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FARO - Q4 2016 FARO Technologies Inc Earnings Call

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PRESENTATION

Operator

Good morning, everyone, and welcome to FARO Technologies conference call in conjunction with its fourth quarter and fiscal year 2016 earnings release. For opening remarks and introductions, I will now turn the call over to Chief Financial Officer, Bob Seidel. Please go ahead.

Bob Seidel - FARO Technologies, Inc. - CFO

Thank you and good morning, everyone. Yesterday after the market closed, we released our fourth-quarter and fiscal year 2016 results. The financial information included in this call is preliminary as the Company has not yet issued its audited financial statements and may differ from those results. Certain prior-year stock compensation expenses were reclassified between cost of sales, general and administrative, selling and marketing, and research and development expenses in the consolidated financial statements to reflect the appropriate departmental costs. The press release is available on FARO's website at www.faro.com.

I would like to remind you that in order to help you understand the Company and its results, management may make some forward-looking statements during the course of this call. These statements can be identified by words such as expect, will, believe, anticipate, plan, potential, continues, goals, objectives, intends, may and similar words. It is possible that the Company's actual results may differ materially from those projected in these forward-looking statements. Important factors that may cause actual results to differ materially are set forth in yesterday's press release and in the Company's Form 10-K for the year ended December 31, 2015.

I will present the Company's financial results, and Simon will deliver his prepared remarks. Afterwards we will open the call for your questions.

At our fourth-quarter 2015 earnings call, we announced the broad reaching reorganization of FARO by vertical market supported with global horizontal functions. Since that announcement, we have worked diligently to transition our financial reporting from geographic segments to three new vertical-based reporting segments: factory metrology, construction BIM-CIM and other comprised of product design, public safety forensics, and 3D solutions.

Our fiscal year 2016 reporting marks a key reorganization milestone by providing our analysts and investors with selected financial data by our new vertical segments. With our ongoing reorganization in 2016, our management team has been focused on our year-to-date performance as mentioned in prior calls. With that in mind, I will focus my remarks primarily on our fiscal year 2016 results accompanied by brief comments from fourth-quarter 2016.



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Sales for fiscal year 2016 was \$325.6 million, an increase of 2.5% compared to \$317.5 million for fiscal year 2015. Excluding the unfavorable foreign exchange impact of approximately \$1.8 million, fiscal year 2016 sales would have increased 3.1% over prior-year. Our 2016 sales increase was primarily driven by marginally higher average selling prices and higher service revenue, partially offset by modest decrease in unit sales.

New order bookings for fiscal year 2016 were \$330.7 million, an increase of 1.6% compared to \$325.6 million for the prior fiscal year. With new order bookings of \$330.7 million and sales of \$325.6 million, our book-to-bill ratio was 1.02 for fiscal year 2016. Product sales were \$256.0 million for 2016, a decrease of 1.5% compared to \$259.8 million for the prior year, reflecting a decrease in unit sales, mostly in construction BIM-CIM, partially offset by a decrease in average selling prices.

Service revenue was \$69.6 million for 2016, a strong increase of 20.6% compared to \$57.7 million for 2015. This increase was primarily due to higher warranty and customer service revenue, driven by the growth of our installed serviceable base and focused sales initiatives.

In factory metrology, sales for fiscal year 2016 were \$236.3 million, an increase of 6.1% compared to \$222.7 million for fiscal year 2015, mostly driven by an increase in unit sales within Asia, higher average selling prices, and service revenue growth.

In construction BIM-CIM, sales for fiscal year 2016 were \$65.1 million, a decrease of 8.2% compared to \$70.8 million for fiscal year 2015, mostly reflecting a decline in unit sales as we transition to our channel from distribution to our growing direct sales force, partially offset by an increase in average selling prices and higher service revenue.

In our other segment, sales for fiscal year 2016 were \$24.2 million, an increase of 1.1% compared to \$24.0 million for fiscal year 2015. Our other segment represents our emerging verticals where we are actively building a sales infrastructure and product offerings to suit the needs of our product design, public safety forensics, and 3D solutions customers.

Gross margin was 54.7% for fiscal year 2016, an increase of 2.0 percentage points above 2015, mostly due to higher average selling prices and includes inventory management. In 2016, we executed an initiative to reduce age of service and sales demonstration inventory, which had a short-term unfavorable impact on our gross margin.

Selling and marketing expenses for fiscal year 2016 were \$79.9 million, unchanged compared to fiscal year 2015. We made the strategic decision to increase our sales force throughout 2016, which in turn increased our base compensation expense and recruiting fees. However, the increase was fully offset by lower commission expense and discretionary cost reductions.

As a percentage of sales, we decreased our selling and marketing expense to 24.5% for 2016 compared to 25.1% for 2015. General and administrative expenses for fiscal year 2016 were \$40.8 million, an increase of 12.2% compared to \$36.4 million for the prior year. This increase was mostly driven by growth-related initiatives, including acquisitions, investments in infrastructure such as HRIS systems, short-term reorganization costs, as well as higher compensation expense. As a percentage of sales, general and administrative expenses increased to 12.5% for 2016 compared to 11.5% for the prior year.

Research and development expenses for fiscal year 2016 were \$30.1 million, an increase of 12.9% compared to \$26.7 million for 2015. This increase was mostly related to higher project material expenses and an increase in headcount to accelerate new product introductions, as well as costs assumed with business acquisitions. Research and development expenses increased to 9.3% of sales for 2016 compared to 8.4% of sales for the prior year.

Operating income for fiscal year 2016 was \$13.3 million, an increase from 1.2% compared to \$13.1 million for fiscal year 2015. Operating margin was 4.1% for 2016 and 2015.

Net income for fiscal year 2016 at \$11.1 million or \$0.67 per diluted share was \$1.7 million lower than the prior year, reflecting increased income taxes more than offsetting higher operating income.

I will now briefly discuss our fourth-quarter 2016 results.



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Sales for fourth-quarter 2016 were \$91.7 million, an increase of 0.4% compared with \$91.3 million for the fourth quarter last year. Excluding the effect of approximately \$1.5 million in unfavorable foreign exchange impacts, fourth-quarter 2016 sales would have increased by 2.0% over fourth-quarter 2015. New order bookings were \$95.8 million for fourth-quarter 2016, a decrease of 4.6% compared to \$100.4 million for the prior year period.

Product sales were \$73.8 million for fourth-quarter 2016, an increase of 4.9% compared to \$77.6 million for the prior year period, reflecting a decrease in unit sales mostly in construction BIM-CIM and lower average selling prices primarily related to higher sales of service and demonstration inventory.

Salvage revenue was \$17.9 million for fourth quarter of 2016, a strong increase of 30.1% compared to \$13.8 million for fourth quarter of 2015, driven primarily by a substantial increase in customer service revenues with improved turnaround times and higher warranty sales. In factory metrology, sales for fourth quarter of 2016 were \$67.9 million, an increase of 2.7% compared to \$66.1 million for fourth-quarter 2015, driven primarily by higher unit sales in Asia and an increase in service revenue.

In construction BIM-CIM, sales for fourth-quarter 2016 were \$17.5 million, a decrease of 5.4% compared to \$18.5 million for the prior year period, mostly related with the lower unit sales and continued channel transition.

In our other segment, sales were \$6.3 million for fourth quarter of 2016, a decrease of 7.4% compared to \$6.8 million for the fourth quarter of 2015. Gross margin for the quarter was 53.1%, unchanged compared with the prior year period, primarily due to strong service margins offset by lower average selling prices.

Operating income for fourth-quarter 2016 was \$3.6 million compared to \$6.8 million in the prior year period, reflecting growth-related initiatives to increased selling headcount and accelerate new product development. Operating margins was 3.9% for fourth quarter of 2016 compared to 7.4% for the prior year period. Net income for the quarter was \$3.5 million or \$0.21 per diluted share compared to \$8.9 million or \$0.52 per diluted share in the prior year period.

Turning now to cash flow and working capital, FARO generated \$37.6 million in cash from operations for 2016, up \$9.6 million over the prior year, largely as a result of improved working capital management. The majority of this cash was deployed for acquisitions totaling \$27.7 million for 2016.

As of December 31, 2016, cash and short-term investments totaled \$149.1 million, of which \$87.3 million was held by foreign subsidiaries. Accounts Receivable was \$61.4 million at the end of 2016, a decrease of 12.2% compared to \$69.9 million at the end of 2015. DSOs was 61 days at the end of 2016, down nine days from the end of 2015.

Total inventories were \$81.0 million at the end of 2016, an increase of 2.1% compared to \$79.3 million at the end of 2015, mostly driven by an increase in raw materials for new product introductions, offset by higher sales of service and sales demonstration inventory.

I will now conclude with headcount. At the end of 2016, our actual period standing headcount was 1485 employees, an increase of 15.3% compared to 1288 employees at the end of 2015. This increase reflects a strategic growth decision to increase our sales force, execute three acquisitions, as well as a lower prior-year comparable given the reduction, of course, of 8% in fourth quarter of 2015.

FARO does not provide guidance. However, we believe that it is possible to make certain relational observations and to provide additional metrics that will allow us -- allow those following us to better understand our efforts and progress.

With respect to sales, FARO has had a number of relatively consistent ratios which characterize its business. Seasonality by quarter is one that most analysts have identified. As we look at the last three years, the average proportion of sales by quarter was 22%, 25%, 24%, and 29% respectively for Q1 through Q4.

Sales headcount represents another key business metric for our leaders. As discussed on prior calls, sales headcount is a driver of our sales growth. We look at sales headcount from two perspectives: actual period ending headcount and time-weighted average experienced headcount over the



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trailing four quarters, which we refer to as FTE or full-time experienced headcount. For sales FTE headcount, we discount the first year of the new employees by an experience factor to better correlate sales effectiveness with headcount.

At the end of 2016, the actual period-ending sales headcount was 536, an increase of 18.8% compared to 451 at the end of 2015. The sales FTE headcount as of year-end 2016 was 486 versus 457 at the end of year-end 2015, representing an increase more closely correlated to our 2016 sales increase, excluding foreign exchange. The ratio of our annual sales revenue per sales FTE headcount for 2016 was approximately \$670,000. This represents a sales effectiveness factor which we hope to increase through sales modernization and other initiatives.

Our intent is to increase sales FTE headcount by 10% to 15% in 2017 while keeping all other headcount substantially flat, except where required to meet customer demands. We usually report quarterly on actual period-ending total company headcount and sales FTE headcount.

I will now hand the call over to Simon.

Simon Raab - FARO Technologies, Inc. - Co-Founder, Chairman and CEO

Thanks, Bob. Good morning, everybody. Last year at this time it was my first opportunity to speak with investors since returning to FARO as CEO. During that call, I outlined our strategic vision for substantial initiatives to reshape FARO to better service its customers with a vertical market approach, global horizontal support department, a new product, Zone D, modernize the sales processes and transformative acquisitions. We indicated that this complete reorganization would take up to 18 months of hard work and dedication by every department in the Company, and that we intended to achieve this while still focusing on operating the business.

12 months later and with six months to go, how did we do in executing this transformation at FARO?

We said that we would reorganize the sales marketing, product management, and financial reporting to a vertical market approach aligned with our customers' applications. The sales, marketing, and product management structure is now in place. Each of our verticals is designed as a globally led sales operating margin contributor with vertical sales, product, and marketing management focused on their respective markets.

These verticals include in order of size factory metrology, customer BIM-CIM, 3D services and support, public safety forensics, product design, and 3D solutions. This organizational structure is designed to drive growth with the application specificity that diversifying 3D market now requires. Our entire financial systems have been reorganized around this structure, and we have now disclosed our financial results for our new vertical segments, except for the 3D services we support which we expect will be complete by midyear.

Our greatest challenge will be to add sales force in the new verticals to catch up to our factory mythology vertical in terms of salesforce headcount to addressable market. We have an aspirational three-year plan to achieve this vertical level loading, but this will admittedly be a challenge and will rely on our development of a robust hiring organization to meet those needs. We will focus on building the necessary hiring process by leveraging our newly implemented global HRIS system and a new global sales training environment called FARO Academy.

Expansion of sales headcount will also have a drumbeat as a necessary component of consistent and sustainable growth. We intend to maintain a consistent expansion of the sales force to meet the addressable markets of our verticals, but will do so intelligently while monitoring global macroeconomic factors.

We said previously that we would transition from regional to global horizontal operational teams to harmonize processes, get best practices, and with the goal to drive down costs to leverage our sales growth and grow operating margin. We completed the establishment of the global leadership and organizational structure across all operational departments.

In addition to managing the verticals, our Chief Commercial Officer, Joe Arezone is also responsible for the global sales and global marketing horizontals which serve all verticals. Our Chief Operating Officer, Kathleen Hall, is responsible for supply chain, manufacturing, and customer service for all verticals, as well as total quality and information technology horizontals and is playing an expanded role in all operations as we complete



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the reorg. Our General Counsel, Jody Gale, is responsible for legal, IP, compliance, and M&A. Our CFO Bob Seidel is presenting with me today, and our latest addition to the C suite is Katrona Tyrrell as CPO leading our human resources organization.

R&D is led in the US and EMEA by Yazid Tohme and by Dr. Reinhard Becker respectively, and FARO Labs, our innovation group, is led by Dr. Bernd Becker. I am confident that this talented group of global leaders will lead us to our stated objectives.

The tangible benefits -- financial benefits will take some time, but the primary infrastructure for our vision to drive the top line and operating margin will be in place by midyear. Sales and marketing are focused on their respective markets. Vertical product management is clearly defining R&D priorities. R&D has been restructured into global specialized groups with agile organizations to apply all necessary talent to new vertical product development and provide product drumbeat.

This has been evidenced already last year with the announcements of 18 new or improved products. We intend to drive our margins back to historical levels through the execution of our global supply chain efforts, as well as technological leadership in our respective markets.

In 2016, we updated our warranty policy to sustainably manage our service and warranty responsibility and significantly reduce age longer inventory and expect to be substantially finished with this inventory correction by midyear. In the meantime, this will continue to slightly depress our gross margin.

The substantive inventory write-downs in the last two years due to supply chain management and inventory obsolescence will be mitigated going forward with strict supply chain and inventory management. Our controlled efficiency in the area of tax in 2015 have been mitigated and led to a top to bottom review of all of our SOCS compliance systems. We entered into 2017 with greater confidence that we can responsibly manage our complex worldwide operations.

While the global vertical horizontal structure is in place, we have more work to do on standardizing our practices around the world. Our goal is still to complete the primary harmonization activities by the end of the second quarter of 2017 within our 18-month previously stated timeline.

We said previously that we would establish a new product drumbeat by re-instilling the original FARO entrepreneurial mindset and return to regularly introducing important products and solutions to our vertical markets. We've made progress over the past 12 months with more to come.

Among the 20 products announced into 2016 and 2017 year to date, in October we announced our next-generation Focus S150 and S350 laser scanner, better suited to our customers applications with an IP (inaudible) rating. We followed up that announcement in January with a truly disruptive price and performance laser scanner offering, the FARO Focus M70 for under \$25,000.

In January, we introduced our next-generation fully portable Vantage Laser Tracker product line. FARO intends to reclaim its leadership in price-performance in all verticals. This will be accomplished both organically and through M&A, which I will review in a moment.

Sales process modernization has taken shape over the past 12 months. We have constructed at reasonable CapEx online real-time video demonstrations studios across the globe with more under construction. These studios are instrumental in rolling out our new products to potential customers to identify application sets and are faster and cheaper than the historical on-site demonstration models.

In 2016 we surpassed our initial target of online demonstrations and set more aggressive targets for 2017. The online demos are being fully integrated into FARO's highly structured sales process and will play an important role in increasing our sales efficiencies.

We believe an aggressive acquisition drumbeat is essential to our growth with a focus on early stage and mid-stage companies with disruptive technologies where FARO engineering can push it to the next level or our channel can multiply the target sales growth. We demonstrated our willingness and ability to execute an M&A drumbeat as a means to strengthen and quickly expand our vertical product offering.

On July 12, we announced the acquisition of BuildIT Software & Solutions to enhance our metrology software portfolio. BuildIT Software suite is used daily on the production lines with five out of the 10 largest aerospace and defense manufacturers and many key FARO customers.

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On August 29, we reported the acquisition of Laser Projection Technologies to expand our 3D metrology product portfolio. We're excited by the possibilities of the VectorRI which we envision delivering unmatched capabilities in large volume non-contact metrology applications, and we expect a full rollout of the Vector around midyear.

In December 2016, we acquired MWF Technology, an innovator in mobile augmented reality or AR solutions. MWF's breakthrough technology enables large complex 3D CAD data to be transferred to a tablet device and then used for mobile visualization in comparison to real-world conditions.

Last year we indicated that we would acquire transformative technology through acquisitions. We made great strides forward in 2016. We're actively working to continue this acquisition drumbeat in the coming quarters.

In summary, we are delighted with our growing vertical and harmony reorganization progress. We still have until midyear to complete our primary reorganization initiatives as we shift our attention and effort back to driving revenue and operating margin growth.

Finally, I would like to thank all of our FARO employees for the tremendous hard work and dedication during this very pivotal 2016. I will now open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jim Ricchiuti, Needham and Company.

Jim Ricchiuti - Needham & Company - Analyst

Just had a couple of questions. With respect to the targets you have for improving sales efficiency, which I think you said, Bob, was somewhere around 10% to 15% in 2017, is that correct?

Bob Seidel - FARO Technologies, Inc. - CFO

The target that we were talking to was 10% to 15% with the relationship to growing our FTE sales headcount. If you look at 2016, per sales FTE headcount generated about \$670,000 of sales. We are looking to take that sales headcount and increase it by 10% to 15% and then through initiatives that we have such as sales process modernization with the online demo studios try to increase to the \$670,000 as we move forward.

Jim Ricchiuti - Needham & Company - Analyst

And I'm wondering, with respect to that, what kind of assumptions are you making for the overall market environment? I guess that's what I'm also getting at. You had a reasonably good bookings number. What are you seeing out there from a demand standpoint in both the factory metrology segment -- which, by the way, thank you for providing this detail -- and the BIM-CIM market just in terms of overall demand?

Bob Seidel - FARO Technologies, Inc. - CFO

Okay. One of the aspects that there will certainly be faceoffs in 2017 is FX rates. If you look at the later half of the year, we had almost a 2% FX impact just in Q4. So certainly that \$670,000 number is based on all else being equal in terms of FX.



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The other piece I would say is it assumes that going forward that we have favorable capital spending throughout the world. That is in terms of political capital spending. We saw in 2015 we had reduced capital spending in Japan. We saw a pickup in 2016. So we said, yes, there needs to be favorable macroeconomic conditions and stable foreign exchange for that to be fairly stable.

Simon Raab - FARO Technologies, Inc. - Co-Founder, Chairman and CEO

Let me add to that comment, thanks, Bob. What's interesting, and the reason we stated the \$670,000 per FTE is that, if you look over the last three years and we will be providing -- we can provide and you can work through that FTE for the last three years, that the sales per FTE headcount was actually quite consistent. So assuming that whatever macroeconomic occurrence has happened over the last three years and the regional conversion of currency, etc., it is still astonishing how consistent that number is over the last two years varying from anywhere from \$670,000 to maybe \$690,000 in a year where we had a lot of the distribution channel for BIM-CIM. But, in general, that's a pretty consistent number.

Jim Ricchiuti - Needham & Company - Analyst

Okay. That's helpful. And Bob, can you perhaps give us some sense as to what the declines were in unit volumes in the BIM-CIM area, which I assume is mainly the 3D scanning product, but can you give us a sense as to what kind of volume declines you saw in the quarter?

Bob Seidel - FARO Technologies, Inc. - CFO

No, we're not going to talk necessarily about the magnitude of the unit sales, but I would say let's step back. If you think about one of the major differences between 2015 and 2016 in our construction BIM-CIM market was, we had a distribution major master supply agreement distributor in the first half of 2015. That transition we went through from that master supply agreement being largely distribution to now focusing more on direct. So, certainly, as we have gone through that transition, our channel has changed. So we're not going to provide at this time, for competitive reasons, any type of unit sales on any product level.

Jim Ricchiuti - Needham & Company - Analyst

Fair enough. Last question and I will jump back in the queue, can you say what acquisitions contributed collectively in the quarter?

Bob Seidel - FARO Technologies, Inc. - CFO

So for us, the acquisitions that we look at generally speaking are early to mid-stage technology as Simon indicated. Generally speaking, this is not us getting that technology, getting it better ready for market, and pushing it through our sales channels. So we think there is some time to I would say generate revenue from that.

With that said, it's not material for us in 2016, the contribution of any single acquisition.

Jim Ricchiuti - Needham & Company - Analyst

Thank you.

Operator

Bobby Burleson, Canaccord.



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Bobby Burleson - *Canaccord Genuity - Analyst*

So just curious about a couple of things. The pricing environments, if you can kind of give us a sense for price pressure, our competition, geographically what the trends are that you saw there in Q4?

Bob Seidel - *FARO Technologies, Inc. - CFO*

Well, I would say that from a price perspective, it has remained relatively consistent. That was a very aggressive competitive pricing market. Generally speaking, the most pricing pressure we face is in Europe. And so that is pretty much what I will say about the pricing market in general. It's been relatively consistent, and what we're looking to do, though, is we're looking to bring out these new products, being a price leader to our technology, and kind of leapfrog and get over the price competition where possible within the product.

Bobby Burleson - *Canaccord Genuity - Analyst*

Okay. And then if we think about some of the things that are evolving on 3D machine vision, I'm wondering if there's any risk of more overlap between what you guys are doing in off-line measurements and what a machine vision -- 3D machine vision provider might be capable of doing?

Simon Raab - *FARO Technologies, Inc. - Co-Founder, Chairman and CEO*

I can answer that. The factory metrology group includes both manual factory metrology and automated factory metrology. In that context, we actually have many developments relating to the optical inspection, which includes 3D vision. So you should expect as we expand the product line in factory metrology that we will make product additions which are definitely involved with machine vision.

Bobby Burleson - *Canaccord Genuity - Analyst*

Okay. Great. And I guess just my last quick one here is just thinking about a previous question about the backdrop you guys are embedding into your assessment of how 2017 might unfold, are you looking for any decent rebound in US industrial production? In the past, you guys tend to read cycles on the way up and on the way down. Do you expect that dynamic to hold?

Bob Seidel - *FARO Technologies, Inc. - CFO*

For us in 2016, certainly I think the automotive industry probably reached at the higher end of this peak. The aerospace industry, which is another primary end customer market, the bookings are strong. I believe that the political environment is going to be largely dependent as we move forward. But there is no reason to believe at this point in time that the seasonality of our sales should change.

Bobby Burleson - *Canaccord Genuity - Analyst*

Okay. Thank you.

Operator

Mark Jordan, Noble Financial.



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Mark Jordan - *Noble Financial Group - Analyst*

A question relative to sales force productivity and the average \$670,000 that you point out. Over the years, I think it's been characterized that your higher performers have been approaching the \$1 million revenue range and obviously specific being lower levels of productivity. I guess my question here is, how do you measure sales force productivity by the different regions, and is there an opportunity to fundamentally move that average number above that \$670,000- \$690,000 range by driving up the lower half of the producing sales force?

Simon Raab - *FARO Technologies, Inc. - Co-Founder, Chairman and CEO*

So let me answer that. So I think there is a -- we are completing a couple of different numbers, first of all. The number that you recall of \$1 million, \$1.5 million was typical on what an account manager on their own felt. But the FTE is the entire sales force, which is our pyramid of our complete sales structure, which includes the account managers, the internal sales specialists, the regional managers, the country managers, and the regional managers.

So the -- that headcount includes the entire underlying sales structure. So those numbers can't be compared.

The only thing excluded from the sales FTE headcount are the two global horizontals for sales operation and sales marketing, global horizontal. So the headcount of those two horizontals is not included in that number. So it is the entire -- just to repeat myself, it's the entire full-time experience headcount starting from the account managers up to the regionals through the [IFSS], through the regionals, and through the country and so on. And -- so that's the full direct sales headcount. And that number then represents not just the efficiency of a particular account manager, but it represents the efficiency of the entire structure.

Mark Jordan - *Noble Financial Group - Analyst*

Okay. You talked about the shift in the construction vertical away from distribution or direct. When do you expect that transition to be fully implemented and back to or above your prior structure sales levels?

Simon Raab - *FARO Technologies, Inc. - Co-Founder, Chairman and CEO*

We were working through a couple of other large companies and their distribution partners rather and their distribution networks, which represent hundreds and hundreds of potential sales people around the world. So, as we transition from there and we were forcibly transitioned from there back to the direct sales force, we -- it takes a reasonable -- I'm actually quite surprised how quickly we caught up from the direct sales force model because we literally had to, over the period of a year and a half, replace the sales efforts of hundreds of salespeople and distribution organizations around the world.

So we're getting there. I think we will continue to head in that direction as we build up the sales force.

Mark Jordan - *Noble Financial Group - Analyst*

Final question for me. It's just relative to your initiatives you have in utilizing the web for your marketing programs. How developed is that, and on a typical sale, how much of the content or contact is based on web-based marketing versus your traditional direct?

Simon Raab - *FARO Technologies, Inc. - Co-Founder, Chairman and CEO*

Well, trying to avoid any strategic revelations about our structure. It has now been enveloped -- it included the [MPR] process. That includes qualification of the lead, preparation before demos, follow-up interactions, and we are even moving it into the service environment to assist in sales and application engineering. So it is becoming really a necessary communication tool throughout every process of our sales organization.



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The idea, though, is to improve the qualification, reduce the number of unnecessary demos, and improve our relationships with the customers directly.

Mark Jordan - *Noble Financial Group - Analyst*

Thank you.

Operator

Patrick Newton.

Patrick Newton - *Stifel Nicolaus - Analyst*

First two are housekeeping questions. I heard the overall headcount, but I did not hear the sales and marketing headcount.

And then second question is -- I think Bob you said that the sales demo inventory burn through should be done midyear, but I'm curious what was the level that flowed through to the fourth quarter?

Bob Seidel - *FARO Technologies, Inc. - CFO*

In terms of the sales and demonstration equipment, we were very consistent in Q4 with our prior quarter where we talked about \$9 million in sales. That was about a 25% increase year over year for us on a quarter basis. So our full-year increase was around 50%. We sold about an additional \$10 million in premium sales equipment.

In terms of the headcount of both selling and marketing, what we were -- we're focused on is our sales headcount, and that's what we will be disclosing going forward. Because that's really where we feel, though, that our investors and analysts can get the most out of information.

Patrick Newton - *Stifel Nicolaus - Analyst*

Okay. And then I guess Bob or Simon. I guess, Simon, during your prepared remarks, you talked about having organizational structure in order to drive margins back to historical levels. Just given the broad range of margin the Company has seen over the last 10 to 15 years, are we right to think that you are trying to return to a 58% to 60% type of gross margin? Can you help us there? And then operating margin has had just a massive range. So, Bob, maybe you can help us understand what are our margin targets post this restructuring -- the Company that hosts this restructuring?

Simon Raab - *FARO Technologies, Inc. - Co-Founder, Chairman and CEO*

I won't speak to any of the operating margin. Obviously I have indicated our intention to keep all the horizontals flat while driving the top-line sales. So you can make some assumptions about the expenses relating to those horizontal expense components of the sheet.

I have been, though, and we have been quite clear about trying to return to what was a very consistent 59% to 60% gross margins in the past, and that would represent a realistic target for us.

Patrick Newton - *Stifel Nicolaus - Analyst*

Great and just last one for me is just you talked, Simon, about 18 new products or revamped products, I think, in 2016, and then Bob talk to a goal of regaining technology leadership so that pricing is not a key area of challenges. I guess my question is, is your portfolio -- or has your portfolio



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reached that inflection point where with the new products that you have that you believe that you have separated yourself and are winning on technology again, or is there still some heavy lifting to be done?

Simon Raab - *FARO Technologies, Inc. - Co-Founder, Chairman and CEO*

I think we're well on the way. Our goal is to be -- by midyear to be substantively back to technological leadership so that we can get back to pricing -- competitive price performance positioning in the market that we have had in the past, and that will take a continuous effort. But I would say we will be substantively there by midyear. Obviously we have introduced the very latest scanner products which are market-leading. Our new tracker products are also -- will be dominant in the market at its current pricing and performance with more to come. And then, of course, we have the other primary product lines which will all evolve as necessary, but the largest changes will have occurred all by midyear.

Bob Seidel - *FARO Technologies, Inc. - CFO*

Patrick, just one additional comment is, generally speaking, we have talked in the past about when we roll out new products. It takes time to take that and move it to our sales column. So there could be a little bit of time until midyear, later half of the year.

Patrick Newton - *Stifel Nicolaus - Analyst*

Great. Thank you for taking my questions. Good luck.

Operator

Hendi Susanto, Gabelli & Co.

Hendi Susanto - *Gabelli & Co. - Analyst*

First question, service revenue has been strong materially in 2016, and it was writing at \$80 million quarterly run rate in Q3 and Q4. How should we view service revenue going forward? Can we expect the \$80 million quarterly revenue as a baseline and it can grow from that level?

Bob Seidel - *FARO Technologies, Inc. - CFO*

Traditionally we have not -- our (inaudible) practice is not to provide guidance on any single number on our P&L. What I can say is what has grown service revenue has been a dedicated effort to sell warranty. So that is a great effort by our CCO and his group.

The other side has been from our COO. She has driven the process on the customer service side, increased turnaround time, service. We have come off a very strong 2014. Those units have come off the embedded warranties. So what I would say is certainly we have to sell the products in order to continue to sell the warranties, but we're going to be as aggressive as we have been in the future to drive that line item on our P&L.

Simon Raab - *FARO Technologies, Inc. - Co-Founder, Chairman and CEO*

And just add to that, I would say that the 3D service and support vertical which we intend to have in place financially by midyear, we will have added to it a number of higher-margin 3D service products that we intend to have -- to increase the overall service margin for that vertical. So I would expect to see growth with the addition of these new services.



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Hendi Susanto - *Gabelli & Co. - Analyst*

Got it. Second question is one bookkeeping question. Bob, how should we model FARO's tax rate near-term? Should we stick with the past estimate of a long-term tax rate of 24% to 26%?

Bob Seidel - *FARO Technologies, Inc. - CFO*

In terms of tax rate, we have not provided guidance because, as you see, year over year our tax rate has been certainly differing year to year based on our geographical distribution. I especially did not provide guidance as we move forward with the different administration in the US, as well as best across the world and how the treatment will be. So what I would say is I won't provide guidance at this time.

Hendi Susanto - *Gabelli & Co. - Analyst*

Thank you.

Operator

Ben Rose, Battle Road.

Ben Rose - *Battle Road Research, LTD - Analyst*

Simon, just a question for you. Regarding in the core factory metrology business which, thanks again, thanks for breaking that out. If you look out into the first half of the year, there have been quite a few new products announced in the last year, and you discussed in your prepared remarks the revamping of the LPT product. Could you talk about which products you are most excited about looking out through, I guess, the course of 2017?

Simon Raab - *FARO Technologies, Inc. - Co-Founder, Chairman and CEO*

Yes, the recent introduction of the Vantage series product line for the tractor, we have really broken into a new price performance area for trackers historically. We expect that this will significantly open up the market, and our intention is to continue to move price performance in that direction as we have always done with all our products.

The other most exciting one is one I did mention in the prepared remarks, which is the VectorRI, which is the laser -- scanning laser radar, which will have a dramatic impact on factory environments for high-speed long-distance measurements contact-free measurement. It represents a whole new (multiple speakers)

Ben Rose - *Battle Road Research, LTD - Analyst*

Could you maybe discuss which --

Simon Raab - *FARO Technologies, Inc. - Co-Founder, Chairman and CEO*

I'm sorry. I don't know what happened. So I expect that that will be an important contributor.

In addition, the Cobalt Imager which was introduced last year is now starting to take form in very specific applications as it relates to our 3D solutions group. And so we're also excited about the potential growth in the metrology area from those configurable solutions.



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So I would say broadly we are excited in many areas of the business for the new product set introductions.

Bob Seidel - *FARO Technologies, Inc. - CFO*

Ben, are you on the line?

Simon Raab - *FARO Technologies, Inc. - Co-Founder, Chairman and CEO*

Bobby?

Operator

Ben, your line is still open. I think Ben is gone, so that's the last question we had for the day.

Simon Raab - *FARO Technologies, Inc. - Co-Founder, Chairman and CEO*

Okay. All right. Well, thank you, everybody, for your attentions today, and we look forward to describing the progress as we go this year.

Operator

This does conclude today's program. Thank you for your participation. You may now disconnect, and have a great day.

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