the bigger installed base now. Any other color you can add as to why that would be?

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

Yes, I think there's two items in there. One, we had a big shipment on one of these older contracts from last year internationally that had just really not high margins, particularly the way the contingent hardware is handled. So those were at a significant negative margin actually the way they were accounted for. And then there was Fleet.

The fleet hardware was swallowed up some of our initial pricing which was more aggressive and then as Jawad pointed out, earlier on there was some confusion with some of our customers about supporting hardware that they might need such as in-car routers, etc. and we made the call that in some cases we provided at our cost, some accommodations to those customers and we think that's the right thing.

The most important thing when we're entering a new market space is to make sure your first customers have a great experience and so in that case we determined the right thing to do was to eat the extra cost and get off on a great launch. I think that was the right call, but it did impact the quarter adversely. We think we've got a pretty good handle on that and we should see continued improvement in Fleet although Fleet relative to body cameras is going to ' we're still in sort of the market interruption phase there so the margins in Fleet will be less favorable than they are in body cameras.

I think especially starting in Q1 we expect to see overall net improvements that are significant particularly in the body camera segment. And then Fleet will improve relative to its performance last quarter, but we'll provide more detail on that in the future.

Steven Lee Dyer - *Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst*

Great and that sort of dovetails into my next question. Just you talked about 2018 being a transition year more focused on profitability in the body camera market. Should I take that to mean the same thing as software and services or is that sort of a deliberate distinction where there might not be as much profitability in that overall segment of the business?

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

You're good. Yes, we are being very specific that body cameras are entering the profitability phase. We do see that the overall Software and Sensors segment at least what we have traditionally had Software segment will be improving, not only due to margin on hardware but also, we will be launching some premium software services that are only possible now that we've built the network, that are going to help raise ARPU and those should be high-margin services.

The effect of Fleet because that is a newer product with lower gross margins, will sort of counteract that a bit. The question comes out as to how successful Fleet is relative to body cameras and that remains to be seen. Ultimately, we run the long term models on Fleet, it is going to be a very profitable segment for us, but we did want to call it out that specifically. You know as we think about these different segments each of them are going through sort of their own S curves and their own lifecycles and we're just calling it out now that very deliberately we think we've hit a point now where body cameras it's time for that shift toward profitability.

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

And Steve, I want to clarify that this is also we're talking about profitability in the body camera segment and we're going to be making investments in other areas but at enterprise-level we are absolutely looking to drive leverage.

Steven Lee Dyer - *Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst*

Right, I guess maybe relative to Mark's earlier question, I mean is it fair to expect improved operating margins next year at least directionally' directionally?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

Yes.

Steven Lee Dyer - *Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst*

kay. A quick housekeeping one, Jawad, and then I'll jump back in queue. The new effective tax rate is obviously a plus, when is that effective and I don't even know what that will be, your tax rate has jumped around so much. I mean how are you thinking about that in terms of modeling?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

Yes, so it has jumped around a bit and we've had a little bit of noise with that accounting change relative to equity this year but the headlining point for us was that we have simplified our tax structure. That took effect in October and, so we would expect that in Q4 you should start to see it come down.

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

So it's hard to estimate what the impact is going to be from any of the new equity tax changes, but we are anticipating it will be south of 40%.

Steven Lee Dyer - *Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst*

Okay, got it. I will hop back in queue. Thank you.

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

One thing I'd like to jump in and add is Jawad has only been here for a few months and the impact on the organization has been pretty significant. Right out of the gate he identified our international tax strategy was not optimal and moved aggressively to rectify it and to have that completed a few months into the job I think was a pretty big accomplishment. I mean that took a lot of work with both accounting and legal to both figure the strategy, implement and execute.

And then frankly bringing Jim Zito in over at accounting, Jawad moved aggressively there as well, said look we know we have not been great at forecasting our expenses and we really need more rigor in our financial systems. Material weaknesses are not something that are acceptable going forward and I was very pleased to see Jawad brought in known people he's worked with and the team at E&Y has been pretty awesome as well to make sure that we move aggressively to get all of these things dialed in, so they are behind us as we move into 2018.

Operator

Our next question comes from Jeremy Hamblin of Dougherty and Company. Your line is open.

Jeremy Scott Hamblin - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Consumer & Retail*

Hi, guys. I want to come back to the hardware margins and think about -- you mentioned that Fleet was about 10% of bookings in this quarter and I am guessing that it's probably going to be an even larger portion moving forward. But you note that you expect hardware margins to return to the 25% level as we enter 2018 but you also note that's excluding Fleet.

So from the perspective of given the difficulties that you've had with gross margins this year and the underperformance on that, what type of level should we be assuming that the Axon Fleet gross margins are going to look like? Is this going to be selling at kind of a -5%, -10% gross margin or how much of an impact could that have on next year's gross margins overall?

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

I think the idea question would probably be better answered at our Investor Day where we go through in a little more detail both the 2018 and the long term. Also I wanted to clarify, Jeremy, that we said excluding Fleet, pass-through hardware, not excluding Fleet in its entirety. So there are components of the deal which are third-party pass-through and that's what we were excluding.

Jeremy Scott Hamblin - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Consumer & Retail*

Okay.

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

Just to put a little more color there we've had discussions, there is elements like routers and servers that are frankly sort of commodity items where we've gone through the debate, do we have our customers go by those independently rather than having a significant portion that we're passing through at very large margins and ultimately, we've made the decision that we need to make it easy for our customers. That's more important than trying to optimize the margins and how they look on our income statement.

So, we think that's the right call. We also I think understand it better, a lot of the deals that flew through this quarter were early deals where we didn't have a great handle on that and so there were a lot more accommodations than we expect to make in the future.

Jeremy Scott Hamblin - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Consumer & Retail*

Yes. No, that's helpful. I think the heart of my question is they've had really, really difficult time forecasting gross margins this year including in this last quarter where you expected them to sequentially be up from Q2 and, yet they were down significantly from Q2.

So what I'm really trying to get at is thinking ahead to next year and forecasting next year it sounds like there will be some improvement but maybe not that much of an improvement.

Luke S. Larson - *Axon Enterprise, Inc. - President*

This is Luke here. I mean, with these new products it's difficult to know exactly what the forecast is going to be. We own that. We are trying to communicate that in such a way where we get more confidence in the products that have more maturity.

With Fleet we're very confident in the long term. With the storage, we just had the largest data migration in history and it was hard for all of the parties involved to understand what all of the components of that transfer would be, and we did not have accurate visibility on that and therefore we couldn't forecast it. That's something that's now behind us.

At the Investor Day we're going to sign up for bottom-line growth over the next three years and we feel really confident about it. We're putting both annual as well as long term performance packages in place for key leaders to hit those targets.

Jeremy Scott Hamblin - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Consumer & Retail*

No, I understand that, Luke, and just to be fair even if I add back the three items that were called out in your summary release, you'd still have gross margins that would have been just under 60%.

So, I'm just trying to wrap my head around thinking is maybe kind of low 60s a better baseline to be thinking about rather than historically the company has been in a 63%, 64%, 65% range and I just want expectations to be set appropriately.

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

So with something like Fleet as we talked about it's tough to know what that pricing is going to do in the early stages and as we ship that hardware there's going to be, given the accounting rules, there's going to be some compression in the upfront margins but we're confident that over time these deals are going to be accretive to our margins and you may not see that effect immediately but again over time we're confident that's going to be accretive.

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

I guess the silver lining on this is Fleet will be largely incremental to the existing business, so it will be adding gross margin dollars even if the percentage rate may not be as high as in the other segments. So the more Fleet we're adding, the more gross margin dollars we'll have been in the business. They just may not be at the same margin percentage.

Jeremy Scott Hamblin - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Consumer & Retail*

Let me move on to operating expenses, which also came in higher than forecast. In terms of -- I just want to clarify, the guidance for the fourth quarter is $53 million to $54.5 million, is that or do we need to back out the recurring amortization expense for the Australian distributor? I mean, since it's recurring I'm assuming that's inclusive of your guidance, but I want to just pin down the range, $53 million to $54.5 million?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

That's correct. It includes --.

Jeremy Scott Hamblin - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Consumer & Retail*

Any cost related to the free camera trial?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

Yes.

Jeremy Scott Hamblin - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Consumer & Retail*

It does' Okay. Okay, great. Let me transition to something that was a very strong positive. On your EVIDENCE.com revenues it looked like they were up about $3.5 million sequentially to about $16 million. In terms of what drove that growth, how much did your active paying licenses increase in Q3?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

I'm not sure I understand the question.

Jeremy Scott Hamblin - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Consumer & Retail*

Your EVIDENCE.com service revenues right, that grew to roughly $16 million in the quarter. My question is how many active paying licenses, what was the increase in active paying licenses in the order, paying license, not the bookings?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

17,000 domestic.

Jeremy Scott Hamblin - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Consumer & Retail*

Okay, great. And then thinking into Q4, is there going to be a similar type of growth in terms of the number of licenses turned on or how should we be thinking about that?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

Yes, we would expect it to be roughly in line with that same growth rate.

Jeremy Scott Hamblin - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Consumer & Retail*

Okay, great. Thanks for taking -- what's that?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

The one thing I want to add there is you know, just to punctuate this, 2018 I think will be the first year that you start to see us adding additional upsell services that would essentially go back and be uplifting to some of those existing seats or some of the additional services we're launching. So historically our primary focus has been on growing the size of the network. We're certainly going to be continuing to do that but some of the things we're doing with AI, etc. give us an opportunity to go back and increase revenue per existing customer.

Jeremy Scott Hamblin - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Consumer & Retail*

Well, you're already growing it pretty nicely on the service revenue side. So we look forward to continued growth and thanks for taking the questions.

Operator

Our next question comes from George Godfrey of CL King. Your line is open.

George James Godfrey - *CL King & Associates, Inc., Research Division - Senior VP & Senior Research Analyst*

Thank you. Thank you for taking my question. Just to be clear on the Q4 so given the revenue growth for the full year of 25% in the OpEx so operating income should be a loss of about $2.5 million is what I'm getting. Maybe a little bit more?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

So I think we're not going to give specific guidance on operating margins for next quarter. What I can tell you is that first of all, we acknowledge that we've got an opportunity to do better at our forecasting and so and I own that. That's part of what we're doing with building out the team and ensuring up our capabilities.

So we wanted to give guidance that we felt we could hit for Q4 as far as operating expenses. The other thing which shouldn't be lost in the comments we've given you is that we are bringing additional expense rigor and it is absolutely our intention to clawback as much of the increase as we can and we're not going to give any specific guidance relative to that, but it is our intention to get Q4 as close to Q3 as we can.

Luke S. Larson - *Axon Enterprise, Inc. - President*

And I would just highlight I think Jawad has shown a lot of leadership here. This is a tough call for a new CFO to come in and say I want to add expense structure to get ready for the 606 change as well as remediate the material weakness. And we could choose not to make those investments, but we feel strongly it's important that we enter into 2018 prepared for 606 as well as have this restructuring with our international entities, in addition to really having a handle on these material weaknesses. So Jawad has made a strong push to come in and say let's bring in the right consultants E&Y to get this done and there is a cost to that and so I'm supportive of that and I think we really believe this is the right investment for the company.

George James Godfrey - *CL King & Associates, Inc., Research Division - Senior VP & Senior Research Analyst*

I appreciate all of that and I'm just trying to understand what the impact of these financial implications are in Q4 and where they're going to go over the next three years. What I was getting at is if we started a margin of -3 and we'll go back to the Investor Day with a target margin of 30% and we take a three-year timeframe and I realize it probably won't work on a linear basis but that's 12 quarters of adding 300 basis points of operating margin per quarter. So my question is are we resetting base expectations relative to where we were a year and a half ago or does the 350,000 seats we're looking at just Axon that space a 20% margin or are those figures a number that we talked about a year ago, do they need to be reset?

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

So we are obviously going to be resetting the forward-looking models in just a few days here so rather than getting into some of the details here. I will tell you just in general we are not optimizing for EPS in the fourth quarter. We're optimizing at a very solid 2018 and a predictable trajectory towards a highly profitable business over the next three years.

And we know that it's not surprising, it won't shock anybody on the call our ability to accurately forecast expenses to the Street has not been a bright spot for us and Jawad has committed that those days will be behind us as we roll into next year. So he's got a team that's really focused on it and we are going to improve our performance there.

George James Godfrey - *CL King & Associates, Inc., Research Division - Senior VP & Senior Research Analyst*

Okay, thank you for taking my question.

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

Thank you.

Operator

Glenn Mattson, Ladenburg Thalmann. Your line is open.

Glenn George Mattson - *Ladenburg Thalmann & Co. Inc., Research Division - VP of Equity Research*

Yes, thanks for taking the question. Just on the Weapons, a little better than I expected. Can you talk about what drove that? Was there one large deal that you called out? I might have missed that. And I'm just looking at the units. Doesn't look like there was any unit growth between the X26 and the X2. They decline in one offset the gain in the other so what drove the year-over-year revenue growth and may be a lot of it is due to the cartridges. If there's no growth in weapons can you give us an idea why cartridges is growing so fast?

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

Yes, so a couple of things. There was some big federal orders. The approval of tasers in the UK. In the United Kingdom ' we've got Josh in the room. Josh, how many cartridges do they typically use in training per Taser' It's significantly higher than the US.

Josh Isner

15 to 20 per officer per year.

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

So right there the expansion of tasers in the UK. That's significantly more cartridges they consume in training than our typical US customer. TASER 60 in the UK has also been helpful in helping them to sort of drive growth and bundle cartridges into service plans.

Glenn George Mattson - *Ladenburg Thalmann & Co. Inc., Research Division - VP of Equity Research*

Sorry, Rick, what was that number on the cartridge usage?

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

Josh?

Josh Isner

15 to 20 cartridges per officer per year between training and real duty.

Glenn George Mattson - *Ladenburg Thalmann & Co. Inc., Research Division - VP of Equity Research*

Versus from what I remember in the US it was like three to five or something wasn't it?

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

Yes, that's accurate, yes.

Glenn George Mattson - *Ladenburg Thalmann & Co. Inc., Research Division - VP of Equity Research*

Okay. And that's sustainable' I mean if they train everyone after a while do they stop using them at that rate or I mean that sounds like --?

Josh Isner

It is completely sustainable so much so that most of our UK customers are committing to TASER 60 premium which builds in that number of cartridges every year and so it's going to trend that way in the UK specifically.

Glenn George Mattson - *Ladenburg Thalmann & Co. Inc., Research Division - VP of Equity Research*

Okay.

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

It's something they're particularly proud of, I'll tell you in the UK. If you talk to UK policing they believe that they are making the proper investment in weapon handling and weapons training and we don't see that going away. They look at other countries that may have had more misuse issues and they believe part of the reason they've had less of that in the UK is the extensive training they do.

Glenn George Mattson - *Ladenburg Thalmann & Co. Inc., Research Division - VP of Equity Research*

Next question on '- you said international large beachhead accounts hurt margins also. Was that in video and can you give us more color on what you're talking about' Are they new countries that we haven't heard about before or just a little color there, Rick?

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

Again we don't like to give too much specific details, but this is one very large customer that we signed last year who's an important flagship customer that opened international market for us and we shipped a lot of cameras on that order.

Glenn George Mattson - *Ladenburg Thalmann & Co. Inc., Research Division - VP of Equity Research*

Okay, great. And then one last point I just want to ask a couple of questions go about the video service sales growing sequentially but there was a one-time catch up in that, right? There's a $2.5 million catch up or something' $2 million-dollar catch up?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

That's right. $2 million catch up.

Glenn George Mattson - *Ladenburg Thalmann & Co. Inc., Research Division - VP of Equity Research*

Okay, all right. Great, that's it for me. Thanks.

Operator

Our next question comes from Allen Klee of Sidoti. Your line is open.

Allen R Klee - *Sidoti & Company, LLC - Senior Equity Research Analyst*

Yes, hi. Two questions just clarifying some stuff you mentioned. For going forward for Fleet gross margins for new sales, can you give us a sense of what type of range that gross margin would be? And then well, I'll just start with that.

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

Yes, I don't think we're prepared to release that number here today.

Allen R Klee - *Sidoti & Company, LLC - Senior Equity Research Analyst*

Okay. And then you said that you're going to add a profitability metric to management compensation. Can you tell us what profitability metric that would be?

Luke S. Larson - *Axon Enterprise, Inc. - President*

Yes, so the way that we calculate our bonus plan is we have an annual set of metrics that the entire company is paid out on and we're going to have one of the key metrics be tied to EBITDA, and then for key executives we do long term three-year performance RSUs that will also be tied to EBITDA. And at the Analyst Day investor conference we're going to lay out a plan for three-year growth on the top line and the bottom line and we'll kind of be showing some targets that we're aiming at that we believe this incentive plan will align.

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

I actually just want to highlight something here. So what you can take away from this is that we don't have any of those profitability metrics in our compensation today. They have all been historically focused on topline growth and that's exactly what the organization has delivered. The system is working really well to do what it was designed to do and now with this shift, this pivot toward profitability we're fully expecting that we're going to execute on exactly the same thing and gain profitability.

So I point to our execution on our topline growth over the past few years as a proof point and more near-term there were some concerns recently about inventory, but we've executed on that and we're very much trending toward the guidance that we gave that year end. We've also held the line on cash flow, so I think the team's got a track record of executing and when we introduce profitability into our compensation metrics I'm fully expecting that you're going to start to see that manifest itself in the P&L.

Allen R Klee - *Sidoti & Company, LLC - Senior Equity Research Analyst*

Thank you.

Operator

Our next question is a follow-up from Steve Dyer of Craig Hallum Capital. Your line is open.

Steven Lee Dyer - *Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst*

Just a couple of follow-ups. I guess directionally, Jawad, the puts and takes of 606 in your business, I mean are there any obvious swings that we should be thinking about? I mean I have some familiarity with it but as you look at what's gotten to be a fairly complex P&L what jumps out at you as puts and takes and opportunities here?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

Yes, good question. So on an overall level we're not expecting 606 to have a huge impact on the business but there is a lot of complexity in our revenue recognition and what we talked about as far as modifying or standardizing our contract language would in effect mimic the effect of 606, which would allow us to accelerate the revenue on hardware components that are delivered up front. And there's really no other meaningful impact other than that, that we're expecting.

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

So just to be really clear, we expect to see hardware margins improve significantly based on 606 although there's going to be some other pressure in the other direction from Fleet at lower margin hardware product initially?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

That's exactly right.

Steven Lee Dyer - *Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst*

Okay, got it. And then I guess just bigger picture as it relates to operating expenses I think one of the hard things about kind of giving operating leverage is there's always something new, a really interesting new opportunity to invest in, which sort of keeps you guys from really optimizing the model. I think it sounds like you'll lay out some bogeys next week.

But just in terms of the OpEx spend, etc., is there any way that you would think about or be willing to sort of take a stab at what you guys are spending on a quarterly or annual basis on nonrevenue producing products or services? Because I mean, the growth has been great and it's obviously important to see that pipeline, but I think it would help investors a lot to know sort of what's going into managing the business and what's going into three years from now as revenue.

Luke S. Larson - *Axon Enterprise, Inc. - President*

Yes, that's a great question, Steve. Currently we think about our business in four key value streams TASER, our digital evidence management and body-worn camera business that includes ancillary products like Axon Signal. We've got Axon Fleet and then we have RMS.

We will at our Investor Day talk about how we're thinking about signaling, how we're having dems in the body camera business contribute to the bottom line. One metric that we're discussing is showing percentage of R&D invested on net new products. So great question. We'll have more to talk about at the Investor Day on our thinking about that.

Steven Lee Dyer - *Craig-Hallum Capital Group LLC, Research Division - Partner & Senior Research Analyst*

All right. Great. Thank you.

Operator

Our next question is a follow-up from George Godfrey of CL King. Your line is open.

George James Godfrey - *CL King & Associates, Inc., Research Division - Senior VP & Senior Research Analyst*

Just two quick ones I hope. Headcount at the end of the quarter?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

We'll get that.

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

Yes, I don't have it at hand.

George James Godfrey - *CL King & Associates, Inc., Research Division - Senior VP & Senior Research Analyst*

Okay. And then just directionally now that you'll be lapping the TASER 60 program is working capital likely to be a drain or a generator of cash in '18?

Jawad A. Ahsan - *Axon Enterprise, Inc. - CFO*

I would say that so we're in this transition right now to a subscription model whereas historically we've been initially selling more book and ship and so you're going to see an impact on working capital. But as our topline continues to grow I would expect that to normalize.

George James Godfrey - *CL King & Associates, Inc., Research Division - Senior VP & Senior Research Analyst*

Got it. Thank you very much.

Operator

There are no further questions. I'd like to turn the call back over to Mr. Smith for any closing remarks.

Patrick W. Smith - *Axon Enterprise, Inc. - Co-Founder, CEO and Director*

Great. So thanks everybody for joining us today. Obviously, we're delighted with the top line growth that we experienced in the quarter and we know we've got some wood to chop on expense issues. We've got some short-term expenditures that we're making to really shore up our finance function. We're confident that's putting the right rigor in place so that we can improve more dramatically on both the top and bottom line as we roll out into 2018 and beyond.

We look forward to giving you guys some more details on that plan. Hope to see you all in New York. Thanks. Have a great day.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone, have a great day.
