

**Operator:** Greetings, and welcome to Transcat, Inc. Third Quarter Fiscal Year 2018 Financial Results. I would now like to turn the conference over to your host, Craig Mychajluk. Thank you, you may begin.

**Craig Mychajluk:** Thank you and good morning, everyone. We certainly appreciate your time today and your interest in Transcat. With me here on the call, we have Transcat's President and CEO, Lee Rudow; and our CFO, Mike Tschiderer. After formal remarks, we'll open the call for questions. If you do not have the news release that crossed the wire after markets closed yesterday, it can be found on our website at [www.transcat.com](http://www.transcat.com). The slides that accompany today's discussion are also on our website.

If you would, please refer to Slide 2. As you are aware, we may make some forward-looking statements during the formal presentation and Q&A portion of this teleconference. Those statements apply to future events, which are subject to risks and uncertainties as well as other factors that could cause the actual results to differ materially from where we are today. These factors are outlined in the news release as well as with documents filed by the company with the Securities and Exchange Commission. You can find those on our website, where we regularly post information about the company, as well as on the SEC's website at [sec.gov](http://sec.gov). We undertake no obligation to publicly update or correct any of the forward-looking statements contained in this call whether as a result of new information, future events or otherwise, except as required by law. Please review our forward-looking statements in conjunction with these precautionary factors.

I'd like to point out as well that during today's call, we'll discuss certain non-GAAP measures, which we believe will be useful in evaluating our performance. You should not consider the presentation of this additional information in isolation or as a substitute for results prepared in accordance with GAAP. We provided reconciliations with non-GAAP to comparable GAAP measures in the tables accompanying the earnings release.

With that, I'll turn the call over to Lee to begin the discussion. Lee?

**Lee Rudow:** Thank you, Craig. Good morning, everyone. Thanks for joining us on the call today. We will follow the same format that we have in the past. I'll hit upon some highlights for the third quarter and then Mike will walk you through a more in-depth look at the financials before I wrap things up at the end with an outlook for the remainder of fiscal 2018 and beyond.

The third quarter was a strong quarter. The team executed well. Our performance demonstrated the strength of our strategic plan and the value proposition that continues to support it. Both of our operating segments turned solid results as we generated record revenue of just over \$40 million in the quarter, up 7.1%.

We continue to build the business for the long term with investments in operational excellence and technology, both of which are designed to expand margins over time. We gained early traction in the third quarter as operating margins improved by 40 basis points. Net income increased more than 44% to \$1.8 million. We benefited from the recent tax legislation that lowered our corporate tax rates. As featured in our news release, our EPS increased \$0.07 to \$0.25, of which \$0.03 was driven by operations and \$0.04 a result of the lower tax rate.

Without question, we're looking forward to a lower tax rates in the future and, while still early, we would expect to utilize any cash windfall the same way we have historically, toward organic growth investments and acquisitions and as a driver for our more recent endeavors to leverage technology as a competitive advantage and improvement of our processes to drive margins and margin expansion. More importantly, we believe the tax cut may provide a stimulus for the overall increase in economic activity and industrial output, which is certainly good for both of our operating segments.

Moving on to performance of our Service segment. We achieved solid organic growth of 7.5%. The quarter represents our 35th straight quarter of year-over-year growth, nearly 9 years. That's a statistic we're very proud of. We continue to take market share particularly in the highly regulated life science space, a space where our quality-oriented service tends to resonate the most and where the cost of failure is very high. Throughout the quarter, we also saw growth in general industrial manufacturing markets, including aerospace and defense.

In addition to strong organic revenue growth, we delivered improved productivity. As expected, we started to see an increase in the productivity for our recently expanded technical workforce along with early impact from our process improvement and operational excellence initiatives. Together, they contributed to the expansion of Service segment gross and operating margins by 30 basis points.

Moving on to Distribution. We achieved record Distribution revenue of \$21.7 million for the quarter. U.S. industrial markets were strong and we were well positioned to capitalize on the growth opportunity. The drivers for the record revenue included the strength of our diversified sales channels, our core end-user sales, our ongoing momentum in rental sales and a strong foundation of new leads generated from our technology-based web investments. Distribution margins in the third quarter improved 40 basis points.

With that, let me turn things over to Mike to discuss the financials in more detail and then I'll come back to talk to the outlook.

**Michael Tschiderer:** Thanks, Lee, and good morning, everyone. I will be starting on Slide 3 of the deck, where we show highlights of our third quarter by segment and on a consolidated basis. We delivered record consolidated revenue of \$40.5 million for the quarter, with improved gross and operating margins as well as net income. Slide 4 has more details. And starting with the Service segment, we continue to deliver solid results. We achieved 7.5% organic growth in the quarter and since 2014 this segment has grown at a compound annual growth rate of 13%. The organic growth rate delivered was in line with our goal of mid- to high-single-digit organic growth.

We saw the Houston market recover by the end of the quarter as our order activity and revenue was back in line with prehurricane levels. As we said previously, Houston is our largest lab and in addition to calibrating customer equipment, it is also our internal standards lab, where we calibrate quite a bit of our own equipment that is used to calibrate customer equipment. We are still working through potential recoveries from the various insurance coverages we have in place for Houston and Puerto Rico and the third quarter results do not include any such recoveries.

Our Distribution segment performed very well in the quarter, as Lee said, hitting a record sales level of \$21.7 million, from increased demand from our industrial customers, added sales through our independent sales rep channel and increased web-based sales, which we attribute to enhanced e-commerce capabilities. Our equipment rental business had another strong quarter, up 44% to \$1 million in revenue. Our rental revenue is still immaterial compared with the Distribution segment as a whole. We believe that the diversification into this business provides an attractive margin profile and differentiates us in the marketplace. Overall, distribution gross margin increased 40 basis points due to strategic pricing opportunities, mix changes in our sales channels and increased rentals. And, despite more operating expense investments, segment operating margin was also up 40 basis points.

In the Service segment, we have made some good, but still initial, progress on the productivity improvement programs that Lee just touched on. As expected, we also worked through some of the shorter term labor constraints from earlier in the fiscal year with Service gross and operating margins both expanding 30 basis points. We expect the investments in technology and

operational excellence to continue to drive more gross profit and gross margin, especially in the Service segment.

Consolidated general and administrative expenses were up about \$500,000 during the third quarter, which reflected our continued investment in technology infrastructure and operational excellence initiatives. However, even with this increase, our total operating expenses were consistent at 17.4% of consolidated revenue.

On Slide 6, third quarter net income was \$1.8 million, or \$0.25 per diluted share. The Tax Cuts and Jobs Act, we'll call as the tax act for today, was signed into law on December 22, 2017. As our fiscal third quarter ended on December 23, we are required to account for and disclose the impact of the tax act in our third quarter. The tax act included a permanent reduction in the federal corporate income tax rate from 35% to 21%, effective January 1, 2018. And so for companies like us with a fiscal year-end, not a calendar year-end, that means a blended federal tax rate is to be used based on a number of days approach with the old tax rate and the new tax rate. Our third quarter effective tax rate reflects this blended rate. Also, as the tax act was signed in the third quarter, we adjusted our U.S. deferred tax accounts in the third quarter. The lower effective tax rate and these deferred tax account adjustments resulted in a \$309,000 reduction of income tax expense in the third quarter.

Given the changes, our effective tax rate for the quarter was down significantly to 21.9%. Our diluted earnings per share increased \$0.07 to \$0.25. And as Lee mentioned, \$0.04 of this increase was a result of the tax act impact, so without considering it, we increased \$0.03 a share.

We now expect our blended tax rate for full fiscal year 2018 to range between 28% and 29%. This blended rate includes a lower federal rate, U.S. state and Canadian income taxes. The tax act also provided for certain repatriation-type taxes to be calculated and pay down certain foreign income. The impact of these provisions were immaterial to us in the third quarter and are expected to still be immaterial for all future reporting periods. Other provisions of the tax act are anticipated to be generally positive for Transcat.

On to Slide 7 we show adjusted EBITDA and adjusted EBITDA margin. Among other measures, we do use adjusted EBITDA, which is a non-GAAP measure, to gauge performance of our segments, because we believe it is a good measure of operating performance and is used by investors and others to evaluate and compare performance of core operations from period to period. I encourage you to look at the reconciliation of adjusted EBITDA to the closest GAAP measures, which for us are operating income and net income that we have provided. On a consolidated basis, our quarterly adjusted EBITDA was up nearly 13% to \$4.4 million, while adjusted EBITDA margin expanded 60 basis points to 10.9%. Both segments helped drive these results.

Slide 8 provides detail regarding our balance sheet and cash flow, which supports our growth strategy. Year-to-date capital expenditures were \$5.1 million and primarily for assets for customer-driven expansion of certain Service segment capabilities, including a mobile calibration fleet investment, RF and electronic assets for aerospace, defense and life science markets and purchases for our pool of rental assets.

With one quarter to go, we have tightened our total fiscal year 2018 CapEx range to be approximately \$6 million to \$6.3 million, with expenditures focused on similar investments as well as on technology and infrastructure to drive our operational excellence initiatives. Of the CapEx planned for fiscal 2018, approximately \$1.5 million is for maintenance or replacing existing Service segment assets and for technology asset replacements.

As we previously announced, we filed a \$50 million universal shelf registration statement on Form S-3 with the SEC on December 20. The SEC declared the shelf registration effective on January 5, 2018. While we have no immediate plans to use this registration statement, we are being proactive in our efforts to maintain flexibility and support our growth strategy.

At quarter-end, we had total debt of \$26.2 million with \$18.4 million available under our revolving credit facility. Our debt levels are down \$1.1 million since the end of fiscal 2017 and our leverage ratio decreased and was 1.7 at quarter-end. This compares with 1.9 at year-end fiscal 2017. We calculate our leverage ratio as total debt on the balance sheet at quarter-end divided by the trailing twelve months adjusted EBITDA. Other companies may calculate such a metric differently.

In the first days of the third quarter, we entered into an amended and restated credit agreement, which extended the term of our \$30 million revolving credit facility to October 2021. We also increased the amount of the term loan to \$15 million, replacing the previous term loan. The excess funds of the new term loan were used to pay down amounts outstanding under the revolving credit facility. We continue to believe we have sufficient liquidity and dry powder for any investment opportunities that meet our strategic criteria.

And lastly, we expect to timely file our Form 10-Q on, or around, February 2.

With that, I'll turn it back to you, Lee.

**Lee Rudow:** Okay, thanks, Mike. So as most of you know, the fourth quarter is an important quarter for Transcat as we typically generate approximately a third of our annual operating income in the quarter. We entered the fourth quarter with good momentum and we believe we're well positioned for a record fiscal 2018. Our pipeline of investment opportunities is strong. We have a high level of confidence, and we continue to take market share. Along the way, and over the longer term, we believe we can improve margins through gains in productivity. We expect technology will become an increasingly important factor in improving our business. Our ability to leverage technology over time will be key. As we continue to grow, we're investing in people, processes and systems to deliver on our goal of margin expansion. Net-net, we like the path we're on, and we continue to forge our way ahead.

So with that, we can open the call to questions.

**Operator:** Our first question is from Dick Ryan with Dougherty & Company.

**Richard Ryan:** Lee, you talked about market share gains, in particular, in the Service sector. Can you give us a little perspective of the value proposition and what you're seeing in the life science space, in particular?

**Lee Rudow:** Yes, in this particular quarter and really throughout the year, what we've been seeing and particularly in life science are significant number of opportunities, increased level of activity and what we're signing. We are really pleased with this and hope it continues. I think it will, and I don't know why it shouldn't, but we're finding that our value proposition, the quality orientation, is really resonating well. So throughout the pharma industry and medical device, we're seeing companies that -- whether it's a byproduct of having some quality issues in the past, not going through their audits with the speed and efficiency that they'd liked, there seems to be a demand for this quality orientation we have. I'm not saying it's easy, but I'm saying it's been easier in these proposals we've been putting together. And I think the value proposition was received really well. So we hope that continues. You're seeing in pharma, you're seeing in med device and, really, throughout life sciences.

**Richard Ryan:** If you look at the contribution under Service umbrella, life science has been right around 40% or a little bit higher in the last couple of years. Looking out over the next couple, where can that contribution go?

**Lee Rudow:** I think you're going to continue to see strength around the life sciences and I would imagine over time that number is going to continue to rise. Now depending on elements like defense spending and aerospace and what our government is likely to do on those fronts, we have positioned ourselves in a much better position than we've been in the last four, five years. Some of these capabilities we've been talking, RF Electronics, puts us in a nice spot, so as that market heats up, in the coming years, I think we're going to be positioned to be very competitive in it. I see the balance of our growth being weighted towards life science, positioned well for defense spending and at the same time always well positioned for general industry. That's how I view the growth looking forward.

**Richard Ryan:** Okay. In your operational excellence initiatives, what sort of margin impact could you see over the next couple of years with those more fully ingrained?

**Lee Rudow:** I'm not going to be specific in terms of numbers, but I will say that what we would look for is growth over time. And this will be a step function, it's not going to be every single quarter. But I think if you look over the longer term, over the next couple of years, you'll see consistent margin improvement as these initiatives get further down the line. I think it'll be recognizable and, like I said, it'll ebb and flow -- we don't look at this quarter-to-quarter, because some quarters we make more investments, we slow things down to speed them up later, if you will. There's training involved, there's investments involved, but I think it'll be consistent over the longer haul, Dick.

**Richard Ryan:** What do you see in the M&A pipeline for opportunities with the pickup in the industrial output? Is that helping or hindering what you're looking at?

**Lee Rudow:** I think our pipeline relative to acquisitions is strong, it's been strong. We haven't been as aggressive in the last year or so, by design. We focused an awful lot on organic growth because we felt like, and still feel like, the market provided ample opportunity relative to organic growth and that's always preferable. But we know, and we recognize and still feel strongly, that acquisitive growth is an important part of how we'll ultimately grow over the longer term. So our pipeline is strong, we work hard to keep it strong and I anticipate that you'll see a blended level of activity moving forward in terms of growth.

**Operator:** Our next question is from Jim Marrone with Singular Research.

**Jim Marrone:** Just to continue with the M&A scene. As far as on acquisition, do you anticipate it would more on the Service segment? Or would it be on the Distribution end? And how so? And would it be, particularly, an expansion of a segment or would it be a geographical expansion?

**Lee Rudow:** Jim, this is Lee and I'll take that question. We still view our Service segment as our primary growth engine and so when we look to make acquisitions, more times than not, we're focused on growing that segment. And so with that in mind we put together our pipeline and work the pipeline. So I see that continuing. We have three primary drivers when we are looking at and making an acquisition in the Service space. Geography, as you mentioned, is one of them. But we'll also acquire to pick up expertise and capabilities that we don't currently have. And wherever we have an opportunity to do what we call bolt-on, where we can leverage our current infrastructure at our current lab by acquiring a facility maybe 30 minutes away or an hour away and consolidating them and achieving the cost and sales synergies pretty quickly, we'll do that as well. We are disciplined, we stick to our three drivers and they tend to be on the Service side, as I mentioned.

Now that doesn't mean that if the right opportunity presents itself on the Distribution segment, whether it's related to rentals and used equipment or core distribution. We would look at that opportunity and we would probably want to dig deep and figure out, are there synergies between our segments, can we sell services to this customer base and vice versa. So I wouldn't exclude it, but our primary growth engine is going to continue to be Service and particularly on the acquisition front.

**Jim Marrone:** Okay, excellent. And just a follow up, if there was an acquisition and looking at your balance sheet, are you looking to a cash deal? Or would it be a lending agreement? And what kind of rates would you be looking at if you were to use the facility, particularly with interest rates expected to go higher? If you can just kind of share a little bit on that?

**Michael Tschiderer:** Sure. Jim, this is Mike. Historically, we've always used cash/debt. And I think it's going to depend, if there is a deal, on the size of that deal. Now that we have the shelf, we have more flexibility if we are ever going to issue securities for a deal. That's going to depend on the size of it. We're in a pretty good position with our credit facility. It's a LIBOR-plus facility and it's based on leverage, which is why we talk about our leverage rate as the lower the leverage rate, the lower we add as a margin on top of the LIBOR rate. We're in the 3% to 3.25% range, total interest right now in the facility. So it's still very attractive, and it's good reason to keep using that. But we also wanted to have that flexibility, which is why we did the S-3 shelf registration.

**Operator:** Our next question is from Christopher Hillary with Roubaix Capital.

**Christopher Hillary:** I wanted to ask, if you could make any comments, there's more incentives out for companies to spend on CapEx and are you seeing that generate any different interest in some of your segments in terms of spending going forward?

**Lee Rudow:** Generally speaking, currently going forward, there's definitely been an increased level. We take pulse on both segments on daily, weekly basis and we're seeing an uptick in activity levels across the board. So for us that would be Internet activity, quotes, orders, backorders, so on, so forth. So we're seeing activity levels increase. I think the genesis, the impetus for that is, is capital available to spend for companies. I can't speak to anything specific, but there is a general increase in level throughout and I think it's based on CapEx increases throughout the industry.

**Michael Tschiderer:** Yes, it seems to be whether it's from cash available, from tax rate reductions or just general industrial sector improvements as markets are strong and indicators are strong, which is more of a willingness to spend and we do see it in both segments, Chris.

**Lee Rudow:** I'll add to that. One thing we talked about in an operation meeting just a week ago, was how much better we're positioned with our digital marketing campaigns and the investments we've made in the last several years. So when there's an uptick in investments, as we're talking about here, we're in a much better position, more favorable than we've ever been in the past in terms of being recognized in the market and drawing people in through our web activities, the search engine optimization, our very robust pay per click program. And all things we do to generate activity from a digital perspective. So that's been part of some of the growth, certainly attributable to our positioning here from a marketing perspective.

**Christopher Hillary:** Great. And then I know you had some comments earlier on the margin levels, but maybe to ask another way, when you look at the strong incremental margins that we saw in this quarter, in the two segments, are there anything that you would point out about whether or not that's a good measure as we go forward, both favorable or unfavorable?

**Lee Rudow:** We certainly spend a lot of time talking about incremental margin. And I would just point you toward our typical fourth quarter to get a general feel for what drives the incremental margin and what's likely to occur and the net of it is volume-based. We have an infrastructure that can handle an increase in volume and when we get an increase in volume, in revenue, you're going to see higher incremental margin. So it's very much volume-based, given the infrastructure that we've built here. Like I said, a typical fourth quarter result, where you see the margins we're able to produce, shows you what the engine can produce with sustained volume throughout the quarter. I would expect that to continue. That's how we look at incremental margins. We'd like to see that volume each quarter and then you would definitely see incremental margins be stronger.

**Operator:** We do have a follow-up question from Dick Ryan with Dougherty & Company.

**Richard Ryan:** On Distribution, a couple of points. Oil and gas was a negative influence a couple of years back, are you seeing anything on that front firm up? And also one of your selling points has been on the capability of delivering precalibrated instruments. How is that being received with the customer base?

**Lee Rudow:** I'll take the first question first. No question in 2016, there was definitely softness in oil and gas. The oil and gas decline impacted our company and others. Any company related to the process industry, which is certainly Transcat. And particularly at that time, the dollar was very strong, exports were down, that affects industrial output in general. So since then, we have seen a recovery in that market. It's not quite what it was, it's still a little bit below, even though we're achieving nice results in Distribution. I would say it still lags a little bit where it was prior to the decline and softness in oil and gas, but it definitely has improved. What was the second question, Dick, can you repeat?

**Michael Tschiderer:** Stock cal.

**Lee Rudow:** Yes, the prior year, we were down in stock cal, this year we're up in stock cal. That's a pretty unique and important part of our value proposition. For those that aren't familiar, when someone buys an instrument, if they can get the reporting data, the performance data on that instrument tested before it leaves our building, even though it's new, that shortens the process for them getting that unit put into use. So instead of having to buy something and then send it out to an independent lab, we'll do all that work up front. We'll provide certification, data, uncertainty values, all the things that really are important to a regulated customer, which is our customer base. And, so to the degree that we are growing that business, that's always a good sign for us.

**Operator:** Ladies and gentlemen, we have reached the end of our question-and-answer session. I would like to turn the call back over to management for closing remarks.

**Lee Rudow:** We appreciate everybody being on the call today and your continued support. For those that are interested, we will be in Milwaukee, Chicago and the Boston area mid-February. We can provide more information on that. Also, we'll be presenting at two conferences. We will be presenting at the Roth West Coast conference in March, I believe on March 12, in California. And then on March 29, we will be at the Sidoti conference in New York City. So feel free to reach out to us anytime. We can certainly set up a one-on-one during those conferences. That's all I have. Have a nice day, take care.

**Operator:** Thank you. This concludes today's conference. You may disconnect your lines at this time, and thank you for your participation.