



Axon Enterprise, Inc.

Third Quarter 2018 Earnings Call

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PRESENTATION

Operator:

Good afternoon. My name is Christine and I'll be your conference operator today. At this time, I would like to welcome everyone to the Axon Enterprise, Inc. Reports Third Quarter 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. If you would like to ask a question during this time simply press star, then the number one on your telephone keypad. If you would like to withdraw your question press the pound key. Thank you.

Luke Larson, President, you may begin your conference.

Luke Larson:

Good afternoon to everyone. I'm Luke Larson, President of Axon. Welcome to Axon's Third Quarter 2018 Earnings Conference Call. Joining us today are Axon's CEO and Founder, Rick Smith, and our CFO, Jawad Ahsan. Before we get started, Andrea James, our VP of Investor Relations, will read the Safe Harbor statement.

Andrea James:

Good afternoon. This call is being broadcast on the Internet and is available on the Investor Relations section of the Axon Enterprise website. During our call we'll be making references to our reported results, which you can find by reading our quarterly shareholder letter, which is available at investor.axon.com and on the SEC website.

Statements made on today's call will include forward-looking statements, including statements regarding our expectations, beliefs, intentions, or strategies regarding the future, including statements around projected revenue growth and profitability.

We intend that such forward-looking statements be subject to the Safe Harbor provided by the Private Securities Litigation Reform Act of 1995. This forward-looking information is based upon current information and expectations regarding Axon Enterprise. These estimates and statements speak only as of the date on which they are made, are not guarantees of future performance, and involve certain risks, uncertainties and assumptions that are difficult to predict. All forward-looking statements that are made on today's call are subject to risks and uncertainties that could cause our actual results to differ materially. These risks are discussed in greater detail in our annual report on the Form 10-K and our quarterly reports on the Form 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 for filings under the AAXN ticker.

Okay. Turning the call over to Rick.

Patrick Smith:

Thanks, Andrea. Welcome, everybody. We've got a lot of exciting momentum at Axon. We expect to finish the year strong and believe our latest product innovations set us up for a fantastic 2019. For those of you who did not get a chance to come to IACP in Orlando and fire the TASER 7, I want you to know that it is a game changer. We don't introduce a new weapon every day, so I thought I'd take a moment to walk you through what we really built with TASER 7.

We essentially reinvented the TASER weapon from the ground up. We looked at all the factors that can lead to an ineffective use and engineered significant improvements on each of those factors.

Throughout human history, lethal weapons have always been the only truly reliable way to stop people. We've gotten to the point now where TASER weapons are getting very close. And as you know, our goal is to make the bullet obsolete.

Fundamentally, we believe that society's gun problem is a technology problem and TASER 7 is a big step closer to solving it. We rigorously analyzed the reasons why bullets can be more effective and more reliable than a TASER weapon, and we looked at all the technical limitations and then invented ways to overcome those limitations to make the TASER weapon more effective. We completely redesigned the entire cartridge system, spooling the wire now inside the darts, which makes the darts heavier. They retain velocity better and because we spool the wire out through a nozzle in the center of the dart, we use the drag from the wire unspooling to stabilize the dart in flight. This design keeps TASER 7 darts really stable, whereas, historically, the wires were folded in the cartridge and the unfolding of the wires actually caused the darts to oscillate, which can cause darts to ricochet off a target depending on the angle of flight at the exact moment of impact.

We also designed TASER 7 to hit with more kinetic energy. We have accelerated the dart and the wire all at one time, and so now when it hits it has more mass and at higher velocity. The tips of the darts are also now designed to break away on impact. So if you hit somebody at a glancing angle, historically, the momentum of the dart might cause it to bounce at an angle and ricochet off the target. Now with TASER 7, the tip of the dart will actually break off and stay in the target if the body of the dart is at an angle where the momentum would have previously carried it away. The dart might ricochet off the target because of the physics around the dart, but instead of that bounce ripping the tip out, the tip will now stay in and the system can achieve incapacitation.

These designs lead to better clothing penetration, which make the weapon more effective, especially in cold weather when people are wearing winter jackets. This has historically been one of the challenging situations with things like heavy leather jackets. TASER 7 improves performance in these scenarios.

We also looked at the way we deliver the electrical charge, and we spend a lot of time thinking about how to maintain the margin of safety of the weapon while improving the electrical stimulation to make it more effective. TASER 7 delivers the same quantum of electrical charge but in a shorter time period. The shorter pulse creates greater current intensity and makes it more effective at stimulating skeletal muscles, while still maintaining similar cardiac safety. We then increased the number of pulses delivered every second from 19 to 22, which further increases muscular impairment. We call these refinements Rapid Arc, denoting both the more rapid charge delivery and the more rapid pulse repetition frequency.

Now all TASER weapons deliver charged voltage but at an extremely low current. The strength of the current from these devices is about three orders of magnitude below the current you can get from a wall outlet. And we'd remind our new investors especially, the point with TASER is not to deliver pain but to deliver neuromuscular incapacitation by overwhelming and mimicking the brain's own signals to tell the muscles what to do. This is why TASER weapons do not rely on pain compliance like the traditional stun gun. So we preserve the same margin of medical safety at the same time we optimize the pulse delivery to achieve better incapacitation.

We also designed a new feature called Adaptive Cross-Connect, which gives a whole new meaning to the term smart weapon. The weapon actively measures and optimizes the charge according to the spread with up to four darts in play.

Now everything I've told you in the last minute or so may sound like abstract technical concepts, but when you see the effect on a human volunteer you will quickly see why these refinements matter. It is significantly more effective. So to a layperson looking at a TASER 7, they might see, well, it's a weapon that fires two sets of darts and wonder what makes it so different from the X2, our previous two shot

weapon. And the answer is, everything. Everything that is under the hood that makes it more reliable and more effective. I have not seen as much excitement about a new TASER weapon since the X26, which we introduced back in 2003. Customers who've seen it absolutely love the new TASER 7. I believe TASER 7 creates a super-compelling upgrade proposition for every existing TASER customer, which effectively resets our ability to drive a whole new upgrade cycle. Plus there are some really important convenient factors. The dock-and-walk capability makes it super-fast and reliable. So you can integrate your TASER 7 into Evidence.com, and you never even have to think about it. Just swap your batteries once a month and we move the data in the background.

TASER 7 also drives the concept of TASER as a service. We're seeing proof points of early adoption with several major agencies that are field-trialing TASER 7 and two major agencies are already committed to full deployment.

Also exciting, after some time—a period of time of capturing data about TASER, we'll be able to start surfacing up insights to officers and their managers to inform officer performance and help them perform better.

So well, TASER 7 is really a fantastic product, and customers love it. So is the new Axon Body 3, which you've probably read about. We're going to talk more about Axon Body 3 as we bring it to market in the middle of next year, but it's our first real-time connected body camera with LTE built-in. Also exciting is Fleet 2, which we just announced in June and we're already shipping to customers. Fleet 1 was our disruptive entry into the in-car market, and Fleet 2 has been racking up competitive wins and sets us up to extend our leadership inside the vehicle. So our product teams are really on a roll and if any of them are listening right now, I want to thank you guys for the amazing and hard work you're doing. These new products are a bridge to keep growth momentum going while we scale up Axon Records. All of our new hardware products drive software revenue because we're really driving adoption of connected devices and the software to manage it all.

Speaking of Axon Records, we're making Axon Records' core functionality free for agencies who sign up for the new TASER 7 Officer Safety Plan, and we're making it free for the full five year period. By core functionality, we mean basic reporting functions. So after an officer shows up at a scene and performs an action, the officer then fills out an incident report about what happened. Our mission is not just to make the incident report a little bit better. Our mission is to make that entire manual form-filling process obsolete. So our goal is to disrupt the entire manual data entry process, and that's why we chose to do a strategy to maximally reduce the friction of market adoption. We see the real value in Records is in the data, not in the form-filling software. We have the largest data set in public safety. We're now at over 40 petabytes—that's 40 million gigabytes. Aggregating the text records in the same system as the video means that we can create a uniquely powerful training set for our AI team to build out the models that extract the incident report right from the video. Freeing officers from typing in data will be something on the order of a—an order of magnitude more valuable than the best form-filling software could ever be. So we're streamlining our pathway to that future.

Now speaking of software, we're thrilled to report that our annual recurring revenue in the Software and Sensors segment has surpassed \$100 million in the quarter. We all knew it was coming, but it's a milestone worth highlighting because it underscores our leadership in developing cloud software for law enforcement.

To be clear, our annual recurring revenue of \$102 million refers only to software and warranty revenue. It does not include hardware in that number. The way we approach the market and strategy—our strategy is to identify where the market is going and then look at what we can do to accelerate existing trends in a way that creates unique customer value and a competitive advantage for us. We've been successful doing that to date, and we're excited to keep that going.

With that, I'm going to hand off to Luke.

Luke Larson:

Thanks, Rick. I think there are three key themes to this quarterly update. They are that we've got strong product development momentum, we're seeing an exciting 2019 sales pipeline, and we continue to focus on driving margins, leverage, and profitability. Let me give some more color about our product momentum and sales pipeline.

In particular, in the last decade that I've been at the company, TASER 7 was the most successful product launch that I've ever been a part of. The International Association of Chiefs of Police conference is a big deal for Axon. It's one of the two major marketing pushes we have each year, the other being Axon Accelerate, which is our user conference. At this year's IACP, we had close to 3,000 customers visit our booth, which featured the ability to fire the new TASER 7 as well as sample our new virtual reality empathy training. At IACP, we put 2,500 chiefs through this shooting experience. The new TASER 7 features were incredibly well-received, and I'm confident in saying that this offer creates certain demand for a compelling upgrade cycle.

Our sales team are also pretty excited. They haven't had a new TASER to sell in several years, and so we think we are well positioned for an incredibly strong 2019. We also had more than 2,500 guests attend a party for TASER 7 and Axon Body 3, where we unveiled the product, followed by a concert from the band OneRepublic. Our marketing team made an incredible tribute video that was played by the band and a chief took an iPhone video of it and shared it online. It was viewed over 6 million times. Jawad has asked me to give you a friendly reminder that the OneRepublic concert was sponsored by Verizon.

Our partnerships with both Verizon and AT&T for FirstNet also sponsored portions of our IACP presence that were hugely synergistic because they're building a nationwide LTE network dedicated to first responders and we are the market leader in connected devices that can communicate over those networks. We believe we'll see an inflection point next year in reliance upon those networks and Axon Body 3 is perfectly timed to leverage that inflection starting in the back half of next year.

The other thing I'd like to update you on is a recent incident we had with a major customer. A VIEVU LE5 camera overheated and no one was hurt, but this did attract some press. You will recall that we acquired VIEVU, a competing body camera provider, in May of this year. I'm pleased to say that we've reached a resolution with the large customer in question. That customer will accelerate their transition from VIEVU cameras to Axon Body 2 cameras and Axon Evidence. The transition may result in some incremental Q4 expense, which Jawad will discuss, but overall this is an excellent long-term development for Axon to accelerate that major customer moving over to the Axon network. Axon is proud to join forces with agencies to make their body cameras a success. Every new customer on that network benefits the others.

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

Jawad Ahsan:

Thanks, Luke. We feel great about delivering another quarter of solid performance, but more importantly, we feel confident about the underlying strength of the business, our strategic direction, and ability to drive meaningful growth going forward. At our Analyst Day one year ago, we projected a three to five year CAGR of 16% to 20% revenue growth with continued margin expansion, and today, we feel very confident about that trajectory. As we approach the final month of the year, we're tracking to hit the midpoint of our revenue guidance. Q4 is typically our strongest Weapons quarter, but this year, we have a

lot of customers trialing TASER 7 for shipment in 2019, so Weapons will be lighter than usual and we expect Software and Sensors to carry most of the growth.

You heard the level of enthusiasm from Rick and Luke around product innovation, particularly the ability to drive substantial volume and margin from TASER 7, which sets us up really well for 2019. We expect a modest contribution from TASER 7 in Q4 with a more significant ramp next year.

Our 2019 sales pipeline looks strong. In addition to TASER 7, we expect growth to be driven by a full year of shipping Axon Fleet 2—which is proving popular with customers—international expansion, and several points of Axon cloud SaaS growth.

Before we go to Q&A, I want to expand on one of the points Luke mentioned regarding a large domestic VIEVU customer that's accelerating its move to the Axon platform. We may have some cost absorption associated with this move in Q4. We're actively working to minimize the impact to our Q4 P&L, but we believe we can absorb a material amount of expense and still produce Adjusted EBITDA margins for the full year within our guidance of 14% to 16%. For the long term, moving VIEVU customers over to the Axon network is a great outcome and provides us with opportunities to deliver even more value-added services to these customers.

Thank you all for dialing in today. And with that, I'll turn it back to Andrea.

Andrea James:

Thanks, Jawad. Just really quickly before we go to questions, I wanted to remind you, last quarter, we had said that in the spirit of being scrappy, we were going to ask most of our investors to listen via webcast and save the conference call line for those asking questions. It's actually thousands of dollars worth of savings per year. So I just wanted to thank those of you who are listening via webcast today for doing your part and helping us stay scrappy.

Operator, let's go to questions.

Operator:

Thank you. In order to ask a question please press star, then the number one on your telephone keypad. We will pause for just a moment to compile the Q&A roster.

Your first question comes from the line of Yuuji Anderson from Morgan Stanley. Your line is open.

Yuuji Anderson:

Thanks for taking my question. On the large customer transition off of VIEVU, outside of the planned replacement there, were there additional body camera rollouts that were originally slated for Q4, and if so, is there a delay there in that rollout because of this activity that's now built into guidance?

Patrick Smith:

Yes, so this is Rick. Some of us have been back and met with the customer there. This is creating a little bit of a delay in the program in that there was a shift. The decision to accelerate over to the Axon body cameras, obviously, it takes a little bit of effort to pivot their supply chain and to make that happen. So it will push out, I think, by the end of February is the goal now to get the complete rollout done.

Yuuji Anderson:

Okay. That's very helpful. And then my second question is sort of a—just broadly on body camera deployments. Anticipation of Body 3, are you seeing customers pausing before that? And can you just remind us broadly how you're handling expected replacement activity before the slated launch?

Luke Larson:

Yes, so the majority of our body camera customers buy on one of our service plans where they get a tap upgrade, and so that allows them to transition to the latest body cameras. So we haven't really seen any kind of blip in demand through Q4 and we expect this to be strong right up until the launch of AB 3.

Patrick Smith:

Yes, the one thing we've learned, by including hardware refreshes in our subscription plan it really does reduce some of the sort of discontinuity that might happen when you introduce a product when people are waiting for the next one. We did want to introduce AB 3 early enough before launch to have our customers have time to put it in their procurement cycle. Also, we felt this year was a really transformative year for the LTE networks with both Verizon and AT&T FirstNet really pushing hard to get these mission critical networks live. So we made the conscious decision to go ahead and announce AB 3 a little further in advance than we would have been with a normal product launch. But what we're hearing from our customers is for the most part they can buy and get started on an AB 2 and just take the AB 3 during their upgrade cycle. So we're feeling pretty good about how things will balance out.

Yuuji Anderson:

Okay, great. Thank you so much.

Operator:

Your next question comes from the line of Scott Berg from Needham. Your line is open.

Scott Berg:

Hey, everyone. Congrats on a great quarter and thanks for taking my questions. I have two. Let's start with that large deal on the old VIEVU cameras that you had mentioned. Rick, I just wanted to understand is there any additional revenue opportunities there? I understand they chose the VIEVU solution over Axon initially because it was more of a price-driven decision versus functionality. And with the new Axon body cameras is there an opportunity for some uplift there in the revenues? And then secondly, since they're bringing on Evidence.com as a result, is there some maybe incremental revenue opportunities there?

Patrick Smith:

Yes, so the way I would characterize this is right now, this is all about helping an important customer that had a challenging situation and we're investing in the relationship. So this is not to create any short-term revenue opportunities, but we believe one of the things that makes us different is we do not allow programs to fail and I think that's what we're demonstrating with the customer in question here. You know, for them to go through to buying incremental services that are not part of the contract, there's a lot of processes they would have to go through. We've basically taken the approach that "Hey, we're going to help you meet your goals and get these cameras live, and we're going to focus on making sure this program is successful." I'm very confident that that will lead to long-term revenue opportunities. But now wasn't the time for us to be having those types of conversations with the customer. We had to help them

through a difficult spot and we think that's the right thing to do. In our history has shown that that pays off in really long-term profitable relationships.

Scott Berg:

Got it. Helpful. And then my follow-up would be—maybe it's for Luke or Jawad—is on the new TASER rollout. A big push to that rollout, at least from a marketing perspective, was to push the Officer Safety Plan and to adapt these via, obviously, via the subscription model. I wanted to hear if you had any feedback from customers on kind of that thought process or what the pricing looks like there and maybe how should we think about those expectations as we go into '19. Does that actually be a little bit of springboard to shift more of those sales to the OSP than a product-driven sale?

Luke Larson:

Yes, so we would expect the majority of the TASER 7 deals to go on a service plan. We've got two kind of great higher-end offerings with the Officer Safety Plan 7, which is \$149 a month, and that includes TASER 7, the AB 3, Aware, and our core RMS offering. We have an expanded offering, OSP 7 plus. It's \$199 a month. That includes all of that plus some additional software capabilities around performance, CAD, RMS integration, AI redaction. And so, one of the great things about going to IACP is oftentimes, you would hear customers, their first question is, "What's the price?" I think you know you've got a winning product when they don't even ask about the price. They're just really excited about the compelling features that Rick talked about. And so we've seen just a really positive response thus far to TASER 7.

Patrick Smith:

Yes, one thing I would add as well, in those two sort of different versions of the Officer Safety Plan, the Officer Safety Plan also includes some of the really intensive data streaming, like live video, etc. So those are price points that are significantly up over the \$99 to \$109 that the Officer Safety Plan has been at historically. Early indications are customers are seeing the value, both between TASER 7 and between the connectivity. When you take a camera and turn it into a live connected sensor, all of a sudden it's not just something that can help you after the event. It can help you during the event and with real-time information. So, for our customers it creates a ton of value and obviously, for our shareholders it's a compelling opportunity to continue to drive up ARPU.

Scott Berg:

Thanks again, very helpful. I'll jump back in the queue.

Operator:

Your next question comes from the line of Keith Housum from Northcoast Research. Your line is open.

Keith Housum:

Good afternoon, gentlemen. A question for you on the new product offering with the RMS and the pricing arrangement. I know it's only been out there for about a month or so and my understanding is the RMS has generally turned over very slowly, but with the offer of 5-year free licenses are you seeing interest in some of the agencies actually looking to accelerate their replacement of the RMS?

Patrick Smith:

I'd say it's probably early for us to characterize whether we're seeing that big of a shift in the overall market. I would say we have a lot more people asking about records in the context of it being included in the new Officer Safety Plan. So I would characterize it's had a generally positive response, but it's early for us to characterize if it has shifted the market yet in a material way.

Keith Housum:

Got you. Can I just follow up on the issue with the large customer? Presumably, now you're going to have excess cameras in inventory. What is the opportunity to sell those cameras, I guess, to other agencies? And then are you seeing any pushback from people who are currently using the LE5 model? Are they looking also to perhaps put those back?

Patrick Smith:

So the incident report that came back showed that this was a battery that was damaged, basically, with a paper clip being inserted aggressively and puncturing through the wall and the battery cell. We are also making some modifications to make that more bulletproof so it's hard to do that. But our analysis is that it's not a defective product and I think as we've had that conversation with customers, they're comfortable and they understand that as well.

I think it was just a bit unique in that the large customer that experienced the issue, it was right in the middle of a transition point and given the complexities around deploying at scale and all the issues in a large city, that there, the customer worked with us and really wanted to accelerate the transition over to AB 2. Frankly, our assessment was that's not a terrible outcome, right? That this sort of shows the value of the system that we built, that we have a major customer looking to accelerate their move over to Axon and the Axon Body 2. In terms of the—this does free up—we had cameras that were on order that were slated for delivery to that customer. We do believe that there are markets, both U.S. and international, where we can sell those cameras. At least that's our current plan. So it's—we're feeling pretty good about where we ended up, that it sets us up really for long term success.

Keith Housum:

Great. Thank you.

Operator:

Your next question comes from the line of Charlie Erlikh from Baird. Your line is open.

Charles Erlikh:

Thanks for taking the question. Just one for me. Is there any change to the margin outlook longer term, specifically in the Software and Sensors segment given all the growth opportunities and investments around those opportunities?

Jawad Ahsan:

Yes, Charlie. No, there are no changes at this point in time. We're still sticking to our full year guidance, also maintaining our guidance for the out-years. We said we're going to drive leverage in the business to the tune of about 300 to 400 basis points in margin. We changed that earlier in the year to Adjusted EBITDA and with the investments we're making in Records and Dispatch, we're very excited about those markets and about those products in particular. And so we're going to be walking the line between driving

leverage in the business and making investments in these new growth opportunities, but at this point in time there's no change to that.

Charles Erlikh:

Okay. Thank you.

Operator:

Your next question comes from the line of Jeremy Hamblin from Dougherty & Company. Your line is open.

Jeremy Hamblin:

Thanks for taking the questions. I wanted to just ask about the Axon cloud revenues. Little bit lower growth in that—in the quarter than we'd seen. Wanted to just get a sense of whether or not—is that a function of just fewer licenses that were activated from your backlog in the quarter or what drove a little bit lower growth in that sequentially?

Jawad Ahsan:

Yes. We're seeing typically normal growth that we've seen in that segment. We didn't see anything in the quarter as far as deployments or installs that was out of the ordinary.

Patrick Smith:

Well, I'm sort of curious where you're drawing that conclusion from that growth was lower than expected.

Jeremy Hamblin:

Just in terms of what the run rates of—from Q2 to Q3 and where the run rates had been flowing from, let's say, Q1 to Q2 or Q4 from last year to Q1.

Patrick Smith:

It's just—I'd say we probably will just take a look at that and we can have a conversation with you offline. But there was nothing that caught our attention that was indicating any sort of slowdown.

Jeremy Hamblin:

Understood. Just—and then another question, I may have missed it, but in terms of international sales in the quarter, what was that as a percent of total sales? And then just an update in terms of, you know, you reported a really nice large order, you know, non-English speaking country. Do you continue to—what kind of progress are you seeing again in those kind of non-English speaking countries, in Europe or otherwise? Just an update there.

Luke Larson:

Yes. So we've been really pleased with our country managers that are managing APAC, EMEA, as well as the Americas. In Italy, in particular, there was a fairly large trial that has now moved to the next phase of the trial where they've expanded from what was essentially six major municipalities in Italy to expand

that to up to, I believe, 50 cities in Italy to continue the testing. So that's a key milestone in that market. As we look to 2019, we feel really good about International contributing at the same level that it did this year.

Jawad Ahsan:

And Jeremy to answer your question specifically, it's through nine months of year-to-date, International is 20% of our overall revenues. That's up 34% year-over-year.

Jeremy Hamblin:

Great. Thanks so much for taking the question. Good luck.

Jawad Ahsan:

Thanks. Thanks, Jeremy.

Operator:

Your next question comes from the line of Jonathan Ho from William Blair. Your line is open.

Jonathan Ho:

Hi. Congratulations on the strong quarter. Can you guys hear me okay?

Patrick Smith:

Yes.

Jonathan Ho:

Perfect. So I just wanted to get a little bit more detail on the Axon Records launch. Can you give us a little bit more color in terms of what you're hearing in terms of feedback from customers and maybe what they're most excited about as they start to test the solution more?

Patrick Smith:

Yes, so what customers are really excited about is that we're taking a very different approach to the problem set, which is what we're not building is sort of a product that is optimized sort of for going through the RFP box checking exercise. I think that's what's led to a lot of really sort of overly complicated and hard-to-use software. The thing that we're really focused on is just crushing the user experience for the things they do day in and day out, where it's all about making that officer able to operate efficiently all the way through the chain of those reports getting through approvals, etc., and ultimately automating the creation of the police report so that cops aren't spending half their time sitting with a keyboard typing stuff up. And we're getting just a ton of excitement. In fact, we had one major city that had recently made—gone through a major RMS, RFP and acquisition process, and we thought they were off the table for a decade. And they're back talking with us already, saying, "This is really interesting. The vision you guys have laid out, if you can deliver on this, we're interested in taking a look and engaging with you," which to me again, was a very pleasant surprise to see an agency less than a couple years out of a major RFP process putting their hand up and saying they're interested. Yes, it's going to be a lot of fun in 2019 as we start to roll this out into the marketplace. Going to be pretty exciting.

Jonathan Ho:

Perfect. Just wanted to also follow up on Fleet 2. Just wanted to get a sense from you guys in terms of how does that look in terms of the initial reception, win rates? I know it's pretty early but just wanted to get some perspective in terms of how we're doing on that as well.

Luke Larson:

Yes. Fleet 2 has been really well received by the market. We've had several customers comment on just the ease of use with the cloud-connected features, which really differentiates us from these kind of large incumbent, burdensome hardware-centric options. We've had really strong performance there. I would expect Fleet to continue to grow as a percentage of our Software and Sensors business, and we're taking share from the incumbents, and we feel really good about its momentum.

Jonathan Ho:

Great. Thank you.

Operator:

Your next question comes from the line of Mark Strouse from JPMorgan. Your line is open.

Mark Strouse:

Yes, hey, everybody. Thanks for taking our questions. So if we can just talk about the kind of the shape, I guess, of the revenue curve for the weapons business. If I remember right, you guys have talked about that being kind of a long term, low double-digit grower. This year, year-to-date you're tracking around 10% or so. If I'm reading your comments, though, correctly, I mean, it sounds like there could be some acceleration in that over the next certain period, 12, 18, 24 months. Not looking for a specific 2019 guidance, but just kind of generically, are you expecting that to accelerate near-term?

Jawad Ahsan:

Yes, that's a fair assumption, Mark, and I think you could probably hear the enthusiasm in our voices about TASER 7 and about the new OSP, how positively they've been received. So at this point in time, we have no update to the guidance. So I'd still say that your assumption of low double-digit growth is a good one, and I'd say that's very conservative.

Patrick Smith:

Over the contract life—I would just say, over the contract life, TASER 7 significantly increases revenue per users because we're increasing with new software services with the dock, with the end-user certification plan. So not only do we think it obviously could open up new markets with its new capabilities. It can accelerate our ability to go back and upsell the installed base but also significantly raise revenue per user.

Mark Strouse:

Right, it's good. And I know it's only been a month or so since the 7 was announced. But can you just talk about what you're hearing from recent buyers of the X2 or the X26? And do you think that the—I believe there's a trade-in credit for those customers. And if so, just kind of talk about if you think that's at an appropriate level to drive upwards of those customers.

Joshua Isner:

Hey, Mark, this is Josh Isner. So we have not had any cause for concern in that regard. We feel that our customers are excited about the trade-in program, and our customers always know that we will never let them fail in any way. So we've—this has been kind of a non-event for those customers and we're doing right by all our entire installed base of weapons.

Andrea James:

So that was Chief Revenue Officer Josh Isner.

Mark Strouse:

All right. Thanks, Josh. Thanks very much.

Operator:

Next question comes from the line of Steve Dyer from Craig-Hallum Capital. Your line is open.

Ryan Sigdahl:

Hi, guys. This is Ryan Sigdahl on for Steve Dyer. Within bookings, S&S bookings, can you break out either the dollar value or the percentage representing 10-year contracts?

Jawad Ahsan:

It's a very small portion. It's—we've signed a few recently, and so we've seen an increase in 10-year deals. But overall, it's still relatively immaterial.

Ryan Sigdahl:

And then maybe just a follow-up on that. Is that primarily at the customer's request? Or are you guys—I mean, 5 years has been the standard for a while. And are you guys now actively trying to move these to 10-year deals? Or was it very specific instances with these customers?

Joshua Isner:

They're customer requests and for us to enter into those deals, we've got to be satisfied with the long-term economics of those. So they're very rare and mainly driven by customer requests.

Ryan Sigdahl:

And then one more for me. Sorry to beat a dead horse here, but with the VIEVU customer that you were talking about, is this a full transition for that department by February? Or will they still have some of the LE4s in service and this is just a transition for all the incremental units?

Luke Larson:

Yes. So they have multiple thousand units already deployed and we're going to keep those in the field. For the remaining units that were yet to be deployed, we're going to transition those to Axon Body 2 and then, we would see kind of on their next upgrade cycle those would all—of the entire deployment would move over to Axon Body 3.

Ryan Sigdahl:

And then maybe, I guess, just one follow-up on that. Then, I'll turn it over. So how difficult will it be then from a back-end user standpoint from Evidence.com to use the LE4s with some officers and then some officers using the Axon Body?

Luke Larson:

Yes. We're going to make it a success and a seamless transition for the customer. So we're really kind of partnering with them on what's the right way to handle that. And we're very confident they're going to see the benefits of the Axon network, and we're actually delighted that we're going to get the opportunity to roll out that with the AB2 sooner than expected.

Ryan Sigdahl:

Thanks guys. I will hop back in the queue. Good luck.

Operator:

Your next question comes from the line of Saliq Khan from Imperial Capital. Your line is open.

Male Speaker:

Hello, this is Reed Matelski (phon) on behalf of Saliq Khan. We are wondering with the improvements of a TASER 7, how does this rollout coincide with the sunset of the law enforcement agencies' existing conductive electrical weapons?

Patrick Smith:

Well, so there's many agencies who bought the X2 or the X26P when those were first launched in the 2011, '12 time frame. There's just a ton of upgrade opportunity there. So having a new weapon—and frankly, we even have agencies that were still using the older X26E, where for whatever reason they have not made it a priority to upgrade those into the current generation of smart weapons. I believe, based on seeing customer reactions, that all of those people are now an opportunity. TASER 7, just it really hit the customer's sweet spot, where I think it's going to be pretty compelling across the board. We've got a lot of customers that have TASERS that are more than five years old that are really primed for a new device.

Male Speaker:

Got it. Thank you. With your service platform push, are TASER weapons beginning to replace guns? And is the total ownership cost of a TASER weapon actually cheaper than a gun?

Patrick Smith:

Yes. I would say the total ownership is cheaper in two respects. One, with firearms there's a lot of training that's required that if—training means cops are coming off the streets, and it's really expensive infrastructure; and two, when you shoot somebody it's really expensive, not just in dollar terms but in terms of litigation, in terms of officer—post-incident, a lot of officers end up leaving the profession. So TASERS save money and they save lives. Now we're not in a point yet—even with TASER 7, it's not yet a replacement for a firearm. We're still, I'd say, about a decade away from where you would start to think of non-lethal weapons as being a legitimate substitute, but we make a big step in that direction. This is one

of the reasons I would think the subscription plans are really compelling to our customers. It's, "Hey, we've got a road map to where over the next decade we're going to outperform even the lethal weapons and when you go on one of our subscription plans," it basically puts them on a program into the future with us, where they know that they're going to get those upgrades as they come available. I've got a number of chiefs tell me that that's one of the reasons they go with us is they trust us as a technology partner across the whole platform—the software, sensors and weapons—to sort of help them transform their agencies on a continuous basis where we're rolling out new software, new hardware, etc. So we're not quite there yet to make the bullet obsolete, but we're making progress.

Male Speaker:

Thank you and just one last one. Given the body cam's AI capabilities would you consider partnering with gunshot detection companies to improve detection and location of the gunfire?

Patrick Smith:

Sure. I mean, we're open to—we generally purchase from the perspective that we need to be open to—have an open platform to collaborate with the entire ecosystem of technology providers so that our customers—they've got difficult job to do and them worrying about a bunch of siloed information systems is not where we want them to be. So we're certainly—we've become, I think, the preeminent cloud software network and we have open APIs and we work collaboratively with our customers and other tech providers.

Male Speaker:

Thank you and thanks for fielding our questions.

Patrick Smith:

Thank you.

Operator:

Your next question comes from the line of George Godfrey from CLK. Your line is open.

George Godfrey:

Good evening and thank you for taking my question. Do you have the TASER weapon operating margin for the quarter there?

Patrick Smith:

Hold on a second. We're getting that for you.

George Godfrey:

And then my follow-on question to that, do you expect the TASER 7, given the higher price point, to be margin positive? To have it come at a higher margin? I believe 40% was kind of the target range a couple of years ago. It seems like it's down around 30% now. Just curious, will that have a lifting effect?

Jawad Ahsan:

Yes, we are expecting TASER to lift the margins overall. The gross margins for the quarter were just under 70%. The operating margin is in the shareholder letter. One thing I'd say is operating margin is not at all meaningful the way that we think about margins. We look at gross margins for Weapons, and Software and Sensors separately and we'll look at Software and Hardware at the gross margin level, but below that it gets a little bit scrambled because we make investments in SG&A across both segments. Some of the allocations are disproportionately hitting TASER than they are Software and Sensors. We'll look at R&D by product line. We go into a lot of depth on that. But SG&A, we budget outside that process. And also, we want to control SG&A, and we've demonstrated that over the course of the year. We've driven a lot of leverage on our SG&A cost. It's lower now as a percentage of revenue than it was a year ago. That's part of the reason we've been able to drive our overall margins up across the business. So for that reason, I'd say it's not all that meaningful to look at operating margins by segment, but it is in the shareholder letter.

George Godfrey:

Okay, let's—Jawad, thank you for that. That's a nice segue because that's exactly where I wanted to go, is if I look at the R&D margin, two years ago it was 10%; a year ago, 16% and now it's 21%. I heard everything you said about being scrappy, but it's more than doubled in two years. And if I look at the SG&A—and I realize there is stock comp and amortization, intangibles, and other things in here, but it's only gone from \$39 million to \$38 million. So it seems like the R&D spend is far outpacing any improvement in SG&A. So my question is, as we go forward from a 21% level, what exactly does the scrappy mean when it applies to R&D?

Thank you for taking my question.

Jawad Ahsan:

Yes. Great question. So scrappy does not apply to R&D. We're pretty open about that within the company. I'm a big proponent of investing more in R&D. We've targeted around the 20% range, and so we have some very exciting market opportunities. This is part of what we laid out on our last Investor Day and at IACP. There are these huge market opportunities ahead of us, and we've got to invest to go capture those. And so we're not going to take our foot off the pedal with those R&D investments. What we are going to do is drive discipline across the business. SG&A, so that's—it's coming down. You should expect to see us drive further leverage there. But what I'd point to is that the overall enterprise, our margins are ticking upwards and will continue to tick upwards over the next few years.

Patrick Smith:

Yes. I mean, at this point, we've got this incredible asset in that we've connected two-thirds roughly of the major cities now to the Axon network. Now to take that and begin to scale out with Records and Dispatch and all the AI capabilities, analytics we can run on top of that network, all of which gives us the opportunity to build and create additional value streams. So yes, we're all about being scrappy in terms of efficiency and making sure that we're being careful how we spend the money, but we also don't want to throttle our ability to grow well into the future by cutting back on our investments in R&D given that we have this really unique competitive advantage and then we can launch new services right within the same framework that our customers are already using. And we think it would be unwise for us to over focus on short-term profitability and leave those opportunities unharvested.

George Godfrey:

Understood, thank you. If I can just slip one more in here. The EBITDA—Adjusted EBITDA margin for the year is 14% to 16% of the range, and for the first nine months, you're at 16.5%. So there's a lot of room in

Q4. Can you just qualitatively or in some measure quantify how difficult is it going to be to transition 2,000-plus body cameras by February for the large VIEVU customers? It seems like there's enough wiggle room here that you could absorb a very expensive project. I'm just trying to get an idea of how expensive or complex that task is.

Jawad Ahsan:

Yes. So this issue, their development center is still unfolding. It's going to depend on exactly which cameras are deployed, how many of each are deployed, how much development work is required, if any, what the transition will look like. There's several factors that go into this and so, for that reason, it's—we're unable to determine at this point what the costs are going to be to transition that customer. So we wanted to reserve—we wanted to maintain some conservatism there as far as our Q4 estimates.

George Godfrey:

Thank you, Jawad. I appreciate it.

Operator:

Your next question comes from the line of Glenn Mattson from Ladenburg Thalmann. Your line is open.

Glenn Mattson:

Hi. Thanks for taking the questions. Operating margin in Weapons was 27% by the way. It was in the release, so there's that figure. But I'm curious about the excitement you guys have seen around the new weapon. I was at IACP also, and certainly, there was a lot of excitement around the booth and everything and—but that's always the case for you guys. You put on a good show down there as usual. There's a significant price point, and I think, if I'm not mistaken, the first new deployments that you saw were the agencies that just took the weapon and didn't take the whole pricing plan. So I was wondering if—what the reasoning behind that was, if there was some sensitivity around the Officer Safety Plan and the increased price there or anything. Just kind of some more concrete evidence about why you're so enthusiastic about the uptake as we look into 2019.

Luke Larson:

So one of the greatest assets that the company has is our TASER instructor network, and so over the next year, we're going to be rolling out an aggressive campaign to hold these events in multiple cities at a high frequency. Since IACP, I've already been to two of these events where we have essentially a roomful of police trainers and we talk about TASER 7. The excitement in the room is palpable in terms of they want this weapon, they want the capabilities, and that's something where it carries through to them going back, talking about officer training and how this is really going to benefit communities. And that goes a long way when you're getting kind of stakeholders to buy in for it. So to me, that's just an incredible data point that's hard to communicate in numbers, but when you see literally hundreds of police officers excited for the device, that's giving me a lot of confidence. In terms of those first two deals, we had actually been talking about those deals before we kind of had the final pricings and stuff bundled. So we really wanted to lock in a couple key launch partners. So I wouldn't read too much into them buying on a program. We were just trying to secure them as launch partners.

Patrick Smith:

Yes, exactly. And I would tell you as well, AB3 is going to be a couple quarters behind the TASER 7. So I would expect we're—we may see more decoupled sort of TASER 7 programs before AB3 really starts

going into field trials, which is fine. That's actually in our interest to continue to accelerate and make sure that we're able to shift and deliver revenue on the TASER 7. And then this happens fairly regularly where as we launch new customers, new features or new products, the customers will come back and they'll do contract upgrades and rewrites. We just—as Luke pointed out, with TASER 7 those customers, we are obviously showing the product to them much earlier in the process to where the new Officer Safety Plans weren't even really fully baked and we did not want to introduce any additional uncertainty and complexity of AB3 into those projects. There is already enough uncertainty with the new TASER 7 weapon, so we focused our sales team on those—in getting those across the goal line.

Glenn Mattson:

What's the pricing like when it's sold as a standalone? Have you released that?

Patrick Smith:

Yes. It's—so the all-in pricing is typically \$60 a month. Sixty dollars a month is what we call a certification plan that includes the weapon, the docks, a subscription plan for all the cartridges they need for training, the online training, the VR empathy training, etc. Then there's a \$40 a month plan where they just get the weapons and docks and then they buy cartridges and training à la carte. So some of the early wins as well, I think, were on the more basic plan because we haven't fully fleshed out the full certification plan. So again, a lot of this was we were in with these customers while the product was still sort of getting finalized in terms of the go-to-value—go-to-market proposition. But you basically expect between \$40 and \$60 a month.

Glenn Mattson:

Okay. So that's like \$500 a year and they're five year lifespans usually, right? So that's \$2,500 basically is one way to think about it. Does that increase from the \$1,200 or so that the prior weapon would sell at? With the dock—

Patrick Smith:

Yes. A good portion of that does go into—yes.

Luke Larson:

We will have an Evidence.com license that'll be like \$7 a month, and then there are some allocated to the cartridges, but the overall economics are—

Patrick Smith:

(Inaudible) in the numbers we gave you. Luke was just saying some of that revenue—that revenue doesn't all come in upfront. A good portion of that is service revenue over the life of the weapon and warranty and cartridges and training services.

Glenn Mattson:

Right. Okay, great. Thanks guys. Good luck.

Patrick Smith:

Thank you.

Operator:

Since there are no further questions at this time, I will now turn the call back to Management for any closing remarks.

Patrick Smith:

All right. For those of you who came out to IACP, it was great to see you there so you could look the customers in the eye and take their temperature on our new products. For those of you that weren't, I'd encourage you to come out to the show next year. Obviously, we're really excited. I think we've now got a lot of opportunity ahead of us. It's all about execution now as we roll into 2019, but a lot of opportunity for us. We just got to deliver on it. And our mission is stronger than ever and the opportunity in front of us is better than ever. Thank you to our shareholders who have been with us for, some of you, for more than a decade, and we'll be back to see you guys with our end-of-year results and we look forward to talking to you then.

Operator:

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