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Axon Enterprise, Inc. (AAXN)

Q2 2019 Earnings Call

CORPORATE PARTICIPANTS

Andrea James

Vice President-Investor Relations, Axon Enterprise, Inc.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

Luke Larson

President, Axon Enterprise, Inc.

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

OTHER PARTICIPANTS

Joshua Reilly

Analyst, Needham & Co. LLC

Mark Strouse

Analyst, JPMorgan Securities LLC

Eric Chao

Analyst, Morgan Stanley Taiwan Ltd.

Keith Housum

Analyst, Northcoast Research Partners LLC

John Weidemoyer

Analyst, William Blair & Co. LLC

Julianna DeSimone

Analyst, Imperial Capital, LLC

Ryan Sigdahl

Analyst, Craig-Hallum Capital Group LLC

George J. Godfrey

Analyst, C.L. King & Associates, Inc.

Charles Erlikh

Analyst, Robert W. Baird & Co., Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Robert, and I will be your conference operator today. At this time, I'd like to welcome everyone to the Axon Q2 2019 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session at which time instructions will follow.

I will now turn the call over to Andrea James, VP of Investor Relations and Corporate Strategy. You may begin your conference.

Andrea James

Vice President-Investor Relations, Axon Enterprise, Inc.

Thank you, Robert. Hello everyone. I'm Andrea James. Welcome to Axon's second quarter 2019 earnings conference call. Here in the room in our Seattle R&D office we have Axon's CEO, Rick Smith; President, Luke Larson; and CFO Jawad Ahsan. Our Chief Revenue Officer, Josh Isner is also joining us remotely. This call is being broadcast online and is available on the Investor Relations section of the Axon Enterprise website. You can find our reported results in our quarterly shareholder letter which we have posted to investor.axon.com and we have also filed with the SEC. Today's call will include forward-looking statements including statements regarding our future expectation, beliefs, intentions or strategies including projections regarding revenue growth profitability and product development. We intend that all forward-looking statements be subject to the safe harbor provided by the Private Securities Litigation Reform Act of 1995.

Axon's forward-looking information is based on current information and expectations. Our estimates and statements speak only as of the date on which 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 Forms 10-K and 10-Q under the caption Risk Factors. You may find these filings as well as our other SEC filings at investor.axon.com or at sec.gov by searching under the AAXN ticker. I hope you all had a chance to read our Shareholder Letter which you can find at investor.axon.com and management's remarks today are meant to build upon the information in that letter.

Please go ahead, Rick.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

Thanks, Andrea. And thank you everybody for joining us today. We're proud of the progress we're making in driving strength in our software business, and we had a strong bookings quarter as our sales team really went out and sold the Officer Safety Plan 7+ this quarter. There's a lot of positive momentum and underlying strength in the business. That said, the quarter did not meet our expectations. So I want to ensure everyone understands the puts and takes that affected our results. As you all know, we've been working hard on ramping TASER 7 and all of the subassemblies associated with the program. We experienced a disruption in our supply chain when our battery component supplier on the TASER 7 was unable to meet our stringent quality standards as its scale. We since worked closely with the supplier to help them scale and it is now producing at production volumes. Unfortunately, as a result, about \$3 million worth of forecasted TASER 7 sales shifted from Q2 into Q3 2019.

From a TASER gross margin standpoint, we also saw some pressure related to a write-off of some obsolete inventory that we were not able to utilize due to design change. While the short-term pain of this write-off was disappointing, we estimate the results with the associated design refinements will reduce our cost of goods for the TASER 7 cartridges by around 33% around the end of this year. Given that cartridges can represent more than 65% of the hardware costs in some TASER 7 programs, these cost savings will have a material impact in improving margins in the TASER segment. Taking a step back on product launches, one of the reasons we brought in Hans Moritz who comes from Intel to lead Hardware Engineering, was I saw opportunities to improve our new product introduction processes. Hans has brought in several senior members on his team and I'm excited by the energy and rigor that they are bringing to our new product introduction process. Of course, that team has been here just a few months. But I've been working with them very closely, and can say I have a high degree of confidence in the improvements that they are implementing.

For example, we now have teams that are spending more time at suppliers earlier in the process. And the overall level of [indiscernible] (00:04:42) between engineering and our suppliers and our in-house manufacturing teams is evolving to a whole new level. Looking to the future, I feel great about our ability to reaccelerate our sustaining growth. OSP 7+ is generating a lot of interest and it's exceeding our expectations. As we mentioned in our shareholder letter, major agency adoption of the OSP 7+ plan already includes Atlanta, Baltimore and Minneapolis. Major agency customer reception to the TASER 7 has been strong, and we expect that revenue will continue to build. You don't see it right now in the P&L because of the low upfront hardware ASP due to bundling, but all the amortized revenue on the TASER 7 program will add up on cartridges, software, and warranty.

Turning to Axon Body 3, we went to a healthy level of detail in our shareholder letter about some of the achievements we've solved in bringing that product to market and what remains, namely completion of the carrier certification. Pretty much every customer I've spoken to this year seems energized about Axon Body 3. We've done demos and tests with some of the largest police departments in the world, and it's clearly a game-changer. This is a really powerful camera and most customers will receive it automatically as an upgrade. Then we can enable a whole new host of services once the hardware supports real-time connectivity. We're going from a body camera that gives you a historical look at what happened to a real-time connected device, and that has the potential to become an assistant on your chest. We're looking forward to putting Axon Body 3 into the hands of customers this quarter, and we're planning for meaningful shipments in Q4.

With that, I'll turn the call over to Luke Larson.

Luke Larson

President, Axon Enterprise, Inc.

Thanks, Rick. For everyone listening today, I just want you to know we take the earnings mix very seriously. I personally take responsibility for it, and I'm very confident in the plans to put in place to correct this. We're laser-focused on improving both margins and the scale of the TASER 7 program. I'd now like to talk about the Software & Sensors segment which was a real bright spot in the quarter and it should continue to be. Not only did we see record bookings but we're driving profitability in that segment as well. I want to highlight that the underlying software and storage revenue in that segment carried gross margins above 80%, and we continue to sign new users at a healthy rate.

In my time at Axon, we created this new category, the body-worn camera and software ecosystem to support it, and we have now proved out sustainability in it. And we don't feel good about that, we feel great about that. This is a great milestone and a great launch point for our next two software businesses. Given that Axon Records and dispatch in those categories, we're not inventing new software category, but intend to simply earn market share in already existing profitable markets. Our path to sustainability at healthy margins should be much faster.

Software segment bookings grew 60% over Q2 of last year and we were up 86% sequentially. To me, this is a testament to our strategy on both product development and also our pricing and sales. We look forward to bringing more and more major agencies on to OSP 7. What's really exciting is that the monthly ARPU for our OSP 7+ customers is around \$100, which is more than double our historic averages. As you know, creating value for our customers and driving ARPU are among our top strategic goals.

For Axon Records, we noted in our shareholder letters that our product has passed acceptance testing with two major cities. What's interesting to note about one of these cities is they aren't doing an entire rip and replace of their existing records system, they're at first deploying several critical modules with Axon solution, and over time they will migrate more and more of their RMF functionality onto the Axon platform. We believe this credibly demonstrates that we have multiple paths to growing our customer base with the software product that will add capability over time.

Now, I'll turn the call over to our CFO, Jawad.

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

Thanks, Luke. When I step back and look at the bigger picture outside of the TASER issue this quarter, there are a lot of positive indicators, from record bookings, to growing ARPUs, to successive OSP 7, to annual recurring revenue growth of 40%, to tight control and operating expenses. There's a lot to be excited about and I believe we have strong underlying fundamentals.

First, we're successfully moving the needle on selling high margin, long term recurring contracts. As Luke mentioned, the new OSP 7 deal that we signed in the quarter carry substantially higher software average revenue per unit than our current average. An important metric that we look at is how much of our revenue is tied to bundled recurring contracts. In 2016, it was 34%. In 2017 it was 46%. In 2018 it was 55%. And we're driving this number even higher in 2019 given that nearly all of our Software & Sensors contracts and half of our new TASER orders to the first two quarters of 2019 are tied to a subscription.

Second, it's important to us to demonstrate that we're building businesses that can stand on their own and fund R&D and new ventures. The core body camera and software business is now doing exactly that, not only self-supporting but allowing us to invest into the next generation of software products we're developing. We achieved this milestone ahead of plan. Third, our cash and short term investments balance grew over \$7 million sequentially despite an approximately \$8 million use of cash associated with our transition to subscription contracts. Finally, we continue to execute on strong cost controls, stripping up the impairment charge, operating expenses actually fell sequentially.

Turning to our outlook, we are reiterating our full-year guidance in providing commentary around our Q3 expectations in the shareholder letter. We recognize that this year is very back half weighted due to the timing of TASER 7 shipments and the launch of Axon Body 3. We have a lot to deliver on but we also have a lot to be excited about and our teams are [ph] head down and (00:10:59) executing.

And with that operator, let's go to questions.

QUESTION AND ANSWER SECTION

Operator: Certainly. [Operator Instructions] Your first question comes from the line of Scott Berg with Needham. Please go ahead. Your line is open.

Joshua Reilly

Analyst, Needham & Co. LLC

Q

Hey, guys this is Josh on for Scott. I was just wondering, can we get some more color, do you anticipate any delays with the AB3 in the certification process with carriers, or any production issues similar to what's happening with the TASER 7, or what gives you confidence that that product will launch on time?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Great question. So this is Rick. So we are performing and passing our internal tests which mimic the carrier certification test. So we believe the design is solid and it's in the process now. I was talking with our VP of Operations just earlier today, he is in Asia and was meeting with the CEO of our supplier. In this case, the AB3 is fundamentally being built by a contract supplier that does very large volumes of lots of cameras and similar electronic devices. So in terms of scale, I think AB3 is a little bit different, in that the TASER devices, those are a little bit more of a boutique where we are producing them in-house. There are no other products like them in the world. And with TASER 7, it was a new design and has become obvious now. We had some challenges in the quarter with that. I think with Axon Body 3, there's a fundamental difference and that this is a product category from a manufacturing perspective that is much less unique. And we're doing this with a manufacturing partner that operates at a much larger scale. And so as we get through the final design lock and certification, I think there's just inherently less risk in what we're building there and being able to scale it quickly.

Joshua Reilly

Analyst, Needham & Co. LLC

Q

Okay. And then I just had one follow-up question. You mentioned \$6 million in the quarter – or there's \$6 million in TASER 7 demand that couldn't be met, and \$3 million of that is going to be met in Q3. What happened to the other \$3 million?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

So we expect that to be filled in the back half of the year. That other \$3 million relates to the cartridges. And so the first \$3 million is pretty easy because we shipped it and that's now then recognized. The cartridges, we anticipate we may still have some backlog in Q3 as we roll into Q4. So there it wasn't as certain that that that backlog would be cleared in the third quarter, but we have higher confidence we'll be able to clear out by the end of the year.

Joshua Reilly

Analyst, Needham & Co. LLC

Q

Okay. Great. Thanks, guys.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Thank you.

Operator: Your next question comes from the line of Mark Strouse with JPMorgan. Please go ahead. Your line is open.

Mark Strouse

Analyst, JPMorgan Securities LLC

Q

Hey. Good afternoon. Thank you for the questions. So understandably, a lot of discussion about the – I'm sorry, can you hear me?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yes.

Luke Larson

President, Axon Enterprise, Inc.

A

Yes. Mark, we can hear you.

Mark Strouse

Analyst, JPMorgan Securities LLC

Q

[indiscernible] (00:14:45) I'm sorry. So the supply issues that [indiscernible] (00:14:50). Excluding the supply issues that you talked about, can you just kind of talk about the demand picture for TASER 7? Is that meeting your original expectations or has something changed there? And then kind of along similar lines, I mean, I understand that the Software & Sensors bookings is at an all-time high. Are you able to kind of say how much of that is tied to TASER 7 with its bundle? It might be hard to break out. But anything that can help investors kind of get a sense of what's included in weapons and what's more of your traditional Software & Sensors looking at like a year-over-year basis?

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah. Hey, Mark. Great one. We're going to have Josh, our head of sales answer that one.

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Hey, Mark. Thanks for the question. On TASER 7, we are definitely pleased with the early in high levels of adoption of the product. As we scale any product I think the availability of trials and evaluations out of the gate is always somewhat of a constraining factor, but we've seen the number of active trials in the fields going up every quarter, and the number of large deals at the top end of the market continue to be encouraging. So we feel really good about TASER 7 long term, especially given that many of our largest TASER 7 contracts are on the \$60 certification plan. So you might not see that early on with the average selling price. But as time goes on, the value of that plan will certainly become evident in the results. On the booking side, all of that is the same way we've always measured Software & Sensors booking. So there's no TASER component in that. It's solely body cams,

Axon Fleet, Evidence.com licenses and our software add-ons that go along with Evidence.com or features of Evidence.com.

Mark Strouse

Analyst, JPMorgan Securities LLC

Q

Okay. Great. That's it from me. Thank you.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Let me add a little bit more color to that. One thing, to me the strongest indicator in the quarter and really the first half of the year was the sales of the OSP 7+ plan. Luke and I stood on the stage and challenged the sales team at the beginning of the year that really this was a year where it's really important that we could prove that we could sell the high volume, high margin software products we've been investing in. And so seeing our biggest orders from our biggest customers coming in on the OSP 7+ plan, not the OSP 7, 7+, that incremental \$50 is all high value and high utility software. To me, that was an incredibly positive result. The other thing I think I would mention there, when we look at the TASER 7 margins, look, nobody is happy about the operational issues that we have to address margin, but that [indiscernible] (00:17:48) another factor with the margins being down, but because of the high percentage of agencies that are bundling OSP 7+ [indiscernible] (00:17:56) discounts across that bundle get applied to the TASER as well as the high – to all the software products. And so the OSP 7+ plan can basically lead to some perceived margin compression, but it's more than perceived, the accounting margin compression on TASER 7, because the whole bundle is applied to the TASER 7 upfront, and then you see more software come in over time. But that is a true first world problem to have that we're seeing so many of our customers buying TASER 7 as part of this larger bundle.

Luke Larson

President, Axon Enterprise, Inc.

A

The other thing that I'm personally excited about that is that all three of those were upgrades from existing body camera deals.

Mark Strouse

Analyst, JPMorgan Securities LLC

Q

Okay. Thank you very much.

Operator: [Operator Instructions]

Andrea James

Vice President-Investor Relations, Axon Enterprise, Inc.

A

I think we can make it two. Two questions is fine. Please go on.

Operator: Your next question comes from the line of James Faucette with Morgan Stanley. Please go ahead. Your line is open.

Eric Chao

Analyst, Morgan Stanley Taiwan Ltd.

Q

Hi team. This is Eric on for James. Thanks for taking our question. Congrats on the initial Records acceptance, that's pretty cool. Just wondering, as you've undergone that testing with your initial customers, have you learned

anything about how we should think about the timing to roll out moving forward, and maybe if the products at a point where it's completely scalable and can be turned on quickly or just how we should be thinking about that with future customers?

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah. So in the back half of this year, we're really focused on making sure that we get the product right with couple major agencies so that we can really scale the product going into 2020. And the way we're thinking about that is nailing the acceptance testing with a couple really agencies that are indicative of the larger market. And we're using the OSP 7+ deals to create a big pipeline so that we can scale rapidly moving into next year.

Eric Chao

Analyst, Morgan Stanley Taiwan Ltd.

Q

Got it.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

I would add to it, this is the first time we've been through the end user training and that's gone particularly well, with the officers really giving on this a lot of positive feedback. But I'd say, it's probably early for us to draw any new conclusions about the deployability outside of these early customers just given we're pretty early in the process.

Eric Chao

Analyst, Morgan Stanley Taiwan Ltd.

Q

That definitely makes sense. And then just thinking of the tie in there with OSP 7, is it being presented in a way where you're pushing for OSP 7 sales with the idea that those customers that sign up will eventually add in the Records functionality, is that kind of the way to be thinking about it?

Luke Larson

President, Axon Enterprise, Inc.

A

Absolutely. We look at this like we're building a long term pipeline of customers that can convert over to Axon Records. So certainly we believe our customers are having a very good experience with Evidence.com, and these OSP 7+ features I think continue to amplify that and we expect a lot of those customers to then as a result have a lot of faith in us to deliver revolutionary Records system.

Eric Chao

Analyst, Morgan Stanley Taiwan Ltd.

Q

Great. Thank you.

Operator: Your next question comes from the line of Keith Housum with Northcoast Research. Please go ahead. Your line is open.

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

Good evening. A question for you guys on the Axon Body 3. I understand that [indiscernible] (00:21:45) next now we'll hear is a certification from carriers, but our understanding especially with AT&T is there's been challenges

that they have, and they're getting the certification process done in a timely manner. What confidence do you guys have that these guys will be able to do it in a timely manner and have it done for you guys by the end of the quarter?

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah. We're confident in the certification process. Obviously, when you're working with a third party, we defer to them on the final say, but based on all the visibility that we have, that's one area where we have a high amount of confidence.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yeah. I would just add on, AT&T has spent in tens of billions of dollars on the [ph] first net (00:22:29) project, and we've heard from them pretty directly that ours is, if not the most critical, one of the most critical used cases of live streaming video. So I think we're getting just a tremendously positive amount of support from them. I think they see this as being a very strategic partnership.

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

Okay. Got you. And then on the [indiscernible] (00:22:52) side of the manufacturing process, it sounds like the supplier issue with the batteries is done. Outside of that issue, how is the scrap rate I guess after that now versus where it was at the end of the last two quarters? Are you guys getting to the double scrap rate that you guys now find acceptable?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

So we're continuing to make progress. I know scrap rates on handles have continued to improve pretty consistently. The issue with the cartridges, I've been personally deeply involved in that. We're feeling really good about where the design is and we think certainly by the end of the year, we're going to see some significant building materials, cost reductions happening in cartridges. In terms of – I'd say that by the fourth quarter, we should be seeing some real progress. I don't know if I would straight line it from Q2 to Q4. We still are still ramping through Q3. But I think by the end of the year, we'll be in a really good spot.

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

Great. Thank you.

Operator: Your next question comes from the line of Jonathan Ho with William Blair & Company. Please go ahead. Your line is open.

John Weidemoyer

Analyst, William Blair & Co. LLC

Q

Good evening. Hi. This is John Weidemoyer for Jonathan Ho. Thanks for taking our questions. If I could, could you elaborate further on the TASER 7 supply chain issue [indiscernible] (00:24:21) on some of what – how you rectified the situation? And obviously, it's probably higher demand than what the supplier has been used to. Was it significantly higher demand that they just never seen it before. And I'm wondering, you're a month into 3Q. Do you

have any data thus far even though it's only one-third to the quarter that gives you confidence that the situation has been rectified?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yeah. So there's one thing in particular, the supply chain issue was with the battery supplier. I would not say that it's mind blowing quantities of batteries. It was more just as we were scaling, we're very sensitive around issues like batteries. This is mission critical [indiscernible] (00:25:08) so we do a lot of testing. And as supply was ramping, we found some things that we weren't happy with how it was scaling. And our team was all over it. I'm really proud of them for that. And in fact, we thought we would get the replacement, the batteries they needed even by the end of the quarter. So it was just one of the disappointments where a shipment didn't come in on time. But I've been assured that the team feels very confident that the supplier has been very collaborative, is taking the feedback and have implemented and we're receiving those in higher quantities, and we continue to keep a very close eye on all the quality issues, and we're feeling we're in a really good spot. But it wasn't like we blew out [indiscernible] (00:25:58) quantity, and I think just a higher retention we're very sensitive on the battery issues and paying a lot of attention, make sure they scaled it well.

John Weidemoyer

Analyst, William Blair & Co. LLC

Q

Okay. That's helpful. So it sounds like it's more of a quality thing than a volume thing. And just another question, so the design change, the \$3 million that was impacted by the design change, was it the design change that was unplanned or was it the amount of impact from the design change that was unplanned?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

So good question. So in order for us to – the design of the TASER 7 cartridges uses some components that frankly adversely impact the cost, and from an availability we also just can't get enough supply to meet the demand. So this was a planned design change. This design change solves two big challenges for us. One of them is, it significantly reduces the cost and the other it also releases a big constraint on quantities. So as we rolled that design change in, we decided to make a risk purchase of some of the components before we completed validation. And I was right in the middle of that decision. In fact, [indiscernible] (00:27:09) was the right call. Those design changes were rolled into training cartridges. Ultimately, we didn't pass validation; I think part of that is because we're really doing heavy validation testing. And so the risk purchase there we ended up having to scrap a lot of what we purchased there and that's what hit the quarter.

We have validated the revision to that design, and we've been testing the heck out of it. That is not completely out of validation, but we've tested it for all of the relevant issues for which it didn't pass in round one, and it went through with flying colors on the issues that we were concerned about. So net is, this was part of a design change. It was planned. We had to scrap the parts because the first pass of the design didn't pass full validation, and we have made a decision to go ahead and purchase on a risk basis before the design was fully validated an asset. Thing about risk is sometimes it doesn't go your way, in this case it didn't, had it passed validation we'd be talking about a very different quarter. But that design has passed the hard parts of validation, and our team is all over it, and I'm feeling really good that this puts us in a much better position by the end of the year.

John Weidemoyer

Analyst, William Blair & Co. LLC

Q

That's a good color. Thank you very much.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

No. Thank you.

Operator: Your next question comes from the line of Julianna DeSimone with Imperial Capital. Please go ahead your line is open.

Julianna DeSimone

Analyst, Imperial Capital, LLC

Q

Good evening. This is Julianna DeSimone on behalf of Imperial Capital. Two questions. What progress does Axon made in integrating with all major CAD systems being used by police departments?

Luke Larson

President, Axon Enterprise, Inc.

A

If I understand the question correctly, it's what progress have we made integrating with CAD systems?

Julianna DeSimone

Analyst, Imperial Capital, LLC

Q

Yes.

Luke Larson

President, Axon Enterprise, Inc.

A

So our current evidence management system, Evidence.com is deployed by pretty much all of our domestic U.S. customers with our body cameras, has a CAD integration that we've used at high volume. I don't have the percentage off the top of my head, but it's used in a lot of agencies to auto categorize the events which is a huge benefits to the agencies from a cost perspective. Now, we are also developing a new dispatch solution that we're currently still in research and development on.

Julianna DeSimone

Analyst, Imperial Capital, LLC

Q

Great. And is the integrated solution that Axon is offering creating a situation in which those law enforcement departments and other large and smaller districts are now under pressure to keep up with their fellow departments in the same states?

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah. I would say our dispatch product is going to be revolutionary in terms of the approach that we've taken, and it's tightly integrated with the Axon platform. So once they roll out our entire suite of hardware and software products, they're going to see just a totally different way of achieving efficacy with this new dispatch solution, which I think is going to put a lot of competitive pressure on agencies to say, hey, are we using the latest technology that's available in these mission critical situations.

Julianna DeSimone

Analyst, Imperial Capital, LLC

Q

Okay. Great. Thank you very much.

Operator: Your next question comes from the line of Steven Dyer with Craig-Hallum & Company Capital. Please go ahead. Your line is open.

Ryan Sigdahl

Analyst, Craig-Hallum Capital Group LLC

Q

Hey, guys. Ryan Sigdahl on for Steve. Given the Q3 and full year guidance it implies a very significant ramp in revenue in Q4. I guess, what gives you confidence in that acceleration, and how much of that has been booked versus expectations for potential deals in the pipeline?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

So let me take the first part, what gives me confidence is the team of people we have working on this. So I have very high confidence in our team's ability to deliver. Josh, do you want to talk little bit about how much of this is already booked?

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Yeah. I'm not going to go into specifics on this, but we have a healthy number of TASER assurance plan upgrades scheduled, as well as several large deals in the pipeline that we have to execute on frankly in the second half of the year. But certainly, it's right there in front of us. And after a miss, the team is a little upset and more motivated than ever to get this back on track, and that's what we're going to focus on doing in the second half of the year.

Ryan Sigdahl

Analyst, Craig-Hallum Capital Group LLC

Q

And then as a follow up to that, I mean, so big revenue ramp, also the incremental EBITDA margins by my math is something like 90% from first half to second half. I guess, as far as OpEx growth or lack thereof versus gross margin expansion, can you help kind of give – what gives you confidence in that ramp and then between the two OpEx and gross margin?

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

Yeah. So the way that I'm thinking about this, look, it's tough to give gross margin guidance in a year when you're launching a new product, and it's really tough to do that in a year that you're launching several products, which is why we haven't given specifically guidance on that. And we don't intend to do that, but we have guided on the top line and the bottom line on revenue and EBITDA. And our intent is to deliver on that. We're very conscious of our margin profile. We spend a lot of time talking about that internally. And we're taking actions to drive to that long-term guidance. Our focus right now is on successful product launches. These are new platforms TASER 7, AB3, these are new platforms that are going to drive value over a long period of time.

And what we want to focus on right now is making sure that these products are performing to our high standards, providing the customers with the great experience. And we're going to trade gross margin dollars to ensure that in the short term. Rick mentioned, for example, there's a team working on design refinements that are going to deliver cost improvements, and that's an example of where we're trading up gross margin dollars to do that. And we're going to continue to do that to make sure that these products are successful. But again, we are mindful of

the gross margin profile and we're driving to that guidance over the long-term. So to recap, we've given a top and bottom line on revenue and EBITDA guidance for the year where our intent is to deliver on that, and we're driving the business long-term on gross margins.

Ryan Sigdahl

Analyst, Craig-Hallum Capital Group LLC

Q

Great. If I can sneak one more quick one in here and then I'll hop back in the queue. Previously, you guys said that you offered a larger TASER trading credit which was effective through July 1 with a lower credit available through the end of the year. Is that still the right plan or assumption? Thanks and good luck.

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Yes, that's still correct.

Operator: Your next question comes from the line of George Godfrey with C.L. King. Please go ahead. Your line is open.

George J. Godfrey

Analyst, C.L. King & Associates, Inc.

Q

Thank you. Two questions. First one, a quick one. What was international revenue in the quarter?

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

We're just pulling that up, George. It was \$18 million.

George J. Godfrey

Analyst, C.L. King & Associates, Inc.

Q

\$18 million. Okay. Following up on the profitability you just talked about Jawad, can you remind me what are you targeting for the long-term operating margin between the TASER business and the Software & Sensors business?

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

So we're not thinking in terms of operating margin because what we – one of the dynamics of the business is that we have all these administrative costs that are basically sitting in the TASER P&L and to try to allocate that is a very arbitrary exercise between segments. So what we have guided to is that gross margins in the TASER segment will be 70% and then Software & Sensors will also be 70% longer term. And then the overall business for 2019, we've guided to the \$80 million to \$85 million in EBITDA. We still are mindful of the fact that we've said at the end of 2017 the 300 basis points to 400 basis points of margin improvement. But again, with all the product launches we have and frankly, the pretty exciting market opportunity we have ahead of us, we want to make sure that we're making investments into the business to capture those opportunities. And so in 2019, the EBITDA guidance is \$80 million to \$85 million.

George J. Godfrey

Analyst, C.L. King & Associates, Inc.

Q

Right. And I appreciate that and I always appreciate the color. I was just thinking in a steady state, whether that's one year, three years, five years; A, what is that margin look like; and B, can you put a timeline on what that timeline is to get to a steady state, because it just always seems like it's constantly pushing out? Thanks.

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

Yeah. So on adjusted EBITDA, that margin, what we're targeting is 30% long-term, and we haven't given a specific timeframe for that margin. But I can tell you that as we bring new software products online, we can expect that margin to accelerate. For example, this quarter when you look at our Axon Cloud business, you strip out professional services, all our software products today are delivering over 80% margins, and we're now over the next 12 to 24 months, we're going to be bringing Records online, dispatch, those are going to be at very high margins as well. And so I would expect that in the next few years here we're going to be approaching that 30% adjusted EBITDA margin.

George J. Godfrey

Analyst, C.L. King & Associates, Inc.

Q

Thank you very much. Thanks for taking my questions.

Operator: Your next question comes from the line of Charlie Erlikh with Baird. Please go ahead. Your line is open.

Charles Erlikh

Analyst, Robert W. Baird & Co., Inc.

Q

Great. Yeah. Thanks for taking the question. I just had a bigger picture question on RMS. When you look at the RMS competitive landscape, there are a lot of existing players. So could you just remind us, what is it about your Records product that gives you confidence in your ability to displace those existing players?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yes. So two things, in the short term, just the integration of digital evidence and Records together is very valuable, not to have to like write your records in one system and then have all of your videos and photos. We're seeing body camera videos. They're becoming the central element of every record. That's the thing it records what actually happen, and having one integrated experience where your video is built right into the record rather than sort of everything else is a digital representation of pieces of paper. And then you separately go into our system that these agencies for their records – I'm sorry, for the video record, so that integration is one. The other I would say is just in general, the level of design experience is just – it's very different from what customers had historically, which is why we [indiscernible] (00:38:24) feedback items from customers who are going through training now saying wow, this is like seven stars on a five-star basis.

And then the long term real advantage we have is to be able to extract the records from our smart sensors. AB3 is a connected device that is really being optimized with multiple microphones, so that we can really do some better transcription and audio tuning, specifically so that we can do better transcription and we can ultimately extract the audio and the video to pre-populate much of the report. These officers today spend, the sensors for today's RMS systems are cops typing on keyboards, the sensors that will power our system, our body cameras, in-car cameras, drones, interview rooms, all the smart sensors, that is the strength of our business today is the engine that will drive our record management system into the future.

Charles Erlikh

Analyst, Robert W. Baird & Co., Inc.

Q

Great. That's helpful. And then, just one quick one on Fleet. Is Fleet getting their reception that you guys expected so far, and I'd also be curious to hear your thoughts on how Motorola WatchGuard acquisition changes the competitive landscape in Fleet or elsewhere.

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah, I mean not to be critical of our competitors, but we were really taking a bite out of WatchGuard's market share with our integrated offering. And so we're not – I don't know that adding two subpar solutions makes a better one. And so we're really confident in our Fleet program, our Fleet roadmap. Our Fleet product lead is the guy named [ph] Blake (00:40:06) and he's just really got a compelling future vision, so we feel really confident about our in-car position.

Charles Erlikh

Analyst, Robert W. Baird & Co., Inc.

Q

Okay. Good luck to you.

Operator: And your last question comes from the line of Julianna DeSimone with Imperial Capital. Please go ahead. Your line is open.

Julianna DeSimone

Analyst, Imperial Capital, LLC

Q

Thanks for taking my question. What types of software and forensic analytics upgrades is Axon working on to enhance the total solution?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Okay. Got it. We haven't – that would require getting into a little more detail in terms of our specific roadmap around what we're doing with Records and dispatch. So certainly, analytics is an area we see as a real differentiator, particularly because of our AI theme, and the thing that we'll be able to automate today very manual processes. But we haven't given any future levels specifics on our roadmap there.

Julianna DeSimone

Analyst, Imperial Capital, LLC

Q

Okay. Great. Thank you.

Operator: That concludes today's call. I now turn the call back over to management for any closing remarks.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

All right. So thanks everybody for joining us on the call today. In the next quarter we will be hosting an event for our analysts and major institutional shareholders at the International Association of Chiefs of Police. The conference this year will be in Chicago, and we look forward to seeing you there and discussing our results on our next quarterly call. So thanks everyone.

Operator: This concludes today's conference call. You may now disconnect.

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