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FARO - Q1 2017 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 first quarter 2017 earnings release. For opening remarks and introductions, I would now turn the call over to Chief Financial Officer, Bob Seidel. Please go ahead.

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

Thank you, and good morning, everyone. Yesterday, after the market closed, we released our first quarter 2017 results. 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, general and administrative, selling and marketing and research and development expenses in the condensed consolidated financial statements to reflect the 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, objectives, intend, 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 and Form 10-Q for the quarter ended March 31, 2017.

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

New order bookings for first quarter 2017 increased by 18.2% to $86.9 million from $73.5 million for first quarter 2016. Sales for first quarter 2017 were $81.6 million, an increase of 7.7% compared to $75.7 million for first quarter 2016. Excluding the unfavorable foreign exchange impact of approximately $1.5 million, first quarter 2017 sales would have increased 9.6% compared to prior year.

Our sales increase was primarily driven by an increase in product unit sales, especially in construction BIM-CIM and higher service revenue. With new order bookings of $86.9 million and sales of $81.6 million, our book-to-bill ratio was 1.06 for first quarter 2017.

Product sales were $62.4 million for first quarter 2017, an increase of 5.2% compared to $59.3 million for the prior year period, reflecting strong unit sales growth of both new and preowned products and construction BIM-CIM segment sales, partially offset by lower average selling prices, mostly related to less favorable product model and geographical sales mix.

Service revenue was $19.2 million for first quarter 2017, a strong increase of 16.7% compared to $16.4 million for the prior year period. This increase was primarily due to higher customer service revenue and continued increase in warranty revenue, reflecting our focused sales initiatives to increase aftermarket sales revenue.

In our factory metrology segment, sales for first quarter 2017 were $57.2 million, an increase of 6.0% compared to $54.0 million for first quarter 2016. This increase was mostly driven by higher customer service revenue and an increase in unit sales, especially sales of demonstration and service inventory, which generated a slight decline in average product selling price.

In our construction BIM-CIM segment, sales for first quarter 2017 were $18.3 million, an increase of 22.8% compared to $14.9 million for first quarter 2016, primarily reflecting an increase in service revenue and higher unit sales, particularly in our Europe and Asia Pacific regions.

In our other segment, sales for first quarter 2017 were $6.0 million, a decrease of 12.4% compared to $6.8 million for first quarter 2016. Sales and profitability of this segment may fluctuate quarter-to-quarter more than the other 2 segments, as our other segment includes our emerging verticals. We're only in the initial stages of building the sales infrastructure and product offerings to suit the needs of these emerging verticals, namely product design, public safety forensics and 3D solutions.

Gross margin for first quarter 2017 decreased to 53.6% from 56.3% for first quarter last year, up 0.5 percentage points compared to prior quarter. This year-over-year decrease was related primarily to the production start-up of new products and lower average selling prices, reflecting higher sales of demonstration and service inventory as well as less favorable product model and geographical sales mix.

Selling and marketing expenses were $22.9 million in first quarter 2017, an increase of 27.8% compared to $17.9 million for first quarter 2016.

We made a strategic decision to expand our sales force aggressively to accelerate revenue growth. As a percentage of sales, selling and marketing expense increased to 28.0% for first quarter 2017 compared to 23.6% for the prior year period.

General and administrative expenses for first quarter 2017 were $10.7 million, an increase of 5.4% compared to $10.2 million for the prior year period. This increase was mostly driven by slightly higher compensation expense and global system implementation costs to facilitate our harmonization initiatives. However, as a percentage of sales, general and administrative expenses decreased to 13.1% for first quarter 2017 compared to 13.4% for the prior year period.

Research and development expenses were $8.5 million for first quarter 2017, an increase of 17.6% compared to $7.2 million for first quarter 2016. This increase was mostly related to engineering headcount additions from our 2016 acquisitions and additional hires to support our new product drumbeat.

Research and development expenses increased to 10.4% of sales for first quarter 2017 compared to 9.5% of sales for the prior year period.

We reported a net loss of $1.5 million or $0.09 per share for first quarter 2017 compared to net income of $3.1 million or $0.19 per diluted share for the prior year period.

Turning now to working capital. Accounts receivable were $60.6 million at the end of first quarter 2017 compared to $60.1 million at the end of first quarter 2016.

Day sales outstanding was 68 days at the end of first quarter 2017, down 4 days from the end of first quarter 2016. Total inventories were $84.5 million at the end of first quarter 2017 compared to $83.5 million at the end of first quarter 2016, mostly driven by an increase in raw materials for new product introductions, offset by lower demonstration and service inventory.

At the end of first quarter 2017, cash and short-term investments totaled $148.8 million, of which $94.8 million was held by foreign subsidiaries, down only $0.3 million from year-end. Our aggressive initiatives to grow the sales team, inventory demands from new product introductions and R&D expenses related to 2016 acquisitions were funded by cash flow from operations, resulting in a neutral cash position relative to year-end.

I will conclude with total headcount. At the end of first quarter 2017, our total period ending headcount was 1,542 employees, an increase of 18.8% compared to 1,298 employees at the end of first quarter 2016.

I will now hand the call over to Simon.

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

Good morning, everyone. Over the past 5 quarters, we have been executing an aggressive set of strategic initiatives to reposition FARO to achieve its long-term financial objectives of delivering mid-teens sales growth with strong gross margins 60% or better and leveraging our cost base to achieve mid-teens operating margin.

The plan was designed as a 3-year effort. And 2016 was year 1 and constituted a restructuring year of globalization, harmonization and upgrade of substantially every part of the business. The restructuring of the sales force around market verticals was intended to drive marketing, sales, product management and development to best serve the specific needs of the factory metrology, construction, public safety, product design and 3D solutions verticals. Each of these verticals represents great potential for growth in 3D measurement.

We were gratified to see the sizable growth in construction in the first quarter of 2017 and believe similar accelerated growth will also appear in the other emerging verticals as they are built out. The growth is a direct result of vertical-specific sales and product management efforts. Our orders growth of 18.2% in the first quarter provided an initial validation of our reorganization and our sales force expansion and process modernization strategy.

We believe this demonstrates that FARO has the potential to achieve its mid-teens top line growth objectives with the right strategy, sales force and products. We anticipate the aggressive pre-investment in the expansion of the sales force and modernization effort will continue for at least 2 years at a greater than 20% rate to establish these new global verticals and to continue our growth in our more established verticals.

In the first quarter, our sales force headcount increased by 30% compared to prior year and increased our full-time experienced sales headcount, a term which I will describe shortly, by 13.9%. The incremental feet on the street was a vital ingredient to deliver this quarter's strong orders growth. While the accompanying increase in selling expense negatively impacted operating income, we pre-invested these selling expense dollars under an aggressive rate to reset our business model to a greater revenue to expense ratio by stabilizing expense growth with the intention of achieving double-digit operating margins by 2019.

Over the longer term, we would anticipate our sales hirings to transition back to a normalized goal of 10% to 15% per year to stabilize the expansion of the sales and marketing expenses.

Sales efficiencies are also expected to increase through the sales modernization initiative we've discussed on previous calls in order to sustain the double-digit revenue growth rate we aspire to.

During last quarter's earnings call, we explained that the sales headcount represents a key business metric for our vertical leaders. We track sales headcount from 2 perspectives: actual period ending headcount and a time-weighted average experience headcount, which we refer to as FTE or full-time experience headcount.

For sales FTE headcount, we discount the first year of a new employee by an experience factor. We are continually monitoring the first year's sales productivity of our sales force to gain a better understanding of how the full-time experience headcount discount factor shifts from vertical and region and over time.

At the end of the first quarter 2017, the actual period ending sales headcount was 593, an increase of 30% compared to 456 for the first quarter of 2016. At the end of the first quarter 2017, our sales FTE headcount was 525, an increase of 13.9% compared to 461 in the same prior year period.

During last quarter's earnings call, we referenced the sales revenue effectiveness factor that we defined as the ratio of our trailing 12-month sales revenue per sales FTE headcount. For full year 2016, this sales effectiveness factor equated to approximately $670,000 of sales revenues per FTE.

As we continue to develop our effectiveness measures to actively manage our growing sales force, we are shifting our focus and discussions to new sales orders rather than sales revenue as the book-to-bill fluctuates. As sales accelerate, we believe that the sales order growth is more immediately correlated with sales force expansion and performance. Hence, the sales effectiveness factor is defined as the ratio of the quarter's annualized sales orders per sales FTE headcount based on the quarter's historical proportion of a full year.

For the first quarter 2017, we saw an increase in our sales per FTE to approximately $763,000 compared to $659,000 in the fourth quarter 2016. We would caution, however, that there may be a seasonal effect of orders per FTE. And for purposes of planning, we continue to use the historically validated annual figure of $670,000 per FTE.

We will review the sales per FTE quarterly. We continue to look for ways to increase our sales per FTE through the online demonstration studios, our new product drumbeat and other initiatives. Our intention is to increase sales FTE headcount by at least 20% in 2017, while keeping all other headcounts substantially flat except where required to meet customer demand. We will report quarterly on actual period ending headcount and sales FTE headcount.

As far as the complete restructuring, our research and development organization was reorganized to be able to provide the vertical product specificity and new product cadence required to grow these new emerging verticals. The success of our business starts with the efficient execution of our research and development teams of next-generation techniques and superior products on a consistent time line.

Since the start of 2016, we have introduced 20 new or upgraded hardware and software solutions to the market. Over the past 2 quarters, our new product drumbeat introduced the next-generation releases of 2 primary platform products. In fourth quarter 2016, we introduced our eighth generation of the market-leading Focus Laser Scanner product line to drive new orders and sales growth, primarily in our construction BIM-CIM and public safety forensics verticals.

This eighth-generation laser scanner was engineered to be better suited to our customers' applications with many new features, superior speed and accuracy, along with an advanced IT readiness rating.

In January, we also introduced our next-generation of the Vantage Laser Tracker product line, which is now fully portable and includes the latest version of our proprietary TrackArm product for large volume measurement. Very significant product introductions tailored to our different verticals will continue this year.

We expect our M&A strategy and cadence will continue in 2017 to complement this R&D strategy by adding new products and technologies to support our growth efforts in the various verticals.

Significant R&D and product management effort is being expensed to leverage these small acquisitions through our growing global channel. R&D and M&A is also focused on mitigating several potential future technology risks by ensuring that FARO has control over essential underlying technologies important to future supply.

Further to this strategy on April 21, we completed the acquisition of Nutfield Technology, a components technology business in Hudson, New Hampshire, which specializes in the design and manufacture of advanced galvanometer-based optical scanners, scan heads and laser kits.

Our first quarter operating margin may be below the expectations of our analysts or investors. We made the strategic decision to act now to aggressively expand our sales force and develop and release new products recognizing that there may be a short-term impact to our financial results.

We are often asked about our current cash holdings and, apart from the obvious use of cash and M&A, we view the operational use of cash to finance our aggressive return to growth company status and expand into new markets as an obvious corporate advantage of our cash holdings, which will necessarily depress operating margins in the short term.

The aggressive early introduction of new major revisions of our core platforms, namely, the Focus Laser Scanner and Vantage Laser Tracker, challenged the organization and resulted in inefficiencies, which are seen as short-term reduction in gross margin.

New approaches to new product development processes are being developed to mitigate production risk in the future and adapt to our new cadence of product introduction and improvement.

Our goal is still to complete the reorganization activities by the end of the current quarter within our 18 months previously stated time line. The primary remaining reorganization priorities in the second quarter will be to continue to expand the sales force as well as drive global process harmonization and manufacturing efficiencies to best practice.

In summary, we are delighted with our reorganization progress, as we end the extensive global effort this quarter. We will then turn our fullest attention to driving revenue, improving gross margin and achieving double-digit operating margin by 2019.

Finally, I'd like to thank all of our employees for their tremendous hard work and dedication over the past 5 quarters in reinvigorating the growth of this company.

I will now open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we'll take our first question from Jim Ricchiuti with Needham & Company.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst of Advanced Industrial Technologies and Display, Vision and Imaging Technologies*

So I think we -- I recognize the investment that you have going on in the business, particularly in the sales side, but if we just look at the sequential change in revenues from Q4 to Q1, I think you're down about $10 million, but up quite a bit OpEx, I think about $700,000. So I'm trying to get a sense as to how we might think about OpEx over the next 1 to 2 quarters? Bob, I don't know if you could help us a little bit with that?

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

As Simon indicated, our goal in terms of our operating expenses, being R&D and G&A, is to hold the headcount where it is. Manage the headcount tightly. So in terms of where our OpEx is going, it should be relatively consistent over the next 3 quarters in terms of G&A and R&D.

On the selling side, we have a -- we are pre-investing in our sales force. You saw what Simon indicated was we would be growing our sales force upwards of 20% this year. So you will see an uptick in our selling and marketing cost throughout the year both from the perspective of added headcount and then as our sales grow, so will our commission.

What you can expect to see in terms of incremental headcount costs would be, call it about a $100,000 base, 6% to 7% commission going forward on those incremental heads.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst of Advanced Industrial Technologies and Display, Vision and Imaging Technologies*

Simon, you've talked about this 3-year plan, and you being in year 2. You've also talked about June having -- by the end of Q2, I think having the platform in place. So help us maybe with what type of milestones we should be looking for both in the second half of this year and just -- and potentially just the year as a whole in terms of the strategy that you've laid out?

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

So as mentioned, we did start to see important increases in gross margin. Our hope is while we have 1Q of period-over-period double-digit growth, clearly, we should be looking for the same thing in Q2 over Q2 of last year. I understand your sequential comment of -- obviously that's -- because of the seasonality, I'm not sure that that's relevant. But Q-over-Q, the growth should continue at the high double digits commensurate with the sales per FTE and the increase in the headcount. So the increase in gross margins should start to be seen.

Clearly, introduction of another few major revisions of core products will be expected as well with introduction of product lines that came out of the prior acquisitions, as we now converted them over to FARO standards and introduced them into our full production lines.

You should also see, I believe, an increase in the sales per FTE if, in fact, our sales modernization effort improves. Now you saw a number change from about $650,000 to about $750,000 or $730,000 per FTE. And that's an important change. It may represent important changes in our sales process, but we want to give it a couple more quarters to actually decide whether that's a real effect or not rather than a seasonal effect. So you should also be looking for that.

G&A will continue to drop as a percentage of the sales. And as Bob mentioned, the R&D will remain basically headcount flat except as it relates to potential acquisitions, in which case those will be outside of the current model.

James Andrew Ricchiuti - *Needham & Company, LLC, Research Division - Senior Analyst of Advanced Industrial Technologies and Display, Vision and Imaging Technologies*

And last question just with respect to the new product efforts. Should that be skewed more towards the second half of this year in terms of new product introductions or is it late in the year?

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

Yes, we have -- maybe I would call it 3 core platforms, which is the Arm technologies, the laser tracker and the scanner market. The other ones are growing and catching up. We've already done a major platform conversion of 2 of those platforms. And we would expect to continue that in the other core platforms as well. So I think that's the only answer I can give on that question.

Operator

And we'll take our next question from Richard Eastman with Robert W. Baird.

Richard Charles Eastman - *Robert W. Baird & Co. Inc., Research Division - Senior Research Analyst*

Could you just kind of reference, you made a number of references, Bob, and I think, Simon, you did as well. But just -- you talked a little bit about the geographic sales mix influencing the gross margin. And I'm curious if you could shed a little bit of color on that? And also if the gross margin -- and I presume this is mostly on the product side, if the gross margin by geography, has there been any change in what each of the geographies is delivering; in other words, either competitive or pricing? Can you just speak to the geographic mix here?

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

Sure. In terms of our sales growth year-over-year, Europe and Asia led. They are about very similar year-over-year sales growth. Our North America business was relatively flat. So how does that impact our gross margin? Generally speaking, our North America is a strong margin area for us in factory metrology, with the automotive sector, the aerospace sector there. So that being flat certainly creates an unfavorable geographical mix.

The second place in reference to geographical mix was we really saw flat Japan sales year-over-year. Japan is a price -- a very good margin country for us. So that's for us the other area.

In terms of product mix, what I also mentioned is we did release some more aggressive value-priced products, Vantage Tracker, the E, the M70. Those products certainly while they are there to get market share for us, they are there to expand the technology, they also put some pressure on the margin. But really, Rick, the main primary driver of margin was the start-up of 2 core platform products in our production process.

Richard Charles Eastman - *Robert W. Baird & Co. Inc., Research Division - Senior Research Analyst*

Okay. All right. And then also, just perhaps you could maybe shed a little bit more light on this demo inventory issue. We've seen this for a number of quarters. And I think one of the things that's probably -- it's difficult to see that on the balance sheet.

The demo inventory doesn't look like it's changed much. And I'm curious, how is it that this inventory is kind of aging? We are shipping, selling it, but we're not seeing any real reduction in the demo inventory numbers on the balance sheet. So just kind of explain that dynamic a little bit?

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

Yes. In terms of the demo inventory, 1 year ago of Q1 '16, we were $34.8 million, our demo and service, we're at $31.9 million. So we have in total reduced that number. And so what we're actively trying to do is sell those what we call at-risk or older items, what we call 3 years or older. Right now, we have in terms of the at-risk inventory, we're trying to reduce that actively. There is about $7 million remaining for us. That's where the lowest margins come from.

Once we go forward from there, we'll continue to have new product drumbeat we have to continue to sell. So it'll be complete part of our business. In -- as we said in our press release though, that our used sales accounting for 11% of our total product sales this quarter. So it will be a continued part of our process. The only thing I would say different, Rick, is there will be newer units that we will be selling.

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

Rick, sorry to interrupt. I wanted to just add one nuance to Bob's response on the -- it was really a mix -- the margin that was affected by geographical mix, primarily by the shipments, not by the orders. Actually, orders in the Americas was up about 15%, it was not flat. So it just happened to be the dynamic of the quarter about where we did the shipping to, which was primarily Europe and the Far East. I just didn't want you to be left with the impression that there was no growth in the Americas. There was a 15% growth.

Richard Charles Eastman - *Robert W. Baird & Co. Inc., Research Division - Senior Research Analyst*

In orders, I understand. Okay. And then, just the last question. In terms of the other segments here with the businesses that are maybe a little bit more in their infancy, how do we expect that those businesses to scale from a profit standpoint? Do we absorb increased losses there as we move forward or will the profit line scale with sales, because it sounds like we've more investment to make there. And I'm just curious, how that relationship will look going forward in the other segments?

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

So Rick, the -- those emerging -- actually all the verticals are viewed from an operating margin contribution point of view, where we include the gross margin and the selling expenses and product management expenses and marketing expenses related simply to that vertical.

So there is a positive contribution right into those verticals. We expect that to be diminished at the beginning, while we accelerate the sales hiring, but they contribute pretty quickly. And they're not a drag. They're not as a great a contribution as the other more established verticals, but they will contribute quite quickly.

Operator

And we'll take our next question from Patrick Newton with Stifel.

James Daniel Gruetzmacher - *Stifel, Nicolaus & Company, Inc., Research Division - Associate*

This is James Gruetzmacher on for Patrick. Just curious as to what drives the increase in your FTE headcount guidance? I believe last quarter, you said 10% to 15%. Now we're raising that up to 20%. Just wanted to know if there is anything specific that's caused you to increase that?

And then, also, as we think about these recent headcount additions gaining experience over the year and adding to the FTE metric, would it be fair to assume that in terms of absolute headcount growth, we won't see anything greater than the 30% year-over-year that you just posted?

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

Right. So your first question is why did we apparently change our tact. We decided, as we noted in our prepared comments, that we decided to accelerate the growth of the FTE headcount. We started getting very positive indicators that the correlation to sales growth was as exclusive as we had suspected. And that the sales per FTE headcount was a number which had a great deal of consistency in the past for the company and that we had a lot of underpenetrated market and new emerging verticals.

So we decided that we would want to create a new balance between the revenue side and the expense side of the company's current structure by accelerating the headcount and resetting the amount of revenues versus what we're trying to fix is our expenses in R&D and G&A as well as depreciation. So we made the concerted decision to accelerate that. We will not be exceeding the 30%. We're shooting for 20%.

However, I have to say that we always retained the freedom to, if we see positive results and increases in the margin and a bifurcation between revenues and expenses, which goes to operating margin, that we may, in fact, decide to continue to accelerate even further. Obviously, we will review that quarterly and make those decisions appropriately. Your last question on the...

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

30%.

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

Yes, so I think I answered that.

Operator

And we'll take our next question from Jordan Mark (sic) with NOBLE Capital Markets.

Mark Conrad Jordan - *NOBLE Capital Markets, Inc., Research Division - Senior Research Analyst of Government Services and Defense Technology*

A question relative to the service revenue. Obviously a very strong quarter there. Is that level of $19-million-plus sustainable through the year and/or do you believe that there is a growth rate that you should expect to see off of this base over time?

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

I think the right answer to that question is that the primary component of those revenues and the increase in revenues is the sales of warranties and extended warranties to establish installed base. So one would expect that if one can get high double-digit growth rates in the installed base through the sales of product, then in the subsequent year after the first year of the built-in warranty that we have the opportunity to substantially increase sales of warranties to that increasing installed base. So I believe if properly executed that, that should accelerate along with the installed base.

Mark Conrad Jordan - *NOBLE Capital Markets, Inc., Research Division - Senior Research Analyst of Government Services and Defense Technology*

Okay. Question with regards to your cash position. As you pointed out, you do have $90-some-odd million outside of the United States. What can you do to deploy that successfully because obviously, I don't think you will bring it back to the U.S. because of the tax burden that you would face?

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

Well, there are 2 uses of the cash. There's 2 uses of the cash, primarily M&A and of course, working capital. Our installed FTE headcount around the world is smaller in APAC and EMEA. So we see a lot of investment to expand those emerging verticals in those regions. And we continue to be interested and have initiatives underway to look at M&A potentials in other parts of the world.

As you know, last year, we also did an acquisition in Germany. And we're looking elsewhere as well. So part of the deployment of that cash will be to focus our efforts on looking at M&A targets in those regions and use of working capital to kind of fill up the locations for sales and service around the world outside of the Americas to bring it better -- to better balance versus GDP around the world.

Mark Conrad Jordan - *NOBLE Capital Markets, Inc., Research Division - Senior Research Analyst of Government Services and Defense Technology*

Okay. Final question from me just would be to go back towards the demo inventory. You talk about monitoring what you call the at-risk component, which is the older product, typically greater than 3 years old. How do you manage the turnover of that demo inventory on a quarterly basis, so that you minimize the amount of product that drifts down into that at-risk category?

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

So we have a process that we follow between our Chief Commercial Officer, Joe Arezone and our Chief Operating Officer, Kathleen Hall. They constantly monitor this. We look at it unit by unit. And then, we look for opportunity to sell that at best possible price around our global sales network. This is an active piece that we manage. And as we go forward with our new product drumbeat, we will have to continue to manage that process as well.

Operator

And we'll take our next question from Bobby Burleson with Canaccord.

Jon DeCourcey - *Canaccord Genuity - Analyst*

This is Jon DeCourcey on for Bobby. So just 2 questions. First, revisit your OpEx comment, with the expectation for R&D to be flat in terms of headcount this year, would you still be expecting the total dollar spend to be down year-over-year, as you mentioned in the last quarter?

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

Well, there is a good piece of the R&D, which is, obviously, expenditure on development and materials related to development. So we are continuing an aggressive development process. And we do intend to come out with many new products, which are under development as we speak.

So the reorganization of the R&D was to make that department more efficient and generate more product suited to the different verticals, so there wasn't an internal reorganization. But I would expect material costs to go up relating to the effort to generate significant new product introductions in the other verticals. So it'd be a bit of a mixed bag.

In addition to that, we have a habit of purchasing a small type -- bolt-on type of companies that we can then process new technologies through our channel. A lot of those come in with R&D and -- or primarily R&D and development staff. So there could be -- and I did mention that in my remarks that a part (inaudible) to keep our organic component flat that there will be additions through the M&A drumbeat that we're continuing.

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

And when you look at it from a $7.2 million to the $8.5 million year-over-year, it's primarily the acquisitions.

Jon DeCourcey - *Canaccord Genuity - Analyst*

Okay. And then my second question is just on the new products that came out in 2016, can you just give any color on the reception to date by customers, which were kind of the leading products? I know some of the gross margin hit was new products that were more value-oriented, but just any additional color on what the reception has been would be great?

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

Well, the increase in the construction BIM-CIM market reflects a very significant uptake of the new -- the eight scanner. It continues to be market-leading. All the various market surveys indicated that it is still the leading product in that market. Its new improvements substantially move it beyond the competition.

The new introduction of the Vantage Tracker, it's a little early to make any statements about it, but it represents a leading class portable performance that has not been seen in that market sector along with the TrackArm concept. It's a little bit early to see the benefit of that. We have an uptick in imager, which is a technology-leading product, which has benefited from the 3D solutions vertical. So it's a little bit early to say, but I would say the biggest indicator is the scanner so far.

Operator

And we'll take our next question from Hendi Susanto with Gabelli & Company.

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

How should we view your aggressive sales force and sales and marketing initiatives among your major verticals and geographies? Which verticals and geography carry the most promising sales leverage when you increase your sales headcount?

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

Well, the -- certainly, our imbalance of about 40% of our sales in the U.S. and 20%-odd in the other 2 regions demand that we -- while there is still even GDPs between those regions -- approximately even GDPs between those regions, we feel that we need to expand primarily in the EMEA and APAC regions, while still also supporting significant increases here.

There has been a tendency for the FTE per headcount to be lower in the APAC regions. And some of that has to do with competitive pricing issues and others -- and other issues around the APAC region. But the balance is a moving target. And as we introduce new products and new categories that suit different markets, you're going to be seeing that affect geographically in a different way. So we're just going to report on a regular basis and -- but it's being measured.

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

And how about among verticals?

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

Well, among the verticals, clearly, the emerging verticals are demanding the greatest increase in our staffing. Now we want to be careful about that, because we also have -- we don't have a fully developed product line in some of those verticals, like product design, for example, has only a couple of products in it while we would like to add and moving on the process of working on several others that add to it.

So we don't want to get the headcount too far ahead of the product availability, so that they can sustain the typical sales per FTE that we would like. Public safety forensics benefits tremendously from our products, so we -- from our current product line. So we believe that we can aggressively grow that. We sell ScanArms, forensic ScanArms and we sell scanners into that market, which are 2 primary core products that are market-leading. So we see greater increase in the headcount in public safety forensics as an emerging one.

So we're trying to strike a balance between keeping our growth in construction in BIM-CIM and metrology markets, while giving attention to these emerging verticals. We don't want to fall into the trap of feeding the ones that have always been our primary producers in the past. And we're trying to level load all the verticals over the next 3 years.

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

And then a question for Bob. Looking at construction building information, they had 23% year-over-year growth in Q1. So it is -- it has like a very strong growth. Any seasonality factor that we should keep in mind when we look into that segment?

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

No. The growth in that area was predominantly driven by higher unit sales, which is in correlation with the release of our new Focus S 150, 350. So it's not necessarily seasonal. It follows the same pretty much seasonal pattern as the rest of our business, Q4 being highest.

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

I see. And then Simon, in 2016, you talked about FARO's strategic interest in factory automation. Do you have any update on that? And whether it will be on your product road map in 2017?

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

Yes, absolutely. We are in the process of working out major agreements with important worldwide robotic manufacturers. We are in the process of continuing to develop sensors for the automated metrology market. And it's become a very big focus. We will have and we have introduced a Robo-Imager Mobile last year as an EA product, as an Early Adopter product that will be converted to a mainline product this year.

3D solutions is a new vertical, which is having some very great early success. And that is entirely around automation with contracts for robotic installations, robotic inspection installations around the world. So we're very focused on that from 2 perspectives. The 3D solutions vertical will be primarily around automated inspection and our R&D around sensors and important 3D measuring devices specifically for that market is the other part of that initiative.

Operator

And we'll take our next question from Ben Rose with Battle Road Research.

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

Just another question on the nice year-over-year growth in the construction BIM/CIM market. Simon, I realize that the new product introduction is at play, but do you see a cyclical recovery in that market, some of the end-user segments in that market? And to what extent is your appetite for adding additional sales headcount kind of confidence that, that market is kind of coming back to life?

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

Well, I think we should separate what's going on at a macroeconomic level in construction from what's happening for FARO and I'll explain that. So we're extremely underpenetrated. There's almost no penetration of that market, and it's a very new market. And so really, what happens at a macroeconomic level, I don't believe that that should have an impact on what's going on for us.

I will say, however, that there is a revolution going on in construction. And that is relating to the use of 3D measurement as part of the management of as-built in the construction process, in the renovation process, post construction and so on and so forth. Everybody is realizing that the significant savings that were made through metrology and manufacturing to reduce scrap and rework have the exact same potentials for savings in the construction business.

So if we have seen anything it's that there is a deep, deep interest for the implementation of 3D measurement technology in the construction industry irrespective of the downturn. As it turns out, in the past, when we had downturns at macroeconomic levels, people were more interested in getting low-cost adaptable and portable measurement equipment into the manufacturing environment to squeeze out profits in those contexts.

So upside or downside in the construction industry, they benefit tremendously from this technology. So we will continue to invest aggressively in the headcount growth around the world irrespective of what the macroeconomics of construction are doing for those reasons.

Operator

And we have no further questions at this time.

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

Okay. Well, then I'll close the call. Thank you, everybody, for your interest today. And we look forward to reporting on next quarter.

Operator

This does conclude today's call. You may disconnect at any time, and have a wonderful day.