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TASR - Q2 2017 Axon Enterprise Inc Earnings Call

EVENT DATE/TIME: AUGUST 08, 2017 / 8:30PM GMT



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CORPORATE PARTICIPANTS

Arvind Bobra

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

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

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

CONFERENCE CALL PARTICIPANTS

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

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

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

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

Saliq Jamil Khan *Imperial Capital, LLC, Research Division - VP*

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

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Axon Enterprise Q2 2017 Financial Results Conference Call. (Operator Instructions) As a reminder, this conference call may be recorded. I would now like to introduce your host for today's conference, President of Axon, Mr. Luke Larson. You may begin, sir.

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

Thank you, and good afternoon to everyone. Welcome to Axon's Second Quarter 2017 Earnings Conference Call. Joining on today's call from management are Rick Smith, CEO and Founder; Jawad Ahsan, CFO.

Before we get started, I'm going to turn the call over to Arvind Bobra, our Director of Finance, to read the safe harbor statement.

Arvind Bobra

Thanks, Luke. Our earnings are available on the SEC website and our Investor Relations site. The identical release contained in the 8-K will be crossing the wire momentarily.

This call is being broadcast on the Internet and is available on the Investor Relations section of the Axon Enterprise website. Please note that the earnings release as well as supplemental materials, including our key operating metrics, are available on our website.

Today, we will open the call with prepared remarks. We will follow the prepared remarks with our standard live question-and-answer session. 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 spending. We intend that such forward-looking statements be subject to the safe harbor provided by the Private Securities Litigation Reform Act of 1995. The forward-looking information is based on 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 the risks and uncertainties that could cause our actual results to differ materially. These risks are discussed in

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our press release we issued today and in greater detail on our annual reports on Form 10-K and quarterly reports on Form 10-Q under the caption, Risk Factors. You may find these filings as well as other SEC filings on our website, www.axon.com.

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

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

Thank you, Arvind, and good afternoon, everyone. We just finished our first quarter since rebranding the company as Axon, and our recent results underscore the timeliness of our name change.

I am thrilled to report record Axon bookings of \$82 million for the second quarter, approaching \$10 million higher than any other prior period. And future contracted revenue continues to grow. At \$446 million, we're rapidly approaching the \$0.5 billion mark.

Our record bookings reinforce our strategic direction and validate our innovation leadership. We continue to consolidate and win market share because we're make compelling solutions for our customers.

And while we welcome the signing of large customers, the increase in bookings in the second quarter came from a diverse group of agencies. This speaks to the quality of our expanding technologies and the trust that law enforcement officers have for us across the board, that also leads to greater predictability in our performance over the long term as we generate recurring revenues from a larger and growing customer base.

The quarter was very strong, but we're just getting started. Our pipeline of new product offerings has never been better, and we continue to expand our international footprint. Our in-car Fleet offering, which began shipping in the second quarter, and our international bookings combined represented less than 10% of total bookings in the period.

As we continue to receive very positive feedback from Axon Fleet, we expect our solution will gain wide adoption and become a larger contributor to both bookings and in turn, revenue.

Once again, this quarter, for agencies which added Fleet to their orders, we saw annual contract value per user was approximately double our average. Early feedback from customers has been encouraging, and one customer that reached out, saying, "I'm so confident in Axon, their product and their people, I'd be more than willing to host additional agencies here, so incumbency, Axon Fleet themselves."

We had 2 very significant win-backs of agencies who had previously deployed a competing body camera solution. After extensive testing and evaluation, Alameda County, one of the major county sheriffs' offices, converted over 1,200 officers over onto the Axon network. And Boulder, Colorado deployed 200 Axon Body 2 cameras as well as 50 Fleet vehicles.

Our cloud-connected in-car view system is one more integrated capability that increases the total value of the Axon network and our ecosystem for our customers.

While international accounted for a small portion of bookings in the quarter, we continue to gain traction in our target markets that should lead to increased bookings in the next few quarters. Law enforcement agencies across the world, which tend to be larger and more centralized than domestic agencies, are beginning to recognize the challenges associated with organizing and analyzing a massive influx of digital evidence. This provides us with a clear and compelling opportunity for our products just as it does in our domestic markets.

As we expand to new geographies, we will continue to put the right people in place to grow the Axon network abroad. I am particularly excited about some of the great work our team in Australia is doing and the traction we have on a variety of opportunities across the country.

One key customer, the Queensland Police Service, has been studying the use of Axon solutions in domestic violence. With over 21,000 domestic violence-related files now in EVIDENCE.com, they have seen a 22% increase in reported assaults, coupled with a 60% to 70% decrease in police



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summary hearings, meaning offenders are taking pleas rather than going to court in light of strong video evidence. This ensures more fair and efficient pursuit of justice in these cases.

And as a result, Queensland recently expanded the number of Axon cameras and licenses from 2,700 to 5,000 starting earlier this summer. Queensland took appropriate pride in announcing that this is the largest rollout of body cameras in Australia and the third largest in the world.

Turning to product pipeline. One of our new technologies, it is particularly timely given some recent events, is the Signal Sidearm, which we announced earlier this year. Signal Sidearm is a wireless technology that alerts body cameras when a firearm is removed from an officer's holster. Our solution is unique in that it wirelessly alerts every camera within a range of about 30 feet and is compatible with existing holsters.

When law enforcement officers must draw a weapon, the last thing they should worry about is their technology. The Axon network gives officers the confidence they need to focus on the work they do. It also assures the public that transparency isn't limited to certain situations.

Considering some of these recent events, Signal Sidearm is needed now more than ever and releasing this product is imperative to allow our Axon cameras to capture escalated encounters.

It is also an important step in extending the reach of the Axon network to connect to other devices. Signal Sidearm is in trial now and will be ready to ship later this year.

Sheriff Leon Lott of Richland County commented to CNN that he's "very excited about this new capability, which will provide a new level of transparency to his agencies."

Our technological innovation is central to the work we do, and just as our team at Axon works diligently to develop cutting-edge products for law enforcement, we work with the same measure to protect what we have built. We aggressively defend our innovative technologies and reject any efforts of competitors to trade on our goodwill and reputation for quality. We have a proven track record in litigating these cases of patent infringement against infringers, and we regard a recent injunction in July against a competitor as a huge success. We shut down the third consecutive infringer.

We believe we're also well positioned as it relates to outstanding litigation regarding Video IP. We felt it's important to make our position clear as we are seeing what we believe are some misrepresentations perpetrated by others on the public domain.

In terms of our national free trial offer, the program continues to be a success. We've had over 1,500 customer inquiries about the offer, and it's serving to restart or accelerate discussions with agencies across the country. We currently have many trials in place. And additionally, as customers learn more about our connected solutions, several of them have decided to bypass the trial process and proceed straight into procurement. This, again, is telling us how compelling our offering is for the needs of our customers. And we've been so pleased with the outcome of trial here in the United States that we've extended the offer to all law enforcement agencies in Canada.

We're now more than halfway through 2017, and I'm excited for the road ahead, from our bookings, to our free trial, to our exciting new technology solutions, we have tremendous momentum moving forward.

I remain excited about the opportunity in our domestic and international weapons businesses. There's so much more to come as we introduce new hardware product, develop record management systems and release our artificial intelligence capabilities.

And with that, I'm now going to hand over to Luke Larson to go through the operational update.

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

Thanks, Rick. We had an exceptional bookings quarter and strong revenue this quarter. I'm proud to share the highlights of our accomplishments.



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Bookings on our Axon platform were \$81.9 million in the second quarter, an increase of 14% compared to the second quarter of 2016 and an increase of 36% sequentially. As Rick mentioned, this is a record for the company and speaks to the increased demand for the multiple capability sets we are offering on the Axon network.

Annual recurring revenue in the second quarter was \$54.7 million, including the contribution from international customers, an increase of 18% sequentially and 159% over the prior year.

In the second quarter, we booked approximately 20,600 incremental new seats on our Axon platform. That brings our cumulative total booked seats to 169,000 since inception and represents 14% growth sequentially.

Operating income for the TASER Weapons segment was \$17.6 million at a 33.2% margin in the second quarter of 2017, up \$15.1 million at a similar margin in the prior year quarter. The increase was driven by a 10% increase in weapons units and a 40% increase in cartridge units, partially offset by higher selling, general and administrative expenses.

The ratio of lifetime value of a customer to the customer acquisition cost in the second quarter was 5.4x, up from the 4.3x in the prior quarter on higher new booked seats. As a reminder, this ratio was calculated only including current product at current price levels. We strongly believe the true value of each customer will be significantly higher as we are able to add premium service tiers and new products.

We had several notable bookings in Q2 as we continue to lead the market. We closed another major city that moved to full deployment of our body camera and EVIDENCE.com platform to over 4,000 patrol officers. We're working with this agency on the announcement but wanted to make sure this was noted as contracted in Q2. This win is yet another example of the trust and confidence large cities have in our platform and solution.

I'm particularly pleased with the incremental contribution Fleet provided to bookings this quarter. The Fleet bookings demonstrate how we are expanding our ecosystem through technology innovation.

Additionally, this quarter, we won a small in-car Fleet deal with an incumbent competitor. In fact, we've won several recent deals from incumbents. In the top 1,200 agencies, we won 12 deals in the quarter away from competitors. In aggregate, these 12 deals represented over 4,000 new booked licenses. Displacing an incumbent provider is never an easy undertaking, however, the benefits of our work flows and technology leadership far outweigh the near-term inconvenience for these agencies.

I'm very proud of these wins as they reaffirm our R&D efforts are well placed in generating strong returns.

In June, we held our second annual Axon Accelerate conference, and it was an absolute success. We had over 600 attendees, and our customers were very excited about the solutions we're bringing to market to meet their needs and pain points. The conference featured 47 interactive sessions with our customers and provided them with an opportunity to learn about our new offerings and provide a feedback. We surveyed conference attendees, who rated the event 4.7 on a scale of 1 to 5. We believe Accelerate will become a unique conference to help our customers adopt to rapidly accelerating technologies and also give us a chance to promote our new platforms.

At the conference, we also previewed our Records Management System offering. Initial feedback on the solution and its intended capabilities has been very positive. Customers trust our vision and ability to execute, and several are willing to commit to us even though our solution won't be available until next year. As a reminder, we are currently working with several partner agencies to develop and trial an early version of the product. Most important, we left Axon Accelerate with a high level of confidence that the value we are delivering to our clients is well established.

In addition, the efforts we are making to extend our technology offerings are in the right areas for our customers and will translate into increased revenues over time.

We have tremendous energy and momentum as we move forward, and I'm really excited about the strength of our team and the opportunities of our integrated solutions that we're bringing to law enforcement.



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And now I'll turn it over to our CFO, Jawad.

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

Thanks, Luke. We're coming off another strong quarter with great momentum in the business. Revenue in the second quarter was \$79.6 million, a 36% increase from the prior year period.

Year-over-year growth was driven by more than doubling in Software and Sensors segment revenue and a 16% increase in Weapons segment revenue. Software and Sensors segment revenue represented 33% of total revenue in the period. A \$13.4 million year-over-year increase in Software and Sensors segment revenue to \$26.6 million was attributable to a 161% increase in our Axon service revenue and a 66% increase in hardware revenue as we shipped over 36,000 cameras in the quarter.

This quarter's record camera unit volume was driven by filling Flex 2 backlog, shipments to international customers and contractual upgrades on customers who have hit the 2.5-year mark on their 5-year contracts.

The second quarter also included \$650,000 in catch-up service revenue previously held pending fulfillment of contractual terms or milestones.

A \$7.5 million or 16% year-over-year increase in Weapons segment revenue to \$53 million was driven primarily by an increase in international revenue and a small increase in domestic revenue. International revenue growth was driven by our continued focus in our Tier 1 markets. Domestic weapons growth was limited as certain Q2 opportunities moved to Q3.

Further, domestic weapons sold on our TASER 60 and OSP payment plans dropped to approximately 25% in the quarter or 35% in the 2017 first quarter. As a reminder, we recognize the full purchase price of the weapons upfront on these payment plans. Despite the lower contributions from these programs in the second quarter, we still grew our Weapons business in the period, with higher contribution from the TASER service plans moving forward.

Total international revenues in the second quarter increased \$6.9 million or 105% from prior year to \$13.4 million. The growth was driven primarily by an increase in Weapons revenue as well as an increase in Video hardware and service revenue. (inaudible) our Smart X2 TASER Weapon in the United Kingdom is limited compared to the 2017 first quarter for the longer-term opportunity in the U.K. and (inaudible).

Annual recurring revenue, which captures the growth of our subscription-based business, at the end of the second quarter was \$54.4 million, representing an 18% or \$8.5 million growth sequentially as we converted approximately 17,500 domestic seats to paid seats. However, we temporarily excluded the revenue in ARR from 4,500 seats in the quarter pending the contracts that we expect to complete later this year. (inaudible) addition of international seats in ARR this quarter.

(inaudible) \$81.9 million were up 14% in the prior year. This represents a \$10 million increase from the 2016 second quarter bookings. As a reminder, the year-ago quarter included the \$20.5 million LAPD win. This further underscores the strength of the recent quarter's record bookings which weren't reliant on any one large order. Fleet bookings made an incremental contribution but still represented a small percent of total bookings.

As we look back to the second half of the year, we have considerable bookings momentum across the domestic and international body-worn camera markets as well as our Fleet offering. It's important to note that our bookings number includes contract renewals, which will become a larger contributor in the coming quarters. The incremental booked seats we provide in our supplemental materials are intended to be net of renewals and upgrades.

Total deferred revenue increased by \$8.6 million sequentially to \$100.2 million. Over 80% of our domestic Video hardware contracts include the TASER insurance claim feature under which customers prepay for their future camera upgrades. Software and Sensors segment deferred hardware revenue or customer prepayments for future camera and dock upgrades represents \$21.8 million of the total deferred revenue balance. These future hardware upgrades will have a lower implied discount in the initial camera purchase and as such, will flow through the P&L at a higher-average selling price.

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Gross margins in the second quarter were 57.3% on a consolidated basis. Weapons segment gross margin remains relatively consistent at 69.7%. In the Software and Sensors segment, we were unfavorably impacted by several items, leading to a 32.7% margin in the quarter. Software and Sensors hardware margins were lower due to shipments on certain multiyear contracts with heavily discounted upfront cameras and docks. We are modifying new contracts to limit discounts on upfront cameras and docks and the allocation of revenue to contingent hardware, which is recognized over the life of the contract rather than when hardware is delivered.

In Q3, we will still be shipping on some of the older contracts and expect to see some hardware gross margin improvement in Q3 and more improvement in Q4. This change partially accelerates the hardware gross margin improvement we expected in Q1 2018 under the new 606 accounting guideline to the second half of 2017.

Software and Sensors hardware gross margin was further impacted by nonrecurring costs related to higher scrap rates on the new Flex 2 camera due to supplier-related issues during launch, which have now been resolved. Software and Sensors gross margin was 70% and was unfavorably impacted by \$600,000 of costs related to the previously disclosed migration from Amazon Web Services to Microsoft Azure's government cloud. We expect to complete migration by the end of the third quarter but will still incur an additional \$750,000 of migration costs in the third quarter.

Consistent with our comments on last quarter's call, we expect Software and Sensors hardware margin in excess of 25% by Q4 and service margins in excess of 75%. At those margin levels, our Software and Sensors gross profit in this quarter would have been \$4.3 million or 50% higher.

Total operating expenses in the quarter increased 3.5%, coming in favorable to our estimate of a 4% to 6% sequential increase.

SG&A costs increased 3.1%, primarily due to increased headcount cost related to our Axon Accelerate conference and our rebranding.

Research and development expenses increased 4.2%, primarily due to our investment in Records Management Systems and advanced artificial intelligence capabilities.

Other income of \$1.7 million consisted of a \$1.3 million gain related to foreign currency, transaction adjustment and interest income, which includes interest on the TASER 60 program.

Income tax expense in the second quarter was \$232,000 for an effective tax rate of 9%. We had a favorable \$400,000 discrete tax benefit associated with the gains related to stock-based compensation. This gain was driven by a change in accounting guidelines this year. Excluding this discrete item, our earnings per share would have been \$0.03 compared to our reported EPS of \$0.04. Our normalized tax rate for the year, excluding benefit associated with gains related to stock-based compensation, is expected to be approximately 40% for the year.

Total inventory in the quarter increased to \$60.7 million, a \$12 million increase from the first quarter. Our inventory growth in recent quarters was driven by several factors: first, to support the potential high demand for dock cameras and docks for the national free trial program; second, to support our significant increase in the volume across our products, including cameras, weapons and cartridges; third, we've increased our inventory to improve customer fulfillment types; lastly, we're in the process of simplifying our international tax strategy, which has required us to carry 2 full sets of inventory. We have a plan in place to significantly reduce our inventory balance over the next 6 months. We've set a target to be below \$50 million of inventory by the end of the year, with further reduction in 2018.

Turning to the third quarter. We expect revenue growth of approximately 15% year-over-year and continue to expect full year revenue growth to slightly exceed our 15% to 20% target range. We anticipate a 4% to 6% sequential increase in operating expenses in the third quarter as we continue to invest in R&D initiatives, add customer-facing roles and expand into new international markets. We could see a slight variance on either end of this range based on the timing of hires and some anticipated expenses within the quarter. This increase does not include expenses related to the national free trial offer. While the offer has generated significant traction, as Rick had mentioned, many of the customers who are getting deep into understanding how our solutions work are choosing to move straight to procurement.

For those who are arranging trials, we typically see larger agencies wanting to test a limited number of cameras rather than for every officer. We view this as a very positive outcome that will result in a lower-than-expected cost in the back half of the year. We now expect to have \$2.5 million



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of expense in the back half of the year versus our prior estimate of \$5 million. We expect margin improvement sequentially in Q3 2017 from Q2 as we incur fewer nonrecurring camera hardware costs, improve hardware pricing, increase Weapons revenue and add users to the Axon platform. Our margin improvement will be partially offset by expenses related to the national free trial offer.

And with that, we're now going to move into the question-and-answer portion of the call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Mark Strouse of JPMorgan.

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

So congrats on the revenue and the bookings. I think we wanted to just dig into the cash flow statement though, if we can, to start. So cash from operations, you've been burning cash for the last 2 or 3 quarters now. Balance sheet is still in very good shape. But just kind of wondering if you foresee any need for a capital raise anytime in the near future?

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

Yes, just to reiterate. Our biggest use of cash has been our increase in inventory. As we mentioned, we've got a plan in place to take that tax to a normalized level by the end of the year. Excluding inventory build, our cash from operations has been positive. (inaudible) meaning our (inaudible) potential builds (inaudible) to provide any additional temporary liquidity in the business, we do have facilities available to us (inaudible) that would be reduction in inventory by the end of the year that we will need to draw on those facilities.

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

Okay. And then with some of the future investments in RMS and AI, I'm just wondering if you have any updated comments around timing of when initial deployments of that technology could begin and when we should expect that to become more material.

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

This is Rick, and I'll take that one. We expect that we will be starting to field trials late this year. We'll likely be making some announcements at the IACP Conference in October about some specific products related to some of these capabilities, and we expect, in 2018, that we'll start to see revenue contribution.

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

Okay. And then just lastly, Rick, you mentioned on the Video IP lawsuits that are out there, you have one company, I don't know, several companies may be misrepresenting the case. I'm just kind of wondering if you can give a bit more detail on your view of how this all plays out.

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

Sure, yes. As you've seen, we've got a -- a competitor puts out press releases on just about every minor ruling in the case. Obviously, it's going to be a complex case. We believe there's very strong prior art to these patents. Some of the evidence is in the form of prior patents and filings that



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we presented at the patent office, which should be noted, they've accepted one of our 2 challenges. And that challenge will proceed to hearing in February on the first patent. Additional evidence, particularly related to public disclosure of our own inventions and marketing of this technology at least 3 years prior to Digital Ally's patent filing, will be presented at the appropriate time in District Court. We also have strong arguments that our technology designs did not infringe these patents, so even if they somehow survive, what we see is very clear prior art that we're presenting. We have strong arguments of non-infringement. And then finally, as with any thorough risk management plan, we've identified alternative technology pathways to achieve similar product value for our customers. So we believe we're in a really pretty strong position.

Operator

And our next question comes from Steve Dyer with Craig-Hallum.

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

If I could dig in to operating expenses a little bit. It looks like about \$25 million or so of operating expenses this quarter, on the software and segments business. As I talk to people who try to get a better read on the real profitability of the Video business, is there any way to kind of, I guess, estimate maybe what portion of that, particularly in R&D, is for projects that are not generating revenue, call it, this year?

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

Arvind -- or I'm sorry, Jawad, why don't you take that one?

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

So we are -- what we're doing for you is continuing to invest in R&D initiatives and customer-facing roles to expand product offerings and geographic reach. We're not disclosing the split of that business between the existing products in this still, but we are making, as you know, an investment in RMS in future products.

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

Yes, the other thing that I would comment on, with our existing revenue streams that we have to market today, which is primarily around our body-worn cameras and the digital evidence management system, we've got a long-term operating margin target with these net new technologies that we're investing in, RMS, Records Management System, which will be a pure software play, it's not going to have the storage cost or the associated hardware cost as well as artificial intelligence features. We expect these to have a lot higher operating margin that will bring up the total operating margin for the entire Axon segment.

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

Okay. Got it. And then, I guess, as it relates to gross margin, it sounds like the issue there has been hardware gross margin and the guidance there is for improvement. So is it safe to say, I guess, all things considered, that sort of near-term, Q2 will mark the operating margin trough for the business?

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

Yes, we still feel that that's the trough for the year.



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

Okay. Great. And then, I guess, a couple of housekeeping issues. One, as it relates to the inventory, working down the inventory through the end of the year, do you expect to have to write any of that down?

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

No. No. There may be some limited exposure, but the build is in primarily in high-volume items.

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

Okay. Great. And then lastly, I don't if I know missed it, but the \$1.7 million other income in the quarter, did you talk about what that was?

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

Yes, so \$1.3 million of that, Steve, was related to a gain in foreign currency transaction adjustments.

Operator

And our next question comes from Jeremy Hamblin with Dougherty & Company.

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

I wanted to just get a little more involved with your international side of your business. I think you had indicated that was \$13.4 million in this quarter. Not seeing as quite as much of a step-up maybe in that as we had expected as a total mix of your business. But Rick or Luke, can you give us a sense of where you expect that international mix of business to flow in the second half of the year? And then really, as we start to get into '18, we sense that you're maybe on the cusp of some nice international wins. But could you speak more to that?

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

Yes, this is Rick. Let me take that one. So we don't give specific guidance, particularly on these international deals. They tend to be large. I can tell you, we have some very large deals in the pipeline that it's hard to tell whether they will close in the second half this year or into '18. I would say, overall, over the next 18-month horizon, we do expect international to be a growing contributor as a percentage.

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

Is that something where you think that international mix could be over 20% though in the -- by the back half of '18?

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

It's certainly within the realm of possibility. But again, I'd -- a lot of it will just depend on some of these larger deals.



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

Okay. And then in terms of some of the geographies you're looking at, without getting specific, historically, you've been doing pretty well with the English-speaking countries. I know a big push has been to progress around that to some of the non-English-speaking countries. What kind of progress now with -- a new sales office in Europe opened up. What kind of progress are you making there?

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

Yes, I think we're feeling really good. We've got a solid team in most of the major Continental European countries now, and we're engaged in customer -- meaningful customer conversations across pretty much all the major European countries at this point. We've also been expanding our presence in Australasia. We've added -- started to add some staff, not only in Australia, but up in Asia, and we'll continue to make a few more investments there. We've also added some salespeople in Africa. I think we're really sort of getting it dialed in. A few years ago, we really started to follow some of what we learned in the U.S., which was that, particularly for the Software and Sensors business, that we really had to have direct salespeople engaging with the customer because these are fairly sophisticated sales that are really kind of hard to accomplish through third parties. And we've seen that result play out in U.K., in Australia, and we've followed that same model. And I think we're seeing all but the same early indicators of success happening now in Continental Europe, and we're, I'd say, even a little earlier in the process in some of the other Asian countries and in Africa. But we're seeing a lot of the same sort of patterns that we saw early in the English-speaking countries, and we really have begun to internationalize both the product and the marketing. So we feel really good about those investments long-term.

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

Okay. Great. And then I want to come back to just the margin question and in getting the understanding of the guidance that I think had been put out there. I wanted to confirm, by Q4, was it -- was that when you're expecting gross margins in the 75% range in Weapons and then back to 25% margins on Sensors and Software? Did I hear that correctly?

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

Jawad, over to you. I believe that 75% was referenced to -- well, Jawad, you got it?

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

All right. The 75% was for the service margins within the Software and Sensors segment, and the 25% was on the hardware margins in that segment.

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

Sorry. Okay. Great. And then just thinking about the hardware in terms of giving us some confidence of working off that inventory. Does it -- should we have the sense that by the end of this year, that, that is fully resolved? Or is there still going to be some lingering issue heading into '18?

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

Yes, this is a big focal point for me and for the leadership team, and we expect to have that resolved completely by the end of the year.

Operator

And our next question comes from George Godfrey with CL King.



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

Rick, could you give us a number of how many free cameras are out actively in the field right now...

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

Yes, I don't think we've disclosed that. I don't think, for strategic reasons, that we're planning to disclose that at this point.

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

Okay. And I think you said some of them have moved right to procurement to go to a fixed model right after getting it. Is that -- did I get that right?

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

Yes, what we're seeing happen, so part of the reason for the inventory buildup was when we announced this program, we wanted to make sure we had sufficient inventory on hand to be able to fulfill on it. And what we have found is that the program was extremely successful from a public messaging standpoint. Remember, we bundled this together with the name change of the company, and it literally drove, I think, over 500 independent news articles that really helped get the message out about the name change and it really drove a lot of customer conversations. However, what we've seen is that customers, once they engage, in many cases, it's as much work for them to do a free trial -- field trial as it is to go ahead and move into a procurement process. So it's -- in many cases, it's actually less total work for them maybe over the long haul if you just move into the procurement process rather than having a separate trial and then doing procurement later. So we have seen a good number of agencies that reach out to us as part of the field trial process, and then I think they just sort of -- they put it into their more standard procurement business process, which is great news. And then the other thing that's caused us to draw down our expectation for inventory needed for this program is that the larger agencies that are looking for field trials are typically saying that they want to do a trial with a subset of officers, not necessarily take cameras for every officer in the agency. So again, our offer was compelling, and then it got their attention and they have engaged. But the net expense of the field trials are going to be significantly lower since they're testing with subsets. The main thing for us is we just want to get them in the field trials or at least into in-depth procurement discussion. And in that respect, it's really working quite well, and we do have some additional large agencies that had gone with competing solutions that are back at the table because of the field trial offer.

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

Okay. So are you constrained either resource-constrained human capital, cameras or infrastructure to meet both the free demand as well as the paid demand?

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

On the body cameras, no. I would say, on the Fleet cameras that we're rolling out, some of the constraints around our ability to scale Fleet are that there is more installation and that's a new product. So that portion of the business we are making, and that's part of the other reason for some of the expense buildup, is to support the installation and customer support infrastructure for Fleet. But the body cameras, we have all that infrastructure in place so there really are -- there shouldn't be any operating limitations to support the field trials and the ongoing business.

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

Got it. And then my last question on the artificial intelligence side. Have any police departments come to and asked you to embed facial recognition software capabilities in the camera? And if so, would that require a new camera or a significant upgrade to the platform, or could that be an add-on feature to the installed base? And I'll leave it there.



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

Yes, great question. So there certainly is interest in artificial intelligence for facial recognition. As we talked about earlier, we believe that's a very sensitive subject with the general public, and it's one where both we and our customers need to move carefully to make sure that we're doing this in a way that sort of respects privacy laws and general privacy rights in this country. So that's an issue. We're in the late stages forming an advisory panel on those ethics and privacy laws. The other piece I would tell you is, well, facial recognition technology is very promising. It's a bit early, we believe, to be putting it out in cameras for realtime identification, just the net error rates in facial recognition, even best-in-the-world cases, are still not at the level of reliability where you'd want to be feeding officers information on which they may make life and death decisions in the field. So we -- as we look at this technology, there's certainly customer interest, there's issues we have to navigate around legal and ethics to make sure we get it right, and then there's also making sure that we get to the right points of maturity of the technology. And so at this point, it's not the limitation of the cameras per se. We have 1080p, high-definition recording capabilities. That's plenty of resolution that is relative to the types of facial recognition technology that are out there today. But we've seen that there are less controversial, more mature and more high-value services that we can offer to our customers using AI that don't carry some of the risks and baggage of facial recognition at this point in time. So our team is really focused on some of those other areas at this point. But we do have -- facial recognition is something that we're monitoring given all those other factors to find when that right product mix and timing would be.

Operator

And our next question comes from Saliq Khan with Imperial Capital.

Saliq Jamil Khan - Imperial Capital, LLC, Research Division - VP

Rick, you noted on roughly 1,500 customers for the trial program. How many of those trial customers are in the region which Axon is not in previously?

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

I don't necessarily have a good read on that. I mean, I would say, in terms of regions, we're in all over the country. We have thousands of customers. We have 95% of U.S. law enforcement agencies using TASER Weapons. So in that respect, we're pretty ubiquitous in the Axon camera and EVIDENCE.com. We also have -- we have customers in every region of the country, so I'd say I don't know that there were necessarily new regions where we did not have a presence. We are seeing it sort of accelerate the conversation though, particularly in agencies that may be in the Northeast, where the Northeast has been perhaps a little slower, in some cases, to adopt a body camera technology. So in that respect, I'd say it probably has helped the pickup and I've had some personal conversations with some large agencies in the Northeast that had previously expressed specific disinterest in body cameras that are now finding it worthy of some exploration.

Saliq Jamil Khan - Imperial Capital, LLC, Research Division - VP

Perfect. And I got just one further question, but I have a myriad, which is now that you're more than halfway through the overall year, what is your outlook on the percentage of the trial users that could potentially become paying customers?

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

Well, at this point, I would say most of the -- we're only about a quarter into these trials. And what's interesting, the smaller agencies are the ones who tend to make decisions relatively quickly, and it's the smaller agencies where we're seeing, I would say, a significant portion of those once they engage in a conversation are moving really more in towards a procurement than an extended trial. And then the larger agencies tend to move slower in general, so like a lot of the larger agencies are still gearing up for how they would do these trials. So it's a bit of the bog out there, where



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the smaller guys are moving pretty quick and the bigger guys as sort of still getting moving because the -- for them, the limitation is less about the actual funding of the program, it's more about the logistics and staffing and just sort of getting the program moving through a larger agency.

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

Yes, and just -- so Rick addressed the timing on that. I would just comment on what we believe the percentage of customers that convert after a trial is very high. We haven't lost a single agency where they've trialed over 100 cameras. And so we feel very confident when customers are trialing our product. Our head of sales like to say our competitor's worst nightmare is the well-informed customer, and we feel really good about these trial programs and expect a high conversion rate.

Saliq Jamil Khan - Imperial Capital, LLC, Research Division - VP

And then I know you guys talked about this previously, but the bureaucratic process that is a part of this overall program of yours as well, has there been some sort of a hindrance to you and your ability to penetrate the marketplace? Or is there a way for you to be able to work around this and work with the agencies to continue to deepen the penetration level?

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

So absolutely. You've hit the nail on the head. I would say, when we talk, where it's been a number of years since the Ferguson, Missouri incident, and when we look at the penetration of body cameras in American policing, a lot of people say what's the main obstacle, it really is just inertia. It's getting these processes moving within these larger agencies. Just in -- and it just takes time, and you've got to identify advocates, you're competing with other priorities. And in that respect, the national field trial, at least, is having the intended effect of where it's getting that higher on their priority list as it's creating a rationale for why they need to do this sooner than later and if there's this opportunity over the course of the next year for them to have a no-charge field trial. So it's helping, but I would say that still remains the #1 -- our #1 competitor is really inertia.

Operator

And our final question comes from Allen Klee with Sidoti.

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

In the Axon segment, you've given -- I'm sorry, you have a new name for now. The product and service gross margins going to 25% and 75% in the fourth quarter, how do you think about how that can improve in 2018?

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

So excluding -- we basically would have -- excluding nonrecurring items, we would have been at \$4.3 million of profit or 50% higher. We still feel, for the long term, the guidance that we've given for that segment is 25% margins, which we -- or 20% margins, rather, which we feel is conservative. So without giving specific guidance, we do feel that there's considerable upside.

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

Okay. And then for the tax rate for the quarter, can you explain -- it came in lower than I had modeled, and is there any reason why I should think that we should be using a lower tax rate going forward?



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

Yes. This is very similar to the same phenomenon we experienced in the first quarter for the (inaudible) for stock-based compensation that drove some favorability (inaudible) we saw (inaudible) quarter of \$200,000. (inaudible) as stock price increases, you're going to see favorability (inaudible). So we take it to use the -- some favorability, but at this point, we expect that our tax rate for the year, normalized, will be approximately 40%.

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

Okay. Great. And then maybe just one last question, bigger picture. I know you're spending to increase your total addressable market. But how do you think about balancing that with when you're going to get operating leverage to basically that we can see the growth in the bottom line numbers? Is there any sense that, that needs to happen in a certain period of time or whatever color you can provide?

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

My perspective here is that there is (inaudible) momentum in the business. And Rick (inaudible) and get it for (inaudible) his words in thinking of a long-term funnel. But what I don't want to do is step on this great momentum. I think we should continue to invest in (inaudible) to capitalize in the great momentum that we're building. I wouldn't put a horizon on when we would expect to see some margins improve. What we do know is that longer-term, we're building a very profitable, sustainable (inaudible) business to go with our profitable hardware business. And (inaudible) horizon on it, but obviously, that's something that we're very mindful of, that we want to do this in a way that's accretive.

Operator

And that concludes our Q&A session for today. I would now turn the call back over to Mr. Smith for closing remarks. Sir, you may begin.

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

Great. Thank you. Everybody, we appreciate you spending time with us here today. Again, really excited at the momentum in the business. I would like to reiterate Jawad's comment at the end. We are looking at the long-term profitability of all the investments that we're making, and we believe the investments around Fleet, artificial intelligence, RMS and international, that each one of those can create revenue flows, highly profitable revenue flows, that are comparable in scale to our existing digital evidence management and body camera business. So when you look at it that way, the investments that we're making really are to build out sort of 4 revenue streams, all comparable to the revenue stream where we're already showing a significant momentum in growth. And when you view it through that lens, you'll understand -- and not only are these additional revenue streams, all of them helped make the ecosystem more defensible, more valuable. Like we pointed out, some of the win-backs we made this quarter were because we had the new in-car capability. So that capability is helping us win body camera deals as well. So each of these capabilities are being built in a way where they are making our current solutions more viable, increasing our win rate, increasing the net value to our customers and frankly, the stickiness of the product and ecosystem long-term. So we're, obviously, very excited to see the growth continue and also begin to really see some of the international markets start to kick in, in a more material way. And with that, we're going to thank you for joining us, and we look forward to joining you in another 3 months for our conference call results on the third quarter. Everybody, have a great day.

Operator

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



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