Axon Enterprise, Inc. (AAXN)
Raising Rating from Neutral to Outperform

Public safety leader. We believe weakness following Q3 results was overdone, and are raising our rating from Neutral to Outperform. Though the stock is still up significantly YTD, we believe the introduction of Taser 7, Body Camera 3 and a growing software portfolio, all provide potential catalysts in 2019. In addition to those drivers, AAXN represents a unique way to invest in the theme around reducing gun violence and improving public safety. Maintain our $69 target price.

- **What happened in Q3?** Q3 revenue and EBITDA were solid, though Q4 guidance was slightly light, due in part to Taser timing, contributing to a 16% decline in the shares.

- **Key upgrade drivers.**
  - **Taser 7 upside.** With significant performance improvements, and the first new Taser in 5 years, we expect a significant upgrade opportunity for many years, with double-digit growth forecast in 2019.
  - **Body camera trends positive.** We expect growing body camera adoption, with Body camera 3, available in mid-2019, adding many new capabilities, including cellular streaming. Overall body camera penetration remains low relative to the officer opportunity.
  - **Software strong.** Evidence.com, its primary cloud software product today, grew 46.9% YOY in Q3. We expect continued strong growth next year tied to body camera adoption, with Axon Records (RMS - Records Management System), providing an additional growth catalyst in 2020+.
  - **International upside.** With multiple trials underway, international could accelerate in 2019+. International represented 20% of 2018 YTD revenue and grew 34% YOY.

- **New product pricing accretive.** The entry level promotional price of $149 for the new Officer Safety Plan, which includes Taser 7, cartridges, Axon Body 3, other sensors, Evidence.com and Records, compares with $109/officer/month previously. Additional features are available at $199.

- **Shift to subscriptions positive.** Subscriptions accounted for 33% of Q3, down sequentially, though we expect that to accelerate significantly as the new products and pricing are rolled out. We view the enhanced visibility positively, though it also negatively impacts cash flow.

- **Key forecasts.** We forecast total revenue to grow 17.8% in 2019, with EBITDA margins expanding to 17.9% from 15.1% in 2018.

- **Key risks.** Risks included body and fleet camera and software competition, execution on new product launches, public safety spending, Taser adoption and expense control.

- **Valuation thoughts.** AAXN is currently trading at 5.5x our consolidated 2019 revenue forecast, above the hardware comps., but below public safety SaaS and broader SaaS. Our $69 target price remains based on 7.5x 2019E revenue.

Axon manufactures and sells Tasers, body/in-fleet cameras, and software solutions primarily to law enforcement agencies.
Details

**What Happened with Q3?**
Q3 revenue and EBITDA of $104.8 million and $15.5 million modestly beat our $102.8 million and $13.1 million estimates. However, the company maintained full-year guidance, implying weaker than previously forecast Q4 results. The company called out lighter Taser sales in advance of the Taser 7 push, which we view primarily as a timing issue. They also expect to incur costs transitioning to the Axon Body 2 camera from the Vievu cameras for part of the NYD following the recent overheating of a Vievu device. While there could be up-front costs, over time AAXN should benefit from migrating more NYPD officers to its core Axon platform. Software revenue also decelerated from recent levels, though still grew 46.9% YOY. We suspect some combination of those factors may have contributed to the weakness following the Nov. 6 results.

**Key Catalysts**

**Taser 7**
Taser 7 was announced at IACP (International Association of Chiefs of Police), the largest industry trade show in October. It is the first new Taser in over five years, and includes significant improvements to misses, clothing disconnects and close probe spreads.

Source: Axon website video

We believe Taser 7 should help drive double-digit Taser growth in 2019+ from the significant upgrade opportunities and new adoption. AAXN estimates that 450,000+ Tasers are currently in use in the U.S., with the addressable market starting with roughly 660,000 domestic patrol officers, and many thousands of additional private and public opportunities.

<table>
<thead>
<tr>
<th>TASER TAM build-up</th>
<th>$/mo. Users</th>
<th>Annual TAM</th>
</tr>
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<tbody>
<tr>
<td>Domestic Weapons, Cartridges &amp; Services</td>
<td>$60 662</td>
<td>$477</td>
</tr>
<tr>
<td>Int’l Weapons, Cartridges &amp; Services</td>
<td>$60 1,824</td>
<td>$1,315</td>
</tr>
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Source: Axon IACP presentation
Body Cameras
Body cameras have been a significant source of growth, though still much earlier for AAXN than Taser. While it appears that AAXN now possesses the highest market share, it has still only shipped roughly 250,000 body cameras cumulatively. Against the broader opportunities across local, state, federal, etc., we believe the opportunity remains significant.

Body Camera 3, which is expected to be available in mid-2019, includes a slew of upgrades, including wireless streaming capabilities for the first time. Other upgrades include GPS, improved video and audio quality, gun shot detection, and wireless offload.

Source: Axon website

In addition to body cameras, AAXN rolled out its Fleet 2 in-car video product this past spring, which should provide an additional growth opportunity. AAXN currently has limited share in this market, though it should be a natural complement to body cameras.

<table>
<thead>
<tr>
<th>Sensors TAM build-up</th>
<th>$/mo</th>
<th>Users</th>
<th>Annual TAM</th>
</tr>
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<tbody>
<tr>
<td>Domestic Officer Worn Sensors</td>
<td>$30</td>
<td>662</td>
<td>$238</td>
</tr>
<tr>
<td>Int'l Officer Worn Sensors</td>
<td>$30</td>
<td>1,000</td>
<td>$350</td>
</tr>
<tr>
<td>Axon Fleet (domestic only)</td>
<td>$52</td>
<td>400</td>
<td>$250</td>
</tr>
<tr>
<td>Source: Axon IACP presentation</td>
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Software
Evidence.com, its primary software product to date, reached $23.9 million of revenue in Q3, up 46.9% YOY. Evidence.com is AAXN's software product that hosts body camera videos in the cloud. On its Q3 call, AAXN noted that its video repository now includes over 40 petabytes of data. Sales are largely correlated to body camera sales, with AAXN paid a subscription fee on a per-seat basis.

In addition to Evidence.com, AAXN plans to roll out Records (RMS - Records Management System) in 2H'19, which opens up a second major software opportunity. Records is principally designed to digitize incident reporting using its existing camera infrastructure. Improving the current largely manual incident writing process should improve efficiency and free up officer time. Records will initially be bundled for free with the Officer Safety Plan, which bundles the new Taser 7, Body Camera 3, Evidence.com and Records for $149 per month, and up to $199 per month with additional AI and other features on promo pricing.
Obviously its software allocation is lower, though its competitive moat and Taser profitability stack up well.

**International**

International represented 20% of YTD revenue and grew 34% YOY. With low Taser and body camera penetration outside of the U.S. and multiple major trials underway, we believe international could provide a significant source of upside in the future. Per the tables above, the international TAM for Tasers and sensors alone is estimated at about $2 billion, with further upside from software.

**Valuation Analysis**

AAXN is currently trading at 5.5x our consolidated 2019 revenue forecast, which compares to its historical average of 3-8x. That puts it above the broader hardware group, justified in part by the Taser competitive moat and growing software focus. On the other hand, it is trading below the broader SaaS group. Obviously its software allocation is lower, though its competitive moat and Taser profitability stack up well.

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Ticker</th>
<th>Price 1/18</th>
<th>Mkt. Cap ($M)</th>
<th>Ent. Val ($M)</th>
<th>Revenue Growth 2018</th>
<th>EV/Sales 2018</th>
<th>EV/EBITDA 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Public Safety Software/SaaS</strong></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Everbridge</td>
<td>EVBG</td>
<td>$56.99</td>
<td>$2,074</td>
<td>$1,966</td>
<td>40.0%</td>
<td>28.0%</td>
<td>10.5x</td>
</tr>
<tr>
<td>ShotSpotter</td>
<td>SSSI</td>
<td>$41.50</td>
<td>$447</td>
<td>$427</td>
<td>43.7%</td>
<td>36.6%</td>
<td>9.2x</td>
</tr>
<tr>
<td>Tyler Technologies</td>
<td>TYL</td>
<td>$187.50</td>
<td>$7,279</td>
<td>$7,056</td>
<td>11.9%</td>
<td>19.5%</td>
<td>21.3x</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td></td>
<td>$3,267</td>
<td>$3,148</td>
<td>31.9%</td>
<td>25.0%</td>
<td>11.1x</td>
<td>6.8x</td>
</tr>
<tr>
<td><strong>Public Safety Hardware</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AeroVironment</td>
<td>AVAN</td>
<td>$103.25</td>
<td>$2,471</td>
<td>$2,214</td>
<td>13.3%</td>
<td>19.9%</td>
<td>54.2x</td>
</tr>
<tr>
<td>FLIR Systems</td>
<td>FLIR</td>
<td>$48.92</td>
<td>$6,768</td>
<td>$6,670</td>
<td>-0.3%</td>
<td>3.9%</td>
<td>3.5x</td>
</tr>
<tr>
<td>Harris Corporation</td>
<td>HRS</td>
<td>$153.09</td>
<td>$18,012</td>
<td>$21,514</td>
<td>0.0%</td>
<td>7.3%</td>
<td>3.5x</td>
</tr>
<tr>
<td>Kratos Defense &amp; Security Solutions</td>
<td>KTOS</td>
<td>$14.97</td>
<td>$1,553</td>
<td>$1,717</td>
<td>-14.6%</td>
<td>10.8%</td>
<td>28.1x</td>
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<tr>
<td>Motorola Solutions</td>
<td>MSI</td>
<td>$128.67</td>
<td>$21,041</td>
<td>$24,244</td>
<td>14.5%</td>
<td>5.6%</td>
<td>3.1x</td>
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<tr>
<td>MSA Safety</td>
<td>MSA</td>
<td>$108.81</td>
<td>$4,195</td>
<td>$4,522</td>
<td>13.3%</td>
<td>5.5%</td>
<td>3.2x</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td></td>
<td>$9,005</td>
<td>$10,147</td>
<td>4.4%</td>
<td>8.9%</td>
<td>3.5x</td>
<td>23.7x</td>
</tr>
</tbody>
</table>

Source: Baird, FactSet
Our $69 target price is based on 7.5x our 2019 revenue forecast. That puts it slightly below the broader SaaS group and public safety SaaS, reflecting a much lower software concentration, offset somewhat by the significant Taser competitive moat. We expect the increasing shift to software and subscriptions to benefit valuation, with the Taser competitive positioning also warranting a premium.

**Sum-of-the-Parts Approach**
Simplistically valuing the Taser segment at 15x 2019 EBITDA implies that the Software & Sensor segment is being valued at 6.5x 2019 revenue. Assuming 20x EBITDA drops the Software & Sensor multiple to 4.2x. With the Taser’s unmatched competitive moat and the Software & Sensor estimated 2019 revenue growth rate of 27.6%, those multiples could be low relative to the growth opportunity.

**Key Forecasts**
In 2019, we forecast 11.7% growth in Taser weapons, 33.7% growth in Axon Cloud revenue, and 19.4% growth in sensors and other revenue, with the consolidated EBITDA margin of 17.9% expanding 280 bps YOY.
**Investment Thesis**

**Strong secular theme around reducing gun violence.** Since its founding in 1993, Rick Smith, and the Axon team, have been focused on reducing gun violence and social conflict through the adoption of Tasers, and more recently, body cameras.

**Taser dominates market, with significant IP moat.** Axon currently counts over 17,000 of the 18,000 police forces as Taser customers. Axon remains the primary if not only supplier of Tasers globally, protected by 100+ patents. We believe the combination of patents and high domestic penetration provide significant competitive moats.

**Body camera opportunity still early; VIEVU acquisition helps consolidate market.** Axon is the market leader in law enforcement body cameras with its Body and Flex cameras, citing penetration in 43 of the 69 largest US cities. We believe there is more domestic growth opportunity ahead, though the international penetration is far less and remains another growth opportunity.

**Evidence.com and RMS significant long-term SaaS opportunities.** Evidence.com has sustained strong growth, growing 46.9% in Q3'18, and the opportunity to expand to its software focus through RMS is compelling. However, while Evidence.com has generated strong growth, the RMS plans are early and largely unproven at this point.

**International early days for all products.** International revenue accounted for 20% of 2018 YTD revenue. Historically, Tasers have enjoyed much greater success in the U.S., which has been plagued by higher rates of gun violence than many other developed countries. That said, doors appear to be opening to greater international interest in Tasers as a non-lethal alternative to guns.

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**Risks & Caveats**

**Camera execution, competition.** Axon competes against a variety of companies, some much larger than Axon, so its ability to innovate and execute is crucial.

**Liability/lawsuits.** Taser lawsuits could impede its adoption and/or perception.

**Government regulation.** Some states and foreign governments do not permit the sale of Tasers.

**Software execution.** Axon is still early in its transition to software, with the longer-term opportunity to connect its Tasers, cameras and current software in a uniform record management system, or RMS.

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**2019 Estimates ($000s)**

<table>
<thead>
<tr>
<th></th>
<th>2019E</th>
<th>2018E</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taser</td>
<td>$282,415</td>
<td>$252,790</td>
<td>11.7%</td>
</tr>
<tr>
<td>Sensors &amp; Other</td>
<td>78,186</td>
<td>66,326</td>
<td>19.4%</td>
</tr>
<tr>
<td>Axon Cloud</td>
<td>121,447</td>
<td>90,866</td>
<td>33.7%</td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td>483,047</td>
<td>409,983</td>
<td>17.8%</td>
</tr>
<tr>
<td><strong>Adjusted EBITDA</strong></td>
<td>86,342</td>
<td>61,791</td>
<td>39.7%</td>
</tr>
<tr>
<td><strong>Adjusted EBITDA Margin</strong></td>
<td>17.9%</td>
<td>15.1%</td>
<td>280 bps</td>
</tr>
<tr>
<td><strong>Adjusted Net Income</strong></td>
<td>54,902</td>
<td>44,650</td>
<td>23.0%</td>
</tr>
<tr>
<td><strong>Diluted Adjusted EPS</strong></td>
<td>$0.94</td>
<td>$0.79</td>
<td>19.1%</td>
</tr>
</tbody>
</table>

Source: Baird
**Selling into governments/municipalities.** Axon’s customers are police departments and other municipal departments, which can complicate the sales cycles as it relates to politics or municipal budgets.

**Company Description**

Axon manufactures and sells Tasers, body/in-fleet cameras, and software solutions primarily to law enforcement agencies.
Appendix - Important Disclosures and Analyst Certification

Approved on 8 November 2018 19:31EST/ Published on 9 November 2018 01:02EST.

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