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AeroVironment, Inc. (AVAV)

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MANAGEMENT DISCUSSION SECTION

Ken Herbert
Analyst, RBC Capital Markets LLC

Hey. All right. Thanks, everybody, for sticking around for today. Really excited for this fireside chat discussion we're going to get to have here over lunch with management of AeroVironment Corporation, ticker AVAV.

Maybe what I wanted to do first is I think before we jump into all the specifics and nuances of AeroVironment, I think part of why we thought this was really exciting, we're just in a really interesting time right now when you think about not only the government, but specifically Department of Defense procurement reform, a lot of the disruptions happening in the marketplace.

And I think we can appreciate what's behind all of this. I think a lot of this has probably caught, myself included, a lot of us off guard in terms of the scope and pace at which I think things are changing and they're really trying to disrupt, bring more technology into what's a lot of legacy systems and really shake things up and turn things on their head and bring in more competition. And I think one of the companies that best exemplifies a lot of what we're seeing today and is incredibly well positioned in this new environment is AeroVironment.

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QUESTION AND ANSWER SECTION

Ken Herbert
Analyst, RBC Capital Markets LLC

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So, I think what I'd like to do is ask Wahid to maybe start with just some discussion around some of what he's seeing at a higher level, not so much company specific, but what's behind a lot of the shift that we're seeing, change in priorities and what you're sensing in terms of all of your customers within the Pentagon and on Capitol Hill today, how we should think about this as investors.

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.

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Sure. So, great to be with you. Ken, you know the company and our story and our business really well since the beginning. So, I think you've got an unfair advantage here...

Ken Herbert
Analyst, RBC Capital Markets LLC

Q

Thank you.

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.

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...which is good. And we appreciate that. At a macro level, I think there's a few things that I could summarize. Number one, US has underinvested in defense for the last decade and a half plus, sequestration started in the first Obama term and that's continued over several years. So, we are severely underinvested, number one.

Two, our threat level and adversaries is getting bigger and more formidable and more serious and more dangerous, whether it's China or Russia. The security risks around the world is not getting better. It's gotten worse. We've got conflicts in every single region of the world. We're now got active conflicts in the Middle East. Europe, you have the same problem, challenge brewing in Asia-Pacific, and as you know, we're fighting a war on drugs in the Southern side of the country, too, in Latin America. So, there's not a shortage of problems out there.

Three other comments I would make is the conflict in Ukraine basically shook up the entire defense industry and defense leaders. If you're a three-star, four-star General, and you're Pentagon and national security expert, you're going to get to throw everything that we did in the last 50 years aside and say we have to fight these wars differently because these war is going to be different. And so we have to retool our military across all services, both US and our allies.

And then the last thing is there's bipartisan support within Congress for both parties and both Houses that we have to invest more in defense. The other two things that I want to mention is really important too is that we have a sense of urgency to do it quickly because we don't have a lot of time. We've exhausted a lot of our stockpiles, the Ukraine conflict.

And the last thing I want to say is the war in Ukraine is not going to be the same as the war in other parts of the world, if US were to fight it. We're not going to be using these first-person view $1,800 drones that fights within a mile or five mile radius with a fiber optic cable, which is a poor man's version of trying to have a solution. It's going to be – that still may be involved, but it's less than 5% of the market. Much, much larger part of the market is the

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other more sophisticated capabilities that are out there. And then so if you were to build a – purpose build the company to focus on that, that is focused on unmanned, I truly believe that AV is on top of that list. We have the credentials.

And I forgot one last point. Because of the sense of urgency, whoever can produce quickly at scale and at the DoD's level of caliber, of rigor and performance, then has a very high chance of getting the lion's share of the business. And that's exactly the company that we built over the last decade and a half. And I think we're positioned really well. You see a lot of those announcements in our Q1 earnings that we just did a couple of weeks ago, and then we've actually announced some major awards even since then last couple of weeks.

Ken Herbert
Analyst, RBC Capital Markets LLC

Q

So, that's great. Well, let me ask you this. Why do you get a sense there's been so much, maybe animosity is too strong of a word, but so much pushback against the legacy defense primes and why such an incentive now to bring more competition in and it seems like almost go out of their way to incentivize companies like yourselves that are disruptive, so to speak. What's behind that?

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.

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So, that was one other key factor that I forgot. I missed [indiscernible] (00:05:19) glad you caught it. There's several reasons. Number one, because of the underinvestment, the industry consolidated heavily over the last 15, 20 years, and it's created these seven or six major primes. By definition, when you get that large and you'd rely on a system that promotes customer-funded R&D and a 10-year development cycle and adoption for 20, 30 years of these very, very large programs, you become an ecosystem that is really difficult to maneuver.

And so, A, the – so that's one change. The second change is the rate of change in technology is much, much faster. And so what worked in the last two, three decades or 50 years doesn't work in the future because the technology that goes into robotics and drones and software changes every – we see in Ukraine – every three, four or five months, not even a year. And so that's one factor.

The second factor is the big primes have become very used to the system where if I'm going to develop you this capability, you're going to pay for the development, and then I run the program of record and I'm exclusively your provider for the next 20, 30, 40, 50 years, whatever the number is. In that model, the US is sick of it. The Defense Department, the Congress in some extent, doesn't want it anymore and it's very valid.

And companies like us who always invest ahead of the program of record requirements even, that's what we do for a living. We've done it since we've been public. So, the recipe that we have is now being copied with a plethora of other players and there's lots of private money that's actually trying to copy our recipe. And so that's the reason why there is an allergy towards these large primes.

And I do believe that our country needs at least a couple, if not more than a couple players like AV that is able to actually challenge and provide an alternative to the market. And the key is going to be who's got the credentials to be able to not only just talk the talk, but actually deliver and deliver in scale and deliver in volume [ph] at effective capability separate (00:07:27). In that perspective, AV is very unique. I think the number of companies then shrink dramatically to one or two or three, that's it.

So, as I sit here and I think a lot of investors struggle with this, I think there's a belief that at the end of the day, if the US won certain capabilities, there's only a handful of companies, primes that can produce it at scale,

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hypersonic weapons and other areas hypothetically, you're breaking into this. What's the risk that we turn around in two or three years and the government realizes, the Pentagon realizes, okay, we really have no choice but continue to work with the primes for the vast majority of what we need and smaller companies like yourself have invested a lot of money and really spent money to spool up.

And it's maybe not quite as rewarding as you perhaps thought, because I think a lot of your companies like yourself are really having to lean into your own internal R&D capital, everybody's ramping to add capacity now to support what is expected to be these big orders, what's the risk that obviously this doesn't materialize?

Ken Herbert
Analyst, RBC Capital Markets LLC

Q

Yeah.

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.

A

So, I think that risk for a lot of the new players who doesn't have – who don't have a customer base, who don't have products that are fielded, who doesn't have a very strong existing franchises, I think the risk is much, much higher for them, because they're now pushing lots and lots of capital and a lot of those are privately funded, VC funded even in some cases, that really building for a hope of the future and taking a higher risk. And I think there will be a lot of disappointments in that area.

In our case, it's not – that's not the case. A, we have a lot of shots on goal. We have well over a dozen shots on goal and we don't have to get all of it right. And so if we even get two to three to four or five, we want to get all of it right, we're working on getting all of it right. And if we just get two or three or four, we're going to be multiple size bigger than [indiscernible] (00:09:25) because each one of those are $1 billion-plus opportunities for us. Number two.

Number three, the categories that we're in, it's almost a 100% unlikely, I'd say almost because there's always one little chance. There is so much overwhelming evidence and support that we have to go this way. And so I think there is almost no downside risk in that regard. Lastly, I would say, we have invested ahead of the customers' requirements on capability products, but in terms of ramping up, we have a very flexible capacity also. We designed our manufacturing footprints not in one location, in multiple different locations for risk diversification, number one.

Two, we can actually switch lines quite easily within a matter of weeks rather than year or months to make one product versus the other. In fact, we've done that several times in our history. So, we have built a lot of what I call flexibility into our system and our operations in our business to make sure that we're not stepping up way too fast or too early and too heavily in one area versus the other.

So, I think I firmly believe that the risk profile for us is far, far less, because we already have a $2 billion business that's generating $300 million worth of EBITDA – adjusted EBITDA this year based on our guidance. And we've got 40,000 plus of our systems installed with 55 to now 100 different countries. So, it's not like we're relying on one product, one customer, one program, one widget, one trick, [ph] with a (00:11:07) large portfolio of systems that we have in multiple markets.

Kevin P. McDonnell
Chief Financial Officer & Executive Vice President, AeroVironment, Inc.

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Addressing a global demand, not just a US demand.

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.
A

Absolutely, global demand. I mean, this is not – US can delay one year, two year, three year, and many of our allies are desperate for the same capability. And it's just franchises that we built around the globe, not just the US.

Ken Herbert
Analyst, RBC Capital Markets LLC
Q

I think one of the – as we look at the sector, one of the knocks-off and against the industry is you're always fighting the last war, right? And what's the risk that we take all these lessons from Ukraine, which involved 1,000 mile front in a heavily ground-centric conflict, and what's the risk that some of that falls apart as you try and apply it to other theaters moving forward? And it's always a tradeoff I know and a struggle that the Pentagon has, but how do you see that playing out?

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.
A

Yeah. So, that's a great point that I think it's a major big lesson that a lot of people miss about Ukraine. The conflict in Ukraine essentially proved a few points. The biggest point is that warfare in the future is different based on use of drones and robotic systems. And it's very agile.

Another point is that the decision-making, the way that the Ukrainians are fighting is distributed way closer to the edge of the battlefield. Squads, company, and even smaller force structures are making decisions, they have their own organic air capability with drones, and they have their own lethality that goes beyond visual line of sight. So all the rules in the past was broken. Those [indiscernible] (00:12:38) stay valid, in my view, in future wars.

What's not going to be the conflict for US is something in Ukraine, for example, flying an FPV from two miles to a target. We all know that our number one adversary globally is China. And US is really zoomed in and focused on how do we make sure that we have superiority and dominance against that power. And we're not going to be fighting within a mile of each other. That conflict is not the same as Ukraine, and it's not over a land for the most part, most likely either.

It's open oceans with 1,000 mile-plus distances, a very sophisticated adversary with enormous amount of jamming and RF [indiscernible] (00:13:19) and EW capabilities. So, those are the things that from Ukraine will not copy in another future war that US may have. Hopefully we don't have one. The best one is to deter the war.

But we have to build this capability in order to actually deter the war or the conflict. And so I think we're positioned incredibly well. I don't think that these things are going to go out of fashion or style or that it's a fad. We invest in these categories, because we fundamentally believe in the long-term thematic investment thesis.

Loitering Munition, here's a perfect example. Everybody has a – there's no army that I know of that doesn't have a main battle tank. A main battle tank is basically obsolete against the Switchblade 600, because a Switchblade 600, two people can set it up right here within 10 minutes and shoot it and take out a main battle tank from 40 kilometers away. There's no weapon system on a main battle tank that can shoot more than 3 kilometers to 4 kilometers.

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So, I can shoot it day and night, and I could do it from any angle I want, and I can do it with almost an hour of endurance. So, that playbook is not going to change because of the future war. All main battle tanks and armored vehicles have to adapt and they have to evolve, and they have to have defensive and offensive capability against that type of a new weapon system. And so, that is an example of something that is going to be sustained over time, and we believed in that category, in that thesis from the beginning.

Ken Herbert
Analyst, RBC Capital Markets LLC

Q

So, that's a great point. Let me ask you this, though, because I see a lot of parallels in other industries. As you fast forward 5 or 10 years, and I know you've got a really unique background through coming more from the tech industry versus coming from a defense prime, for instance. But if you think about this in 10 years, who wins? Is it the companies that are making the hardware, or is it the companies that are actually making the software and the AI that empowers all of this?

And to what extent do the robotics themselves become commoditized? And how do – because we've had a lot of discussions around what makes the Switchblade 600 so successful, is obviously your ability to adapt the software or the navigation tools and everything else as the war in Ukraine has evolved. How do you think about how you're positioned or how the industry is positioned from a hardware versus software perspective?

And then ultimately, when you look at some of the private software companies or public software companies that play in AI and in this area, are already getting multiples you could argue that are significantly higher than what hardware companies like yourself are getting and certainly higher than ever what a defense prime would get. So, how do you think about that evolution playing out?

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.

A

So, you're hitting a lot of that very, very good nerves on these questions, which I like. I'm glad you brought this up, because there's a few key nuggets here that we need to decipher a little bit more. Number one, we have been a software-defined hardware provider for ever since I've been with the company.

I actually came up through the tech world. I've never worked for defense contractor. I've never been in the military before. I'm an engineer, I'm an electrical engineer background-wise. And AV is the only company that I work that's in aerospace and defense. So, the reason why we haven't sold – we sold software in the past is because the US DoD did not know how to buy this kind of software. So, majority of the systems that we use is actually had enormous amount of software already in it.

Half of our engineers today, almost half, 40%-plus of our engineers today are actually software engineers. And we've got the – every single flavor of software engineers you can think of, whether it's embedded software, ops engineers, pythons, GUIs, et cetera, et cetera, AI, computer vision, et cetera. The other myth here is that companies that are trying to get more funding, they love to make a case that they're a software company because it fetches a higher multiple and higher valuation.

We're not in this business for overnight success. We're in this business building a long term, sustainable, value creation entity, which we've done since we've been public. And we are focused on a much longer term picture. So, it's very easy for me to just get up and just make claims that we're a software company. I don't want to do that because I don't need to do that. I don't want to do it and it's not the right thing to do.

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And – but if somebody is raising $0.5 billion, they would love to say they're a hardware – software company and then go claim also that you're going to build [indiscernible] (00:17:49) manufacturing facility for hardware. That's the only hardware – software company I know is building a million square foot manufacturing facility. So, there is a lot of, what I call, misinformation that is kind of muddying the waters of what the reality is.

Now, long term, I do believe that software is going to become more and more and more important, which it has and it comes in many different flavors. So, we are today, for example, in Ukraine iterating on software and we're rolling it out to our existing installed base of systems currently which is in use within Ukraine. Our Pumas already had several upgrades and things that we're learning about tactics that the Russians are using against the Pumas of the Switchblades and we're [ph] just (00:18:35) rolling those innovations and improvements literally on a monthly basis.

And we have people, boots on the ground. So, to your question, that type of change and adoption and adaptation is going to be very much a standard. You're going to see things that are going to go in stockpiles, but the government and the military has to have the ability that says if that software improves, we're going to be able to upgrade it.

That's why we developed a lot of our systems from grounds up to be called, for example, for the US Army, it's called MOSA, Modular Open Systems Approach, which means every subsystem within a drone system or a Switchblade system or a rocket or missile is modular, it's based on an open interface, and the customer can actually swap it out and put a competitor or a similar or different module in. And that is going to become more and more and more relevant and required within the US DoD, I believe.

Now, lucky part is, because we're so vertically integrated, we're open, we're very open and we actually are – we've made our systems and we've winning based on being open system architecture. But we have the expertise in those verticals that allows us to actually design those systems at the best in breed and to be able to compete.

Ken Herbert
Analyst, RBC Capital Markets LLC

Q

Do you get a sense that the Pentagon or the Department of Defense, based on everything you've said, is actually in a position now where they've fundamentally shifted how they buy software or how they look at buying systems to break the vendor lock and enable upgrades and enable a separate sort of software purchasing. Are you – have you seen enough sort of nine months into this administration that gives you confidence that these changes will stick?

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.

A

I have seen some change, yes. I definitely – the biggest change I've seen is the focus and the intensity and the energy that the administration and the department is putting into trying to change. I believe the challenge is going to be that as great as we all think it should be, it's hard for it to become that great, because there's a level of interdependency between hardware and software that is almost inseparable.

And so even MOSA, you can become somewhat detached from reality, like the amount of money you're going to invest and making a small drone MOSA-compliant could become cost prohibitive and actually have to just design a whole new system. Yeah. So, there is a breaking point. If it comes to an aircraft carrier, a manned fighter jet or a much larger multimillion-dollar system, I could see the value and the benefit.

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The smaller the dollar value becomes, I think it becomes more and more [indiscernible] (00:21:16) disposable, which to me means that this open modular – open system architecture could not be the real solution long term just because it costs less to just replace this to just kind of like replace a module within it, you know. There's a point in the curve that crosses that inflection.

Ken Herbert
Analyst, RBC Capital Markets LLC
Q

So, as you're building AeroVironment today, how do you manage the growth and how do you manage avoiding becoming what your lazy legacy competitors represent today? How do you manage that for your business?

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.
A

That's a great question because I was asked that same question earlier in one of our one-on-one investor meetings at your conference and there's like four or five key things that I worry about the most. The number one is we got many shots on goal. The likelihood of making many of these shots, if not all of them, is incredibly high and should – make sure that we execute effectively in scaling our business to make sure that we capitalize and we don't mess up. And that we have a great track record on that from our history and as there's one thing that Elon Musk says that I agree with, 10% of the effort is making a prototype, 90% of the effort is actually scaling it and making it into large scale production.

And it is so true because I've lived that entire life. Before AV, I was in a business that we made industrial products, which is now part of Schneider Electric [indiscernible] (00:22:47) speaker yesterday, I was here. And we made 10 million units a year. And every – setting up a factory is fraught with so much, so much problems and challenges and difficulties. So, when people make that sound like easy, they just don't know what they're talking about, quite honestly. It is a very, very difficult, hard thing to do. So, that's one.

Another area is capital allocation. What do we invest? We have so many phenomenal technologies and areas of growth that many of these could basically dwarf the size of our company. So, how much money do we allocate, where? We've got a process, we're doing much better, but there's always an area of concern. Third, I would say, is keeping the DNA and the culture of the company. As we grow, we do not want to be – I mean, we have chosen to be this kind of a nimble, agile, innovative company, and that's in the DNA of our company. And I am a stickler when it comes to hiring because of that reason, because we want to make sure we preserve that as we grow.

And so if you look at my top four or five issues, obviously, honestly, none of it has to do with competitive threats. It's not because we don't take competitors seriously. We do. We've always taken it seriously. I mean, we've competed with Raytheons and Lockheeds for two decades plus very successfully, and we still have a very high share, we have very high win rates, and we have very, very satisfied customers. And so we've built our franchise based on that kind of a performance. So, we don't take it lightly, but it's not my top five concerns because what takes our company from here to point B, the future, the next three to five years is really all those four or five issues that are all internal to us rather than external to us.

Ken Herbert
Analyst, RBC Capital Markets LLC
Q

Well, maybe, Kevin, let me maybe pull you in for a minute because you guys could invest a lot of money, you've got a lot of opportunity. You've obviously got quarterly results, shareholder expectations. How do you think about sort of the process for evaluating these opportunities, disciplined to these opportunities because you could lean into 20 different opportunities, but obviously that might not be conducive to sort of near-term cash flow and near-

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term earnings growth? So, as the CFO, how do you think about the ability to manage all of this in what looks like a really phenomenal opportunity set, but maybe you can't push the thread on everything?

Kevin P. McDonnell
Chief Financial Officer & Executive Vice President, AeroVironment, Inc.
A

Well, we're just going through our long term planning process as a combined company, and we're definitely going to face these issues. But we do try to do an annual or at least semi-annual process of that allocation of R&D if you just look at it that way. To me, it's important to have a goal in terms of your EBITDA target that you want to hit and – because it helps you rationalize the most important opportunities.

I'm sure we have 30 great opportunities, for instance, that there's probably seven or eight that really realistically we can invest in. And that process of having to rationalize this about the market opportunity, the time to money are the things that are going to drive the decisions to head that way with some – maybe some wild bets here or there. But for the most part, it's really a disciplined approach to the allocation of R&D dollars that we've kind of employed over the last few years. Now, it's going to be at a bigger scale, more diverse portfolio. So, it is going to be a little bit more challenging, but I think we've got the right discipline to do that.

Ken Herbert
Analyst, RBC Capital Markets LLC
Q

Yeah. One of the knocks and to Wahid your point, I've covered the stock for a long time, one of the knocks on the stock coming out of the Gulf wars and out of the great financial crisis was you lived off recurring revenues associated with an older portfolio of Pumas and Ravens and you were maybe a little late to invest in the Switchblade or some of the newer technologies, right, that obviously have really taken off.

How do you sort of manage that complacency with an installed base and a service revenue and a revenue stream around that with obviously really pushing the new opportunities because it's really easy to get addicted to the legacy products and the revenues associated with that, and the services associated with that against obviously where the puck might be in two, three, four, five years from now?

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.
A

Yeah. So, that's a very valid point. There's a few things that are very different than what it was like, let's say, 10 years ago or so. The number one was that, at that time, we were more susceptible to a portfolio risk, because we were – we didn't have 10 shots on goal, and we didn't have the broad portfolio on multiple franchises and different, different revenue streams and customers, markets, geographies, products, et cetera. So, that's by far the biggest change from that that like before.

The second one was also another reason is that we take capital allocation and investment very seriously, because we're investing our shareholder money and we treat it like our own money, we want to make sure that we invest it wisely. One of the reasons why we delayed some of the investments is because the customer wasn't buying yet and we didn't see enough of a buying sign – signals from the customer, and we didn't see the customer converging into some kind of what they really need.

And so, they were talking about, I want this, I want that, but the need was not really well – increasingly agreed upon. And so, those two factors specifically changed significantly, and we were basically – ready in these areas and we kept investing in early development activities, but we waited until we see the eyes on the customers that

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they're really serious about it. Now, it's very obvious, it's very obvious, and we're very fortunate, because I invested in a new factory for Switchblade before the Ukraine conflict.

And we were already making Switchblades, and we went from 1,000 a year to multiple thousands a year right away. And so, historically, we've been very good at scaling and doing that right. But I do agree that one of the things I worry about a lot is, are we investing enough in the areas that I believe it's a fantastic opportunity. This is a generational opportunity. I mean, in my career, in 30-plus years, I've only had this one other time, and that was not at AV before that. And so, I think it's really unique, and we've worked really hard to get ourselves in this position.

We've worked over a decade-and-a-half building the pieces and we've purpose-built this company knowing that what the future is going to hopefully be like. And so far, it seems like we've placed our bets in, if not 100%, at least 80%, 90% of the places where I'd place us. And the areas that we missed, we have missed is probably mostly timing. Timing is still playing. So, that's how we approach it, and I think we feel really good about it, and I think we're in a very good spot in that regard, but we can always do better.

Ken Herbert
Analyst, RBC Capital Markets LLC

Q

So, I would agree. I don't think you see any risk that the robotics and automation, and what we're seeing in terms of adoption of these technologies within the Pentagon and in a national security setting, that train has left the station. There's no rolling back the clock on that, and the technology is such that it will continue to evolve pretty quickly. As you think about that moving forward, what are three or five areas within the technology that make this work, where you're really investing now, where you think AVAV will truly be differentiated within this broader sort of autonomy robotics universe?

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.

A

Yeah. So, that's another great question. There's three or four areas that I think is very critical. The first one is our investments many years ago and continued investments in our entire software ecosystem. We just announced, as you know, called AV_Halo, which is essentially an ecosystem. It's not just one product, it's an entire portfolio of software tools that enables all these robotic systems, where they're on the ground, in the water, under the water, AVs or non-AVs, and we actually integrate with more non-AV products today than we do with AV products on the AV – under the AV_Halo umbrella.

So that's one area. And within the AV_Halo software ecosystem, we have three or four key areas that is even more critical. One is, for example, autonomy. Autonomy for drones is very different than autonomy for cars. It's a very different problem, it's a complete different set of technical challenges. So that's one area which we lead. We're really the leader in that space, by far the leader. And I'm saying leader not because that we have the technology, but we have the track record of our system being actually utilized in the field effective better than anyone else's in the entire globe that we know of.

Another area is the area of computer vision and neural networks that allows these drones not to find their way somewhere like a human, but also then when they find their ways to find the right object, it's to find the right ATR, automatic target recognition. It's being able to recognize a Chinese small boat from an American boat, a T-72 tank from an Abrams tank. These are very unique set of computer vision, data sets and annotated libraries that the algorithm is not the problem or the challenge. The problem is getting access to this data and training it the right way to be able to do that. So, we're ahead of everybody, and by the way, our software is running on a lot of our competitor platforms, too, unmanned systems.

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The other area is also the underlying key technologies in terms of C2, it's called command and control. You saw the example, the U.S. Marine Corps made a decision very recently, they chose our KINESIS that essentially it's called AV COMMAND that allows you to control multiple robots. If I'm a soldier, I'm going to have three different types of drones, five different kinds of ground robots and a UUV, whatever else I have, I'm not going to carry 7 or 10 controllers. I have to have one controller, a simple user interface that allows me to not only just see what's going on from these assets, but also command them and control them and tell them to do a mission.

And so, we bought a company, as you know, called Tomahawk that is the leader in that space. And over the last three years, we've been able to improve that even more, and we were chosen as the standard for the U.S. Marine Corps going forward. In fact, we already control a whole bunch of other ground robots and stuff that we don't make in that atmosphere. So, that is going to continue to happen and the rest of it.

Another area, just to round it up, is also the software that goes into battle management. Players in the industry are making this very complicated. And it's so confusing, you don't know exactly what this is. And so, we don't want to play that game. We are not made of that fabric. What we're going to do is continue to launch products and describe exactly what it does and how it fits in the bigger picture.

So, what is AV COMMAND, what is AV – so all these pieces we're going to describe and we're going to explain it, because besides investors, actually, our customers don't even know exactly what these things do for our competitors and there's so much FUD in the market.

And so, I believe that we have by far the most sort of prolific set of software solutions [indiscernible] (00:33:55). The second area that we're doing is that platforms that use commonality across multiple software verticals and hardware verticals. So, we are developing modules that are avionic modules, radios, gimbals, sensors that could go into more than one platform. That is what gives us also an advantage over all the other competitors, because one of our dollars equates to $10 of others people's investing in it, and it allows us to stay agile in that regard, too. Many of the changes that we made in software for Puma apply to Switchblade, from Switchblade it apply to JUMP 20, and that's going to be the model that it's going to help our military get a bigger bang for their buck.

Ken Herbert Q

Analyst, RBC Capital Markets LLC

So, you've recently completed the largest acquisition in the company's history, BlueHalo. Maybe you can talk a little bit about the strategic rationale behind that. And I guess, more importantly, bigger picture, sort of what you see within consolidation in the defense industry? Is the areas you talk about are very exciting and there's some scarcity to it. How do we think about consolidation or how should we think about consolidation over the next few years?

Wahid Nawabi A

Chairman, President & Chief Executive Officer, AeroVironment, Inc.

Yeah. So, I think the – there is two levels of consolidation that's taking place, the big primes, the seven, they're going to continue to try to supplement and complement their portfolio with things that are out there, and most likely we're one of the targets, makes a lot of sense for them. But we're up for sale every five days a week at least or most of the weeks. And so, that's not an unattainable question or a problem.

The other area is companies like us who's trying to build enough of a mass, not because we want to be big, but because we want to solve our customers' problem better. Our acquisition has been delivered specifically for the warfighter and for the – our customers. So, the BlueHalo, we've known that company for since existence. I've

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known them, the firm and as well as the – and actually, you guys helped us, thank you very much, you were our advisors on this.

And I think it's the – one of the best acquisitions we've ever made. It's large, but the interests and the beliefs of the two shareholders are 100% aligned, because it was an all-stock deal, number one. It's rare for a private equity to take all-stock. They're a believer in the long-term strategy. And if you look at the two solution sets, portfolio-wise and capability-wise, there's almost no overlap. There's a little bit of a technology overlap, which is actually good, but we do not serve in the same domains. They have a space business that we were missing.

So, to be an all-domain robotic unmanned systems coupled with AI, autonomy, computer vision, software, which is our strategy since the decade-and-a-half ago, BlueHalo is like a – fit like a glove in the hand. It's that critical for us to be in these categories. We did not have an RF Counter-UAS solution set. We intentionally stayed away from that, because we were too busy building our Loitering Munition and our small UAS and medium UAS business. They were there and directed energy solutions for – to take the cost of shooting down a $100,000 drone from $2 million to $3 million today with the big primes missiles to $10 a shot.

And if you guys come to our Open House at the end of this month, two weeks from now, you'll actually hopefully get to see a demo of it. And so, they had the solution for – they are upgrading the entire space department's – the entire Department of Defense's geosynchronous satellites RF communication with our phased array SCAR, it's a $1.7 billion program that we won against the major primes, and that's rolling out [indiscernible] (00:37:39) number is going to be produced this year.

So, they have a half a dozen of these products that was in development phase, getting ready to go to low-rate initial production, and we have a lot of expertise on how to transition to production and scale. And so, that was a tremendous benefit for them. And our portfolio now is literally unmatched. You look at our portfolio, not only does we have the solution set that we need, we still have some holes, it's never going to be perfect, but it's unmatched in the industry, number one; and two, it's backed by legitimate customers and scale and proven installed base and customers that could say you don't have to like – it's not a prototype, it's in production.

Ken Herbert
Analyst, RBC Capital Markets LLC

Q

Yeah. So, let me ask you, one of the aspects I think that's most exciting about BlueHalo was the counter unmanned or counter unmanned aerial systems marketplace. We tend to think of that today predominantly as something in a warzone or warfighting atmosphere. But I can see a scenario in several years where it becomes much more ubiquitous in our daily life around infrastructure and airports and other things. How do you see this playing out? How do you see the opportunity set for AVAV? But also just sort of more generally, how we should think about this as we think about impacting our daily lives perhaps over the next several years?

Ken Herbert
Analyst, RBC Capital Markets LLC

Q

So, that's another nerve point that you hit that's really important. I felt this way about, for example, Switchblade 10 years ago, and I knew that it's not a matter of if, it's a matter of when. It's going to take some incident in the world for people to realize the value of Loitering Munition. Because it's just the way it does, it is just like remarkable what it – so, I think Counter-UAS is something that I hope it doesn't follow the same pattern. And Ukraine warned [indiscernible] (00:39:29) the Switchblade and Drones.

I hope it doesn't take a national, social catastrophe of some sort, where somebody is flying 1 or 50 or 20 of these drones from a mile away and causing all kinds of problems for citizens, right, and that's a real threat. That's a real,

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real threat. I firmly believe that as adoption of drones and use of drones, both commercial and defense industry goes up, there's going to be bad actors, they're going to be – they're going to do crazy stuff. And we have to protect our commercial sites, airports, nuclear power plants, military bases, the Pentagon – I was in Congress last two weeks, and almost every senator and congressmen I met with they said, when can we put one of your solutions over Capitol Hill and over the Pentagon, over the White House, and these are things that we have to protect.

And it doesn't cost billions of dollars to protect them. And that's why we actually even announced a partnership with Sierra Nevada Corporation, which has another really proven track record of scaling and it's a private company, of course, but we did the Golden Dome. The Golden Dome is a capability, an initiative within the department to protect these things in a situation. And so, we believe we have the solutions that is off-the-shelf today that can do it. So, I think our Counter-UAS solution, both the RF jammers as well as the directed energy system that we have, is going to be just a matter of when. And it's already ramping up, but it's 5 to 10 years behind in terms of adoption than a small drone and loitering munition.

Ken Herbert
Analyst, RBC Capital Markets LLC

Q

So, I'd be interested, maybe Kevin again, from your perspective, you didn't come from the defense prime or the industry as well. So, you bring a completely different perspective into the CFO role. As you think about sort of balancing again this long-term opportunity with sort of near-term expectations, how do you feel the company is positioned from a financial standpoint now to really take advantage of these opportunities?

Kevin P. McDonnell
Chief Financial Officer & Executive Vice President, AeroVironment, Inc.

A

Well, I feel the same way, Wahid said, the best opportunities had in his career. I feel the same way and I've been with some very high-growth companies. But we definitely have the opportunity from where we sit today and all the breadth of our portfolio, the importance of those products to the defense of the US and its allies to double in the next three or four years. So, we're aiming for that type of growth. We need – fortunately, we raised some capital, put us in a good position, our balance sheet to be well-positioned for that. We're very EBITDA profitable. So, we think we're in a great position to capitalize on all these markets, both in US and internationally. So, some great opportunity for growth. And so, we say 15% to 20%, but in our hearts, we hope much more.

Ken Herbert
Analyst, RBC Capital Markets LLC

Q

In terms of growth opportunity?

Kevin P. McDonnell
Chief Financial Officer & Executive Vice President, AeroVironment, Inc.

A

Growth – it's hard in this business. One of things I've learned be in defense business now for over five years is that timing is the most difficult thing to predict. But if – it seems as if timing is becoming less of an issue, there's a sense of urgency. I think, I don't know if we touched on it today, but basically they're moving forward, these programs of record, maybe with two providers versus waiting two or three years to pick one for five years, let's just move forward with a couple and try them and get going, let's get using these products and understanding how they play in our force structure and things like that. So, I think that trend is in our favor. The trends of some of the initiatives to loosen up regulations for more export of drones and things like that is also in our favor. So, a lot of macro factors are very much in our favor and there's nothing better than doing a big deal when the macro trends are in your favor.

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Ken Herbert
Analyst, RBC Capital Markets LLC

Q

Yeah. Secretary Hegseth likes to show off his drones or likes to show off different aspects of the drones. How much time do you spend in the Pentagon and what are your relationships like there, and is there more you need to be doing there?

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.

A

So, that has changed significantly over the last five years as well. If you asked me that question five-plus years ago, I would have said, I go there couple of times a year, three or four times, and most people don't know who we are, and they know some of our products, but they don't know who we are. And now, it's – I'm there very frequent. I spend more than 30%, 40% of my time. We moved our headquarters to Arlington, Virginia, which is right across from Pentagon. And now, not only do we go there very often and very frequent, there's a lot of requests for us to come in, either testify in different committees or actually provide and ask – they want to talk to us and they know who we are, what we do. And they know that companies like AV has the wherewithal to actually help the department and help the government and help our nation.

And so, that is very important to me, because of my personal background. I'm very committed to the mission. And I benefited from the U.S. Military as a refugee that came to US 30-plus years ago. I was born and raised, as you know, in Afghanistan. And so, I escaped Afghanistan, because of the Soviet invasion of Afghanistan. And now, I'm making Switchblades to try to take down the communists. So, it's a – who would have ever predicted that. And so, to me, being able to help and actually – our country needs us. I mean, it's just not us, companies like us is a requirement for us to be able to fight the threats that we have.

I believe that majority of Americans, unfortunately, don't realize how serious this is, how much the things that we enjoy on a daily basis and our kids are really at real risk here. And I think we need to just realize that we're fighting over budgets and this and that, and we're talking about a defense budget that's 3% or 4%. And we don't realize that everything is at risk. If we don't let this – if we don't win this competition, everything is off the table – on the table. And that's a significant change for the world, not just the United States. So, I think we got to do what we got to do, and I'm there quite often, and that's why I'm committed to this mission, because we got to help.

Ken Herbert
Analyst, RBC Capital Markets LLC

Q

Maybe just take a step back. You, obviously with your legacy products, had quite a lot of success internationally. What's your view on international markets? And I know we've talked a lot about sort of an installed base internationally is very important. What are you seeing there in terms of either support from the government to sell more internationally? It sounds like regulations around international sales have opened up. And how much of a focus is that for you now just relative to what you're seeing here, obviously, in the United States?

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.

A

I mean, for us, it's huge. The main reason why it's huge is because historically, every product that we developed for the US DoD has eventually become the global franchise. We did the first one that's probably very notoriously well-known as Raven. We've got the largest number of Ravens installed in the US, has several thousand of them, and internationally, we got a couple thousand as well at least. And Puma has become the next one, and then the Switchblade is the next product, and there's at least two variants of Switchblade that 20 different countries want it.

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And so over the last 20 years, we've gone from one or two international customers to over 55. And vast, vast majority of that is in our non-lethal small UAS, Ravens and Pumas and Wasps. There is a huge potential opportunity for us to – and in some years, our international small UAS revenue has been bigger than our domestic. So that's how big this franchise is for us. And Switchblade is following the same exact trend, probably in a faster timeframe. And, yeah, so you should expect to see many more countries there, number one.

Two, BlueHalo products that we acquired, that was part of our strategy for the synergies and growth that every one of those customers is going to require Counter-UAS solutions. They want lasers, they want space comms and phased arrays, they have satellites in space, not all of them, but many of them do are close allies. And we can actually export and sell to them that as well.

And lastly, there is a strong, strong energy and focus and effort, intensity and effort. I mean, real – it's visible within Congress as well as within Pentagon and The White House and the departments, State, Commerce and DoD, to take these things, especially the things that we make. Quickly give them to our allies, enable US companies to export more, support that. You saw the announcement just a couple – a few days ago that came out about the regulations and policy around do you consider a loitering munition and a drone a missile or not. And the Administration's position is we don't.

It's not the same as exporting a Tomahawk or a cruise missile. And so, that is going to open up a lot of doors. There is very, very – and guess who's going to benefit the most. I think we're going to benefit a lot from it, if not the most, because we are ready and we can deliver now, and most of our allies need it now. It's not five years from now, it's this year, next year, the following year, because they're exposed. And if they have money to spend and you can deliver, I think you're going to get a lion's share of the business, which we have done in the past.

Ken Herbert
Analyst, RBC Capital Markets LLC

Q

So let me just maybe to bring it home, how do we think about this business in five years? If we're sitting up here in five years, how does AVAV look and what's different? And what's your aspiration as you think about this business, either from a financial metric standpoint, size metric, just what's your five-year plan look like for the business from an aspirational standpoint?

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.

A

So, I mean, it's in our future state definition, very simple, a all-domain unmanned robotics system solution provider with autonomy and AI software. It's basically building the next-gen prime that the US needs with the qualities and attributes and adjectives that our customers don't like about our current primes. That's agile, innovative, invest in R&D, defense tech prime is basically what we say we are.

And we've proven that formula. We're on that trajectory. I think our shareholders have done well in the last decade or so, and I've been here for 15 years. I can genuinely and honestly tell you with a lot of confidence that I look at our cards and I look at the market, we have never had better odds of success. We've never had better cards, that's A. B, I've never felt so good about our cards against our competitors also. Because, yeah, we have got competitors and there are going to be more players in the market if the market is going to become several billions of dollars, tens of billions of dollars, there's going to be more companies, and there's going to be room for others to also be successful.

But it's hard to then bet against AV. I mean, if you look at the odds, I think it's going to be really hard to – and the downside is not much at all. I mean, look at the kind of growth that we have. We've got franchises that are

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generating revenue, as Kevin said earlier, that has a large installed base, loyal customer base, they are in the fabric of militaries around the world and that ain't going to change tomorrow. It's going to be more of it, but it ain't going to change. And all that provides opportunity for sustainment upgrades of – so, there's a lot of good things that are – that is going our way, knock on wood, so.

Kevin P. McDonnell
Chief Financial Officer & Executive Vice President, AeroVironment, Inc.

A

I guess, I would add that kind of the vision would be a very diverse portfolio of products and capabilities, multiple product categories that are probably over $1 billion, but a lot of $200 million and $300 million product categories that are getting us to that over double where we're at today, something like that. So, very diverse, but we're not relying on one thing or that to gain success.

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.

A

Yeah. And if you ask me which one is going to be the one, there's like 10 candidates. So, we're working on all 10-plus, but we don't have to get them all right to get to what Kevin just described. And that's fundamental to our strategy, and we're working on every single one, but I think vast majority of them have the likelihood of converting into that kind of a franchise and a portfolio.

Ken Herbert
Analyst, RBC Capital Markets LLC

Well, we really appreciate the time. Kevin, Wahid, it's great to have you with us here. Appreciate everybody sticking around lunch. Hope – obviously, really appreciate the support for RBC and hope everybody has a great conference, and thank you very much for the words.

Wahid Nawabi
Chairman, President & Chief Executive Officer, AeroVironment, Inc.

Thank you.

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