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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to AeroVironment's Fiscal Year 2024 Second Quarter Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your speaker today, Jonah Teeter-Balin. Please go ahead, sir.

Jonah Teeter-Balin - *AeroVironment, Inc. - Senior Director of Corporate Development & IR*

Thanks, and good afternoon, ladies and gentlemen. Welcome to AeroVironment's Fiscal Year 2024 Second Quarter Earnings Call. This is Jonah Teeter-Balin, Senior Director of Corporate Development and Investor Relations.

Before we begin, please note that certain information presented on this call contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements involve many risks and uncertainties that could cause actual results to differ materially from our expectations. Further information on these risks and uncertainties is contained in the company's 10-K and other filings with the SEC, [and] particular in the Risk Factors and forward-looking statement portions of such filings. Copies are available from the SEC on the AeroVironment website at www.avinc.com or from our Investor Relations team.

This afternoon we also filed a slide presentation with our earnings release and posted the presentation to the Investors section of our website under Events and Presentations. The content of this conference call contains time-sensitive information that is accurate only as of today, December 5, 2023. The company undertakes no obligation to make any revision to any forward-looking statements contained in our remarks today or to update them to reflect events or circumstances occurring after this conference call.

Joining me today from AeroVironment are Chairman, President and Chief Executive Officer, Mr. Wahid Nawabi; and Senior Vice President and Chief Financial Officer, Mr. Kevin McDonnell. We will now begin with remarks from Wahid Nawabi. Wahid?

Wahid Nawabi - *AeroVironment, Inc. - Chairman of the Board, President & CEO*

Thank you, Jonah. Welcome, everyone, to our fiscal year 2024 second quarter earnings conference call. I'll start by summarizing our performance and recent achievements, after which Kevin will review our financial results in detail. I will then provide information about our outlook, including our increased revenue projections for the remainder of fiscal year 2024. Kevin, Jonah and I will then take your questions.

I'm pleased to report that our second quarter results once again exceeded expectations, and we remain on track for our best year ever. Our key messages, which are also included on Slide #3 of our earnings presentation are as follows. First, second quarter revenue rose to \$180.8 million, up 62% year-over-year, representing a record Q2 for AeroVironment. We also posted very strong bottom-line results powered by record demand, strong operating execution and effective supply chain management.

Second, we have a healthy backlog of \$487 million, which is higher than the start of our fiscal year and provides solid visibility for the quarters ahead.

Third, on our last call, we announced our intention to acquire privately held Tomahawk Robotics, which we successfully completed in September. As I will review in a moment, we are well on our way to fully integrate the 2 businesses, while [ravaging] our combined technology across our portfolio. And fourth, we are updating guidance, including an increase to our revenue target, reflecting our strong performance and the impact from the Tomahawk acquisition.

Overall, we're very pleased with our performance through the first half of this fiscal year, which included significant top line revenue acceleration and record EBITDA. We remain optimistic about our future, exemplified by higher growth, improving operating results and enhanced value creation for our shareholders.

As we said last quarter, this reflects not only near-term demand dynamics related to global [comp mix], but also a long-term shift in military strategy for the more frequent use of intelligent multi-domain unmanned systems, which are easy to use, highly effective and provide a compelling value proposition.

Our differentiated portfolio offers the greatest breadth and depth of unmanned solutions to meet the growing demands of our country and allies. We are an industry leader in contested environment as well as AI-enabled autonomous operations and governments are around the globe are witnessing these unmatched capabilities effectively perform on real and highly contested battlefields.

As a testament to the incredible effectiveness of our innovative solutions, we now have 9 different unmanned platforms deployed in Ukraine, all receiving high levels of praise. We could not be prouder and more honored of how our solutions and team members are helping our customers successfully achieve their vital missions.

We're also pleased with our progress on fully integrating Tomahawk Robotics into our existing business. As a reminder, Tomahawk, now part of our Unmanned Systems segment, is a leader in AI-enabled robotic common control systems and open standard communications.

As a company, we are increasing interconnectivity and interoperability across our portfolio, making it easier for our customers to successfully manage their growing fleet of unmanned systems. We have already received positive feedback from our customers and intend to leverage this combination to better support their current and future missions.

We now offer an unmatched capability to integrate unmanned platforms across multiple domains, while providing a common operating picture for the war fighter. For all the reasons just mentioned, we remain confident in our ability to deliver strong value to our stakeholders in fiscal year 2024. We expect that our cutting-edge solutions will be at the forefront of government decision-making for years to come.

Now let me provide an update on current developments within our segments. Starting with our Unmanned Systems segment, revenue more than doubled year-over-year. Shipments during the quarter continued to reflect strong demand across nearly all our product lines with significant growth in our Puma and JUMP 20 systems. We have nearly completed delivering all the Puma LE and Puma 3 AE systems, which were part of last year's large Ukraine FMS order.

We have received additional follow-on orders for Ukraine, which we expect to fulfill later this fiscal year. A portion of these new orders for Ukraine are direct commercial sales to the government of Ukraine. This is another testament to the battle proven and industry-leading capabilities of our Puma system. We also began delivering the initial batch of JUMP 20 systems to Ukraine as part of our previously announced \$42 million award under the Ukraine Security Assistance Initiative.

We remain confident that the JUMP 20 system is also the most capable solution in its class and expect additional shipments to Ukraine in the third and fourth quarters. Additionally, it is important to highlight 2 recent successful tests of the JUMP 20. First, we successfully demonstrated a fully autonomous flight at the U.S. Navy's hybrid fleet campaign in QS, Florida.

During the exercise, we showcased the JUMP 20's ability to launch and recover from a vessel moving more than 20 knots without user intervention. Second, our team supported the U.S. Army in several allies at their Arcane Thunder exercise in Poland. This event held in September utilized several of our systems as part of a demonstration of the Army's modernization initiative. The customer response to the JUMP 20 has been very positive, and we plan to continue investing in this platform to meet our customers' future needs.

In summary, segment growth this quarter was due to record deliveries overseas, and the demand for our system is expanding. There are multiple potential orders in the pipeline, which are not yet reflected in our backlog. The global trends we discussed previously, plus our healthy pipeline of opportunities, provide even more reason to be optimistic about our Unmanned Systems segment for the remainder of fiscal year 2024 and beyond.

Moving to our Loitering Munitions segment. As anticipated, this quarter's revenue was approximately flat year-over-year. Our shipments are meeting expectations, and we continue to build inventory in anticipation of the numerous opportunities in our growing pipeline. Namely, we're expanding sales to allied countries across the globe, continuing shipments to Ukraine, backfilling U.S. stockpiles and pursuing future DoD (inaudible) [of] the record.

We're actively in negotiations with the U.S. government to secure a large multiyear sole-source IDIQ contract for Loitering Munitions products, which will meet the substantial U.S. DoD and international allies demand. There is also proposed legislation in Congress to continue supporting Ukraine, Israel and Taiwan, which includes additional funding for Switchblade. We continue to make progress with new international customers. We are currently engaged with more than 20 countries, who wish to receive Switchblades and about 1/3 of those cases are actively in the U.S. DoD's export approval process.

At the same time, we've responded to multiple U.S. DoD customer RFPs for multiyear programs of record acquisitions this past quarter. These include the U.S. Marine Corps solicitation for its organic precision fires, or OPF program and the U.S. Army's low altitude stocking and strike ordinance, or LASSO program. The U.S. Army recently stated that AeroVironment will receive a sole-source contract to provide 100 Switchblade 600s for LASSO Increment 1 for testing and fielding.

We're optimistic about the future of this program due to the incredible real-world performance of our Switchblades and our significant high-volume manufacturing capacity. We're also working on integrating Switchblades onto other vehicle platforms, such as Abrams tanks, Humvees, the next-generation Optionally Manned Fighting vehicles and on helicopters through the long-range precision munition program.

To summarize, the LMS pipeline is robust with many opportunities not yet reflected in our backlog, and we remain optimistic about the future growth potential of this business. We expect the LMS segment to be a stronger contributor of revenue growth in the second half of this fiscal year.

Moving to our MacCready Works segment. Quarterly revenue was also roughly in line with last fiscal year as this segment continues to focus on developing key technologies and incubating future solutions. Our HAPS team continues to make progress on the development of a full-scale next-generation Sun glider, while also working with the U.S. DoD on defense missions.

We expect to benefit from additional funding perhaps in the government fiscal year 2024 budget, which is awaiting approval by Congress. In addition, we continue to see strong engagement in developing novel next-generation defense solutions. Last quarter, we spoke about DARPA's ancillary program, where we have now been awarded a small contract for Phase 1 of its development. We're also progressing on a jointly funded program under development by the U.S. Army's Combat Capabilities Development Command, or DEVCOM in Natick, Massachusetts, called the Squad Operations Advanced Resupply, or SOAR. This large autonomous unmanned aircraft system will provide long-range precision delivery within contested environments.

Flight testing of the first system is currently underway, and we expect Phase 3 development to be funded by the government fiscal year 2024 budget as well. As you can see, we have many exciting and innovative development projects in our MacCready Works pipeline and remain excited about the potential to develop new capabilities, which could lead to new lines of business from this segment.

With that, I would like to now turn the call over to Kevin McDonnell for a review of the quarterly financials. Kevin?

Kevin Patrick McDonnell - AeroVironment, Inc. - Senior VP & CFO

Thank you, Wahid. Today, I'll be reviewing the highlights of our second quarter performance, during which I will occasionally refer to both our press release and earnings presentation available on our website.

Overall, we had another outstanding financial quarter as the second quarter finished strong in terms of revenue, adjusted gross margins and adjusted EBITDA and backlog. As Wahid mentioned in his remarks, revenue for the second quarter of fiscal 2024 was \$180.8 million, an increase of 62% as compared to the \$111.6 million for the second quarter of fiscal 2023.

Slide 5 of the earnings presentation provides a breakdown of revenue by segment for the quarter. Our largest segment during the quarter was Unmanned Systems, UMS, which is a combination of our small UAS, medium UAS, UGV and recently added Tomahawk businesses. UMS had revenue of \$132.8 million in the quarter, which is up 115% from last year's \$61.6 million, driven primarily by strong international demand for our improvement systems.

As Wahid mentioned, we also began shipments of the JUMP 20 product to Ukraine during the quarter, which contributed to the revenue growth. Loitering munitions systems, or LMS, recorded revenue of \$30.2 million, a 3% decrease as compared to the \$31.1 million last year during Q2. The Switchblade 600 product was the primary driver of revenue during the quarter, and at the same time, we are beginning to ramp up the production of the Switchblade 300 Block 20 product, which was introduced earlier this year.

Revenue from our MacCready Works segment came in at \$17.8 million, a decrease of 6% as compared to the \$18.8 million from the second quarter of last fiscal year. We continue to see strong demand for machine learning and autonomy capabilities with various agencies of the U.S. DoD and U.S. government agencies, which was offset by lower SoftBank funded HAPS revenue.

On Slide 5 of the earnings presentation, there's a breakdown between product and service revenue. Specifically, during the second quarter, product revenue accounted for 81% of total revenues, a notable increase from the 56% in the corresponding quarter of the previous year due to strong product revenue from small UAS and to a lesser extent from lower COCO service operations.

For the remainder of fiscal 2024, although we expect product revenue to be close to 80% of total revenue, we also expect LMS revenue to increase as a percentage of product revenue. LMS revenues have lower gross margins relative to small UAS products, so we expect a shift to reduce product gross margins.

Speaking of gross margins, Slide 6 of the earnings presentation shows the trend of adjusted product and service gross margin, while Slide 12 reconciles the GAAP gross margins to adjusted gross margins, which excludes the intangible amortization expense and other noncash purchase accounting items. In the second quarter, consolidated GAAP gross margins finished at 42%, up from 23% in the previous year. The improvement in GAAP gross margins was largely a result of improved product service mix and strong product gross margins from international small UAS.

Second quarter adjusted gross margins reached 43%, marking a substantial increase from the 27% recorded in the same period last year. This improvement was driven by the same factors as for the GAAP gross margins. Adjusted product gross margins for the quarter were 47% versus 38% in the second quarter of last fiscal year due to the high mix of international revenue from our small UAS products during the quarter.

In terms of adjusted service gross margins, the second quarter was at 28% versus 12% in the same quarter last year. Last year, we had accelerated depreciation on a portion of our assets, which negatively impacted our service gross margins. We expect fiscal year 2024 adjusted gross margins

to end up in the high 30s to low 40s following the anticipated increase in Loitering Munitions Systems revenue in the second half of the fiscal year, both in terms of dollars and percentage of total revenues.

In terms of adjusted EBITDA, Slide 13 of our earnings presentation shows a reconciliation of the GAAP net income to adjusted EBITDA. In the second quarter of fiscal 2024, adjusted EBITDA was \$40 million, representing an increase of \$33 million as compared to the \$7 million from the second quarter of last fiscal year. The main factors contributing to this increase were higher revenue and favorable revenue mix, which was partially offset by incremental SG&A expenses and investments in R&D.

SG&A expense, excluding intangible amortization and acquisition related expense for the second quarter was \$26 million or 14% of revenue compared to \$19 million or 17% of revenue in the prior year. While R&D expense increased year-over-year in terms of -- in dollar terms, R&D expense as a percentage of revenue was 12% versus 15% in the corresponding quarter of last year. We expect R&D to continue to run closer to 12% for the full year as we continue to invest in new products and upgrades to existing products to meet the evolving needs of our customers. This also includes internal funding of our HAPS solar aircraft.

Now turning to GAAP earnings. In the second quarter, the company generated net income of \$17.8 million versus a net loss of \$6.7 million recorded in the same period last year. The increase in net income of \$24.5 million can be attributed to several factors, namely a \$49.5 million increase in gross margin driven by a rise in sales volume and improvements in revenue mix and the \$2.9 million decrease to intangible amortization and other acquisition-related expenses were partially offset by a \$11.6 million increase in taxes, a \$6.7 million increase in SG&A expense, a \$5.4 million increase in R&D spending and a \$3.8 million increase in unrealized losses in equity-related investments.

Slide 10 shows the reconciliation of GAAP and adjusted or non-GAAP diluted EPS. The company posted adjusted earnings per share of -- diluted per share of \$0.97 for the second quarter of fiscal 2024 versus a \$0.01 per diluted share for the second quarter of fiscal 2023. Turning to our balance sheet. Total cash investments at the end of the quarter was \$121.5 million, which is a decrease of \$6.9 million from the second quarter of fiscal 2023.

During the quarter, we reduced our term debt by \$50 million to \$80 million. Inventories increased \$6 million during the second quarter of fiscal 2024, primarily driven by the Tomahawk acquisition. Inventories will remain at these higher levels as we prepare for shipments in coming quarters and carry extra inventory as a result of supply chain risk minimization.

We continue to have a strong balance sheet with over \$100 million of cash in investments and approximately \$100 million available under our working capital facility.

I'd like to conclude with some highlights of our backlog metrics. Slide 8 of the earnings presentation provides a summary of our current fiscal 2024 visibility. As Wahid mentioned, our funded backlog at the end of the second quarter of fiscal 2024 finished at \$487 million. Visibility to the midpoint of our revised FY '24 revenue guidance range is 98%.

Now I'd like to turn things back to Wahid.

Wahid Nawabi - AeroVironment, Inc. - Chairman of the Board, President & CEO

Thanks, Kevin. Given our strong quarter performance and the addition of Tomahawk Robotics, we have revised our guidance and increased revenue outlook for fiscal year 2024 as follows. We anticipate revenues of \$685 million to \$705 million. Net income guidance of \$45 million to \$51 million or \$1.66 to \$1.90 per diluted share. This decrease reflects Tomahawk acquisition-related expenses.

Non-GAAP adjusted EBITDA of \$119 million to \$127 million and non-GAAP earnings of \$2.46 to \$2.70 per diluted share. We expect an evenly distributed second half revenue split between each of the remaining 2 quarters of this fiscal year. Based on our record first half performance and a strong backlog, we now have almost full visibility to the midpoint of our revised revenue guidance. And as expected, gross margin for the second half of this fiscal year is anticipated to be lower than first half, primarily due to product mix.

Lastly, while the situation in Washington has led to slower decision-making, we know our solutions are crucial to our customers in the U.S. and around the world. While operating under a continuing resolution slows down new program starts, we remain optimistic that budget priorities will be resolved and that our programs will eventually get funded. We hope that our supporters on both sides of the aisle can achieve consensus in the very near future.

We are very pleased with our position midway through the fiscal year as we continue to meet the needs of our growing customers. The trends we see now represent an inflection point in our growth, which should drive greater demand beyond our current fiscal year.

As I've stated in the past, our nation and allies are realizing the immense value proposition of our distributed autonomous unmanned solutions enabled by AI. We expect strong growth even when the active conflicts wind down as there will be still an underlying need for deterrence with many new programs supporting further adoption of our innovative and battle-tested solutions. We continue to lead the industry in contested environment operations, autonomous missions and true Loitering Munitions capability.

AeroVironment solutions can identify threats, track them in real time and neutralize them with maximum effectiveness while minimizing collateral damage. We will continue to invest in our innovative solutions to ensure they meet our customers' [exact] standards and perform when needed in real-world environments.

Now let me once again summarize the key points from today's call. First, we delivered record second quarter results, exceeding expectations and raised our revenue outlook for fiscal year 2024. Second, our backlog remains strong, reflecting global demand for our innovative and combat-proven solutions. Third, we successfully completed the Tomahawk Robotics acquisition and are on track for onboarding this business into our Unmanned Systems segment.

And fourth, the outlook for AeroVironment Solutions continues to improve due to the strength of our product lines and accelerating global demand. We're well prepared to execute in the second half of this fiscal year and now expect further double-digit top line growth in fiscal year 2025.

Before turning the call over for -- to questions, we're excited to welcome retired General Joseph Votel to our Board of Directors. General Votel brings extensive knowledge of today's military operations and strategy, especially with Joint Special Operations Command, or JSOC, and Central Command, or CENTCOM. His guidance will be instrumental in helping AV meet the current and future needs of our country and allies abroad.

And finally, thank you to our investors for their unwavering support of our mission, and thank you to our customers for putting their faith in AeroVironment. Our success is due to the talent of our team who go above and beyond to continuously improve our products, strive for new innovative solutions, effectively manage the company's supply chain and meet our customers' needs in a timely and expeditious manner. We are honored to support our country and allies at this critical time, and we expect further success during the remainder of fiscal year 2024 and beyond.

And with that, Kevin, Jonah and I will now take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Greg Konrad from Jefferies.

Gregory Arnold Konrad - Jefferies LLC, Research Division - Equity Analyst

Great quarter. Maybe just to start, and I might have missed it, but did you give any color around the contribution from Tomahawk in the revised guidance? Or how do we think about the higher guidance from core versus the Tomahawk contribution?

Wahid Nawabi - AeroVironment, Inc. - Chairman of the Board, President & CEO

So Greg, Tomahawk Robotics is now part of -- as a product line within our Unmanned Systems segment. And as you know, we don't break down the details of each of our product lines because we have several of them. However, what I can say is that in terms of our guidance, the increased revenue top line guidance is attributed to both organic demand and growth in our business as well as the portion of it is related to the acquisition of Tomahawk. We believe that both of these 2 are fairly equally represented in terms of the demand for the second half of this year. We see strong growth across our product lines and our core businesses as well as the addition of Tomahawk. So we're very excited about both.

Gregory Arnold Konrad - Jefferies LLC, Research Division - Equity Analyst

And then maybe just for the second one, staying on Tomahawk. You mentioned integration. Can you maybe provide road map and kind of timing and major milestones when you think about that integration and maybe potential revenue synergies and how you're thinking about timing and magnitude of some of those events?

Wahid Nawabi - AeroVironment, Inc. - Chairman of the Board, President & CEO

Of course, for sure. So the feedback so far from our customers, which is the most important thing for me, in particular, has been extremely positive about the acquisition and the synergies that we're going to be able to deliver in terms of improving our customers' experiences in a common operating picture for the war fighter. In terms of integration, we have a very detailed multiphase integration plan. We're on track. We're ahead of our schedule. They are now already integrated with our business in terms of being part of our Unmanned Systems segment.

We have actually expanded the role and responsibility of the 2 cofounders of Tomahawk Robotics. They're now general managers of our larger businesses within AeroVironment. They're very excited about the prospects of the future. In terms of the road maps, we're already working some of those. We're very excited. And in fact, we're more bullish now than we were even before that there's tremendous synergies between our capabilities and our products and technologies, namely -- and the foreseeable future, we're going to be able to integrate pretty much all of our products.

Our unmanned ground vehicles or unmanned UAVs, air vehicles, all with the Tomahawk Robotics common controller as well as would allow us to actually integrate other third-party platforms into this effort. Now that effort is a multiyear effort because there are lots and lots of demand for integration from external customers even in partners, but also -- and on-site there's significant opportunities for [integrate].

The last thing I want to mention is that their location in Southern -- in Florida -- in Eastern Florida, actually is very positive for us, too. They've got a tremendous team. We're very excited and encouraged by their talent, both engineering and business. And we're going to actually start to scale our resources in terms of headcount even at their facilities. So it actually gives us a better footprint in the East Coast where most of our customers are as well as allow us to hire and grow our talent as our growth desires -- or requires it.

Operator

And our next question comes from the line of Peter Arment from Baird.

Peter J. Arment - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Yes. Nice results. Hey, Wahid, could you give us the latest kind of status update of the Switchblade 600? I know there's been some recent articles out there about some of the Eastern European countries looking to start to take delivery of that product. Where are we in terms of the potential production for the Switchblade 600?

Wahid Nawabi - *AeroVironment, Inc. - Chairman of the Board, President & CEO*

Sure. So I'm glad to report that we've had many -- several of the U.S. government and U.S. DoD's leadership as well as congressional leaders visit in the last couple of weeks related to our Switchblade production. We have a significant amount of production capacity which we've invested in. We were very fortunate. That's a major plus because we can deliver Switchblade by the thousands now. And we can deliver them at U.S. DoD program of record quality and caliber and maturity.

Secondly, there are several -- about 20 different countries that we're engaged in, in terms of their interest in acquiring Switchblade or wanting to receive Switchblade. About 1/3 of those cases are already an active Department of State and Department of Defense export approval process.

So I expect in the next 6 months or so that this process will go faster than before because the demand is very high and the U.S. defense organizations as well as Department of State is very favorable towards helping us equip these countries with Switchblade. We've delivered quite a good chunk of those Switchblade 600s and 300s so far to the U.S. DoD. All of these cases so far for Switchblade remain to be FMS cases.

So, A, [we've] delivered a lot. There's 5 countries that have already spoken for them and they've gone public about it, and it's made its statements. There's a total of 20 countries that we're actively involved with and about 1/3 of those are actively in the export approval process, which is really, really encouraging and positive.

In addition to that, Peter, I also want to mention that we're actively negotiating with the U.S. DoD on a very large multiyear IDIQ sole-source Switchblade contract that allows the U.S. DoD to purchase large quantities of Switchblade for multiple years from AeroVironment and then actually fulfill the needs for Ukraine for the U.S. DoD stockpiles and programs as well as for our allies in the FMS cases. That actively is in process. It will take some time, but it's very encouraging.

Peter J. Arment - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

And Kevin, maybe just a quick one for you on -- you made some comments about that, you kind of expected the gross margin -- adjusted gross margin for the year to end up in the low 40s to high 30s. Maybe you could just -- that implies, I guess, in the second half of the year if you're going to be in the high 30s that you'd see that gross margin come down, I guess, maybe to mid-30s or so. Is that primarily tied to the LMS revenue ramp? Or could you maybe -- highlight maybe some of the puts and takes there?

Kevin Patrick McDonnell - *AeroVironment, Inc. - Senior VP & CFO*

Right. So you kind of have a combination of a little bit lower small UAS revenue and then that's kind of replaced by the lower margin element in the second half.

Operator

And our next question comes from the line of Ken Herbert from RBC Capital Markets.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

Hey, Wahid, maybe if I could, just to sort of put a finer point on the mix impact in the second half of the fiscal year. What's your outlook for growth, specifically within the LMS segment for the second half of the year, I mean second quarter growth there? I mean, consistent with your expectations, but flattish down slightly. How much of the second half growth is going to come from that segment relative to UMS or MacCready Works?

Wahid Nawabi - AeroVironment, Inc. - Chairman of the Board, President & CEO

So Ken, I'm glad you asked that question. First of all, this fiscal year, Loitering Munitions as a whole, we expect it to be the strongest driver of our growth overall. It's going to be very, very robust growth for the whole year. That's our expectation. As we expected, and as I said in my comments, the first half of the year is very much in line to our expectations and how we thought it's going to play out, primarily because the contracts for Switchblade are very large, lumpy contracts. We had a very strong fourth quarter, if you remember last fiscal year, which we had a record shipments and record bookings. That has allowed us to ship on the first quarter and the second quarter according to our plans.

Second half is going to be very dominant in terms of growth and revenue driver for Switchblade 300 and 600. We have a robust pipeline for Switchblade that is not only going to fuel our second half performance in terms of revenue and bookings, but it's also going to fuel our fiscal '25 and beyond. I mean the pipeline for Switchblade 300 and 600 looks extremely promising.

It just takes a little while primarily because of the nature of the product, the government contracting process and the FMS approval process that we have to go through for all these exports. But overall, I think second half is going to be dominant by our Loitering Munitions business, both in terms of bookings as well as in terms of revenue performance for the year.

Kenneth George Herbert - RBC Capital Markets, Research Division - Analyst

And maybe Wahid or Kevin, what's your outlook for full year free cash flow? I mean you've sort of used [\$36 million] or so through the first half of the year, your significant investments in working capital. Do we expect much relief in positive free cash in the second half of the year? Or how do we think about the full year from a cash basis?

Wahid Nawabi - AeroVironment, Inc. - Chairman of the Board, President & CEO

I mean, I'm not banking too much on a lot of relief. But I think the working capital levels will stay around this mark here in the third and fourth quarter, maybe even up a little in the third quarter and then come down a little bit in the fourth quarter. And then I think you'll start to see some improvement, at least as a percentage of overall sales in FY '25.

Operator

(Operator Instructions) And our next question comes from the line of Pete Skibitski from Alembic Global.

Peter John Skibitski - Alembic Global Advisors - Senior Analyst

I think -- I guess, one for me, how do you guys -- what's the right way to think about the -- kind of the time frame or the path to improve LMS gross margins? And what are the major factors that impact that through the midterm?

Wahid Nawabi - AeroVironment, Inc. - Chairman of the Board, President & CEO

So Pete, we actually have seen fairly strong improvement on the gross margin of our Switchblade product line as a whole relative to the last several years, and we continue to make even more progress. Having said that, our small UAS, especially international contracts and orders are by far the most profitable products because we've invested for many, many years in that product line, and we're able to sell those as a commercial item to a lot of our international customers.

So while our small UAS has set a very, very high bar in the industry, if not only just for AeroVironment. Switchblade gross margins and profitability is fairly strong and it's improving. How well that it's going to be -- usually our hardwares are in the upper 40s -- mid-40s or low 40s and Switchblades are in the mid to high 30s. So it's not that much off of our small UAS and it's improving. We have several activities and strategies on improving that,

one of which, of course, is volume and lowering the cost inputs and allowing us to actually get more efficient in production, which we are making significant improvements, and our team has managed that really well.

And the second thing is also in terms of improving the cost in terms of the Block 20 product. Switchblades Block 20 and the next-generation systems are actually easier to manufacture, has less labor content and much more automation in terms of its manufacturing capabilities. So we've got several activities, which many of them have already paid some dividend, and they'll continue to pay dividend going forward as well.

Peter John Skibitski - *Alembic Global Advisors - Senior Analyst*

Just one more for me. I just want to understand, guys, in terms of this big Switchblade IDIQ just coming down the pike, how will that product sort of -- and how that meets Army requirements, how would that differ from the LASSO contract for the Army, assuming you win LASSO at some point? I don't know if time frame is on that, but it seems like similar products. So I don't know if LASSO is deemed as a mid to long-term replacement for the Switchblade IDIQ? Or what's the right way to think about that?

Wahid Nawabi - *AeroVironment, Inc. - Chairman of the Board, President & CEO*

Sure, Pete. So let me add some comments or color to this thing. Historically, U.S. Army has been the main contracting office for procuring Switchblades for U.S. DoD as well as for our allies, and that remains still the case right now for the most part. And we used to have a large contract that we bought under for multiple years. And since the demand has gone up so much higher, that contract has reached a ceiling. So now the U.S. government basically buys these on individual UCaaS or [undefinitized] contract action items -- actions, which is laborious for both the government as well as for us.

What they have started to do is to actually initiate another very large multiyear sole-source IDIQ contract for all Switchblade, both for U.S. DoD as well as our allies. So the LASSO contract and some of the other ones, until that large multiyear contract is in place, will still be executed and awarded to us based on these UCaaS. But long-term what we want is a larger contract vehicle that allows the U.S. government to buy from many customers, many opportunities and funding sources and fulfill those much easier.

So we're very pleased that the U.S. Army and U.S. DoD has taken that initiative. We're actively working that. It's going to take some while because of the [CR] situation as well as with the bandwidth of U.S. DoD in terms of contracting resources, but we feel very good. We've already turned in our proposals. We're negotiating the rate structures, and I think it's going to be more of a matter of when versus [if]. And when that goes into effect, then it actually allows a lot more volume to go through and a lot more procurement to happen much faster in terms of their time. And so we're looking forward to that. It will be very, very positive for us and for our customers.

Operator

And our next question comes from the line of Louie DiPalma from William Blair.

Michael Louie D DiPalma - *William Blair & Company L.L.C., Research Division - Analyst*

I'm following up on several of the recent questions. You mentioned the Army announcing that they awarded AeroVironment 100 LASSO systems. Are those 100 systems already in backlog? And what's the general expected time line for the LASSO program in terms of Phase 1 and subsequent phases?

Wahid Nawabi - *AeroVironment, Inc. - Chairman of the Board, President & CEO*

Sure. So, Louie, that particular contract award has 2 very positive aspects to it, and that's why I highlighted it. Number one, it is the first initial tranche of the LASSO program of record potentially, which puts us in a very, very good position. So eventually, as you know, these programs will be

[completed], but to be already selected on the first phase and have products go into the U.S. Army for testing and fielding is very, very positive. Secondly, that order is not in our backlog.

So while our Switchblade and Loitering Munitions business, backlog is pretty healthy, we -- many of these opportunities that I mentioned on my comments is not reflected on our current backlog. All of these opportunities are additional orders and contracts that we expect to book in the next 6 to 12 months. And in fact, that demand continues to increase rather than decrease in terms of its pace as well as the top line.

So our pipeline and our portfolio looks very robust for Switchblade, both 300 and 600. And domestically, we've got several programs. Internationally, we've got lots of countries, and we're also working on many other platforms to integrate Switchblade onto, such as the Humvees, the Abrams and OMFV, et cetera, et cetera. So all in all, we've got a lot more upside on our Switchblade product lines over the next 6 to 12 months in terms of orders.

Michael Louie D DiPalma - *William Blair & Company L.L.C., Research Division - Analyst*

And I think you and Kevin both mentioned that the second half of the year should be heavy in terms of both Switchblade 300 and Switchblade 600. And will Switchblade 600s also be shipped to those 5 international customers in the second half or some of those 5 international customers?

Wahid Nawabi - *AeroVironment, Inc. - Chairman of the Board, President & CEO*

The answer is yes, Louie. Many of those international customers -- I can't specifically name any of them because of the respect and confidentiality for our customers. But vast majority, if not all of those customers, desire and have requested both Switchblade 300 and 600. And same is true for the supplemental budget that is in front of Congress for Ukraine, \$100 billion-plus budget item, the supplemental package that's in front of Congress that is for Israel, Ukraine and potentially Taiwan. There are line items dollars for both Switchblade 300 and 600 for those 3 countries. And so we feel pretty strong that long-term, since Switchblade 600 is a very new product in terms of its [like] in the market, is going to be equally as large of a product and revenue generator for us as of 300. And obviously, the selling price of the 600 is significantly higher because it's a much bigger Loitering Munitions.

Michael Louie D DiPalma - *William Blair & Company L.L.C., Research Division - Analyst*

And one last one for Kevin. Do you expect SoftBank -- or for both of you, do you expect SoftBank to continue funding HAPS? And is AeroVironment prepared to continue funding like HAPS and Sunlider on its own if SoftBank drops out?

Kevin Patrick McDonnell - *AeroVironment, Inc. - Senior VP & CFO*

Sure. So, a, SoftBank is very committed to this program. We are working with them very closely. They continue to fund us, although the funding for them has reduced slightly because of their financial situation over the last couple of years. There's a much bigger discussion and known variables in the Japan's economic situation and the pandemic, et cetera, that's affecting that.

Number one, that's the underlying reason. But however, SoftBank is very committed to us. We're actively engaged with them. We're talking to them all the time very regularly, and we're progressing that process. So I do not expect them to stop funding our Sunlider anytime soon. They're committed to the mission. They still believe on the platform, and they believe in the long-term value proposition of HAPS. It's just that they have intentionally slowed down over the last 2 years because of the overall macroeconomic situations that they're faced with.

Secondly, we are funding it to some small amount, primarily because there is IP involved that we would like to make sure that we own and we protect. We've always done that, and we'll continue to do that. And lastly, we have received our initial contract award from the U.S. DoD, and there is additional funding, a significant amount of funding actually, relatively speaking, and the government fiscal year '24 budget for HAPS and the U.S. DoD budget.

So when the government fiscal year '24 budget is approved, we expect that eventually to transition into a contract environment. And we're actively working this program with the U.S. DoD. There's very strong support and desire for this capability [in] U.S. DoD as well.

Operator

And our next question is a follow-up from Ken Herbert from RBC Capital Markets.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

I just wanted to follow-up on the EPS guidance. I mean, you did just under \$2 in adjusted EPS in the first half. The guidance implies \$0.60 to \$0.70 in the second half of the year at the upper end of the range. Aside from mix, as you really ramp Switchblade sales, is there anything else in particular of EPS that's sort of driving the significant step down first half to second half?

Kevin Patrick McDonnell - *AeroVironment, Inc. - Senior VP & CFO*

We definitely expect a step up in R&D in the second half of the year. So that's going to be part of the equation there for the EPS So you're going to see a little bit lower margins, you're going to see a step up of the R&D expense in the second half.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

So mix in R&D, I guess, would be how we should think about that?

Kevin Patrick McDonnell - *AeroVironment, Inc. - Senior VP & CFO*

Yes, that's right. Normally, our years are all reversed around. So there's a little bit of a backwards here.

Wahid Nawabi - *AeroVironment, Inc. - Chairman of the Board, President & CEO*

Yes. And as I said to Ken, on my remarks, as you saw, we have an exciting number of other programs and projects where there's a lot of demand for those systems, including the DARPA ancillary, the SOAR program with the U.S. Army and with the [OSD] for a large contested logistics capability. Those programs are getting a lot of traction. And we do not want to slow down those efforts and make sure that even though if there's a continuing resolution, we accelerate those things because the desire and demand by the U.S. DoD for those capabilities is very high.

And we also believe that we're very unique in the sense that our solutions are considered the most innovative and the most capable in these categories that the U.S. DoD is feeling very strongly about. So we're going to expect to actually ramp up R&D investments in the second half to support those developments in order to fuel our future growth and shareholder value creation.

Operator

This does conclude the question-and-answer session of today's program. I'd like to hand the program back to Jonah for any further remarks.

Jonah Teeter-Balin - AeroVironment, Inc. - Senior Director of Corporate Development & IR

Thank you once again for joining today's conference call and for your interest in AeroVironment. As a reminder, an archived version of this call, SEC filings and relevant news can be found under the Investors section of our website. We wish you a good evening and look forward to speaking with you again following next quarter's results.

Operator

Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.

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