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Axon Enterprise, Inc. (AAXN)

Q1 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Mike, and I will be your conference operator today. At this time, I would like to welcome everyone to Axon Reports Q1 2019 Financial Results. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session.
[Operator Instructions]

I will now turn the call over to Luke Larson, President of Axon. You may begin your conference.

Luke Larson

President, Axon Enterprise, Inc.

Thanks, Mike. Good afternoon to everyone. I'm Luke Larson, the President of Axon. Welcome to Axon's first quarter 2019 earnings conference call. Before we get started, Andrea James, our VP of Investor Relations will read the Safe Harbor statement.

Andrea James

Vice President-Investor Relations, Axon Enterprise, Inc.

Hello, everyone. Here in the room in Scottsdale, we have Luke Larson, our CFO Jawad Ahsan and our Chief Revenue Officer Josh Isner, and CEO Rick Smith is joining us from San Francisco. 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 and our quarterly shareholder letter, which we've posted to investor.axon.com, and we've also filed with the SEC.

Today's call will include forward-looking statements, including statements regarding our future expectations, beliefs, intentions or strategies including projections regarding revenue growth, profitability, and products 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 and 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 Axon ticker, AAXN.

All right. Go ahead, Rick.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

Thanks, Andrea, and thanks for joining us to our investors today. This is a symbolic quarter for Axon because it is the first quarter where we're recognizing high margin software revenue on our TASER program. That revenue will

grow as we move TASER 7 through the installed base and drive subscription contracts. And the marginal cost of that revenue is so low that this quarter it rounds to zero. So that feels pretty good. That's why you build software businesses. Our recurring revenue is now more than \$122 million, up 47% from a year ago.

Our shareholder letter is pretty robust this quarter because our team accomplished a lot since our February update, including significantly retiring product launch risk on Axon Body 3 and moving closer to day zero with a major city agency deploying Axon Records. Our software product launches, Axon Performance and Redaction Assistant, are setting new industry standards for using AI to drive efficiency, managing body camera programs.

And I'm especially excited about our FedRAMP certification. That's a stealth initiative we've been working on for three years. Securing FedRAMP opened up the federal market for us. Last month, Luke and I attended an Axon Salute to Federal Law Enforcement on Capitol Hill formally kicking off our entry into the federal market. Any of these accomplishments we're announcing this quarter could have been impressive on its own. And I'm really proud of Axon's teams who continue to push hard and deliver on behalf of our customers.

Every products we bring to market is the result of extensive discussions with our customers. In the early days of TASER, we would develop new products in a black box and unveil them when they were finished. That's a model that can result in spectacular successes or failures. We spent millions of dollars developing the TASER X3, a three-shot TASER that I still believe was a great weapon, it's one of my personal favorites, but it was a commercial failure and we barely sold any because it was just too big and complicated.

I'm glad that I learned that lesson early on, today no product is developed in a vacuum. We spend a lot of time listening to customers and what we're hearing is that the result of this means TASER 7, Axon Body 3 with LTE connectivity and Axon Records are all game changers and customers love them. And while we've been confident in demand for these products, we're increasingly confident about the timelines we've publicly announced, Q3 for Axon Body 3 and later in the year for Axon Records.

Making a slight pivot, I want to let you know – I want all of you to know that I have a book coming to market later this month. It's called The End of Killing. It's a personal project. I did not seek permission from the board before writing it because I believe it's a book that needs to be written, and I want you to hear about it from me. The subject involves my life's work and much of the work it acts on, which is using technology to solve one of humanity's oldest problems, the killing of people.

I've been giving talks around the country to champion this idea, and one thing that I ask audiences is to guess under what scenarios police are trained to shoot to kill. It's a bit of a trick question actually because police are not trained nor authorized to shoot to kill. Police are trained to shoot only to stop a threat. It just so happens that up until now, the best tools we've given them to stop a threat are lethal bullets. Killing is a technology problem, we're making a dent in it and Axon is well-positioned ultimately to help solve it.

We're getting a lot closer to competing with the handgun with TASER 7, and I think we'll get even closer with TASER 8. I've challenged our internal teams to develop a TASER weapon that outperforms a handgun as measured by time to incapacitation of a threat within the next decade, and I believe less lethal energy weapons will surpass the performance of kinetic projectiles within this same timeframe. The bullets days at the top of the force spectrum are numbered.

Speaking of TASER, let me turn the call over to Luke to do a bit of a deep dive on booting up TASER 7.

Luke Larson

President, Axon Enterprise, Inc.

Thanks, Rick, and thank you to everyone who could make it out to Axon Accelerate last week. We had nearly 2,000 attendees largely representing the top 1,200 U.S. agencies in law enforcement as well as attendees from police forces around the world. Our Axon Accelerate attendance was very intentional to get the right customers there. We also invited several analysts and investors and it was great that they got to see the excitement as well. One of our key goals for the year is to create a rabid fan base.

And I'm here to tell you at the event, we sold out our [indiscernible] (00:07:05) stuffed animals of canines. We sold over \$30,000 worth of T-shirts and Axon branded swag. We will never be complacent with building on our customer relationships, but selling out the stuff really blew me away. Of course, the purpose of the conference is not to sell T-shirts, we also generated more contract pipeline at Accelerate than we generated at IACP, a conference with over 10,000 people. Now IACP is still very important conference to us, but to me, these numbers are a great leading indicator that we're building the preeminent tech conference in public safety.

In February, I told you that I was laser-focused on three main execution items this year, ensuring the success of the TASER 7 launch, bringing Axon Body 3 to market and launching Axon Records. Let's drill down on the first one. We feel confident that TASER 7 will be a major revenue and gross profit driver for our business over the next several years. In Q1, TASER segment gross margins were pressured by two main factors, ASP, the average selling price, and scrap rates, both will improve over time and we're improving even as we speak.

On the ASP side, we're making the strategic decision to offer trade-in credits to major agencies, many of which were buying new TASER devices from us early as a year ago. We offer a prorated credit to incentivize customers to adopt TASER 7 sooner and this delivers a greater total customer lifetime value than if we waited for their existing TASERs to age beyond their useful life. So we're seeing some near term ASP compression related to these credits, but this was expected and will naturally fade out over time as existing devices in the field age, actually view this as an extreme positive. And then it means we've got a great response to our new weapon where customers want to upgrade early.

Now I want to touch on TASER 7 manufacturing yields and scrap rates which are all tracking to plan. Especially, we want to shine a light here for the benefit of our software-focused analysts and investors. Axon in specifically our TASER units has more than 25 years of experience in manufacturing TASER devices, and we've invested heavily in building out this capability. Anytime we introduce a new TASER, there is a production ramp that requires us to refine the production process.

Because TASER devices are used in tactical situations, we perform validation checks on every device before we ship it to the customer. If any part of the weapon does not pass our validation checks, we scrap it and improve the manufacturing process. This process is par for the course for historical TASER launches. With Taser 7, we're seeing a high demand and so we're ramping production more quickly than previous models. For example, our Q1 unit volume for TASER 7 is on par with the entire first year shipping of the TASER X2 which we introduced in 2011.

I feel very confident that we have clear line of sight to meeting customer demand while also improving yields with steady state production by the end of 2019. Regarding the other execution items, Rick already touched on those, we are very excited to talk more about Axon records once it is live with our first major city customer.

Now, turning the call over to Jawad.

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

Thanks, Luke, and thanks to all of you for joining the call today. April marks my two-year anniversary with the company and also coincided with the two-year anniversary of changing our name from TASER to Axon. I'm really pleased with our execution and how we've strengthened the business model over the past 24 months and I believe we're just getting started. As many of you know, we made a commitment to our investors to drive strong growth on the top line while also demonstrating leverage. And a lot of my day to day is spent ensuring we do exactly that.

I've done this before, grown a SaaS business while driving leverage and I'm thrilled that Axon is also proving that it can be done. In Q1, we reported strong revenue, and you'll notice that we're raising our full year revenue outlook by \$5 million while holding adjusted EBITDA guidance in line. This is very much by design. We've told our product teams that the way to earn more R&D budget is through the top line, but we're confident we can deliver \$80 million to \$85 million in adjusted EBITDA for 34% growth at the midpoint. The adjusted EBITDA margin will vary depending on revenue as we look to accelerate our investments in R&D.

With that said, as you can see from our guidance, with Q2 looking like Q1 in both revenue and adjusted EBITDA, we've set ourselves up for a strong back half with much higher margins versus the first half. Another important area of focus for us is corporate strategy including ways to grow our total addressable market or TAM. Today, we have a \$8.4 billion TAM, which primarily reflects our four strategic areas of investment, TASER, cameras and digital evidence management, Axon Records and Axon Dispatch.

As we look out longer term, we see a great deal of potential to extend Axon's growth outside of our existing scope. Our successful transition to both technology products and SaaS business leaves us incredibly well-positioned to develop new revenue streams. We have a unique opportunity to take the same products and feature set we've developed for law enforcement and find applications for enterprise users who want similar capabilities.

Axon has the right balance sheet, the right customer relationships and the right foundation of law enforcement technology products from which to expand. We're continually thinking about the best way to steward our capital and exploit our market leadership and ensure we do that in a disciplined way to drive shareholder value.

Thank you, everyone. And with that, we'll go to Q&A.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from Jonathan Ho from William Blair.

Jonathan Ho

Analyst, William Blair & Co. LLC

Q

Hi. Good afternoon, and congratulations on the strong results. I just wanted to start out with a question on, I guess, the TASER 7 impacts from, I guess, the credits that are being offered. Can you maybe quantify for us a little bit how that works and help us understand maybe how that works through the next couple of quarters as well as maybe over a longer timeframe?

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah. So when we launched TASER 7 and this is actually historical practice that we've used is we offer trade-in credits for customers that have weapons that are under the five-year useful life, and we have kind of a prorated calculation where if you were to, let's say, buy an X2 three years ago or two years ago and now you want to upgrade to a TASER 7, will give you some of the value of that useful life back in the trade-in credit. We usually use it to make sure that we smooth out good customer relationships, and again, I actually view this as extreme positive in that we're seeing major city customers that want to upgrade to the TASER 7 because it's such a fantastic weapon.

Jonathan Ho

Analyst, William Blair & Co. LLC

Q

Got it. And then just talking a little bit about Axon Records, you noted that the initial launch customer is getting pretty close at this point towards the back half of the year. But can you maybe highlight what they can do with your system versus what could not be done before, particularly since you're integrating some of the camera capabilities as well?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yeah. I'll take that one. So first, I would say we just came out of our Axon Accelerate Conference and I was talking with the head of Records just a few moments ago and we have a ton of customer interests across the board, and we've been doing some demonstrations with various prospects across the country and getting very positive feedback. So the way to think about Records is our launch product will have a couple of very unique features. Probably the most unique feature is the ability to integrate your digital evidence seamlessly in with the Records, so we call it video at the heart of the Records.

So if you think about having your video in a totally separate system you have to log into, it is just a much clunkier experience, whereas the way human beings communicate now, we don't really send text-only messages or documents very much. We tend to communicate using pictures, video, text, even emojis. Even our correct Records system won't have emoji, it will have a very integrated audio/video capability along with the text elements. So that's sort of the way to think of it at the outset.

And then we've just really done a nice job. The team has – and hitting all of the basic foundational work that you're not doing duplicate data entry for three different forms that there's a dynamic input form experience, so

you're inputting only the data that's necessary based on the type of report you're filling out and that can grow, if one incident end up being a stolen vehicle and a felony assault and some other thing historically might require several different reports be filled out in sort of duplicate data entry. So that's sort of the foundation.

But what really will differentiate us over time is that we're evolving the use of AI to extract video from the audio data center. So this is where having both hardware and software is unique advantage for us. So Axon Body 3, we spend a lot of time tuning it with a multiple microphone array to be able to optimize how we handle voice data that's coming in, so we can describe it more accurately and be able to have AI models that over time will learn when the officer asks what is your name, the next statement is likely to include the first name and last name and to begin to extract that information and prepopulate the report.

So I'll just wrap. I think at our conference, we talked a bit about how – if you think about autonomous driving, we're calling this autonomous report writing. And actually, it's not as difficult a problem as autonomous driving is, but it will evolve in several stages. So we're at sort of stage zero to one right now which is all about getting all the basic data structure right, so that we can begin to optimize some of the AI data extraction using our smart sensors when those go live this summer as well. So launch of Axon Body 3 and Records really complement each other in that Axon Body 3 [indiscernible] (00:18:01) optimized to begin moving into this AI-driven future.

Jonathan Ho

Analyst, William Blair & Co. LLC

Q

Thank you.

Operator: Your next question comes from Mark Strouse from JPMorgan.

Mark Strouse

Analyst, JPMorgan Securities LLC

Q

Hey, good afternoon. Thanks for taking our questions. So it sounds like you can't divulge too much information yet about the major city that's adopting Axon Records, but are you able to say was that a competitive displacement? And then, are they adopting your entire solution as it stands today or are they kind of cherry-picking certain modules?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

I'll take that one. So this was a customer that's been a development partner. They did look at the available options in the Records space, but there we've been primarily focused heavily on developing the Records system with them. So you can think of it with them as a standalone that it's not part of a bigger economic package. This is really focused on developing the Records system.

Mark Strouse

Analyst, JPMorgan Securities LLC

Q

Okay. And then congrats on getting the Redaction Assistant out the door. I guess can you just kind of talk about based on the trials that you've run so far kind of the efficiency gains that new customers are seeing? I think you guys are throwing out this data as multiple hours in the past for certain minutes of video. I mean is that process now down to minutes of Redaction? Maybe you can compare that to kind of your prior Redaction tool and see if some of the other competitors that are out there?

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yeah. So, great question. So, we just launched. One of the launch partners was a city prosecutor that was meticulously tracking the time that we're spending on Redaction and before the Redaction Assistant compared to afterwards, once they deployed Redaction Assistant, the city attorney reported they were spending 80% less time per video on Redaction and that actually was going to lead to a change in how they budgeted. They wouldn't need to budget for more people to be able to do the Redactions. So that's the one that comes to mind. We're a little early in the game in terms of having a bunch of agencies, but that first feedback of 80% was pretty enlightening. Our target was to reduce Redaction times by at least 50%. It looks like we're outperforming that.

Mark Strouse

Analyst, JPMorgan Securities LLC

Q

Got it. Okay. And then just one more quick one if I can for Jawad or Josh. Can you just remind us when the TASER 7 upgrade, your credits end? And I guess kind of secondary to that, do they kind of dwindle down over time each quarter?

Luke Larson

President, Axon Enterprise, Inc.

A

Hi, Mark. Yes, absolutely, they do go down over time. They will start to – so we had an offer in Q4 of last year and went down as of Q1, it is staying flat Q1 and Q2, and then it is declining every quarter after that. So, essentially, that's done to be fair to customers but also to draw some urgency around upgrade cycles. So you'll see a lower trade-in credit as of July 1 compared to what we're offering this quarter.

Mark Strouse

Analyst, JPMorgan Securities LLC

Q

Are you able to say does that completely end though by the end of 2019 or does it drag on into 2020?

Luke Larson

President, Axon Enterprise, Inc.

A

We are planning to assess that decision at the end of the year. So I think I can't really give an answer there other than they'll continue to decline through the end of this year and we'll assess it in December.

Mark Strouse

Analyst, JPMorgan Securities LLC

Q

Okay. Thank you very much.

Operator: Your next question comes from James Faucette from Morgan Stanley.

James E. Faucette

Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you very much. I wanted to ask – maybe for Jawad. Can you just walk us through a little bit – one thing that kind of I look at is when you see the magnitude of upside versus your guide for the full year – I don't think it's a big deal, but I just want to make sure I understand the puts and takes of why maybe the guide for the full year isn't at least as much as is what the upside was in the first quarter.

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

Yeah. So what we're actively doing, we're making a conscious decision to reinvest the upside from revenue into the business. When we came in at 2019 as you put together our budget process, we were oversubscribed, there were more things that folks wanted to do than we had the budget for. And so what we said was that as we progress throughout the year as we feed on revenue, we're going to let – basically take that and reinvest it into the business. And so that's what we're doing. We've raised our guidance for the year on revenue but we've held it on EBITDA.

James E. Faucette

Analyst, Morgan Stanley & Co. LLC

Q

Got it. Okay. That's clear. And then I guess I'll open it up to whomever but as you're rolling out – just thinking about long term as we're rolling out the different software products and its applicability beyond just police forces, et cetera, how do we think about the opportunity beyond that and what needs to happen to even start to expand it further into whether it's court systems, prosecutors' offices or even more broadly within the emergency response – within your emergency response deal? Thank you.

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah, so oftentimes, these first responder units will use the same technology platforms, and we've actually seen some very interesting inbound demand from these adjacent markets. We are being pretty tightlipped for competitive reasons on our exact approach. I would say we're definitely looking at the adjacent public safety spaces in addition to making a strong push into the federal space as well as international markets as well.

James E. Faucette

Analyst, Morgan Stanley & Co. LLC

Q

That's great. Thank you.

Operator: Your next question...

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Yeah, this is Rick. Let me add one more detail, one thing that I think will really help make body cameras more appealing in additional markets is once they are real-time connected and can live stream, I think that just opens up a whole bunch of additional use cases from the traditional – where we've been so far which is record an event and then some hours later, you dock the camera and that information becomes available. Being able to live stream that information opens up as you can imagine just a whole host of different types of services that I don't think we even understand yet.

Once the camera is out there, we believe this is one of the things it will evolve and we'll iterate together with our customers. But I think that both in law enforcement and for these other markets – like for emergency medical services, being able to live stream video from a scene using a system that has made law enforcement public safety and HIPAA types of regulations to be extremely valuable for emergency room positions or others to be able to see what's happening out in the field. So that's just one example of where that live connectivity we think really could open up the available markets that we'll be interested.

James E. Faucette

Analyst, Morgan Stanley & Co. LLC

Great. Absolutely. Thanks.

Q

Operator: Your next question comes from Scott Berg from Needham.

Scott Berg

Analyst, Needham & Co. LLC

Hi, everyone. Congrats on a good quarter and thanks for taking my questions. I guess we'll start on the FedRAMP side, Rick, or maybe Luke wants to take a question. How should we think of what products are going to be sold into that area? Is it going to be TASERs, cameras, drones, software? Help us understand what that opportunity looks like.

Q

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

Yes. Basically all of the above. Our options – now, we have been selling TASERs historically to the federal markets, but they've not been using our cloud services, so FedRAMP now opens up the entire platform up to FedRAMP Moderate, which covers most of the use cases for all of the above, for fleet, in-car systems for body cameras, for federal agencies to start using Evidence.com for managing their TASER weapons. And certainly, we think drones could be an interesting space there as well.

A

Scott Berg

Analyst, Needham & Co. LLC

Got it. Helpful. And then on the – I guess, Jawad, on the future contract value, it's up nicely, a little bit less than 50% year-over-year. But your new bookings in software and sensors is down. How should we think about that metric? My guess is there's some camera movement in there given the expectations of some of those sales are being pushed off to the second half when AB3 is ready?

Q

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

Yes.

A

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

Yeah. The first thing I'd say – so Josh is here with us today, so I'd love for him to weigh in. One of the first things to note is that in Q1 last year, we had a large – a very large international booking, about \$30 million. If you strip that out, we were actually up year-over-year. And then Josh, would you like to add color?

A

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

Yeah. I'd say the Q1 results in video bookings are purely at this point seasonality. I think Q1 is kind of our softest quarter of the year. Sometimes there is a large one-time or like was the case – a lot last year in Q1. But I certainly have a lot of confidence that this is not a sign of kind of anything to worry about. I actually think we're going to have a very strong rebound in the next few quarters in terms of Axon booking. So Q1, people get new regions, people have new quotas, we have the sales meeting, first week of the year is kind of a dead week, so it's just

A

naturally kind of our slowest quarter of the year. And again, I think there's a lot of reason to be optimistic that that number bounces back.

Luke Larson

President, Axon Enterprise, Inc.

A

And I would just add, your – I think your comment on AB3 was correct. We announced AB3 [indiscernible] (00:28:30) at IACP in October, and then re-emphasize all of the capability that Rick addressed with the [indiscernible] (00:28:39) and live streaming. And so we expect that to start shipping at the end of Q2, and we think that will – end of Q2, beginning of Q3, we think that will drive to high demand.

Scott Berg

Analyst, Needham & Co. LLC

Q

Great. That's all I have. I'll jump in the queue. Thanks, again.

Operator: Before we move to the next question, I'd like to remind people to please limit to one question and a follow-up. Thank you. Your next question comes from Will Power from Baird.

William V. Power

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

Q

Yeah. Great. Thanks for taking the questions. Yeah, first one, maybe a bit of a follow-up perhaps for Rick or Luke. But I'd just qualitatively love to get your perspective or color on conversations that accelerate around AB3 and how you're thinking about the pipeline and what customers are perhaps most excited about with that product. I guess as part of that, should we expect something similar to AB3 to what we see in TASER 7 with respect to potential trade-ins and credits, how do we think about that? What that might mean for gross margins in the back half of the year.

Patrick W. Smith

Chief Executive Officer & Founder, Axon Enterprise, Inc.

A

Got it. So yeah, one of the really nicest surprises, I would say at Accelerate this year was just how much interest there was in the live connected services. When we first really started talking about live services with our customers, there was a lot of questions about whether that's something that they would actually use and we decided to go all-in. Our customers – almost all of our customers are on a hardware upgrade program, and we could have chosen to do an AB2 plus where we could have done a next-generation body camera and focused on cost optimization on the hardware and met our financial obligations.

But we felt the right thing to do was to extend ourselves and actually make this a really powerful camera upgrade, so while our customers are effectively on the iPod upgrade program, we're giving them an iPhone, and we believe that was the right thing to do because it basically enables a whole host of new services that we could begin to sell once the hardware can support real-time connectivity. I would say a year ago, that was a little bit dicey, it was not the super easy decision to make in that as we were calibrating with customers, it was not universally clear that they would basically value those connected services enough to want to pay for them. And I think we put that concern largely to rest this year.

I think our team has done a really good job of understanding what the customer use cases are and I'll give you one example. So one of the downsides you worry about, sometimes with police union management relationships is if it's seen as a micromanaging tool where the chief is going to be walking in on his cell phone remotely and trying to micromanage the scene, that is a sort of thing that customers would absolutely not react well to.

But when we help them understand, hey, if you're going into a situation where you're just uncomfortable that you as an officer could activate the live stream and ask your fellows to watch your back and know that other people are going to be able to see what's happening and begin to rally support if they see it's starting to go downhill, right, because sometimes before an officer calls, their intuition is starting – calls for help is starting to – they're starting to see things and make them uneasy, and for us to give them the ability to share that with the rest of their team actually gives them a real sense of comfort going into the unknown.

And I think as a result, somewhat of the positioning and a lot of great work the products done in the product design, every customer I talked to this year was very interested in the connected real-time services. And maybe every customer might be an overstatement, maybe some other people on team might have found some customers that were less interested. But I would say it was a real homerun making the move to include LTE and Axon Body 3.

William V. Power

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

Q

Okay. Great. Yeah. And just any color from – I guess, anyone on the team on how to think about gross margins for just really the broader sensor segment in the second half of the year as AB3 rolls out?

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

Yeah. So what we expect is that we're not going to like [indiscernible] (00:33:13) we're not going to really see any – there is no trade-in credit on the body camera, and those margins – we're managing that segment to about 25% margin, and we expect that that will continue in the second half.

William V. Power

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

Q

Okay. Great. Thank you.

Operator: Your next question comes from Steve Dyer from Craig-Hallum Capital.

Ryan Sigdahl

Analyst, Craig-Hallum Capital Group LLC

Q

Hey, guys. Ryan Sigdahl on for Steve Dyer. Quick question as it relates to guidance. So in the press release, you expect significantly higher growth rates in the second half of 2019. But based on Q1 actual, Q2 growth of 16% to 17%, it implies something like 16% to 20% in the second half of the year. So that basically brackets Q2 expectations. What am I missing there?

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

I don't think you're missing anything. We expect that Q2 is going to look very similar to Q1 and we're really ramping up for a strong second half.

Ryan Sigdahl

Analyst, Craig-Hallum Capital Group LLC

Q

So the significantly higher growth rates in the second half of the year, just maybe some color there on that comment.

Luke Larson

President, Axon Enterprise, Inc.

A

Sure. We'll be in full production on TASER 7 and shipping...

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

Shipping AB3.

Luke Larson

President, Axon Enterprise, Inc.

A

...AB3 and going into Q4 with shipping our Records product as well.

Ryan Sigdahl

Analyst, Craig-Hallum Capital Group LLC

Q

All right. Sounds like a little bit of conservatism done in that 2019 guidance. Based on that, secondly, just on the TASER 7, what – of the orders in the quarter, what percentage were upgrades versus new users? And then what percentage of those TASER 7 orders received trade-in credits? Thanks.

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah. So, just if I understand the question correctly, it's what percentage – we kind of view every customer as being a previous TASER customer. The question is what percentage are using the trade-in credits at this point. I think the majority of the deals would have some trade-in credit.

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Yeah. By definition, the only ones that wouldn't are ones that never have deployed TASERs before.

Ryan Sigdahl

Analyst, Craig-Hallum Capital Group LLC

Q

So just to clarify that, so it's anyone that has a TASER gets a credit, not just ones that are under the five-year useful life warranty?

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Correct, but it's scale to how old the weapon is. So by far the least valuable trade-ins are the ones that are older than five years, and the most valuable ones are the one that are within one year old and it just scales throughout the life cycle of the weapon.

Ryan Sigdahl

Analyst, Craig-Hallum Capital Group LLC

Q

Great. Thanks, guys. I'll turn it over from there. Good luck.

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

George J. Godfrey

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

Q

Thank you. Two questions. Jawad, is the 300 to 400 basis point margin improvement on an annual basis now off the table?

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

Yeah. George, we – at the beginning of the year, we changed our guidance. We're still over the three-year period, managing to driving leverage in the business. And what we said specifically for 2019 is that we're going to deliver \$80 million to 85 million in adjusted EBITDA. Now the margin rate, the reason we don't want to guide to that specifically is that's going to vary depending on where revenue comes in. And given that we've committed to reinvesting any additional revenue into the business, the margin rate is going to be really difficult for us to guide to. So rather than guide to that, we're guiding to \$80 million to \$85 million in EBITDA.

George J. Godfrey

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

Q

Okay. So just so I'm clear is we could have that type of improvement in any given year. But are you saying the three-year accumulative will average out to that range, so that's still on the table or no? I just want to make sure I understand that.

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

When we put together our budgeting for 2019, for 2020, our expectation is that we're very much going to be driving leverage. And again, if it turns out that it's 300 to 400 basis points, what we really are looking at – when we set our budget, for example, for the \$80 million to \$85 million, we wanted to stay within that range. When we put together a budget for 2020, it'll likely be in the same range as well. We want to consistently year-over-year continue to drive our EBITDA margins up. But again, what we're really more focused on is not so much. What we want to do is invest in the business and make the right investments in R&D to capture this opportunity ahead of us while at the same time driving leverage, but it's both of those, we're not prioritizing a specific margin target.

George J. Godfrey

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

Q

Okay. And then looking at the balance sheet, DSO this quarter 117 days. Q1 two years ago, that was 51 days. Is that the new level we should expect going forward?

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

No, that's an anomaly. And what we're seeing is that as we expected, we did our follow-on offering. There was a greater shift to subscription, many of these invoices are paid annually in advance, it's a different model. And as we're making this transition, we're working with our customers to make sure that we're working with them and doing what's right for them and helping them transition to these longer term – or sorry, these recurring contracts. And so that's something that, in that transition, we're experiencing a bit of an anomaly but we don't expect that to continue.

George J. Godfrey

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

Q

And can you give an estimate for CapEx? And that's my final question. Thank you very much for the answers.

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

So we're anticipating in the range of \$12 million to \$15 million for the year.

Operator: Your next question comes from Jeremy Hamblin from Dougherty & Company.

Jeremy Hamblin

Analyst, Dougherty & Co. LLC

Q

Thanks, guys. Congress on the good results. Wanted to come back to the weapon segment for a second, and you've had some nice traction thus far on the TASER 7 but in terms of thinking about the kind of the units and how they're going to play out the remainder of 2019, the growth that you might see in that segment from the TASER 7, how do we expect that in terms of taking over the total units that you sell in 2019 given the trade-in credits and so forth versus what we saw in the first quarter, we had about 25,000 of the legacy units and about 9,000 of the TASER 7?

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Yeah. I'd say the expectation is TASER 7 becomes a larger percentage of total handles sold in each quarter. I think as we rolled out T&E units and so forth, it's going to take time for TASER 7 to scale to that point. And there is some international orders and it was Q4 in the UK, our Q1, so X2 is the only legal weapon there. So some of those dynamics led to selling more smart weapons than T7, but over time, our expectations and what we're driving toward is making sure that T7 becomes the most commonly sold handle as we go throughout the year.

Jeremy Hamblin

Analyst, Dougherty & Co. LLC

Q

To be more specific, yeah, as we get into, let's say, Q3, Q4, would you expect T7 to be at least 50% of the total units sold?

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

I'm not sure I can give a specific number because again, it does rely on – like if there is large international deals in process with other units or if there's a big one-time order of X26P or X2, if it kind of temporarily skew the numbers. But we certainly expect the trend to be that T7 becomes a larger and larger percentage of total handles sold throughout the year.

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah. And I think we have a very illustrative chart from our road show that shows how we've been very effective at transitioning to the new technology from the original X26 to the X26P and the X2 and we would expect our execution to be the same as we transition to TASER 7.

Jeremy Hamblin

Analyst, Dougherty & Co. LLC

Q

Okay. And then one other question on Axon cloud service revenue. You saw your gross margins fall down 90 basis points sequentially and down almost 500 basis points from where you were a year ago. Can you give me a sense just in terms of that change, what's driving that and how we would expect that to play out at the remainder of 2019?

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

Sequentially, we're not really seeing much of an impact. There's always – there's some cyclical, but our pure – the pure software component of that is still flat, it's a very high margin. It could be driven by the mix of lower margin professional services, so that's something that that tends to weigh in up but again, that's part of the cyclical.

Jeremy Hamblin

Analyst, Dougherty & Co. LLC

Q

Okay. Thanks, guys. Good luck.

Operator: [Operator Instructions] The next question comes from Keith Housum from Northcoast Research. Keith Housum, your line is open.

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

I'm sorry. Can you hear me now?

Luke Larson

President, Axon Enterprise, Inc.

A

Yes.

Jawad A. Ahsan

Chief Financial Officer, Axon Enterprise, Inc.

A

Yes.

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

Sorry about that, [indiscernible] (00:42:54). Can you guys provide a little more color on the FedRAMP opportunity? First-off, is that included in the \$8.4 billion TAM, and perhaps some numbers around how many are perhaps potential users out there?

Luke Larson

President, Axon Enterprise, Inc.

A

Yeah. So today, our TAM is largely focused on municipal law enforcers. As we look to grow that over time, we see federal being a very real opportunity to get deeper penetrations into the federal police forces but also our ultimate goal would be to have the actual like big Army and more penetration into the larger operating units.

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

Sorry, right now, that number is not including of the FedRAMP, your \$8.4 billion opportunity?

Luke Larson

President, Axon Enterprise, Inc.

A

No, it's not.

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

Okay. Got you. And then as a follow-up question, can you just provide a little bit color on the international efforts during the quarter and how they were comparing to last year and how – I guess, some of the RFPs are looking for the rest of the year?

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Sorry, you are looking for an update on international weapons?

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

International overall weapons and the body sensors [indiscernible] (00:44:15)?

Joshua Isner

Chief Revenue Officer, Axon Enterprise, Inc.

A

Yeah. Certainly, that's been where most of my attention is focused along with the T7 upgrades. I think we're seeing a lot of good indicators. Our Tier 1 markets are performing well, upgrading weapons, consolidating video contracts and so forth, I think we're starting to see some really good signs even back in the last year in Tier 2 markets and I'd expect to see that momentum continue into some of our Tier 2 markets this year. So certainly, the expectation we're working towards is

[indiscernible] (00:44:49)

Keith Housum

Analyst, Northcoast Research Partners LLC

Q

Great. Thank you.

Operator: And there are no further questions at this time. I will turn the call back over to the presenters.

Luke Larson

President, Axon Enterprise, Inc.

Great. Well, thank you everyone for a good Q1, and we will talk to you on the next earnings call. Thank you.

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

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