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FARO - Q2 2017 FARO Technologies Inc Earnings Call

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PRESENTATION

Operator

Good morning, everyone, and welcome to the FARO Technologies Conference Call in conjunction with the second quarter 2017 earnings release.

For opening remarks and introduction I will now turn the call over to Chief Financial Officer Bob Seidel. Please go ahead, sir.

Robert E. Seidel - *FARO Technologies, Inc. - CFO*

Thank you and good morning, everyone.

Yesterday after the market closed, we released our financial results for the first six months and second quarter of 2017. The press release is available on FARO's website at www.faro.com.

As a note, certain prior year stock compensation expenses were reclassified between cost of sales, selling and marketing, general administrative and research and development expenses in the condensed consolidated financial statements to reflect appropriate departmental costs.

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, continue, goals, objective, intent, 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, 2016, Form 10-Q for the quarter ended March 31, 2017 and Form 10-Q for the quarter ended June 30, 2017.

I will turn the call over to Simon to provide an update on our company's strategic initiative, and afterwards will return with a summary of our financial results.

After our prepared remarks, we will open the call for questions.

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

Thanks, Bob, and good morning, everyone.

At the beginning of 2016, we undertook a systematic global reorganization initiative, which we termed Going Vertical in Harmony, aimed at reinventing FARO's organizational structure and business processes worldwide and returning FARO to our longstanding status as an innovative, high-growth technology company. The end of our second quarter marks the successful completion of this extraordinary process.

Today, we are laser-focused, and the pun is intended, on growing our market verticals. We have harmonized literally hundreds of global processes and have a far more agile and efficient platform.

We have used our balance sheet, cash, knowhow and global-marketing reach to aggressively create important new products, pursue strategic acquisitions and grow the top line.

Over the last six quarters, we have been investing in the platform necessary to support FARO's long-term growth, increased sales and marketing personnel, new web-based demonstration studios, activation of new verticals, increased R&D, aggressive new product development and acquisition of next-generation technology.

However, there's a natural maturation period between the hiring of sales people, investing in system improvements, executing acquisitions and seeing the top- and bottom-line results from these investments.

Consequently, while our short-term profitability necessarily has been negatively affected, we can already see the benefits of these investments and are confident in the value being created.

Following are some important observations on our recent investments and growth initiatives.

The front-end loading of our sales organization is necessary to achieve accelerated growth. It takes approximately one year to mature a salesperson from startup status. Consequently, as we grow the sales force there will be a gap of time between the incurrence of the related training and onboarding costs and the realization of the resulting tough-line contribution.

Since the start of Going Vertical in Harmony in January 2016, we expect to increase the sales headcount by 42% to the end of 2017, which includes an additional 20 sales hires in the second half of 2017, resulting in 21% growth in 2017.

Following this front-end investment, we only anticipate increasing sales headcount by 5% to 10% annually until 2019.

At the end of the first quarter, we reported that we would increase FTE sales headcount by at least 20% in 2017 and are substantially on plan. As a reminder, sales FTE headcount is a time-weighted average headcount measure which we (inaudible) discount the first year of a new employee by an experience factor.

We ended second quarter 2017 with an FTE sales headcount of 516, an increase of 21.7% compared to the ending second quarter 2016. Our trailing 12-month average FTE was 473, an increase of 13% compared to the same prior year period. The trailing 12 months orders for FTE was 746,000 at Q2 2017.

In the past, we reported orders for FTE at 670,000 based on a period-ending calculation. We are now using a trailing 12-month orders for FTE to better account for our seasonality, resulting in orders for FTE for Q4 of 2016 of 769,432 sales FTE.

We ended our second quarter with an incremental start-up sales headcount of 111 for a total sales headcount of 627. We refer to start-up headcount as the difference between the ending headcount and the FTE headcount.

The start-up sales headcount increase resulted in an incremental cost of approximately $5.5 million in selling expenses for the first half of 2017. We expect to end Q3 and Q4 with FTE headcounts at 570 and 610, respectively, for a net increase in sales FTE headcount of 26% and 34%, respectively, compared to year end 2016, thereby demonstrating the benefits of frontend loading.

Our new web-based demo studios have gained significant traction as part of our modernized sales process. The studios, which have been set up around the globe, are increasing utilization rates and have helped us reach and qualify more customers in shorter time than ever before possible. We are currently performing over 1,000 web demos per quarter and expect this rate to increase substantially.

Our vertical focus is leading to significant growth in product portfolio expansion in the construction BIM/CIM. The tremendous value proposition of building and construction information management solutions is still in the early adoption phase. We believe that we have the most advanced, cost-effective solution in the market.

In second quarter of this year, we proudly introduced -- produced our 10,000th laser scanner. In the second half of 2017, we intend to introduce the first ever fully featured CAD-based surveying and construction 3D quality-controlled software called BuildIT Construction for use with the FARO laser scanner and tracer laser projector.

FARO's construction BIM/CIM segment boasted an order growth rate of 30% for the first half of 2017, on the strength of this commitment to a vertically-focused agile organization.

Our other segment, which includes product design, public-safety forensics and 3D machine vision increased by 12% in the first half of 2017.

Expansion of our 3D capabilities outside of our traditional factory metrology market into the new verticals with much larger addressable markets is an essential component to our growth strategy.

Enhanced and virtual-reality, factory-quality control tools are increasingly used in factory metrology and automation. Like BIM/CIM (inaudible) and virtual-reality tools are in the early adoption phase.

In the second half of 2017, we intend to introduce FARO Visual Inspect, the first ever ER VR tool for factory quality control, enabling factory assemblers to literally see the CAD model of what they're building projected on the physical part. We expect that this product line will grow quickly and establish a new standard in fully-informed and individualized quality control.

High accuracy and resolution 3D sensors that see and measure on the move are the next evolution in factory automation. In the second half of 2017, we intend to introduce two new products into this space. The Dynamic Machine Vision Sensor, DMVS, will be introduced as an early-adopter product that can see in high resolution and accuracy 3D while on the move. Dynamic 3D vision sensors that allow robots to see and measure in high accuracy while moving will change the way factories program and use robots.

In addition, we will introduce the Vector RI 3D Laser Radar, which will be capable of performing multiple high-speed 3D scanning measurement operations over large distances and at multiple locations at the same time.

We are renaming our 3D Solutions Vertical to 3D Machine Vision to better align with its purpose and our new product.

Product-line excellence will drive sustained growth. Over the last 18 months, we've executed on our commitment for a new product drumbeat, releasing leading new products across our portfolio.

In October, we introduced our next-generation laser scanner, the Focus S 150 and Focus S 350. Then in January, we introduced the Focus M 70, which sets a completely new standard in value-priced performance.

We also released our completely new laser tracker line, the Vantage F and Vantage E, and, in August, we plan to introduce our new Focus S 70 Laser Scanner and technology.

As well, we intend to introduce the Quantum S and Quantum M FARO Arms. The Quantum S and Quantum M FARO Arms represent the most accurate, portable, rugged FARO arms that we have ever produced.

We have listened to our customers' demands for application-specific software by releasing vertically-focused software applications for factory metrology, construction BIM/CIM product design and public safety forensics.

With upcoming releases in the second half of 2017, we expect our entire product line to reach the technical excellence required to hold a premium position in the various vertical markets and deliver a strong return on investment to our customers.

Gross margin increased in the second quarter by 3 percentage points from the first quarter to 56.6%. We continue to target 60% gross margins effective by 2019. We have several key initiatives underway, including better pricing practices, design changes and supply-chain optimization. We expect to hit the target in time despite continuing to disrupt the market with new value-priced offerings.

However, we do expect quarterly fluctuations in margin as we introduce value-priced elements to our product line, continue to reduce our aged pre-owned inventory and deal with competitive pressures.

I'll make further closing remarks after Bob reviews our financial results.

Robert E. Seidel - *FARO Technologies, Inc. - CFO*

Thank you, Simon.

We believe that year-to-date financial information is more in line with how we actually view our progress and manage our operations throughout the year. With that in mind, I wanted to start with an overview of our financial and operational performance for the first six months of 2017 compared with the first six months of 2016.

New order bookings at 175.8 million were up 13.3% with similar percent increases in both product and service orders. Reported sales at 164.2 million were up 6.5%. Service revenue continued its strong growth trend by increasing 18.0%.

Gross margin of 55.1% was down 1 percentage point on a lower first quarter. Net loss of 5.1 million compared to net income of 6.5 million in the prior year, primarily reflecting our pre-investment in startup sales headcount.

Let us turn to second quarter 2017 results. New order bookings for second quarter 2017 increased by 9.1% to 89.0 million from 81.6 million for second quarter 2016. Sales for second quarter 2017 were 82.7 million, an increase of 5.3% compared with 78.5 million for second quarter 2016.

Excluding an unfavorable foreign-exchange impact of approximately 1.4 million, second quarter sales -- second quarter 2017 sales would have increased by 7.0% compared with the same prior-year period.

Our sales increase was primarily driven by continued service-revenue growth and higher average selling prices. With new order bookings at 89.0 million and sales at 82.7 million, our book-to-bill ratio was 1.08 at second quarter 2017.

The increase in our book-to-bill ratio was mostly due to the demand for the new Focus M 70 Laser Scanner in both the construction BIM/CIM and public safety forensics verticals, which temporarily exceeded our production capacity late in the second quarter.

Product sales were 62.5 million for second quarter 2017, an increase of 1.4% compared with 61.6 million for the prior year period, primarily reflecting higher average selling prices and generally modest unit sales increases.

Service revenue was 20.1 million for second quarter 2017, a strong increase from 19.2% compared with 16.9 million for the prior-year period. This increase was primarily due to the continued increase in warranty and customer-service revenue driven by the growth of our installed serviceable base and focused-sales initiatives.

In our factory metrology segment, sales for second quarter 2017 were 57.2 million, an increase of 1.9% compared with 56.2 million for second quarter 2016. This increase was mostly driven by an increase in service revenue and slightly-higher average selling prices.

In our construction BIM/CIM segment, sales for second quarter 2017 were 18.9 million, an increase of 13.2% compared with 16.7 million for second quarter 2016, primarily reflecting an increase in service revenue and higher average selling prices.

We ended the second quarter with approximately 5 million in product sales backlog between construction BIM/CIM and public-safety forensics, as our demand for a new focus laser scanner model exceeded our production capacity late in the second quarter.

In our other segment, sales for second quarter 2017 were 6.6 million an increase of 15.5% compared with 5.7 million for second quarter 2016, mostly driven by higher sales in our public safety forensics vertical.

Gross margin for second quarter 2017 increased to 56.6% compared with 55.9% for the second quarter last year and increased 3.0 percentage points compared with first quarter 2017. The increase is related primarily to higher average selling prices and improved production efficiency in our factory metrology vertical.

Selling and marketing expenses were 26.0 million in second quarter 2017, an increase of 39.0% compared with 18.7 million for second quarter 2016. This increase was driven primarily by an increase in selling headcount as part of our strategic initiatives to drive sales growth. Selling and marketing expenses as a percentage of sales were 31.5% for second quarter 2017, compared with 23.8% of sales for the prior-year period.

General administrative expenses for second quarter 2017 were 11.9 million an increase of 16.0% compared with 10.2 million for the prior year period. G&A headcount remained unchanged compared to second quarter last year. The increase was mostly driven by higher compensation expense and global system implementation costs to facilitate our harmonization initiatives. As a percentage of sales, general administrative expenses increased to 14.4% for second quarter 2017 compared with 13.0% for the prior year period.

Research and development expenses were 9.0 million for second quarter 2017, an increase of 25.4% compared with 7.2 million for second quarter 2016. This increase was mostly related to engineering headcount additions from our 2016 acquisitions. Research and development expenses increased to 10.9% of sales for second quarter 2017 compared with 9.2% of sales for second quarter 2016. Our net loss was 3.6 million or $0.22 per share for second quarter 2017 compared with net income of 3.4 million or $0.20 per share for the prior year period.

Turning now to working capital, accounts receivable was 58.8 million at the end of second quarter 2017, compared with 56.8 million at the end of second quarter 2016. Days sales outstanding was 65 days at the end of second quarter 2017, down one day from the end of second quarter 2016.

Total inventories were 93.1 million at the end of second quarter 2017, compared with 84.9 million at the end of second quarter 2016, mostly driven by an increase in raw materials to support a new (inaudible) and higher demonstration inventory to outfit our new sales hires.

At the end of second quarter 2017, cash in short-term investments totaled 139.6 million of which 99.9 million was held by foreign subsidiaries.

I will conclude with total headcount. At the end of second quarter 2017, our total headcount was 1,580 employees, an increase of 16.8% compared to 1,353 employees at the end of second quarter 2016.

Simon, will now make his closing comments.

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

Thanks, Bob.

In summary, FARO has the necessary elements in place to leverage a new cycle of sustainable growth into new verticals with very substantial addressable markets. FARO is in control of its destiny for the most part, and the risks to the company's business are substantially mitigated by various attributes. FARO is globally distributed with sales evenly distributed between the Americas, EMEA and APAC, minimizing geographic risk.

FARO has a direct sales force of over 600 people and minimal dependence on distribution, thereby guaranteeing product and market focus. FARO's top five customers generally comprise less than 5% of sales. Hence, there's no existential reliance on any one customer. FARO serves multiple unrelated markets, which is intended to maximize addressable markets for its technology and to minimize cyclical risks.

FARO now has a globally-integrated, efficient operational and manufacturing structure and has achieved the growth year to date with no increase in G&A headcount. FARO's hardware technology platforms are very broad with deep resources and a proven ability to innovate and now more agile than ever with a newly-organized platform structure and progressively more globally-integrated use of resources.

FARO software platforms in all verticals are best or approaching best in class and are now also working towards full global integration and resource utilization.

FARO has over 17,000 customers and a worldwide direct service and training organization generating a recurring revenue stream of almost 24% of total revenue in the first half of 2017.

FARO's financial stability is characterized best by no debt and approximately $8 per share in cash and improved globally-integrated financial controls.

After our investments in 2016 and the first half of 2017, we are now focused on delivering mid-teen sales growth, historically-higher gross margins and mid-teen operating margins by 2019, as well as technical leadership in all product categories. We believe that the short-term risk and costs inherent in these initiatives will be rewarded with increased sustainable shareholder value.

I'm also proud to announce that we will be releasing our new global website later this month in up to 15 languages which fully represents our newly-focused vertical markets and our geographic reach. I invite you all to explore the new website, which we expect will improve in content every day.

We deeply appreciate the patience of our shareholders and the hard work of our employees around the world and look forward to reporting on our progress each quarter.

I'll now open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

We will take our first question from Jim Ricchiuti of Needham Company. Please go ahead.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst*

Hi, good morning. A couple of questions. First on operating expense, and I understand, recognize the selling expense is a bit of a moving target, just given the headcount additions that are planned, but if we look at G&A and if we look at R&D, fairly significant increases from the March quarter. Are these levels we should think about on a go-forward basis in absolute dollars?

Robert E. Seidel - *FARO Technologies, Inc. - CFO*

Jim, thanks for joining the call. If I look at R&D specifically, much of R&D, the increase you see year over year, the overwhelming majority of that, driven by the acquisitions that we made in 2016. So it's a fair representation in the absence of other acquisitions coming onboard in the future. What you see now is kind of a baseline going forward. Because if I look at the increase of 1.8 million year over year, 1.4 of that is related to the acquisitions.

In terms of G&A, G&A is up 1.7 million, but, again, I would say that the baseline that you see are an average between Q1 and Q2 is more representative of where we're going forward.

The big piece here with Simon and I and the leadership team are focused on in these two areas is managing the overall headcount for these, controlling the absolute dollars and really holding those dollars as best as possible going forward, so we get leverage as we grow the top line.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst*

Okay. And with respect to the goal of getting to mid-teens operating margins in 2019, how should we think about the, you know, the path to that goal? I mean, obviously, initially, you've got some significant front-end expense, but, you know, in terms of measuring where you are relative to that goal as we think about the back half of this year with some of the newer products, I mean, how shall we think about this path? Is it going to be fairly gradual or do you -- You know, what is your sense in terms of, you know, seeing some of this productivity from some of the hires you've made over the psat six-nine months?

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

Jim, it's Simon. Thanks for that question. I think it's a very important one.

The sales for FTE, which is still holding at around the $760,000 mark annualized, is the primary tool that we're using to predict our top-line growth, along with the maturation of the sales force where we -- as we noted, we would end up with almost 40% increase in FTE headcount over the beginning of 2016 at the end of 2017.

We only expect to increase the sales force between 5% and 10% at the max in 2018 and 2019. Increased efficiencies of the sales process through the web studios as well as improvements of our product line are expected to sustain the high 700,000 of sales per FTE.

If you look at the expenses we just talked about being respectively flat, except for potential acquisitions that we may make, which are unpredictable at this point, we would expect, then, to see that increase in operating margin.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst*

Okay. Thank you. I'll jump back in the queue.

Operator

We will take our next question from Greg Palm of Craig-Hallum Capital. Please go ahead.

Gregory William Palm - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Good morning. Thanks for taking my questions.

Unidentified Company Representative

Yeah, thank you for initiating coverage. We appreciate it.

Gregory William Palm - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Simon, maybe start with some of the newer products that you talked about launching. I guess the first ones in the machine vision vertical, just curious what types of applications and markets are you targeting? You know, what do you sort of envision as the market opportunity there?

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

I think it would be commensurate with the expectations of growth in automation. As you know, robotics have been very much in the news lately, and there's a new wave of collaborative robots which are also being introduced by all the robot makers. That means that more robots involved in more collaborative manufacturing sizes with people. That means that we need very active 3D machine vision while the robots are moving to provide them the degree of awareness that's required for that kind of work.

In addition, the new technology has allowed us to introduce new methodologies for part, pick and place as well as various operations such as welding, because you'll have real time 3D monitoring of the robot positioning.

So we expect it to grow commensurate with the robot market. We have good relationships with companies such as KUKA and have integrated products with them.

We also have the cobalt imager, which is a structured light sensor for doing 3D measurement, in combination with the DMVS and our Vector RI, which is rather than putting a sensor on a robot, this is a robotic sensor. We expect to have growth in that sector, which is related very much to the growth in automation around the world. It's our newest vertical and we've recently hired a head for that.

And you should understand that one of the inertial issues around that market is the fact that it's a lot of custom work, and so it represents a slightly new business model for us, and we are developing the internal structure to make sure that we can deliver solutions based on customer requirements by our users.

Gregory William Palm - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Any sense on how big that opportunity is and what's the competitive landscape there look like?

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

There are a number of companies with sensors for vision. However, they're not a vision on the move. So we are unique in that respect and have IP that covers that.

We do not have a good fix on the addressable market for ourselves. I would make it commensurate with robots. The robotic market analysis shows that the greatest growth in robotics will be in the area of inspection, and, of course, that's our area of expertise. So it's a little early for us to be able to determine what our addressable market will be.

Gregory William Palm - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Got it. Bob, you mentioned backlog. Can you tell us how that compares, that 5 million, to your over-year levels and then Q1? And then can you maybe talk a little bit about your production capacity, when some of that might get freed up here?

Robert E. Seidel - *FARO Technologies, Inc. - CFO*

Sure. So what I was referring to in my prepared remarks is that, you know, we had 82.7 million in revenue this quarter, and, you know, you saw the book to bill of 1.08. Much of that book to bill related to that we brought forward the new M 70 laser scanner as well as our Focus S 150, 350, and we ended the quarter with about $5 million of chippable backlog, just related to that product and those two verticals BIM/CIM factoring -- and BIM/CIM in public safety.

So if you look at it, that would have -- if we would have shipped that 5 million, you would have been in more 12% sales growth than where we came in at. So that's a piece.

Really, as we go forward, though, we'll be working through the process to really work through our launches for the new Quantum to make sure that we have supplied both for our demo units and supply for our customers as well as working through really our supply chain and production on our laser-scanner unit to clear the backlog out as soon as possible.

Generally speaking, we come in to any quarter with $12 million to $14 million of backlog. We came into this quarter with the same. We tend to clear that out by the first two months of a quarter, and we see that going forward the same. Our goal is to get back to closer to the 1.0 book-to-bill going forward.

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

In addition to that, we are ramping up production capabilities in all the areas. What caught us a little bit flatfooted was the mix change. When we introduce a new model like the M 70, which is a lower-priced unit with less performance for specific markets than our usual BIM/CIM market, we can't predict what the product mix will be, and our predictions were wrong. There was a much bigger uptake of the M 70 than we had expected, and we've now caught up. But when we introduce these products, we're going to have these little mispredictions of product mix going forward, but we accommodate those quickly within the next quarter.

Gregory William Palm - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

And just to be clear, the Quantum is that an entirely new arm product or is that just the refreshed version of your base product now?

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

No, that's a completely new product. We're very proud of it. It's got a new level of portability with onboard batteries. It's one that is the first product on the market that is fully ISO certified, and we also have put it through very rugged ISO-based, ISO-certified ruggedness testing. So it's a completely new product with about 25% increases in our -- for the top model in accuracy. So we're -- Kind of unprecedented ruggedness, portability and accuracy, and it is a completely new product.

Gregory William Palm - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

All right. I'll hop back in queue. Thanks.

Operator

(Operator Instructions)

We will take our next question from Ben Rose of Battle Road Research. Please go ahead.

Ben Z. Rose - *Battle Road Research Ltd. - Founder and President*

Yes. Good morning.

A quick question for Bob here, you know, I'm looking at the trajectory of services revenue in 2006. It looks like you saw a pretty good acceleration in year-over-year growth. Would you expect that to be the case in this current year?

Unidentified Company Representative

Well, with the implementation of our dedicated service sales agents and an increase in our (inaudible) base, we really, as you said, really started to see that uptick in our service-revenue growth I would say starting Q1 of 2016. You know, you saw that uptick from Q4 2015 to Q1 of 2016.

We maintain that after-market sales team dedicated to selling warranties, repair activities, much of the increase has been from the warranty side, to really drive that service revenue growth. So the near-term growth outlook remains positive and really for the remainder of the year, we would see similar increases.

We certainly recognize though that we must increase our unit sales growth from product sales, deliver those units to the field, get them into our installed base to provide really a long-term, sustained, double-digit, mid-teen sales growth from the service revenue.

Ben Z. Rose - *Battle Road Research Ltd. - Founder and President*

Okay. And a question on sales and marketing, you know, with regard to the compensation of the sales force. Could you speak maybe just in broad terms as to kind of the fixed versus variable component of that? You know, trying to get a flavor for if given the increase that you're seeing in orders, if that translates into revenue in the back half of the year. You know, what kind of -- you know, sort of incremental compensation expense we could see.

Robert E. Seidel - *FARO Technologies, Inc. - CFO*

As we talked about on our Q1 2017 call, we indicated an average sales person costs about $100,000 US a year between salary, benefits, travel. And, then, generally speaking, we incur about 6% to 7% average commission rate.

So as Simon indicated in his prepared remarks, you know, we ended the second quarter at 627 in our sale take out (inaudible) period, which then translated to selling and marketing expense of 26.0 million.

We will be adding about 20 additional new sales hires probably (inaudible) over the next two quarters. So we would expect to end the year at 647. So I think you can look at our trailing two quarters and you can look at the fact we'll be adding 20 more sales people, (inaudible) over the next two quarters, combined with the statement on our compensation, you get a pretty good understanding of how at least the headcount (inaudible).

Then think about what we indicated in terms of the orders per FTE, our top line will grow and you will get a very good idea, I believe, how our selling and marketing should trend, how we would expect it to trend.

Ben Z. Rose - *Battle Road Research Ltd. - Founder and President*

Okay. And then just kind of a final question for Simon, in terms of the go-to-market strategy for the 3D Sensor, you know. As we understand the market, you know, there are a variety of companies that are selling, you know, using direct-sales forces versus distribution. Can you speak to the kind of advantage that you think might be provided with this direct-sales force that you're setting up versus others who are going to the market through third-party distribution?

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

I think the advantage that we see most often is when you're bringing new concepts of product in. For example, the DMVS is a completely new concept, and we require missionary work in order to convince people how to use it.

You know, FARO's had a tradition of working direct versus through distribution. We saw the reliance on distribution effect our laser scanner sales when we went through our experiences in early BIM/CIM market. So keeping control over our direct sales force is relevant.

With respect to the margins that that effects, typical discounts to many distributors are in the 25% to 35% range in any case, so the question is for that discount to the retail pricing, what kind of sales force and what kind of control over your markets do you want to have? So we view direct sales as a far more communicative and responsible way to grow the product lines.

There are products which are more commodity-based as they progress through their lifecycle, and those could be amendable to some kind of distribution, but in the case that you represented, which is in the 3D vision, there's this custom issue around it.

Now, there are some companies that use value-added resellers. We're going to have to also speak to them. I believe that they will become part, integrators will become part of this 3D machine vision group in terms of its sales process. It's the one vertical that we have not added substantive sales staffing in. We've only just recently added leadership in there and of the 20 that we intend for the rest of the year, only about half of them will be going into that new vertical.

So I expect your point is correct in the sense that ultimately value-added resellers or integrators are going to be required for that vertical and it'll be part of building out that sales force or that representation in the marketplace. So probably much less direct in 3D machine vision and much more through integrators.

Ben Z. Rose - *Battle Road Research Ltd. - Founder and President*

Okay. Thank you.

Operator

(Operator Instructions)

We will take our next question from Patrick Newton of Stifel. Please go ahead.

Patrick M. Newton - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP and Senior Analyst*

Good morning, Simon and Bob. Thank you for taking my questions.

I guess first, Bob, a clarification. You talked about 5 million in product sales backlog in BIM/CIM and public safety forensic. I wanted to make sure that would all have shipped in the June quarter had you not had some of these capacity constraints.

Robert E. Seidel - *FARO Technologies, Inc. - CFO*

Yes.

Patrick M. Newton - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP and Senior Analyst*

Okay. So it's reasonable to think then you would have been -- I think you said 12% growth would have put you around 87 million, 88 million normalcies now, which would have you flat and then you could layer on that extra roughly 5 million in revenues is a ballpark way to think about how September could play out.

Robert E. Seidel - *FARO Technologies, Inc. - CFO*

Yes.

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

That is correct. I think that's -- I mean, your point is one around why we're trying to emphasize (inaudible) growth rate at this point. We don't have large fluctuations or encapsuled orders or anything like that, so our order growth rate is highly representative of our efforts.

With all the new product introductions and the product mixes and our ability to respond one quarter to the next with respect to getting (inaudible) at the point I made before about the M 70 mix surprise for us, going forward, you know, there's going to be that kind of quarterly variation, and that's why we're looking at order growth as the primary indicator. But your point is correct if you had added that back in, it would be up around the percentage of growth that we would have expected.

Patrick M. Newton - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP and Senior Analyst*

Great. Appreciate the detail, Simon.

And then, I guess, on the aged service and sales demo inventory, is there any impact you can quantify in the June quarter and just remind us, you know, how close you are to getting that demo inventoried to the age that you want long term?

Unidentified Company Representative

Yeah. So, Patrick, in the second quarter of 2017, we sold about 5.8 million in aged service and sales demo equipment. Now, that was down 15% compared to prior year. You know, so we would anticipate an increase in the second half of 2017 in selling our aged service and demo. Just as we release the new Quantum arm, we will have demo units available for sale.

At the end of the second quarter of 2017, we have approximately 6 million of aged service and sales demo equipment. We consider aged anything greater than three years. So that's what we're working on continue to sell.

But, generally speaking, we look at this business as there will be always a continuum. What we're trying to do, a continuum of used equipment that we're selling, maybe it's 10% of our product sales, generally speaking, and what we're trying to do is just make sure that the service and demo inventory we have is of newer age.

Patrick M. Newton - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP and Senior Analyst*

Okay. That's helpful. And I guess if we take that information paired against the gross margin in the quarter and then think about your long-term march towards 60%, does this kind of rough level around 56% currently somewhat of a floor that we should march up from or could there be some variability that could pressure that, you know, over the next few quarters?

Unidentified Company Representative

You know, as I would look it, I'm not going to provide specific guidance, but I would say that we are focused very much between pricing actions, production to increase gross margin.

Now, when we do have a new product coming out of the magnitude that the Quantum will be, it's a significant percentage of our revenue, we may see some fluctuations in gross margin in Q3, Q4, whether it's on the manufacturing cost side or selling off the demo equipment. So I would say that, you know, let's get to kind of more of a Q4 state before we call a floor, but, certainly, you know, we have enough of a historical track record to say 55 to 56 is kind of a floor.

Patrick M. Newton - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP and Senior Analyst*

Okay. And then I guess taking a longer-term view and looking at this 60% gross-margin target kind of trying to couple some of the forward investments you've made on the sales side, is there any type of operating margin target range that you could share that you would target over the same time frame or is there any type of revenue level or growth rate that's embedded to meet that 60% gross margin target?

Robert E. Seidel - *FARO Technologies, Inc. - CFO*

The last earnings call, in Simon's prepared remarks, what we really indicated was three specific financial goals or objectives that we have by really the end of 2019. It is mid-teen sales growth, get to, you know, high 50s, 60% gross margin, control our head count on G&A, R&D and hold the dollars on those operating expense lines to really get to a double-digit operating margin.

I think if you look back at 2012 through the 2014 time frame, we've demonstrated the ability to do that when our G&A was, you know, low double digits, when our R&D was more 7% to 9%, and so we've demonstrated the ability to do that in the past and we're focused on doing that same coming in the future. I would say it's probably, you know, our objective by the end of 2019.

Patrick M. Newton - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP and Senior Analyst*

Thank you for taking my questions. Good luck.

Operator

And we will take our next question from Ben Clevy (phonetic) of Noble Capital. Please go ahead.

Ben Clevy

Thank you. Just a couple of quick questions here. You described improvements in your manufacturing costs -- cost structure in the metrology segment. I'm wondering, first, if you could just provide any kind of color on that improvement, either qualitatively or quantitatively?

Unidentified Company Representative

Sure. The factories are under review for all kinds of efficiency issues around lead manufacturing. We're also -- a significant (inaudible) in our supply chain procurement to make it more global with seeking the best prices worldwide for our underlying components. And so between the lead manufacturing and the new supply chain procurement effort globally, we believe that the costs will come down.

Ben Clevy

Okay. And then so that the margin improvement that you saw this quarter, do you think it was kind of -- Do you think that was due in equal parts to both the improvement that you saw in that structure and average selling price? Did one of those two outweigh the other?

Unidentified Company Representative

It's average selling price, which was the predominant reason for the margin increase.

Ben Clevy

Okay. Thank you. And then the average selling prices, you describe them improving both in the metrology and construction segment, but didn't elaborate on that on the -- within your other segment. Can you just kind of discuss selling prices in that segment and if you anticipate those, you know, prices to expand in that segment here in the next couple of quarters? Thank you.

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

I think I can make a general comment regarding all the verticals, which I think is relevant to all of them, and that is that we cannot have premium pricing unless we're the technological leader in our particular technology categories. So our effort in all the verticals is to achieve technological (inaudible) and provide a very high price-valued proposition -- a value-priced proposition to our clientele.

So it's going to be spotty here and there, how things go as we change our product mix. For example, we just introduced the M 70, which is a laser scanner which sells in the mid-20 K range. It's taking a larger piece of our scanner product mix, even though we have S 350s which sell up in the $60,000 range. So it's going to be affected by product mix and the rate of uptake in each of the verticals. But the effort overall is to increase the quality of the product line, so that we can demand premium pricing where possible.

Ben Clevy

Very good. Thanks, Simon. I'll jump back in queue.

Operator

And we will take our next question from Hendi Susanto of Gabelli and Company. Please go ahead.

Hendi Susanto - *G. Research, LLC - Research Analyst*

Simon and Bob, good morning, and thank you for taking my questions.

My first question is about (inaudible) for Simon. In my past conversation with prior management, high-speed, real time performance is one of the key challenges in real time 3D measurement. Would you please share how we should think how FARO can address that requirement?

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

Well, the technology, the DMVS technology is quite unique in the sense that it can provide high-resolution 3D imaging while the robot is moving. This means that the programming and planning around the use of automation can be significantly enhanced by that kind of data processing.

As I noted, we are only beginning to build our 3D machine vision vertical and we expect that vertical to be primarily dependent on integrators and value-added resellers as well as a smaller direct-sales force.

So, you know, it is a new product. It's a new category and will mean changes in the way people approach automation and programming of robots.

Hendi Susanto - *G. Research, LLC - Research Analyst*

And, then, Simon and Bob, you shared a number of full-time (inaudible) headcount employees. Would you be able to share roughly what portion of those headcounts have reached maturity levels?

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

Sure. As we indicated, our current raw headcount was around 627. Five-hundred and 16 of those had achieved what we call STE maturity at the end of Q2 2017, and it's the 111 difference between those two which we called the startup, which is how we explained our $5.5 million investment into the expanded sales force.

Hendi Susanto - *G. Research, LLC - Research Analyst*

And, Bob, what product specifically drove higher ASP in the first half of 2017?

Robert E. Seidel - *FARO Technologies, Inc. - CFO*

It was really across all our product lines and across all our verticals. There was a great amount of pricing discipline instilled in our commercial organization that we saw, and also with the two new products that we have launched up to this point in time provided the ability to drive higher pricing in the market. They will focus on price and margin.

Hendi Susanto - *G. Research, LLC - Research Analyst*

Okay. And then, Bob, I noticed that the tax rate is lower in Q2. Any color on that?

Robert E. Seidel - *FARO Technologies, Inc. - CFO*

Really, our tax rate is going to fluctuate quarter to quarter just as our geographic mix fluctuates in our sales. So there's no real true driver of that other than geographic.

Hendi Susanto - *G. Research, LLC - Research Analyst*

Got it. Thank you.

Operator

(Operator Instructions)

We will take our next question as a follow up from Greg Palm. Please go ahead.

Gregory William Palm - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Yeah. Thanks for taking the follow up here.

Curious if you could comment on the competitive landscape, just in light of all your, I guess, recent product refreshes/new introductions. You know, by my math, it seems like you are possibly starting to take share back from competition. So, you know, first, wanted to get your thoughts there if you could confirm that.

And, then, secondly, maybe, you know, how is the competitive landscape adjusted or changed or how you might think it responds going forward?

Unidentified Company Representative

Thanks for that question.

The competitive landscape is fairly aggressive out there. I would say that there are no other pure plays like FARO in terms of 3D measurement of our size. So we have companies that we're competing against that have large alternative revenue bases, and we see a lot of discounting in the other markets. We view that as a sign of some desperation in terms of keeping market share. We're trying to keep a discipline around that and approach it differently by taking market share through having good value propositions in our product.

We have competitions that low ball in many markets. We find that we can sell higher-priced used equipment against discounted new equipment from that competition because of the FARO brand name. And that, of course, makes us happy.

But, on the other hand, you know, we do have to respond to market pressures, and I can describe the pricing out there as to be fairly aggressive, particularly in what would now be commodity market areas like the arm business and tracker businesses.

And our expansion into these other verticals are specifically geared to access, of course, new -- address more market, but then also to deal with different kinds of competition and retain margin by addressing those differently.

And so we don't like to get into price battles. We certainly won't, and we'd rather be at healthy margins going forward.

So I would say it's going to vary and change between each of the verticals, but I can't point to any one particular competitive company that's across all our verticals that is making a difference on our response in the marketplace.

Gregory William Palm - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. I know you're focused on bookings growth going forward, given the kind of the puts and takes around, you know, revenue and production capacity and what not, but I know you don't guide, but would you be disappointed if you didn't grow sales, you know, revenue by double digits this year compared to last?

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

Yes. Yes, we would. I mean, we have put a huge investment into our sales force. At the end of the year, we'll have an increase in the sales force by 20%. Many of those will have matured to FTEs by the end of the year. If we don't sustain our high 700,000 of sales per FTE, we will not achieve those kind of growth rates, and that would be a severe disappointment.

The entire plan is premised on the idea that we can sustain the sales per FTE while we mature the FTE count, and that's the primary methodology we're going to use for top-line growth.

Of course, we feed those vertical sales forces with new product, which is part of R&D initiatives, and we try to increase efficiencies with the web demo studios, but all combined if they don't result in a double-digit growth rate, we're going to have to back off and reexamine what our premises were.

Now, there are going to be fluctuations. For example, in the rate of maturation of the sales force and the different verticals. Remember that we are also entering new emerging markets for us, new emerging verticals with new fresh sales forces in territories that we've not covered before, in addition to the new products. So there are some risks around that that we have to work through.

But, yes, I mean, your question was about a disappointment. We would be disappointed, and, right now, the indications are very positive that in the trailing 12 months, even with all the additions that we've made, that our sales force, FTE sales force has been able to sustain the high 700,000s in sales per FTE, and we hope that that continues.

Gregory William Palm - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. Thanks again.

Operator

At this time, we have no further questions.

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

Thank you, everybody for joining our call today and we look forward to reporting on the next quarter.

Operator

This does conclude today's program. Thank you all so much for your participation. You may disconnect at any time.
