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Axon Enterprise, Inc. (AAXN)

Q4 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Carmelie, and I'll be your conference operator today. At this time, I would like to welcome everyone to the Axon's Q4 2019 Earnings Call. All lines are placed on mute to prevent any background noise. After your speakers' remarks, there will be a question-and-answer session at which time instructions will follow.

I'll now turn the call over to our host for today, Andrea James, VP of Investor Relations & Corporate Strategy. You may begin your conference.

During Q&A, in the interest of time, the company request that you limit your questions to one initially and then get back in queue for any follow-up.

I'll now turn the call over to our host, Ms. Andrea James. You may begin.

Andrea James

Vice President-Investor Relations & Corporate Strategy, Axon Enterprise, Inc.

Thank you, Carmelie. Hello, everyone. Welcome to Axon's fourth quarter 2019 earnings conference webcast. I'm Andrea, as just introduced. Here in the room, in Scottsdale headquarters, we have Axon CEO, Rick Smith; President, Luke Larson; CFO, Jawad Ahsan; and Chief Revenue Officer, Josh Isner. And joining us from our global software hub in Seattle is our Chief Product Officer, Jeff Kunins.

I hope you've all had a chance to read our Shareholder Letter, which was released after the market closed. You can find it at investor.axon.com. And for the first time, we've published an ESG addendum, which you can find in the PDF linked on our website.

Management's remarks today are meant to build upon the information in that letter. During this call, we will discuss our business outlook and make forward-looking statements. Any forward-looking statements made today are pursuant to and within the meaning of the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995. These comments are based on our predictions and expectations as of today and are not guarantees of future performance. All forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially. These risks are discussed in our SEC filings.

I will now turn the call over to Rick Smith, our Chief Executive Officer.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

Thanks, Andrea, and thank you, everyone, for joining us today. I'm incredibly proud of everyone here at Axon for delivering another banner year with strong top and bottom line performance while simultaneously executing on several major product launches. 2019 was the year we planted the flag for our moon shot to make the bullet obsolete with the publication of my book, *The End of Killing*. Before this decade is out, we will deliver a taser weapon that will outperform a semi-automatic pistol in the effective and reliable incapacitation of a human subject. That will be a game-changer. And we've doubled down on our mission to make the justice system more efficient, more transparent, and more equitable. We will leverage the power of artificial intelligence to enhance public safety but with oversight from our industry-leading AI ethics board to ensure we also cherish and preserve individual

rights and privacy in the balance. We are emboldened as we look to the future from our strong base of execution our team delivered this past year.

In 2019, we scaled the all-new TASER 7 while implementing significant design improvements in the cartridges. We introduced the industry's first body camera with live streaming, and we went live with Axon Records. We also made significant investments in people and processes to improve future product launches.

I told you in August that we had high expectations for Axon Body 3 and we're planning for meaningful shipments in Q4. We delivered on that promise. Q4 revenue of \$172 million was up 50% year-over-year, reflecting record volume camera shipments. About 75% of our body camera units shipped in Q4 were Axon Body 3.

For the full year, we grew revenue 26% to \$531 million. It feels great [ph] to tap (00:03:55) \$0.5 billion in revenue, but I'm more focused on what this signifies. Axon products provide real value to our customers and the communities they serve. We're absolutely thrilled that customers are selecting our most meaningful integrated bundles. We're going to keep innovating on behalf of this historically underserved market. And our top line performance demonstrates that our customers are savvy and eager to adopt the latest technology.

We're also very pleased with our bottom line performance. In Q4, six additional performance goals in our eXponential Stock Performance Plan for our employees became statistically probable in light of our strengthened future outlook. This did result in a significant catch-up stock compensation expense that affected GAAP net income. Excluding the impact of that, the results are pretty impressive.

In Q4, we more than tripled our adjusted EBITDA over last year; and for the full year adjusted EBITDA grew 43% to \$88 million. I would again like to thank you, our shareholders, for approving our eXponential Stock Performance Plan, which aligned the entire company to the same growth goals as my CEO performance plan. I believe the strong performance and increased probability of hitting those goals are the direct result of our implementing the most innovative, widespread incentive program in any public company today, so thank you.

We delivered operating leverage in 2019 even with gross margin headwinds as we sell our five-year, high-value integrated bundles, which carry a lower gross margin upfront but increase in years two through five. So, we are successfully selling customers our highest value offerings in a true win-win scenario. But that does create some margin pressure and we were able to deliver bottom line leverage this year regardless.

We've all embraced the practice of being very intentional and strategic with our capital allocation and our R&D investment, and I feel confident that we exited 2019 the strongest we have ever been.

Now, Luke can talk about how, in 2020, we're focused on building for scale.

Luke Larson

President, Axon Enterprise, Inc.

Thanks Rick. I, too, want to congratulate our team. Our company goal was to ship 60,000 Axon Body 3 cameras in 2019 in order to support our upgrade programs as well as the demand for the new product. This was an ambitious goal. And given some of the headwinds we faced in Q2 with operations, it was really important to us, as an organization, to deliver on this goal for our customers as well as shareholders. Everyone executed at year-end from sales, to engineering, to manufacturing, to operations, and supply chain. And we not only made a lot of customers happy, who are waiting on their new cameras, but we proved we have the muscle to meet a surge in demand even on a new product line.

Not only that, we accomplished this record revenue quarter while also sequentially reducing operating expenses, excluding stock comp, and driving adjusted EBITDA leverage. In fact, if we exclude stock comp, SG&A was down both year-over-year and sequentially, and this is really a testament to our strength in cost control muscle as well as leverage we see in our model.

Looking forward, our big theme for 2020 is build for scale. This means making sure we have the right tools and people in place and then everyone stays focused on execution just like in Q4. We see ourselves as building a \$2 billion revenue business, and we get there by staying focused on our mission and building upon our virtuous cycle. More users means more data, which means better products leading to better societal outcomes, which means more users completing the virtuous cycle.

In 2020, we will continue to drive adoption of the Officer Safety Plan, which combines a taser, a body camera, and a host of mission-critical software capabilities. More than 100 agencies have adopted Officer Safety Plan 7 and more than 70% of those users on the highest tier, which carries the most premium software features.

Before I turn the call over to Jawad, I want to take a moment and talk about the coronavirus. Our operations team has been effective managing through this situation thus far. And at this time, given the current impacts, we feel that we can manage toward our full-year guidance and that we have some flexibility to be adaptable. However, like every company dealing with this, we are closely monitoring this and in constant communication with our supply chain. And this may impact year-end if the situation further develops. But currently, we feel good about our guidance.

With that, I'll turn over the call to Jawad to talk about some of our areas of expansion for 2020.

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

Thanks, Luke. Before we move on to our 2020 outlook, I also want to take a moment and say how proud I am of our team. After a tough Q2 last year, our teams faced [ph] any of the challenges (00:08:57) and worked hard to regain ground, proving that we could deliver strong top line growth and margin expansion in 2019. If our finish to the year reinforces anything, it's that Axon has a strong sense of accountability. Our customers are counting on us to deliver lifesaving products, and our credibility with shareholders is vitally important to us.

At our Investor Day in November of 2017, we laid out a three-year vision for the company that showed our path to continued strong top line growth while also turning around our declining margins. We also set a goal for ourselves to be profitable in the body camera and DEMS business within three years, and we achieved that ahead of schedule. Since 2017 our revenues have grown at an annual CAGR of 26% and our EBITDA margins have expanded to 16.5% on an adjusted basis. The body camera business is now profitable and the TASER 7 and Axon Body 3 launches are now behind us.

We are heading into 2020 with strong tailwinds on profitability that we intend to use to slingshot our way to the next phase of growth. We have built a high-growth, high-margin, high-retention, \$161 million ARR enterprise software business, and we haven't even begun recognizing revenue for Axon Records.

Today, we're charting a new path to the company. We had set for ourselves a North Star that by the end of the decade, we'll have achieved the following. First, taser weapons will be the primary means to stop a threat. Second, AI-enabled body cameras will eliminate the majority of manual report writing. Third, cloud-enabled devices will be the primary means to dispatch officers in the field. And finally, Axon will be a household name by virtue of the transformative value we'll create for society and shareholders.

From a financial standpoint, we'll also have built the business that we're targeting to deliver revenue growth of over 20% per year and achieve continued operating leverage with EBITDA margins approaching 30% on an adjusted basis. To get to these outcomes, we see a unique opportunity to accelerate the funding of some of our most promising new growth initiatives. In 2020, we'll invest over \$100 million in R&D and new channel growth excluding stock comp. An example of one such R&D initiative is dispatch.

Our goal is to bring dispatch to market in 2020, and that team is tracking so well under the leadership of Josh Pepper that we expect to have our first paying customer live within the first half of this year. This deployment will see Axon displacing a major competitor in the dispatch space. We expect to have a competitive dispatch product in market and widely available by the second half.

In terms of channel growth, one of our key initiatives is our investment in federal. In 2018, we hired Richard Coleman from General Dynamics to head up our federal business, and he has led us to some terrific early wins such as the US Forest Service and the DoJ's Bureau of Alcohol, Tobacco, Firearms and Explosives. We're excited about the prospect of serving that \$1.5 billion TAM, and we'll be investing more aggressively in this area going forward.

While we're very excited about the momentum we're carrying into 2020, we are not stopping to celebrate. We are instead putting the pedal to the floor, and you can expect us to continue to execute with a high degree of accountability.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Scott Berg with Needham.

Scott Berg

Analyst, Needham & Co. LLC

Q

Hi, everyone, and congrats on a very strong quarter here. Several questions, where do I start, because I get one. I guess let's start on the CAD environment a little bit. I like the announcement that you're going to have the product available this year. We've done a fair amount of work kind of on this space. One of the things we found is customers are less interested in a cloud-based CAD model, at least today.

Can you help us try to understand the successes that you think you're having there at least early on with maybe a beta customer or two in particular that can kind of untap this area that may be different than what they're used to today?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yep. Yeah. We love entering new markets where the initial customer reaction is no. When we started with electrical weapons, we heard no. We started with the body cameras, we heard no. We started with the cloud digital evidence software, we heard no. That tells us we have the opportunity to be first and move the market.

When we think about CAD really what they're talking about is reliability. And indeed, the reliability and uptime of the major cloud providers dwarfs what your average municipal city could do in terms of uptime themselves. So, reliability really comes down to two things; the reliability of your Internet connectivity, and the reliability of the system if you lose Internet connectivity.

So, the first one is [ph] not a (00:13:58) huge problem to solve. They have redundant Internet access through multiple carriers. And over the next few years, I think we're going to see all sorts of new ways to connect to the Internet; 5G, lowered satellites in addition to ground-based systems.

So, it is certainly a fear that customers have because I think they sort of think in terms of, well, sometimes I lose Internet connectivity but that's a solvable problem. And then the other is, if you do lose connection to the Internet, we've engineered our system in such a way that we've done some demos where we watch customer's jaw hit the table when we just unplugged the Internet and the system keeps chugging away just fine.

So, when we get in front of actual customers with demos, we think that it's an absolutely solvable perception issue that sets us up to again I think move the market in this direction.

Scott Berg

Analyst, Needham & Co. LLC

Q

Great. Super helpful. Congrats again.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Thanks. [ph] This can go much better with democratic state. (00:14:58) People are like limiting their questions. That's great. [indiscernible] (00:15:01).

Andrea James

Vice President-Investor Relations & Corporate Strategy, Axon Enterprise, Inc.

A

Keep going, Carmelie.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Keep going, Carmelie.

Operator: Your next question comes from the line of Jonathan Ho with William Blair.

Jonathan Ho

Analyst, William Blair & Co. LLC

Q

Can you hear me okay?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yeah, we got you.

Jonathan Ho

Analyst, William Blair & Co. LLC

Q

Perfect. So, when we look at your guidance for 2020, how do you think about sort of the growth over the course of the year? And what maybe gives you the confidence that we're going to have a little bit of a stronger second half ramp?

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Yeah. Ultimately, I think there's an element of – first of all, this is Josh Isner. Ultimately, there's an element of seasonality there where the second half does tend to be stronger as we spend the first half of the year building up the pipeline. With people in newer territories, we're doing a lot to expand our channel in terms of both inside and outside sales right now. And so, while we expect good results in the first half of the year, certainly, similar to last year, we'll see revenue weighted towards the back half, and we're already laying the groundwork right now for that to become a reality.

Jonathan Ho

Analyst, William Blair & Co. LLC

Q

Thank you.

Operator: Your next question comes from line of James Faucette.

James E. Faucette

Analyst, Morgan Stanley & Co. LLC

Q

Hi. Thanks a lot. I wanted to ask, you talked about in the press release in the prepared comments about increasing investment during the course of 2020. I'm wondering if you can provide some color as to where that investment is directed, what kind of roles, et cetera? And then what do you expect the outcome and time to pay back to be on that investment, just what kind of calibrating?

Obviously, things are going [ph] at least as whatnot (00:16:45) a bit better than you'd expect to maybe a little while ago. And so, just trying to get a sense as to where you're thinking about that investment and the impact it'll have.

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

Yeah, that's a great question and it's the right way to think about it. We are making investments and expecting to leverage that into our next phase of growth. And so, the investments really fall into three categories. The first one is the investment we're making in the product. And, as you know, Jeff Kunins, who joined us as Chief Product Officer, has just reinvigorated our product organization. And under Jeff's leadership, we've decided we're going to make investments specifically in things like dispatch, was a big one that we've highlighted as an area we're excited about for accelerating an investment in addition to investments we're already making in products like Records.

The second area channel investments. So, we mentioned federal. Federal is an interesting one that's both a product investment. There are some work we need to do to get the product ready for the federal market. But then there's also a channel investment as we build out the channel under Josh Isner and his team.

And then third, Luke mentioned in his prepared remarks how we're building for scale, and a portion of the investment we're making in 2020 is also to help build the business for scale and really in some of these support functions and systems and processes that are going to get really support us as the company approaches \$1 billion in revenue.

And as far as the payback, that's something that really you can see reflected in our strength in the outlook over the – we've got an outlook for the next few years that's reflected in the additional tranches that became probable. So, we're expecting that payback certainly within the next few years.

Operator: [Operator Instructions]

Q

Re-queue us.

A

All right, we'll do.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

We didn't hear that last question here at Axon.

Operator: You're next question comes from the line of Joseph Osha.

Joseph Osha

Analyst, JMP Securities LLC

Q

Hello there, everyone. Can you hear me?

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

Yes.

Joseph Osha

Analyst, JMP Securities LLC

Q

Okay. Great. Thank you. As we look into 2020, it's interesting the unit composition of your – the CEW business has kind of [ph] purposed (00:19:12) around a bit. I'm wondering if we can expect in 2020 that mix to shift more decisively over to TASER 7. Thank you.

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Yeah. Absolutely. I think the first half of last year was the time where large and small agencies were evaluating the TASER 7, trialing it in the field for 30- to 60-day periods at a time. And that led to a little slower adoption in the first half and obviously picked up in the second half. And we expect to continue to have momentum toward upgrading our TASER customers to TASER 7. Specifically, this year, we are very, very focused, as a sales team, on upgrading all of our customers to 2-shot devices, again, especially TASER 7.

And the market is responding well to that concept and we feel like we've got the most effective and just best overall CEW we've ever come out with. We're hearing it from our customers. There's excitement over it

internationally as well, and we have a lot of confidence that we're going to have a big year with TASER 7 this year.

Joseph Osha

Analyst, JMP Securities LLC

Q

Thank you.

Operator: Your next question comes from line of Will Power with Baird.

William Verity Power

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

Q

Great. Thanks. Yeah. I guess, first question on AB3. Obviously, you have a really strong quarter and it seems like above perhaps your expectations or at least relative to guidance. So, just kind of curious on what drove I guess the upside relative to prior expectations? How much of that was kind of pull forward?

And I guess kind of tied into AB3, any thoughts with respect to contract manufacturing impacts from coronavirus, any other supply chain impacts you call out there that give you any pause for concern on meeting demand out there?

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah. Great question. Let me answer the first part about the general AB3 demand was driven by two primary things. One is in our bundled offerings we have TAP – some upgrades. One is our TAP program where they pre-signed for the second device. And so, there's a lot of demand for that that we had previously sold in addition to new demand for the product.

In terms of the corona virus, as it sits today, our ops team has been working around the clock since this broke and we've been in communication with our supply chain, too, and had actually kind of diversified this with some of the tariff impacts earlier in the year.

And so, as it sits today, we've got a clear path, but this is a dynamic situation, and like everyone monitoring it day to day.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yeah. I would just double down. This is Rick. The significant majority of those AB3 units were part of our hardware subscription plan. So, one of the great things that I believe we actually innovated as a business was this idea of combining a SaaS software with hardware with predetermined upgrades, so they get a new camera every two-and-a-half years and we saw the power of that. Whereas, for example, in TASER 7 there was more testing and time to ramp whereas with AB3, because that was on an automatic upgrade plan, we had tens of thousands of cameras waiting for delivery, so it really became just our ability to produce and ship.

So, we've been very pleasantly – maybe surprise is too strong a word. It's been great to see that reaction and that element you can expect to see us to continue to move toward in our business. It really helps our customers, too. They want to be on the latest technology and being able to not worry about whether it's hardware or software or a service knowing that with one contract plan with Officer Safety Plan they just continually get updated to the latest capabilities.

William Verity Power

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

Great. Thank you.



Operator: Your next question comes from the line of Charlie Anderson with Dougherty & Company.

Charlie Lowell Anderson

Analyst, Dougherty & Co. LLC

Thanks for taking my question and congrats on a great end of the year. I wanted to focus on TASER gross margins. I wonder if there's path back to 70% or so there, just know what you're seeing there in terms of the – what's embedded in the guidance for 2020 for TASER gross margin? And also, on that cartridge number it was very large in Q4. Just wondering what's going on there and sort of the interplay between cartridges and units moving forward. Thanks so much.



Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

Yes. Yes. This is Rick. So, yes, we continue to – we believe TASER margins will continue to march back upward from here heading back towards 70%. Jawad, have we given a timeframe on that or just [indiscernible] (00:24:01) on the 70%? And then on the large number of cartridge shipped, and so one of the things that impacted TASER margins last year was we had a margin issue on the cartridges in the first half of the year. That led to the challenges in Q2. And I'm so proud of the team that they were able to not only correct those delivery challenges, but also to engineer a fair amount of cost out of the cartridges.



Now, we'll really begin to see those cartridge cost savings in 2020 because once we got the cartridge redesign done, we have a lot of back orders. So, the reason those cartridge shipments were so high was we had cartridge down, production down for a good part of Q3. That demand really built up into Q4, so we had a very heavy margin – I'm sorry, we had a very heavy shipment quarter on cartridges and we're still struggling with higher-than-usual scrap since the new design came online and higher than the cost that we expect to see going forward. So, we expect to see a significant improvement this year in margins in TASER business.

Charlie Lowell Anderson

Analyst, Dougherty & Co. LLC

Great. Thank you so much.



Operator: [Operator Instructions] The next question comes from the line of Jeff Kessler with Imperial Capital.

Jeffrey Ted Kessler

Analyst, Imperial Capital LLC

Thank you. Thank you for taking the question. With regard to the integration of Evidence into the entire package, at what point- you talked about the various parts of your program beginning to draw – I guess if you want to call it – draw demand in. At what point do you see enough of the rest of the business out there sold as a system, so that customers will be asking for Evidence as opposed to you having to push-sell it into them?



Luke Larson

President, Axon Enterprise, Inc.

A

So, since 2008, we've been selling a combined digital evidence management cloud software system with the body camera, and that we've been very successful at creating this category of a cloud-based software and a connected hardware device. In the last few years, we've now bundled that with our taser offering as well. And our latest programs include some of our advanced software capabilities like Records, which are mission-critical to agencies. And we're seeing a lot of demand in those bundled offerings. And when we go in, you lead with the entire capability as a service for how we can create value for the agency. And the demand is very strong, strongest for our highest-value bundled offers.

Jeffrey Ted Kessler

Analyst, Imperial Capital LLC

Q

And that ultimately leads to profitability for Evidence.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yes.

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah.

Jeffrey Ted Kessler

Analyst, Imperial Capital LLC

Q

Great. Thank you. Thank you very much.

Luke Larson

President, Axon Enterprise, Inc.

A

Great. Thank you.

Operator: Your next question comes from the line of Mike Latimore with Northland Capital.

Michael Latimore

Analyst, Northland Securities, Inc.

Q

Great. Thanks. Awesome quarter. I think over the last few years, so you've been building out an enterprise software sales team. I guess, how many people do you have in that group and how fast you think you might grow that this year?

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Well, look we're making investments across the business. Certainly, we're making investments on the sales team, in the field to get ready to sell additional products like Records and Dispatch. I think it's equally important that we're making investments on our customer success team to ensure that customers are having a great experience with us and they continue to use all of the elements of the bundles that they're buying. We're also making

investments on our inside sales team, in our federal channel, in international. And we'll keep investing in the channel until we feel like we have full coverage across the market.

And so, we're going to keep adding people to make sure they have a reasonable number of accounts to manage. We're going to keep adding people to make sure that we offer the best customer experience in the market. And when that day comes, we won't need to add people anymore.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Hey, what one thing I would add, Josh – this is Rick. it's not like we're – we're not building a software sales team from scratch. Ten years ago we had a taser weapon sales team. When we launched body cameras and software, it was really a combined offering of body cameras and cloud software. And so, there, as we scaled up that team, that team is almost entirely people that come from enterprise software sales backgrounds because it really is an enterprise software sales that comes with hardware attached. And so that same sales team, we're continuing to expand it but that same sales team already has that skillset and they're dealing typically with the CIOs and the people that are at least in the more sophisticated agencies. The body camera is being driven by the IT shop that has the relationship with that sales team.

So, I just don't want to leave the impression that this is a new thing we're building up. We already have I think a very capable software sales team. We're just now arming them now with very-high margin, pure software place that they can sell as well.

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Absolutely. And we're focusing on coverage, right? Like the most important thing is these very talented salespeople have manageable territories and manageable, account list that they're able to sell into. And certainly, we're doing that in a very calculated way.

Michael Latimore

Analyst, Northland Securities, Inc.

Q

Great. Thank you.

Operator: Your next question comes from the line of Keith Housum with Northcoast Research.

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

Hey, guys. [ph] Hoping you guys (00:29:54) give us an update on the Records systems. I know that you guys are a few quarters into [indiscernible] (00:29:58). How close are you guys actually recognizing revenue on a consistent basis with that, and perhaps can you give us an idea of how many customers you have using it and lessons learned over the past few quarters?

Jeff Kunins

Chief Product Officer & Executive Vice President-Software, Axon Enterprise, Inc.

A

Sure. This is Jeff. Well, first, I think we are – I am incredibly excited, we're all incredibly excited about Records for three key reasons. The first is just, hands down, the experience. Every single agency we have showed it to simply loves the Axon Records experience. It's hands down the best they've ever seen in the category regardless of

whether they're ready to switch to it yet or not. And number two is the thing we call Standards, and Standards, specifically the module within Axon Records, that's used for use of force and internal affairs reporting. And it's a unique, fast, and high-value way for customers to immediately start using and getting value from Axon Records right now, immediately, regardless of whether they're ready to switch over their entire RMS yet. And customers love it. And as we've already seen, like we talked publicly before about Cincinnati in particular, it perfectly tees-up their decision to then go all in with Axon Records as soon as they're ready to make a change.

And then the third is that as we continue to build this out, it's the [ph] SAM (00:31:26) or addressable market for the category. And I'm incredibly encouraged both by the velocity and the quality that we're building out Records at. And we're on track, just to dimensionalize that for you, that by the end of 2020 we're going to be the obvious RMS choice for about half of domestic agencies both large and small. And we're incredibly excited by the feedback we've gotten from live customers like Fresno and Cincinnati with Standards. And the momentum is great and we're super excited about it for the rest of the year.

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

Got you. So, are you guys recognizing revenue already or is it still some time in 2020 we'll see that?

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

No, we are not recognizing revenue yet.

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

Great. Thank you. And then if I ask quickly [indiscernible] (00:32:13) I guess I'll be the one guy that doesn't comply with the one question rule. Could you just help us understand – sorry. Help us understand what's different in terms of federal agency that requires additional investments in the product compared to what you have currently?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yeah, I'll take that. So, federal agencies, just the way they purchase is just really quite different. It's almost like just a different language. So having people with federal sales experience like Richard Coleman, it's just a different animal from the talent and the sales process that happens at state and local agencies. And then there's things like getting the product through the FedRAMP certification. That's like, what, two or three years and millions of dollars of investment to be compliant with the FedRAMP standard, which is not a standard that applies for the product in state and local agencies. There we were CJIS compliant with a much easier standard to get to. There's just a lot more compliance load on dealing with the federal agencies.

And so, at this point, it's our understanding we're the only FedRAMP software product in this category, and we've now started to bring agencies online. And so, we're continuing to build that out. We're also – there will be times where federal agencies are going to just have additional capabilities that we'll need to invest and it might be different from some of the state and local guys.

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

Great. Thank you.

Operator: Your next question comes from the line of Andrew Uerkwitz with Oppenheimer.

Andrew Uerkwitz

Analyst, Oppenheimer & Co., Inc.

Q

Yeah. Hey. Thanks, team, for taking my question. Could you walk us through some mechanics around – and maybe it's already happening in this Q4 body camera number. But as we think about some of the larger agencies you've signed two, three years ago, as they upgrade to the next body camera and the next taser because I think a lot of the rollouts early on were phased. So, will the upgrades also be phased or will those be kind of one time all at the same time? And then, finally, on the back end of this question, as we start lapping some of these bigger contracts, how does the renewal process work on some of these big contracts? Thanks.

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Sure thing. So to answer your first question, the upgrades are generally not phased. The reason being is early on when you're deploying a new technology, onboarding a set number of users every month or so forth works really well. But then when you upgrade to a different version of the camera that has different features and different docs, you want to have parity across your whole agency using the same platform. And so, all the contracts are designed to support phase rollouts upfront, but then have an upgrade universally across the agency at the two-and-a-half-year mark. And so, that's what we're executing on right now.

In terms of renewals, we're very focused on that. And we have a lot of confidence and we've seen last year with over 100 customers on our new OSP programs that we're effectively able to position the value of the OSP 7 and 7+ offerings, and customers are very excited about that. So, our sales team is very, very focused on not only renewing these customers and preparing for their renewals, but also making sure that we're demonstrating the value of n]w features within the bundles and, of course, an effort to convert these customers to RMS as well as part of that process.

Luke Larson

President, Axon Enterprise, Inc.

A

And I would just add one more comment on that. Oftentimes, we're not waiting for the renewal to come up. Our sales team is engaged early, early in the process on, as Josh said, demonstrating the value. So, oftentimes, we're able to upgrade them before the renewal even comes up and get them on another multiyear contract on one of our higher offerings.

Andrew Uerkwitz

Analyst, Oppenheimer & Co., Inc.

Q

Got it. Thank you, guys.

Operator: [Operator Instructions] The next question comes from the line of Scott Berg with Needham.

Scott Berg

Analyst, Needham & Co. LLC

Q

Hi, guys. I figured I'd squeeze one more and even though I was compliant on the first time.

A

Well done.

Scott Berg

Analyst, Needham & Co. LLC

Q

Jawad, just a follow-up question on gross margins a little bit. With the AB3 camera obviously it was a good quarter in terms of devices that we booked in shipped. But I think there's a little bit of an expectation that the gross margins on those devices would be better than some of the AB2s going forward. The gross margins in the quarter were actually a little bit worse than what we saw in the last couple quarters. Can you help us understand the push and pulls to move the gross margins on that product category maybe over the next one or two years?

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah, great question, Scott. This is Luke. And on the AB3 it actually has a higher hardware BOM cost. So, the initial gross margin is not going to be – it's actually going to be worse than the AB2. Where we made a big bet is by making that a connected camera with an LTE component, so that we can sell additional services. And that's the bet that we're making as an org, so much so that it's one of our key kind of company level bonus goals is to upsell those advanced software features on top of our AB3 platform.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yeah. And I would just add on there. As we went through our product planning, we had debated about whether to do two versions of AB3, one with LTE and one without, because, as we mentioned, the majority of those shipments were cameras that were owed as part of an upgrade. And we could have shipped them, a camera with much lower cost, but we felt that much more important than short-term hardware margins is we're building long-term service revenues and that it was worth that investment. And from a customer experience, we thought, well, how delighted would our customers be when they're effectively on the iPod upgrade program and they get an iPhone for no extra charge.

So, effectively is what's happened [indiscernible] (00:38:29) camera to an LTE-connected camera and we believe that now it's really about proving all of the high-value services we can run over that connection that will be very enticing. So, that's the bet that we've made. We'll just have to see how it plays out over the next couple of years.

Scott Berg

Analyst, Needham & Co. LLC

Q

Great. Thanks, guys.

Operator: Your next question comes from the line of Jonathan Ho with William Blair.

Jonathan Ho

Analyst, William Blair & Co. LLC

Q

Good afternoon. So, with the incremental investments that you're making, is this also maybe temporary in nature in terms of a pull-forward or should we be thinking of this as potentially a new baseline level of spend around the R&D? Thanks.

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

Yeah. It's an investment we're making in 2020 given the opportunity that we have ahead of us. And I would not expect that this level of investment would continue because, as you know, we've got these goals in place that are very ambitious and the expectation is, with the guidance laid out, just try to get to a business approaching 30% EBITDA margin, that we're absolutely going to start to realize operating leverage at some point. And so, I think about those investments as short term in nature.

Operator: Your next question comes from the line with George Godfrey with C.L. King.

George J. Godfrey

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

Q

Thank you. Congratulations on a great quarter. Could you give us the international revenue for the quarter and update us on how expansion has been going outside US? Thanks.

Luke Larson

President, Axon Enterprise, Inc.

A

International revenue was flat at \$24 million in the quarter, year-over-year. And, Josh, do you want to add some color on that?

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Yeah. Hey, George. So, ultimately, two things I'd say about international. The last three years we made a very, very focused effort to shore-up what we would refer to as our tier 1 markets, which are the UK, Canada, and Australia. And I'm really proud of the teams in those markets for gaining a dominant market position in both CEWs and in video in those markets. We feel like, at this point, we've earned the right to continue to invest in tier 2 and tier 3 markets now. And we expect some of those markets this year to develop into meaningful contributors to international revenue.

Secondly, obviously, we launched two new products last year domestically, TASER 7 and Axon Body 3. And we're really proud of the fact that we grew by over 30% domestically last year. Candidly, a lot of our focus was getting those products off the ground domestically, so that this year we can get them off the ground internationally.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yeah. I would just add that, typically, internationally, both for TASER weapons, there can be a national approval authority. So, TASER 7 we'll have to go through to get approval in those new markets and that takes time. There's not that delay in the United States meant for AB3. The LTE chips effectively if you use in the US are different than the ones you use in Europe. And so, again, we weren't actually offering AB3 in those international markets yet because we have to bring up a new SKU that have the appropriate wireless connectivity, and that will be coming online this year.

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

And I would say lastly, George, that our international bookings did grow by double-digit percentage last year. So, we're certainly excited about the direction we're heading. Obviously, with bookings, those do take time to translate into revenue. And so, again, the leading indicators are encouraging and we're going to work really hard this year to grow that number.

George J. Godfrey

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

Q

Thank you for that. And I'm doing this from memory. Tier 2 markets, France, Germany, Italy, the Netherlands, and Belgium, is that right?

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Most of those are correct. We've got a couple of others that we had not disclosed and don't intend to at this time.

George J. Godfrey

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

Q

Got it. Thank you again.

Operator: Your next question comes from the line of James Faucette with Morgan Stanley.

James E. Faucette

Analyst, Morgan Stanley & Co. LLC

Q

Thank you very much. Just wanted to ask a quick follow-up. You talked about that you had taken into account a little bit the potential impact from coronavirus, et cetera. Just wondering if you can help at least dimensionalize how much of an impact that may have had on the way that you formulated guidance or outlook for 2020. And along those same lines, just a little color if you could on how we should think about the relative growth rates within the different product lines and parts of the business?

Luke Larson

President, Axon Enterprise, Inc.

A

Yes. So, on the first part of your question with the coronavirus, a couple of things give us a lot of confidence that may be different from other companies. And you're probably very familiar with a lot of the consumer tech companies have said their forecasts are being impacted by this. For us, we don't sell into China at all, so there's no revenue impact there. The bulk of our orders we can kind of see into the pipeline and forecast our demand and different from a consumer company. [ph] We're not doing (00:43:45) just in time. We plan this months and quarters in advance. And so, that gives us a fair amount of confidence certainly in the first half of the year to deliver those commitments. And in the back half of the year we're putting contingency plans in place and diversifying our supply chain, so that we can be adaptable to those. But there's certainly risk there but we've got confidence based on what we know.

In terms of the product growth at the back half of the year, maybe I...

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

I would just say, whereas when you've got countries going into lockdown and consumers aren't going out and buying things, that obviously is going to have a big impact on many businesses whether they're in travel,

entertainment, consumer products. It's early to say because we're early in this game. But if I look at this public order and the investments governments make in the infrastructure, I would not expect those to be adversely affected. We're not relying on people going to a store to buy something. In fact, I wouldn't say that there could be any positive headwinds, but there may be public order implications when you start talking about the things that are happening in Italy with significant levels of quarantines, et cetera.

So, we don't have any indications of any negative demand impact from coronavirus. I'd say most of what we would – we're more focused on is just making sure we don't get supply chain impacts because we do have some suppliers in Asia. But we feel we've got that pretty well at hand right now.

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

And then in terms of growth by category, I don't think we're going to disclose a lot here at the moment other than we expect CEW to grow by double-digit percentages this year. And, of course, we've given the revenue guidance already. And so, certainly more color to come on that as we get through the year here.

James E. Faucette

Analyst, Morgan Stanley & Co. LLC

Q

Thanks.

Operator: Your next question comes from the line of Joseph Osha with JMP Securities.

Joseph Osha

Analyst, JMP Securities LLC

Q

Hey, I got back on. I kind of feel like Amy Klobuchar right at the end of the debate. I wanted to ask a little bit about something we haven't talked to as much about, which is some of the consumer CEW stuff. I know that's something [ph] too odd (00:46:04) that we had talked about when I was down there. Is this an area that we might see more focus on in the coming year?

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

In 2020, no. We're very focused – so, 2019 was an important year for us for launches on the devices, TASER 7, Body 3. And in 2020 we're focused on software. Consumer is still very important to us. One of the reasons I joined the company was to help Rick make the bullet obsolete, and consumer is very much a part of that. It's a part of our strategy going forward, and we hope to share some exciting updates on that in the future. But at this point in 2020, we're not making any additional investment in that other than what we're already doing.

Joseph Osha

Analyst, JMP Securities LLC

Q

Okay. Thank you.

Operator: And at this time, I would like...

A

[indiscernible] (00:46:48) Sorry.

Operator: Okay. At this time, I would like to turn the call back over to management for closing remarks.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

Awesome. Hey, thanks, everybody. Obviously, I couldn't be prouder of the team. We hit some significant challenges at the middle of the year. We had conversations with a lot of folks wondering if we were going to be able to pull it out. And we said we're committed to hitting what we said we're going to hit for the year. And I got to tell you, there was a lot of hard work that went into that. I just couldn't be prouder of the team, and there are a lot of smiles as we've rolled into December and we were able to meet good on our commitments.

So, just want you guys to know a lot of people put blood, sweat, tears, a lot of heart into making sure that we met our commitments. And thanks for sticking with us and we're really excited to see what we can show you in results here in 2020.

So, with that, have a great day and we'll talk to you on the next quarterly call.

Operator: This does conclude today's presentation. You may now disconnect.

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