FARO Technologies, Inc. (FARO)

Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

<table>
<thead>
<tr>
<th>Price ($) (5/15/20):</th>
<th>51.17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Cap (mil):</td>
<td>901</td>
</tr>
<tr>
<td>L-Term Rev. Gr Rate Est:</td>
<td>20%</td>
</tr>
<tr>
<td>L-Term EPS Gr Rate Est:</td>
<td>15%</td>
</tr>
<tr>
<td>Debt/Cap:</td>
<td>0.0%</td>
</tr>
<tr>
<td>ROE:</td>
<td>1.0%</td>
</tr>
<tr>
<td>Rating:</td>
<td>Neutral</td>
</tr>
<tr>
<td>FY Dec</td>
<td>2019A 2020E 2021E</td>
</tr>
<tr>
<td>FY P/E</td>
<td>81.2x 82.5x 26.9x</td>
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</tbody>
</table>

Company Description

FARO makes 3D documentation and portable metrology tools, i.e., portable coordinate measuring machines (CMMs). Portable CMMs ensure parts/tooling/assemblies meet original CAD specifications at the point of manufacture (vs. conventional, fixed location/off-line CMMs or non-computer-based single-use check fixtures). Auto, aerospace and heavy equipment are core Metrology customers. 3D documentation, i.e., 3D laser scanners, captures detailed 3D spatial measurements used in AEC/survey, forensics and industrial asset management.

Revenue Profile

Sales by Vertical (CY19E)

Sales by Region CY19

Sales and OP margin trends

Competition

<table>
<thead>
<tr>
<th>Product</th>
<th>ASP</th>
<th>Competitors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quantum - E/S/M Arms</td>
<td>~$40-65K</td>
<td>Hexagon AB, Nikon (Metris), Tokyo-Boeki</td>
</tr>
<tr>
<td>Arm + LLP (Scan Arm)</td>
<td>~$65-95K</td>
<td>Hexagon, Nikon (Metris), Steinichler Optotechnology</td>
</tr>
<tr>
<td>Vantage E/Vantage S (Laser Tracker)</td>
<td>~$75-100K</td>
<td>Hexagon (Leica Geo), Automated Precision, Nikon</td>
</tr>
<tr>
<td>Focus 3D Scanner (70/150/350)</td>
<td>~$25-60K</td>
<td>Hexagon (Leica), TRMB, Zoller+Frohlich GmbH, Topcon</td>
</tr>
<tr>
<td>Freestyle 3D Scanner (handheld)</td>
<td>~$12K</td>
<td>ARETEC, Mantis Vision, DotProduct, Creaform (AME)</td>
</tr>
</tbody>
</table>

Source: Company reports, Robert W. Baird & Co. estimates

* Note: LLP attachment adds ~$25K-$30K (est.) to base ARM price

Source: Company reports, Robert W. Baird & Co. estimates
Quick Summary
Neutral-rated as intermediate-term impacts from COVID negatively impact the global demand environment for Metrology. We expect this dynamic to worsen before it improves. We forecast a quarterly revenue level through Q3/20 that will challenge profitability. However, the key focus should be on the impressive progress to re-craft the business model to deliver sales efficiency, R&D focus and operating leverage (structurally reducing operating cost). Although COVID’s impact on demand is a major intermediate-term distraction on sales, progress implementing structural strategic initiatives appears on, or ahead of, plan.

- **Q1 results reflected late-quarter COVID-induced demand paralysis.** Revenue was $79.5M, -15% Y/Y as Product sales -21% Y/Y. Product sales declined sharply as Scanner sales to Public Safety and BIM/Construction markets weakened late in the quarter. 3D Manufacturing/Industrial Metrology, also lower exposed to aerospace and automotive end markets. Service revenue (~30% sales) was a resilient, +4% Y/Y.

- **Orders were $77.9M, -23% Y/Y.** Management noted some "order push-outs late in Q1". Book-to-bill was .98X. Regionally: North America -9% Y/Y, EMEA -24%, Asia-Pac -13%, incl. China (6% sales) -43%.

- **Adj. GPM was 55.5%, -140bps Y/Y, as lower volume in Product sales dragged down consolidated GPM%. Product GPM was 59.2%, -170bps Y/Y, Service GPM was 45.2%, +260bps Y/Y. (GAAP) EPS was -$0.84 absorbing a restructuring charge for strategic/planned cost actions. Adj. EPS (excluding restructuring, options expense, purchase amort.) was -$0.02.

- **We anticipate/forecast Q2 to trend weaker**, both orders, revenue and adj. EPS, as end market trends eroded late in Q1 and despite "China recovering," FARO's exposure to industrial metrology, public safety and construction should be expected lower in EMEA/U.S. in Q2 due to the global pacing of the COVID pandemic mitigation efforts. We are currently modeling a Q/Q revenue improvement for Q3E, but admittedly visibility is limited.

- **The key focus should remain on FARO executing to its strategic initiatives to realign the business model.** Supporting this effort is a restructuring plan targeting $40M of annualized savings by YE20E. Adj. OPX for CY19A was $204M, Q4/19A adj. OPX was $53M. The target was to reduce by -$40M annualized to ~$165M for YE20E. Toward this target restructuring efforts began at the end of CY19E. For Q1/20A adj OPX was $44M (with progress ahead of pace as COVID discretionary cost actions subtracted an additional -$2M). Execution to target was impressively on track.

- **Post-1Q, we adjusted our CY20E/21E adj. EPS higher** to $0.62/$1.90 from $0.03/$1.33 as we better account for the pacing/magnitude of the cost actions. Our revenue forecasts increased modestly: $324M/$395M from $321M/$362M as we take our best guess at the pace of a post-COVID demand recovery.

Investment Thesis

- **New FARO leadership advancing has introduced a new strategic plan** aimed at providing more complete solutions (increased software elements); enabling account reps to sell all FARO products/customer centric vs. product centric; re-tooled marketing efforts and accompanied by a major reduction in the cost/SG&A footprint. Keys, to us, will be implementing the initiatives with minimal sales/customer disruption, developing or assembling the intended "solution" elements and the ability to sell them, and ultimately realizing a more efficient, sustainable go-to-market structure.

- **FARO is a leader in the growing market for 3D metrology tools.** FARO’s Arm, Tracker products (Metrology) allow precise measurements at the point of production or assembly and insure product or sub-assemblies remain within design specifications and tolerances. Increasing adoption of non-contact measurement (Cobalt, Freestyle, LLP) offer growth and product line expansion opportunities for FARO.

- **FARO’s AEC (Laser Scanner) products are disruptive,** with its low entry price/size/performance characteristics. Expanded product range over LTM has increasingly boosted FARO's credibility in AEC (3D documentation) market. Offers solid growth opportunity as 3D technology in AEC markets have become more widely adopted and FARO's products have gained increased acceptance/share.

- **Addressable market has attractive growth characteristics.** FARO’s products stimulate new measurements, creating new applications that drive addressable market (est. $5B+) growth. FARO’s core 3D Metrology, AEC and forensics/public safety markets that are projected to grow +6-8% through 2022.

- **Embedded operating leverage ultimately tied to sales productivity.** Metrology sales process has historically been high-touch, missionary and mainly direct. New leadership/CEO is undertaking dramatic re-engineering of the sales/go-to-market functions to streamline and drive sales productivity, deepen customer engagement and penetration and improve lead generation. Large CY20 restructuring undertaking expected to reduce annualized operating expenses ~$40M (by YE20), support effort to achieve ~20% adjusted EBITDA margin.

- **$60 price target** assumes 15X our CY21E adjusted EV/EBITDA, or 25X CY21E adj. EPS, plus cash per share. Both multiples assign credit to FARO largely achieving the restructured, more efficient business model as intended and a recovery in revenue growth in CY21E that aligns with market growth. Compares to a historical FARO trading range of 10X-25X EBITDA. EPS has been to erratic to have established a historic trading range. We believe there is opportunity for further multiple expansion as the restructuring plan advances successfully and visibility on the updated sales/solutions approaches improves, although we expect CY20 sales will reflect macro-challenges demand challenges.

Risk & Caveats

- **Re-org efforts inject disruption (and modeling risk).** FARO’s restructuring (announced 1Q/20) intends to reduce headcount by almost -30%, change go-to-market strategy, presenting risk that sales cycles and customer relationships could be disrupted.

- **Short-cycle business, limited revenue visibility.** FARO provides no financial guidance. Sales ~90 days visibility, at most, with orders favoring final month of a quarter, limiting sales visibility.

- **Ability to leverage expenses.** 85-90% of FARO sales are direct, which requires heavy investment in field sales force and sales force productivity to drive sales growth. Also, R&D commitments remain relatively high and need to address both hardware and increasingly software capabilities. FARO has an intermediate term adjusted EBITDA margin goal of ~20% (CY19A 7.8%).
Appendix - Important Disclosures and Analyst Certification

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