

Operator: Greetings, and welcome to the Transcat, Inc. Third Quarter Fiscal Year 2020 Financial Results. Please note, this conference is being recorded. I will now turn the conference over to your host, Craig Mychajluk, Investor Relations. Craig, you may begin.

Craig Mychajluk: Thank you and good morning, everyone. We certainly appreciate your time today and your interest in Transcat. With me on the call today we have our President and Chief Executive Officer, Lee Rudow; and our Chief Financial Officer, Mike Tschiderer. After formal remarks, we will open the call for questions. If you do not have our news release that crossed the wire after markets closed yesterday, it can be found on our website at 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 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. 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 would like to point out as well that during today's call we will 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 have provided reconciliations of non-GAAP to comparable GAAP measures in the tables accompanying the earnings release.

So with that, let me turn the call over to Lee to begin the discussion.

Lee D. Rudow: Thank you, Craig. Good morning, everyone. Thank you for joining us on the call today. To kick off this morning's call I'll provide an overview of fiscal 2020 third quarter results, then turn things over to Mike to provide a closer look at the financials. I'll return to wrap things up with an outlook for the fiscal year and beyond, before we open up the line for questions.

We had solid growth in the third quarter, generating \$43 million across both segments. While growth was solid, the third quarter was atypical. October and November 2019 started out very strong with double-digit organic growth similar to what we generated in the second quarter. That momentum gave way to a very slow December, which we believe was negatively impacted by holiday timing that drove an unusually high number of extended plant shutdowns.

The positive news, and as we mentioned in our release, sales in both our Service and Distribution segments bounced back as we moved through January and into early February, providing confidence in our belief that December was an anomaly.

Fiscal year-to-date, we generated \$8.2 million in cash, up 13.6%. With an active organic and acquisition pipeline, the strong cash generation is expected to continue to fund growth opportunities.

Turning specifically to our Service segment. In the third quarter, where industrial demand was reported to have weakened and we experienced a drag from the holiday schedule, our Service business continued to grow at a rate of 7.8%. The growth demonstrates the effectiveness of and focus on the highly regulated life science and aerospace and defense markets. The third quarter represents our 43rd consecutive quarter of growth. That's almost eleven straight years.

While the Service business grew 7.8% in the third quarter, the month of December actually declined year-over-year and the lower-than-expected revenue was unable to fully offset the largely fixed costs related to the Service business. In fact, this is particularly true this past December as we strategically

built additional capacity into our operation throughout the year. Still, Service gross margin improved 10 basis points, which we see as a very good sign under the circumstances.

There are two primary drivers of the increase in Service gross margin. The first driver is the tangible improvement in many of our Service processes as we continue to drive operational excellence throughout our lab network. While there's much work to be done, we are pleased with the noticeable progress. The second driver is the net increase of 37 technicians, which represents a 12% increase over the prior fiscal year period. Our technicians today are more seasoned than this time last year, and we believe we're well positioned to handle double-digit growth.

Technology continues to play an important role across many fronts. An important technology component is the development of faster and more effective acquisition integration tools. Some tools have been created, others are still in the works. The calibration industry remains fragmented and continues to provide a real opportunity for Transcat to expand geographically and leverage additional capabilities and synergies.

Improved data analytics is another technology component. Timely and predictive data is key to continuous process improvement and a competitive advantage in the market. And of course, driving automation into our calibration process remains high on our list.

The acquisition of Infinite Integral Solutions in the second quarter of fiscal 2020 continues to position Transcat nicely for the future. IIS specializes in calibration automation software. At present, we're making our way through the programming stage for initial implementation, which we anticipate a launch in the next three to four months.

Moving to Distribution, revenue increased 3.5% in the quarter. Our higher-margin instrument rental business also increased 3.5% to \$1.2 million in the quarter. This represents a lower growth rate than what we've seen recently, so we saw less-favorable impact on Distribution margin. A similar story here as with Service, as we believe the lower rental growth rate in the quarter was an anomaly, and we expect more typical growth rates for rentals moving forward.

The Distribution segment continues to differentiate our unique value proposition, generate gross profit dollars, solid cash flow and perhaps, most importantly, provide leads to foster strong organic Service growth. With that, I'll turn things over to Mike.

Michael J. Tschiderer: Thanks, Lee, and good morning, everyone. I'll be referring to the slides that we did post this morning. I'll start on **Slide 4**, which provides detail regarding our revenue on a consolidated basis and by segment. As a reminder, we have two reportable business segments, Service and Distribution.

As Lee mentioned, we had another solid quarter with consolidated revenue of \$43.2 million, which represents a record level for a fiscal third quarter, with an increase of nearly 6% on a consolidated basis. The reported revenue for both segments was negatively impacted by the timing of the holidays in December, especially with Christmas falling on a Wednesday. This mid-week holiday impacted customer operations and working hours more than we would expect to see if the holiday was at the beginning or last day of a work week.

Service segment revenue increased 7.8% to \$22.1 million, which was all organic. This increase in Service revenue reflects new business from the highly regulated life science sector and includes new and ramping-up, multiyear, client-based lab contracts; growth in the FAA-regulated aerospace and defense sector; and in general industrial manufacturing.

Distribution sales were up 3.5% to \$21.1 million. This growth rate was generally in line with our overall revenue growth expectations for Distribution.

Service segment gross margin improved 10 basis points over the prior year third quarter. As Lee mentioned, that progress we have been making over the course of the fiscal year was muted by December as our service cost, especially our technician workforce, which we have been growing to meet the double-digit growth we have been experiencing, was under-absorbed as essentially a fixed cost.

However, as Lee described, hiring, retaining and training our technicians has been and will continue to be a major focus for us.

The Distribution gross margin was impacted by the growth in our higher-margin rental business. The growth in rentals was less than what we have seen in recent quarters, although we do expect a stronger growth rate in the fourth quarter of fiscal year 2020. Rental revenue was \$1.2 million in the quarter.

Slide 5 shows the drop-through to the operating income and operating margin lines. We are encouraged with the start of our fiscal fourth quarter and when combined with our focus on Service productivity metrics, we expect to see improvements in our various profit margins going forward.

Slide 6 shows our bottom line results. Despite the softness in the quarter, we are still generating earnings at a record pace as depicted on a trailing twelve-month basis. Our effective income tax rate was 22.1% in the third quarter and continued to be aided by the increased discrete income tax benefits related to share-based awards due to stock option exercise activity. As a result, we have adjusted our full fiscal year 2020 income tax rate expectations down slightly to range between 17% and 18%.

Looking at **Slide 7**, we show adjusted EBITDA and adjusted EBITDA margin. Among other measures, we use adjusted EBITDA, which is a non-GAAP measure, to gauge the performance of our segments because we believe it is a good measure of operating performance and is used by investors and others to compare and evaluate performance of core operations from period-to-period. I encourage you to look at the provided reconciliation of adjusted EBITDA to the closest GAAP measures which, for us, are operating income and net income.

As one would expect the fiscal 2020 third quarter segment and consolidated adjusted EBITDA results reflect our early commentary around December's impact on revenue and margins.

Slide 8 provides some detail regarding our balance sheet and cash flow. Year-to-date, net cash provided by operations increased \$1 million, or nearly 14%, to \$8.2 million, and was used for funding capital investments, acquisition-related payments, paying down debt and covering tax withholding obligations for netting of share awards, which are shown as a repurchase of common shares. Over the trailing twelve months, we have generated \$13.6 million in cash from operations.

At quarter end, we had total debt of \$19.7 million with \$23.4 million available under our revolving credit facility. Our debt level was down \$1.3 million since the end of fiscal year 2019. Our leverage ratio at quarter end also declined to 1.07, and is calculated under the credit facility as the total debt on the balance sheet at period end divided by the trailing twelve months adjusted EBITDA, including giving credit for any acquired EBITDA. Other companies may calculate such a metric differently.

Year-to-date capital expenditures were \$5 million and primarily focused on technology infrastructure, funding organic growth opportunities and for the purchase of additional rental pool assets.

As noted in the press release and on **Slide 9**, we have lowered our CapEx spend expectation for fiscal 2020 to a range of \$6.8 million to \$7.1 million from the previously provided range of \$7.8 million to \$8.2 million. This change was largely due to the timing of certain projects and not having to spend as much on Service lab replacement assets as first estimated. We continue to believe we have sufficient liquidity for any investment opportunities that meet our strategic criteria.

And lastly, we expect to timely file our Form 10-Q after market closing today. With that, I'll turn it back to you, Lee.

Lee D. Rudow: Okay. Thank you, Mike. As many of you know, the fourth quarter historically is the most impactful quarter for Transcat. We got off to a good start in January and early February, and we expect to have record revenue and profits for the fiscal 2020 year. We believe the increased Service capacity we created throughout the year is a differentiator and provides a competitive edge moving forward. With an increase in capacity, we are well positioned to support double-digit Service growth.

Our new business and acquisition pipelines are healthy and active. We expect operational excellence and technology initiatives to continue to drive improvements in productivity. Improvements in productivity are expected to benefit gross and operating margins this fiscal year and into the future.

Our confidence in our strategic plan and overall direction is high, and we have strong momentum and high expectations heading into fiscal 2021. With that, operator, we can open the line for question

Operator: Our first set of questions come from the line of Gerry Sweeney of ROTH Capital

Gerard J. Sweeney: So one question, maybe 2 parts, to start off with. I wanted to see, is the bounce back in revenue that we're seeing in January and early February sort of on par with the growth that you were seeing in October and November? And then the follow-up to that would be the slowdown in December, was there any chance that's just companies being a little bit more proactive earlier in the quarter and just prepping for a longer seasonal or holiday shutdown?

Lee D. Rudow: This is Lee. It's difficult to tell. I mean we had a really strong October -- we had a strong second quarter. We saw that continue right into October. One of our best months ever. November held its own, it was pretty strong as well. I don't know and the data doesn't clearly show that there was pull-forward and people are getting ahead of things. There might have been some of that, it wouldn't surprise me, but I have not looked at definitive data around that point.

If you do the math on the average impact of a day in terms of revenue for Service and you figure a mid-week holiday, somewhere along the line of 2, 3, 4 days were lost. And I don't think it's any more complicated than that. It's pretty much straightforward. It's not something we even spend a lot of time thinking about. We saw it coming. We knew it was going to be soft. It's a little softer than we thought, granted a couple of more days, but nothing that really surprised us. January got off to a really good start.

And so when you look at January, I think it's performing right in line with expectations and a little bit better. Throughout the fourth quarter, what happens with our business, it tends to scale right up until March. And March is our best month of the year, and we were pleased with the way we have started. So I'll leave it at that. I think that everything was in line with expectations for the start of Q4.

Gerard J. Sweeney: Okay. And then one more question. Again, a little bit newer covering you guys. But back, I think, earlier last year, you added a bunch of capacity. And then in the press release, you talked about 37 techs on a year-over-year basis. Did you add any techs in the last 1 or 2 quarters? Because I think selling costs were up a couple of hundred thousand quarter-over-quarter, and I do know it takes a couple of quarters to get them going. One, did you add any in the last 1 or 2 quarters? And should I just anticipate sort of a gradual uptick every quarter in techs?

Lee D. Rudow: I would look at it as more gradual. We add techs all the time. So if the question is did we add techs in the third quarter, yes, we did. We hire for a couple of reasons. If we land a new large account or a new client-based account, we'll hire employees to service that new work. So there's new work that we gear up for. And then there's the planned hiring throughout the year, that's more gradual and kind of keeps pace with where we think sales are going and trying to get ahead of it. And that's a timing game. In the past, we've fallen behind. And I would say this year, we've done a really nice job of staying ahead of things and being more predictive, more accurate in our predictions, and I think it's played out well. And I think if the volumes that we anticipate in Q4 come through, you're going to see good margin enhancement because we got ahead of it.

Operator: Our next set of questions come from the line of Mitra Ramgopal of Sidoti & Company.

Mitra Ramgopal: First, just wanted to follow-up on the last question as it relates to adding techs, if you could give us a sense as to the labor market and the ability to continue to add, if necessary.

Lee D. Rudow: I would say it's been a positive encounter in the last 60, 90 days, we've really done a nice job. So it started with us increasing our recruiting staff here the year before and having that team be more experienced and effective. And, about the last 60 to 90 days, we have not had a difficult time finding the people we need to support our growth. I wouldn't have said that a couple of quarters before that, but I think the process has turned for us and we've done well.

Michael J. Tschiderer: I think the other thing we've also seen, in addition to those improvements and the hiring and the onboarding, is the retention of those techs through the various training and development plans that are now in place for that piece of the workforce. Turnover is expensive, so if we can hire the right people and then keep them, it helps our productivity going forward.

Lee D. Rudow: Yes, that's a really good point. So turnover is a by-product of better training and better management, and I think we've accomplished a lot in both fronts.

Mitra Ramgopal: Okay. And then on the question of training and productivity. Typically, how quickly would you say someone is up to where you'd like them to be after being hired?

Lee D. Rudow: So if you're hiring someone that's new to the industry and is not a calibration technician, let's just put that aside for a moment. But if you hire someone that has some calibration experience, the learning curve is dependent upon their ability to pick up our systems, and that usually takes about 30 to 60 to 90 days. So a good quarter for them to get productive, an experienced person and productive with our processes and our methodology. By the second quarter and third quarter, they're up and running. And I'd say the process takes 2 to 3 quarters before they're doing what we expect and reaching the expected levels.

If you're new to the industry and we're breaking in people on the lower-end disciplines that don't require the experience level, it's a good 6 months before a technician starts, let's call it, breakeven, meaning they're doing enough work to pay for themselves. It takes a good year for them to get profitable. And so it varies depending on the level of technician we bring in and it sort of runs the range.

Mitra Ramgopal: Ok, that's great. It's very helpful, thanks. And then switching on the acquisition opportunities. I know you said you have a pretty strong pipeline there. And I'm just wondering if there's any incremental comment you might add in terms of just the environment and things like pricing, et cetera, if that has changed.

Lee D. Rudow: So from a multiple perspective, we're seeing things in line with our historic trends in terms of acquiring. Maybe some of the deals we're looking at have a turn or 2 more. So instead of 4 to 6x, we might be looking, in some cases, at 7. We will see even 8. But all these deals are extremely accretive for us. And so we're going to keep an open mind in terms of multiples in that range. So generally the same, maybe a little bit of escalation there. I would characterize the pipeline, if I take a word that I'm comfortable with, it would probably be active. So it's a big part of our strategic plan to grow through acquisition in addition to our strong organic growth, and we have an active pipeline.

Michael J. Tschiderer: And just kind of following up on the valuation and the multiples that we're seeing. It's not like there are deals that we're losing to others, it's been pretty quiet. And we've talked in the past that it really is Trescal that is the only other third-party provider that's buying any companies. They've been pretty quiet in the U.S. over the last quarter. So it's not like we're seeing big multiples that we are losing in bidding contests. There's still a lot of good companies out there for very accretive prices.

Mitra Ramgopal: Okay, that's great. And then I know you talked about in terms of adding some new lab-based contracts. And I'm just wondering if those are wins you're getting from competition? Or is it a case where some might have been doing it in-house and is now outsourcing it for the first time?

Lee D. Rudow: In most cases, our success with CBL, client-based labs, as we now have over 21 or 22 of them, have been a result of in-house labs externalizing the work and outsourcing the work. And we have positioned ourselves over the last couple of years to be the ideal company to take on that opportunity. So we positioned ourselves to do a nice job with outsourcing, and we continue to do that. It's not to say others can't do it, but when we do run into competition for some of these larger deals, we've had a very high success rate and win rate. I see that continuing. And I think that we're still positioned to do really well in that space, and most of it tends to be outsourcing from what was previously in-house lab for manufacturing, particularly in life sciences and aerospace and defense.

Mitra Ramgopal: I wanted to follow-up a little on the Canadian market. I know you had highlighted that a little. And I was just wondering, based on the recent acquisition you made, if you're sort of getting any additional traction as a result.

Lee D. Rudow: Just to clarify, the acquisition of IIS, which was a software company, it was not a calibration service company like we've made other acquisitions for. It wasn't that we bought a book of business and employees, it was a software play for that automation software.

Michael J. Tschiderer: Yes. And relative to the strength of the Canadian market, we've been really pleased with the performance this year. If you go back to the prior year, it was a soft market for Canada. We talked about it quarter-to-quarter. Most of it was the volatility of trade agreements and the uncertainty in their economy. But I think there's been some pent-up demand that is making its way to the market. And that year is behind us. So each quarter, we've had a strong quarter for Canada year-over-year, back to what we would call, our typical and expected results. We see that continuing. A good start to fourth quarter as well. And so I would expect Canada to finish strong.

Lee D. Rudow: Yes. And it's been nice to see that it's kind of broad based, too, both in aerospace and defense, as well as in life sciences. So it's been an encouraging year for them.

Mitra Ramgopal: Okay. And is there any impact or benefit for you as a result of the recent trade agreement?

Michael J. Tschiderer: I think just the lack of uncertainty, is going to be a positive for us. And we haven't gotten any direct feedback in terms of the particular elements of the agreement and the favorability it might provide. But I think, overall, just having the uncertainty behind this is going to be a plus.

Operator: Our next set of questions come from the line of Chris Sakai of Singular Research.

Chris Sakai: I think maybe you've talked about this. I just wanted to know about how business in Canada was doing?

Lee D. Rudow: Yes, you must have been dialing in. We just answered that question. Business in Canada is doing very well. It's a recovery year for us. Each quarter has been better than the prior year's quarter. We think it's going to be a strong finish and a lot of the uncertainty of the prior year is behind us. And we're going forward more optimistically, and we expect good results in a nutshell.

Chris Sakai: Okay. Great. And then how is the integration of IIS doing?

Lee D. Rudow: It's doing pretty well. So IIS was a unique supplier/developer of automation software for the calibration process. And we acquired them with the goal of taking a year or so and programming and developing onto their platform. We are doing that. In my presentation just a few minutes ago, I mentioned that I think somewhere in the first quarter, in the next 3 or 4 months, we're going to launch our first set of automation protocols around pressure calibrations, and that will be based on the IIS software. So that will be our first time using it in the market. And I'm sure there'll be some learning curve, but we're looking forward to it. So we would expect to expand beyond pressure once we get that down.

Operator: We have reached the end of the question-and-answer session. I will now turn the call back over to management for any closing remarks.

Lee D. Rudow: Okay. This is Lee, and thank you all for joining us on the call today. We appreciate your continued interest in Transcat. We'll be participating in the ROTH Annual Conference in Dana Point, California, on March 16th. We'll also be participating in the Sidoti Spring Conference in New York City on March 26th. So feel free to reach out to us at those events or really at any time. Otherwise, we look forward to talking to everybody again after the completion of our fourth quarter. Thanks again for participating on the call. Take care.

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