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FARO - Q3 2016 FARO Technologies Inc Earnings Call

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PRESENTATION

Operator

Good morning, everyone, and welcome to FARO Technologies' conference call in conjunction with its third-quarter 2016 earnings release.

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

Bob Seidel - *FARO Technologies, Inc. - VP of Finance and IR*

Thank you, and good morning to everyone. Yesterday, after the market closed, we released our third-quarter 2016 results. The press release is available on FARO's website at www.faro.com.

I would like to remind you that in order to help you understand the Company and its results, management may make some forward-looking statements during the course of this call. These statements can be identified by words such as expect, will, believe, anticipate, plan, potential, continue, goals, objectives, intends, may, and similar words. It is possible that the Company's actual results may differ materially from those projected in these forward-looking statements.

Important factors that may cause actual results to differ materially are set forth in yesterday's press release and in the Company's Form 10-K for the year ended December 31, 2015.

I will present the Company's financial results. And Dr. Simon Raab, President and Chief Executive Officer, will deliver his prepared remarks. Afterwards, we will open the call for your questions.

Before going directly to our third-quarter results, I would like to say a few words about our year-to-date 2016 performance. We believe that year-to-date 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 highlight our financial performance on key metrics for the first nine months of 2016 compared to the first nine months of 2015.



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Sales of \$233.9 million were up \$7.7 million or 3.4%. New order bookings of \$234.9 million were up 4.3%. Service revenue increased by 17.6%. Gross margin of 55.3% was up 2.7 percentage points. Net income of \$7.6 million increased by \$3.7 million. We generated \$28.5 million of cash from operations.

Let us turn to third-quarter 2016 results. Sales were \$79.6 million, an increase of 9.8% versus \$72.5 million in the prior-year period. New order bookings were \$79.8 million in the third quarter of 2016, an increase of 10.5% compared to \$72.3 million in the third quarter of 2015. With new order bookings of \$79.8 million and sales of \$79.6 million, our book-to-bill ratio was 1.0 for the third quarter of 2016.

Product sales increased by \$3.5 million, or 6.0%, to \$61.3 million for the third quarter of 2016, reflecting strong sales performance within our Asia and Americas regions, offset partially by lower average selling prices due to our initiative to reduce aged service and sales demonstration inventory. Service revenue increased by \$3.6 million, or 24.6%, to \$18.3 million in the third quarter of 2016, primarily due to an increase in warranty and customer service revenue.

As mentioned in last quarter's prepared remarks, we have a growing installed base of over 15,000 customers for which we have refocused our warranty and service sales efforts to better care for our customers and leverage customer loyalty. The service revenue generated by this broad customer base represents a significant recurring and growing revenue stream.

In Asia, sales in the third quarter of 2016 were \$19.5 million, an increase of 18.8% compared to \$16.4 million in the prior-year period, driven primarily by a strong sales increase in Japan. In the Americas, sales in the third quarter of 2016 were \$37.0 million, an increase of 10.0% compared to \$33.7 million for the third quarter last year, primarily reflecting higher units sold of our 3D documentation products and a strong year-over-year increase in service revenue.

In Europe, sales in the third quarter of 2016 were \$23.1 million, an increase of 2.9% compared to \$22.4 million for the third quarter last year, mostly due to strong service revenue growth, offset partly by lower average selling prices.

Gross margin was 53.6% in the quarter, up 5.5 percentage points compared to 48.1% in the same prior-year period. This substantial increase was mostly related to a \$7.9 million inventory write-down in the third quarter of 2015. Our gross margin is below our prior two quarters in 2016, driven primarily by lower average selling prices due to our initiative to reduce aged service and sales demonstration inventory, as well as a slight decline in our service margin.

Selling and marketing expenses increased by \$0.7 million, or 4.1%, to \$19.7 million in the third quarter of 2016 compared to \$19.0 million in the third quarter of 2015. This increase was related mostly to higher employee-related expenses as we increased our salesforce to drive top-line growth. As a percentage of sales, selling and marketing decreased to 24.8% compared to 26.1% in the third quarter of 2015.

General and administrative expenses in the third quarter of 2016 were \$10.8 million compared to \$8.2 million in the third quarter last year. This increase was mostly driven by an increase in our incentive compensation accruals, higher headcount, and acquisition-related expenses. As a percentage of sales, general and administrative expenses increased to 13.5% compared to 11.4% in the third quarter of 2015.

Research and development expenses increased to \$8.0 million in the third quarter of 2016 compared to \$5.8 million in the third quarter of 2015. This increase was primarily related to higher compensation expense from an increase in our incentive compensation accrual, higher headcount, and acquired businesses.

In addition, we recorded an expense related to the write-off of certain patent assets. Research and development expenses increased to 10.0% of sales in the third quarter of 2016 compared to 8% of sales in the prior-year period.

Operating income in the third quarter of 2016 was \$0.8 million, an increase of \$1.7 million compared to an operating loss of \$0.9 million in the prior-year period, primarily due to higher sales and the increase in gross margin. Our operating margin was 1.1% in the quarter compared to negative 1.3% in the prior-year period. In the third quarter of 2016, we recorded an income tax benefit of \$0.1 million, primarily due to a change in the geographical mix of our full-year expected pre-tax income.

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Net income in the third quarter of 2016 was \$1.1 million or \$0.07 per diluted share, representing an increase of \$2.0 million or \$0.12 per diluted share above the prior-year period.

I will now briefly discuss a few balance sheet items. As of September 30, 2016, cash and short-term investments totaled \$153.3 million, an increase of \$2.9 million compared to \$150.4 million as of December 31, 2015, primarily driven by strong cash flow from operations of \$28.5 million, offset partly by the acquisition of BuildIT Software & Solutions and Laser Projection Technologies totaling \$20.9 million.

Accounts receivable decreased by \$12.5 million to \$57.4 million as of September 30, 2016, compared to \$69.9 million as of December 31, 2015. DSO was 66 days at the end of third quarter 2016, down 4 days from the end of fourth quarter 2015. Total inventories increased to \$88.9 million as of September 30, 2016, from \$79.3 million as of December 31, 2015, mostly driven by our new product drumbeat, acquired businesses, and an increase in our salesforce.

Finally, I will conclude with our headcount numbers. We ended 2015 with 1,288 employees. As of September 30, 2016, we have grown to 1,440 employees, in line with our stated goals to invest in our salesforce and execute a more aggressive acquisition strategy. Geographically, we added 607 employees in the Americas, 511 in Europe, and 322 in Asia.

I will now hand the call over to Simon.

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

Thanks, Bob, and good morning, everyone. Our renewal initiatives are progressing well. We have achieved several key transformative milestones since our last earnings call. We demonstrated our willingness and our ability to execute on an M&A drumbeat as a means to strengthen and quickly expand our vertical product offerings.

On July 12 we announced the acquisition of BuildIT Software & Solutions to enhance our metrology software portfolio. BuildIT's software suite is used daily on the production lines of five out of the 10 largest aerospace and defense manufacturers, and in key customers for FARO. BuildIT has differentiated itself by its high degree of customization, and we plan to leverage that capability in the introduction of future metrology products.

On August 29, we reported the acquisition of Laser Projection Technologies to expand our 3D metrology product portfolio. LPT has traditionally sold the Tracer laser projection platform, which is an optical template device projecting the image of a part for the correct location on a structure or assembly. In September at the IMTS trade show, we showed the VectorRI from the same acquisition, which represents a next-generation product platform offering dynamic, high-speed projection and measurement.

The VectorRI uses proprietary radar imaging technology and will disrupt the market with its high-speed imaging. It will deliver unmatched capabilities in large volume, non-contact metrology applications with high-speed distance measurements, high-speed beam steering, image contrast functionality, and projection guidance. The VectorRI has been introduced as an early adopter product as we ramp up production.

These acquisitions demonstrate our commitment to an M&A drumbeat, with additional acquisitions to be expected in the coming quarters.

In our renewal process, we have talked extensively of our strategic vision to be the technical and market leader in 3D measurement, and how a new product drumbeat is one of the essential components to achieving and maintaining that leadership. Throughout the year, our team has demonstrated this vision through a consistent pattern of new product introductions and software upgrades.

In October we achieved a significant milestone by introducing the next generation of our Focus Laser Scanner at the INTERGEO show. The Focus S models are certified with an IP54 rating for environmental endurance in the difficult construction and public safety environments often confronted by our customers. In addition, the newly added and exclusive on-site compensation feature makes it possible for users to verify the scanner accuracy on-site whenever needed.



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We continued our initiative to differentiate our existing platform products to better address the problems of specific verticals. In August, we introduced the FARO Forensic ScanArm, which offers our public safety forensic customers with a tailored hardware and software solution. Mid-September, through our early adopter program, we introduced the Freestyle 3D Objects, which is the first hand-held color laser scanning solution to address the needs specific to the public safety forensics and product design verticals.

When we introduced the first FaroArm years ago, a founding principle was to provide adaptable 3D measurement technology at a more affordable price than existing solutions. Our goal was to expand the addressable market to small and medium-size businesses. Recently we continued the same philosophy with the release of the FARO VantageE laser tracker to provide a value-priced 3D measurement option for distances up to 25 meters.

Our software development teams delivered several next-generation releases. Our 3D documentation software team released SCENE 6.1, which greatly enhances the functionality of fully integrated meshing tools and simplifies operations with a redesigned user interface.

Our public safety forensics vertical introduced FARO Zone 2D, a completely new diagramming software offering for law enforcement, fire service, and insurance professionals. FARO Zone 2D allows users to quickly generate accurate 2D diagrams without the complexity of traditional CAD programs. And finally, we launched our PointSense 17.5 to accelerate workflows inside Reddit and AutoCAD for our construction BIM/CIM vertical customers.

The new product drumbeat requires fundamental changes throughout the entire operations of our business. At the end of the third quarter we had \$33.7 million of service and sales demonstration inventory on our balance sheet. Typically, service inventory is used to provide temporary replacement product to a customer covered by a premium warranty when the customer's unit requires service or repair. Sales demonstration inventory is used by our sales representatives to present our products to customers.

With more frequent product introductions, our sales must team turn over our sales and service demonstration inventory more quickly. As a result, we have implemented an initiative to systematically reduce our aged service loaner and sales demonstration inventory through warranty policy changes and targeted sales initiatives directed at customers seeking lower entry costs.

The sales of our service and sales demonstration inventory is generally transacted at lower margins and will temporarily decrease our gross margin. Our sales of used pre-owned equipment almost doubled compared with the prior-year period; hence, our third-quarter gross margin was below our prior two-quarter run rate, due primarily to this temporary inventory initiative.

On our last earnings call, I stressed the importance of our management team to continually monitor and adjust our sales infrastructure in order to effectively drive top-line growth. The discipline becomes even more imperative as we expand our product portfolio through business acquisitions and our new product drumbeat.

Management is preparing for our future growth by systematically and aggressively increasing the global salesforce in the different verticals. This will increase selling expenses in the new verticals as the initial large-scale hiring is implemented throughout 2017. In Q3 of this year, sales headcount increased by 39 heads or 7% from the end of the second quarter.

Besides adding feet to the street, we are continuing to modernize the sales process by transitioning our traditional sales approach focus on on-site demonstrations to a hybrid one of multimedia and web-based demonstrations. For a limited capital investment, we have now online demonstration studios up and running across the globe.

The primary objective is to leverage current technologies on the Web to change the historical capital equipment sales approach. Sales and marketing expense still represents our largest percentage of operating costs; and, therefore, is a fertile area to seek improvements to leverage growth to the operating income. We are pleased with the initial customer feedback, and plan to continue to refine the experience over time.

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Since embarking on our renewal initiatives, we have been re-examining every aspect of our business. Our broad-reaching renewal of FARO centers ongoing vertical, which means driving sales growth by aligning sales, marketing, product management, and R&D to focus on specific vertical markets. As we transition our Company to a vertical approach, we must remain agile and flexible to adjust structure and strategy when appropriate.

Our Chief Commercial Officer, Joe Arezone, and his leadership team, recently reevaluated our previously announced verticals and decided to merge metrology and factory automation into factory metrology. This vertical is designed to provide both manual and automated metrology solutions primarily to industrial and manufacturing end customers. As of now, we are aligning our business along five verticals: factory metrology, product design, construction BIM/CIM, public safety forensics, and 3D solutions.

When we announced our renewal initiatives in February, we indicated a 12- to 18-month implementation period. Given our progress to date and the evaluation of what lies ahead, we are committed to substantially completing the renewal and reorganization efforts by mid-2017.

We are in the process of transitioning our segment financing -- our financial reporting from geographical regions to verticals. Our third-quarter financial results continue to be reported on a geographic regional basis. We are in the midst of harmonizing our business practices to a single global approach in an effort to reduce complexity and streamline our operating costs.

As we introduce new products, we will be differentiating offerings by vertical to better solve the problems of our customers. And during the implementations period, we will encounter certain implementation costs such as system configuration expenses or recruiting expenses, increased selling expenses, and lower gross margins. And we remain focused on minimizing the incremental financial cost of the renewal and vertical expansion.

Historically, the fourth quarter is our highest sales, revenue, and profitability quarter. The FARO team will remain focused on sales execution with the intent to deliver a strong finish to 2016 while also continuing to execute on our renewal initiatives, and to harmonize our processes in order to position ourselves for the future.

I'm proud of our significant accomplishments thus far in 2016, and I want to thank all FARO employees for their continued focus as we improve the way we do business.

I'll now open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Ben Hearnberger, Stephens.

Ben Hearnberger - Stephens Inc. - Analyst

I wanted to start walking through the income statement, and looking at what you would describe as one-time on the cost side. I know you called out M&A costs and G&A, a patent write-off in R&D, and then we've got this old equipment that we're discounting. Can you walk us through and call out what would be considered maybe one-time in nature?

Bob Seidel - FARO Technologies, Inc. - VP of Finance and IR

Sure. If I look at the income statement and I start with selling and marketing, we had recruiting and relocation costs associated with our -- filling our salesforce globally. We do not plan to call out how much that is; but it is approximately half, call it, of the year-over-year increase.



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The G&A, there, we had transaction expenses related to our acquisitions, so that was a primary driver for us. And in R&D, we had the patent write-off. This is somewhat recurring from the perspective as patents expire and we choose not to renew those, we will have those expenses. We had a slight [bit] in Q2, slightly higher in Q3. And then some M&A in terms of the acquired businesses coming through in R&D that you would not have in the prior year.

So what I would say also is when you look down at the prior-year comparison, one of the factors -- not a one-time, but one of the factors that is a driver is our incentive compensation is a higher level this year than last year. So if you look at that \$6 million, we have approximately \$2 million in higher incentive compensation year-over-year.

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

Ben, this is Simon. I wanted to just add one other item. With the creation of the verticals, where metrology of course -- factory metrology is our biggest one, we have to put in a large number of new sales staff in the new verticals. And it will be one-time in the sense that we need to create a basis for, let's say, a more regular growth going forward. So we could have actually several tens of employees hired in emerging verticals like public safety, around the world, and then move towards a more systematic quarterly growth from that point on.

So, in 2017, what I was referring to was the fact that we would need to do some major hiring initiatives, which will mean that selling and marketing expenses will get ahead of sales for a few months as those sales teams -- those newly implemented sales teams ramp up in the verticals which do not have substantive salesforces at the moment.

Ben Hearnberger - Stephens Inc. - Analyst

Okay. So, sales and marketing is going to grow ahead of sales. How do you think about G&A and R&D as we look out over the next year? Are we at, on an absolute basis, a decent level? Or could we continue to step those lines up as well?

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

The plan is to keep all that flat as possible right now. So there's no -- one of the ideas behind harmonization and the efficiencies across the world is that we should be able to get the -- we should be able to handle higher sales growth with an existing general and administrative cost structure.

With respect to R&D, the reorganization of R&D also means the same thing. In fact, I would like to see that number come down as a percentage of sales. We just have to be -- I think we can be far more effective about the products produced for the same dollars.

So, the quick answer to your question is that we'll keep those two flat, and hopefully the top line will grow. And then that means, as a percentage of sales, we expect those to drop.

Bob Seidel - FARO Technologies, Inc. - VP of Finance and IR

And on the G&A, Ben -- as you look at our quarterly trend in 2016, we were at \$10.5 million, \$10.2 million, \$10.8 million. If you think about the activities that we have in Q3 in terms of the M&A, things like that, I consider we've basically done what Simon has just indicated. We have held that absolute dollar amount, excluding these initiatives.

Ben Hearnberger - Stephens Inc. - Analyst

Okay. One last question. As we think about trying to produce stronger revenue growth, I think a big piece of that is contribution from all the new products you've launched. Can you walk us through which new products you are most excited about, which you expect to be material contributors in 2017? And then maybe just talk about the general environment, as well, as we enter 2017.



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

Sure. So, clearly one of the most exciting products I've seen in a long time is the VectorRI, which came with the LPT acquisition. We think this is nothing less than a watershed potential change in technology in factories for doing measurement and building guidance within the manufacturing environment. That's an early adopter product right now, because we need to ramp up the production, so we believe that will start to have an important impact in 2017.

The other product which is gaining some significant momentum but requires some significant restructuring in the way we deliver it is the Cobalt Imager, which was introduced last year. But it became apparent that without an integrated group that provides solutions for customers that it wasn't going to get its full traction. That group is in the process of being formed. We have many projects on our plate, and we expect that Cobalt also make an important contribution.

Finally, I think the next biggest contributor will be the Focus S, the newly introduced Focus scanner, which will have dramatic implications. It's a market leader. It's got about 60%-odd of the market, and it represents a very important future growth area.

Ben Hearnberger - Stephens Inc. - Analyst

Okay. Thank you very much.

Operator

Patrick Newton, Stifel.

Patrick Newton - Stifel Nicolaus - Analyst

Just focusing on the sales headcount, I calc about a 7% sequential increase. When are we going to see mid-teens growth on the headcount side, Simon? And then can you just comment on how your employees are adjusting to the change to increase products to sell, and to the vertical reorg?

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

Sure. I'm going to ask you to repeat the second part of your question in a second. With regards to the sales growth, staffing growth, you'll start to see that starting in this quarter. Moving forward, we want to get everything up to the point where we are seeing generally a high-teens growth in all the verticals. There was an infrastructural need to establish the various departments correctly before we started throwing people at them. But it's not an insignificant increase to see 7% increase in just the one quarter-over-quarter.

So, we are ramping up, and we're trying to define those for our budgets for next year. But you should expect to see double-digit growth in the salesforce in 2017.

Patrick Newton - Stifel Nicolaus - Analyst

Great. Yes, the second part of the question was how your sales teams are adjusting to having -- vertical-focused, and an increased product portfolio to sell.



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

Well, there's obviously excitement. There's definitely -- salespeople are excited by having new products and knowing that they can count on it. Customers, of course, define their loyalty by an expectation for new technologies, and proper support of that. So there's an initiative to better define the products for all the verticals. So, the pricing and performance of these products is going to contribute to the effectiveness in the sales.

In the early emerging markets that we have gone after -- the product design, for example, and the public safety -- I would call those formative. But the marketplaces are extremely interested and excited about the products we're bringing to them, and have been well welcomed. So, it's a little early to tell, but everybody is excited, both from the customer and the salesforce perspective.

Patrick Newton - Stifel Nicolaus - Analyst

Great. And then I know it's still very early stages, but given some of the changes you've made to your demo process, is there any noticeable change in the close rates or in number of customer interactions?

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

Well, the number of customer interactions has increased, for sure. We're able to show much more early adopter products, much more broadly around the world. The number of early demos has gone up. I can't say that it hasn't had an effect yet on the close ratio. We have had sales that have derived entirely from Web demos without an on-site demo, which of course is always interesting to us. And I think it's a little early for us to say. We'd certainly hope that the close rate will go up.

Patrick Newton - Stifel Nicolaus - Analyst

Okay. And then, Bob, just on some revenue and inventory questions. Can you help us out in understanding contribution to revenue from acquisitions in the quarter? And then pertaining to the sale of aged servers and demo inventory, what was the resulting revenue contribution? Is there any way to approach that -- what gross margin would have been, if you exclude the discounting impacts?

Bob Seidel - FARO Technologies, Inc. - VP of Finance and IR

Patrick, at this point, we do not plan to disclose the sales revenue contribution from the two acquisitions. We have already had published the 8-K for both the purchase of BuildIT Software & Solutions, which was \$3.8 million, was the purchase price; and then Laser Projection Technologies, which was \$17.1 million.

We have not historically, and not go forward, really segregate out those businesses and call out the revenue contributions. What I will say, though, is when we do publish the K in the coming days, you will see of course the purchase accounting and how that purchase price will be allocated across our balance sheet. You will get that level of detail.

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

I think the other thing to -- I think it's important to hear our philosophy about the way we are going to do these acquisitions, and the type of acquisitions. It's my experience -- and these are the ones I most favor, are the ones who where you have a low -- a small company with a great technology that has not found its channel properly yet.

So, we don't view these from the classical accretive point of view. We view them more as -- how does this technology look in our channel, and what can our channel do with it? And what can we do to the technology to bring it to its -- some kind of fruition?



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So I don't think much is gained philosophically or analytically by looking at their accretive. Now, if we were doing much larger acquisitions, I think that would not be true. It's our tendency, and we will continue in the future, to do these string-of-pearls type of acquisitions: small, important technologies that can make large contributions to our channel.

Bob Seidel - *FARO Technologies, Inc. - VP of Finance and IR*

In terms of the -- the second part of your question was related to one of our initiatives to reduce our aged service and demonstration inventory. As I look at it, Patrick, we think into the third quarter, at a 56.1% gross margin year-to-date basis. And our third-quarter margin is 53.6%. The primary driver -- one of the primary drivers for us is being from that 56% down to the 53.6% relates to selling off the -- or our initiative to reduce that risk for our shareholders of having that aged service and demonstration inventory.

We highlight that in our Ks and our Qs before, that risk. That was a major driver of that margin decline. So it was about double the sales that we would normally see in that category business. And as Simon indicated, it really helps to get that slow entry -- lower barrier entry for some customers.

Patrick Newton - *Stifel Nicolaus - Analyst*

And can you just quantify what double is, since we don't really have a baseline? Was it a couple million in top-line contribution? Anything to help us, in essence, figure out what the organic growth rate is versus [perching at] inventory.

Bob Seidel - *FARO Technologies, Inc. - VP of Finance and IR*

It was approximately \$9 million in revenue for the aged demonstration and service sales in the quarter.

Patrick Newton - *Stifel Nicolaus - Analyst*

And that was roughly double the norm, you said.

Bob Seidel - *FARO Technologies, Inc. - VP of Finance and IR*

That's correct.

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

And then, Simon, you talked about \$34 million in service and demo inventory exiting the quarter. What is the right level, long-term?

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

That's hard to say. It's got a lot to do with the reliability, [which is] kind of an actuarial analysis of how much inventory we hold for premium warranties as a function of the reliability of the product. So, one of the primary tools that you use is to improve reliability, and, hence, reduce the actuarial requirement for having available premium warranty equipment.

I think it could come down substantively. And I would hope -- of course, as the number of installed units goes up and premium warranty sales become an important part of sales, there's a counter to that reduction process. So, I'm not prepared to say what the right number is.



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Patrick Newton - *Stifel Nicolaus - Analyst*

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

Operator

Jim Ricchiuti, Needham & Company.

Jim Ricchiuti - *Needham & Company - Analyst*

When would you anticipate that some of these actions -- these initiatives you're taking on the service, demo inventory side -- will be behind you, as you look out over the next couple of quarters? Can you give us any sense? It sounds like it's going to continue for a bit of time.

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

Yes, it's part of the initiatives that should be done by mid-2017, at the current rate that we're going at. Which is why I mentioned slightly depressed gross margins from that effect over the next couple of quarters. So I would expect this quarter, and maybe the next one or two.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay. And you gave a little bit of color on what you are seeing in the various geographies? But I wonder if you could maybe elaborate a little bit more on that. If we look at the Americas, you called out, I think, one of the factors in the strength you saw in that region -- better conditions in 3D documentation. How is the metrology business going, and did it go in the Americas?

Bob Seidel - *FARO Technologies, Inc. - VP of Finance and IR*

So, what we saw in the Americas was a nice improvement over where we were at in the prior quarter. As you know, last quarter we talked about it being somewhat down. We saw strength on the metrology side of our business, both driven by -- partially by these lower-priced products of the demonstration sales and service sales. But also really around just the pure factory metrology point of view in terms of the high-accuracy Arm product as well. So we saw very good results out of our aerospace, automotive customers, relating to our metrology business.

As you look around the globe, we saw the same out of Japan. It's been a very nice increase for us year-over-year 2016 in Japan what we had -- than what we had in 2015. I would say the only area where we saw some, I would say, market softness and higher competitive pressures would have been in Europe, Jim.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay, that's helpful. And just in general, anything unusual on the pricing side in terms of price competition that you may be seeing out in the market? Other than the initiatives that you are taking, but just in general, what's the pricing environment?

Bob Seidel - *FARO Technologies, Inc. - VP of Finance and IR*

I would say this, is that every time I talk to the sales teams out there, certainly there each quarter it seems to ratchet slightly up in terms of price competition. Where we are looking to go, though, is, as Simon indicated, is we move forward with our initiatives, raise our platforms of products, and we will become the price leader and somewhat get out of that game. But I would say right now is that where we see the largest price competition is in those markets that we have reduced demand or selling demand: Europe, China, those types of places. That's what we hear from the sales teams; consistent with prior quarters, maybe a notch up.



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Jim Ricchiuti - *Needham & Company - Analyst*

Okay. If we go back 10 years or so, you've always generated pretty healthy sequential revenue growth. In Q4 it looks like it's probably averaged around 20% or so from Q3. Are there factors that we need to consider with this historical pattern and your ability to show, call it, mid-teens sequential growth, or up in the current quarter, as it relates to maybe some of the initiatives you're taking? Will there be some changes in Q4 that we might see versus historically?

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

I think, at this point, the historical pattern is probably the most preferred predictive approach. I do believe that there's an opportunity for some of the initiatives to change from that historical balance between the quarters. But I don't think that that's going to really happen with any strength until many of these initiatives and product repositionings occur in 2017. So I would say at this point, you should view historical patterns as being representative for this quarter.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay. Thanks a lot.

Operator

Richard Eastman, Robert W. Baird.

Richard Eastman - *Robert W. Baird & Company - Analyst*

Very quickly, if we look at the overall sales growth -- this, call it, 10%, round-up in the quarter -- could you provide any insight into the five verticals, and how they may -- how the growth in the five verticals may have lined up with that, call it, 10% year-over-year sales growth?

Bob Seidel - *FARO Technologies, Inc. - VP of Finance and IR*

Well, we are not ready, of course, to do the segment reporting. But I can suggest to you that the primary volume is coming from our factory metrology, which is our predominant group. The second in line would be the BIM/CIM, part of which we call -- or which was part of what we used to call 3D documentation. The public safety will start to become much more significant as headcount goes up, as well as product design and 3D solutions. So it is a little early to be able to report that (multiple speakers).

Richard Eastman - *Robert W. Baird & Company - Analyst*

Okay. And then the surface growth, what's the visibility there on continued double-digit growth in service? We made a full-court press here on service contracts and customer support there, and that has clearly shown up. But I'm curious what the runway is there, given that that growth has exceeded your product growth for some time? So obviously you are harvesting the installed base, but how do you feel about maintaining a 15% or 20% growth rate in service year-over-year, going forward?

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

Well, I would like to say that we -- in short order, let's say the next 6 to 9 months, that we saturate it at its current level, and then it grows commensurate with the increase in the installed base. That's what I would hope. So I would expect that with the new initiatives and making use of that installed



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base, that let's say the next three quarters, we would see a catch-up to make sure that we have properly premium warranties and provided programs for all our installed base. And then subsequent to that, I think it should track the increase in the installed base.

Richard Eastman - *Robert W. Baird & Company - Analyst*

Okay. And then just a quick question. I think to interpret maybe something you'd said earlier, Simon, the headcount growth here over the next, call it, 12 months is expected to be double-digit. Is that right? And that is sequentially?

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

Systematically, year-over-year, I would expect to see a high double-digits increase in the overall headcount in sales.

Bob Seidel - *FARO Technologies, Inc. - VP of Finance and IR*

In sales and marketing.

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

In sales and marketing. Of course; we are keeping everything else flat. It's just sales and marketing.

Richard Eastman - *Robert W. Baird & Company - Analyst*

Again, when you project out, given the cost of the realignment and the filling of the verticals here in terms of headcount, do you project out that profitability runs closer to breakeven here for the next few quarters?

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

Well, we are better than breakeven now, so I'm not sure what you mean.

Richard Eastman - *Robert W. Baird & Company - Analyst*

Well, you are better, but certainly not maybe (multiple speakers).

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

Yes, no, you make a good point. I believe that there will be a little bit of cat-and-mouse as we aggressively increase the headcount in the new, emerging verticals, as I mentioned in my talk, that I believe that if selling expenses could get ahead of the actual sales. But our ability to ramp up salespeople has been pretty good in the past 6 to 9 months to get them up and running. So I think you make a good point.

But remember also that we have a lot of new product introductions, which even through the existing installed salesforce, should generate some important growth. Our hope is that we will still be able to balance those out, and continue to show good cash flow and profitability.



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Bob Seidel - *FARO Technologies, Inc. - VP of Finance and IR*

As Simon indicated is we are focused as a team, as a Company, as a leadership, to complete these initiatives by mid-2017. And so, after we get through that mid-2017, all the things that we've talked about in the past -- in terms of how we're going to leverage G&A, R&D as a percentage of sales -- we're absolutely focused on that, as Simon indicated, in terms of keeping absolute dollars in R&D and G&A, and lifting gross margins.

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

One of the areas where I think that we have restructured and harmonized has been in the commission and payroll structure. We have reduced the variable part on the commission part and increase the fixed part. On the short term, that might have a slightly larger impact on the cost of selling. But very quickly, with sales increasing, you start to get ahead of the selling expenses. So, we have made changes in our process in so many different ways that at this point, we would be very unhappy if we were not profitable throughout the process. So it will be a little bit of a balancing process.

Richard Eastman - *Robert W. Baird & Company - Analyst*

And just move to the last question. I think, Bob, when you ran through some of the OpEx items, you commented that incentive comp was up pretty much across the board there. And I'm curious, is maybe the driver in the increase in incentive comp -- is it based here on these organizational changes and milestones? Or is it based on sales growth? I'm just curious, across the board with incentive comp up, obviously we are performing to whatever our goals are. And our goals are to -- what? Increase headcount? To get our verticals realigned? These initiatives that we've focused on?

Bob Seidel - *FARO Technologies, Inc. - VP of Finance and IR*

Our incentive compensation program is tied to what ourselves and our compensation committee views as the interests of our shareholders, which is grow revenue and to take that to the bottom line and to growth net income. And so we had targets set out for the beginning of the year, which were aggressive targets both for growth of our sales and growth of our net income.

And if you compare that -- how we're achieving versus how we achieved on those prior metrics last year -- that's why the incentive compensation is up about \$2 million, quarter over quarter. Because last year we did have a \$7.9 million inventory write-down, which caused us to not meet those objectives for our shareholders. So again, we're performing -- our incentive compensation program is aligned to the pockets of our shareholders.

Richard Eastman - *Robert W. Baird & Company - Analyst*

So, the \$0.07 EPS in the quarter, that was ahead of your plan?

Bob Seidel - *FARO Technologies, Inc. - VP of Finance and IR*

The \$0.07 -- no. What we are saying is this, is that year-over-year we are closer to our plan than what we were last year. So if I look at year-over-year the incentive compensation, what we have accrued in our accrued liabilities on our balance sheet is about \$2 million of expense higher than what we were last year in the quarter. Just because of the better performance that we've had this year versus last year.

Richard Eastman - *Robert W. Baird & Company - Analyst*

Okay. Very good, thank you.



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Operator

Mark Jordan, Noble Financial.

Mark Jordan - Noble Financial Group - Analyst

First question, relative to your expectations for the verticals, do you believe that the salesforce in each of the verticals -- say, the metrology versus public safety -- will eventually have the same level of sales productivity? Or is there a structural difference between verticals with regards to expected performance?

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

That's actually a really great question. It's a question we ask ourselves here, too, as we try to model what's going forward. Right now, it looks like yes, it does. It seems to be -- our average price, if you think about our products anywhere from the \$30,000 to \$70,000 range -- so, for argument's sake, let's call the average sale around \$50,000 when you add software and hardware. The limited number of demos that an individual can do in the field seems to be the limiting factor to the number of demonstrations, and obviously the number of sales as a function of the close rate.

So now you understand why we're trying to do some of this modernization initiative, to break the back of those limits of the number of demos you can do and the quality of those demos for the purposes of the close rate. Right now we have the expectation that the sales group will be the same in terms of the average sales.

The one area where we think is the highest risk is where the prices are substantively different overall, and that's in the product design category, where reverse engineering does not require a high degree of accuracy; and, hence, the product categories tend to be slightly lower priced.

But then again, the sales process may be easier in those cases, and that's yet to be determined. So, right now, I think the safe answer is to tell you that we expect the same kind of dollar sales productivity per salesperson.

Mark Jordan - Noble Financial Group - Analyst

A second question for me, relative to M&A. Obviously you had a couple of small technology purchases. Do you expect more on that front? Or were these a couple of unique events that occurred, and we may go an extended period of time without additional transactions?

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

Yes, as I said in my preamble, we expect to continue these types of acquisitions. That's all we can tell you, is that we expect to continue that.

Mark Jordan - Noble Financial Group - Analyst

Okay, thank you.

Operator

Ben Rose, Battle Road Research.



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Ben Rose - *Battle Road Research - Analyst*

First question for Simon: it's been a few quarters since you've introduced the early adopter program. And at a high level, could you speak to your level of satisfaction so far with the results that you have seen?

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

Yes; a very interesting area of concern. The idea, of course, was to do a small-scale introduction of new technologies in order to get immediate customer feedback and interest in the marketplace, depending -- and we would do this in a limited manner, geographically and technologically.

One of the first ones, for example, was the scan localizer, which was a device for positioning and linking together the scans by the Focus Scanner. We learned from that that people are quite interested in that for interior design. We need to, for example, make some small changes in the device.

But we also learned that there was a secondary market, which we really didn't have a good feel for, and that's just the 2D scanner market, which resulted in our Zone 2D product introduction. There's a lot of people that are interested simply in getting floor plans well-defined quickly. So we discovered things. And I think we can say that we discovered elements of the marketing story for each of these products that we have introduced, from an early adopter point of view.

It allows us to show the market that we're working on new things; get feedback from very specific types of clients. Remember that these early adopter clients had to register themselves, commensurate with the expectations for an early adopter, which relates to service and support and performance of the devices. So it's actually interesting that we have people signing up. But they are predominantly in the metrology vertical right now, while we are slowly adding people in the BIM/CIM and in the public safety areas.

So I would say it's been rather productive. It's a tremendous tool in product management to get feedback quickly and make optimizations in the product for the vertical. Remember that in public safety and in BIM/CIM that a lot of the technologies that we're bringing have never been used before. So it's a certain amount of missionary work, and getting that early feedback is essential. So, we feel very good about it, and we think it will play a very important role going forward.

Ben Rose - *Battle Road Research - Analyst*

Okay. Thank you very much.

Operator

(Operator Instructions). Henden Susatomo, Gabelli & Company.

Hendi Susanto - *Gabelli & Co. - Analyst*

Congrats on good growth in Q3. One question: you have large number of new product introductions. How should we think about the gross margins of those new products, relative to the overall gross margin? Secondly, when would we see a positive benefit of shifting more into value solution approach and higher software contents?

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

So, historically, our margins, as you will recall going back some years, has been around 60%. That seemed to be a magic number when we were leading in terms of the -- being technology leaders and demanding higher prices. We think that there will be a higher margin in the value-added



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3D solutions vertical, where we're actually providing a much higher value-added. But I would expect that -- the goal for us, as a software and hardware mix, is to get back up into the 60% gross margin area.

Hendi Susanto - *Gabelli & Co. - Analyst*

And any insight into the timing, whether we should see some improvement in gross margin sometime in 2017?

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

Absolutely. It's our plan to incrementally develop that by introducing technology-leading versions of our technology, getting premium pricing. And of course, the advent of the 3D solutions vertical will also increase that. So mid-2017 continues to be our goal line for expectations to see the results of our efforts.

Hendi Susanto - *Gabelli & Co. - Analyst*

Thank you.

Operator

And there are no further questions at this time.

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

Thank you, everybody, for attending our third-quarter conference call, and we look forward to speaking to you again soon. Thank you.

Operator

Thank you. This does conclude today's FARO Technologies conference call in conjunction with its third-quarter 2016 earnings release. You may now disconnect your lines. And, everyone, have a great day.

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