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Transcat, Inc.

First Quarter 2023 Financial Results Conference Call

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CORPORATE PARTICIPANTS

Tom Barbato, *Chief Financial Officer*

Mark Doheny, *Chief Operating Officer*

Lee Rudow, *President and CEO*

CONFERENCE CALL PARTICIPANTS

Greg Palm, *Craig-Hallum Capital Group*

Scott Buck, *H.C. Wainwright*

Gerry Sweeney, *ROTH Capital*

PRESENTATION

Operator

Greetings, and welcome to Transcat, Inc. First Quarter 2023 Financial Results Conference Call.

At this time, all participants are in listen-only mode. A question-and-answer session will follow the formal presentation. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Tom Barbato at Transcat, Inc. Please go ahead, sir.

Tom Barbato

Thank you, Operator, and good morning, everyone. We appreciate your time and your interest in Transcat.

With me here on the call today is our President and CEO, Lee Rudow, and our Chief Operating Officer Mark Doheny.

We will begin the call with some prepared remarks and then we'll open up the call for questions. Our earnings release crossed the wire after market closed yesterday, and can be found on our website transcat.com and the Investor Relations section, along with the earnings presentation slides that we will be referencing this morning.

If you would please refer to Slide number 2, as you are aware, we make forward-looking statements during the formal presentation and Q&A portion of this teleconference. These statements apply to future events, which are subject to risk 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 in the documents filed by the Company with the SEC. 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.

Additionally, 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've provided reconciliations of non-GAAP to compare GAAP measures in the tables accompanying the earnings release.

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

Lee Rudow

Thank you, Tom. Good morning, everyone. Thank you for joining us on the call today.

Yesterday, we announced strong first quarter financial results reporting significant year of year gains, revenue, margin, and earnings across our entire business platform. We also announced exciting organizational changes that better position the Company to execute our day to day operating objectives and at the same time achieve our strategic long term growth vision. I'll talk to both our results and our organizational changes, but first I'll start with our first quarter year over year financial highlights.

Consolidated revenue is up 14% to $54.7 million as demand for our products and services remain strong. Consolidated gross margin expanded 100 basis points to 29.3%. Was driven by margin expansion in both our Service and Distribution segments. Service revenue grew 23%. Organic service revenue grew 9%. Service gross margin increased 20 basis points to 32%. Adjusted EBITDA, which is a very important metric for Transcat given at our level of acquisitive growth grew 20% to $7.3 million.

The 23% growth in our service business represented the 53rd straight quarter of year over year growth. Demand for our services continues to be strong and we continue to capture market share from third party service providers, OEMs and in-house calibration labs. The next acquisition is proving to be a significant differentiator and a great addition to our unique value proposition that is resonating very well throughout our target markets.

The NEXA platform enables Transcat to cross sell what we are now calling Single Source Solutions. Examples include computerized maintenance management systems to optimize calibration asset and data flow, reliability, validation, and various compliance services that are critical to the calibration ecosystem. We believe the Single Source Solution platform that I'm referring to creates a competitive edge for Transcat as we execute our service growth strategy.

On the service growth margin front, margin gains were primarily a function of organic volume growth and strong acquisition performance, offset somewhat by start-up costs at recently won client based labs. We are also benefiting from the opening of our new technician training center in Houston this past November. The concept of establishing our own training school has been in the works for years. The hardworking and dedicated technical leadership team brought this important differentiator to fruition.

Moving on to distribution; revenue grew 3% to $20.8 million despite extended vendor lead times and supply chain shortages that delayed the conversion of open customer orders. Demand, however, continues to be strong, as back orders were up 17% from the beginning of the quarter. Year over year distribution margin increased 150 basis points or 25%. The margin expansion was primarily driven by a favorable mix and a continued growth of our rental business, which is within the Distribution platform. Overall, we're pretty pleased with the Fiscal 2023 first quarter results. The strong performance is a great way to start our new fiscal year.

Turning to acquisitions. In the first quarter, we closed the Cincinnati based Alliance Calibration acquisition, which we anticipate will be a great bolt onto our date and operation. Integration is underway and we expect the acquired team, which is very talented to work closely with Transcat to drive the anticipated synergies and capture market share in this important region. Entering the second quarter, our acquisition pipeline remains robust and our balance sheet remains strong with a leverage ratio just over 1.8 times.

Now, let's move on to the organizational changes that we announced in yesterday's press release. There are two role changes. Both enhance our organizational structure at what we believe is a unique time of opportunity for Transcat. In Fiscal 2022, we surpassed $200 million in annual revenue. This is an important growth milestone for the Company, but what is more important is our strong belief that we're just getting started. To that point, Mark Doheny, our current CFO will be assuming the role of Chief Operating Officer, and Tom Barbato, our current Senior VP of Finance will be promoted the Chief Financial Officer. This is a great time to appoint Mark in the COO role to oversee the day-to-day operations of the business.

Mark is a talented executive with large company experience, and in two years with Transcat, he demonstrated the acumen, instincts and drive that we believe is a perfect operational fit for the anticipated growth of the Company. Moving Mark to the COO position will allow me to spend more time with large customers, M&A opportunities, recruiting and developing talent, and perhaps more important than anything else, leveraging our unique value proposition, which now includes the next asset management systems across a range of targeted end markets for Transcat.

The move with Mark was made possible by our ability to recruit Tom Barbato to the organization a little over six months ago. Tom is an experienced Public Company, Operational CFO, and has already made significant contributions to our financial leadership team, and the entire organization for that matter. His roll up your sleeves and get things done attitude is a great approach and a perfect fit for Transcat's culture. Congratulations for both guys as we position Transcat to achieve the long term growth objectives that we set for ourselves.

With that, I'll turn things over to Mark Doheny for some comments on his new role, and then we'll turn it over to Tom Barbato for a deeper look into our first quarter financial results.

Mark Doheny

Thanks, Lee.

While I have really enjoyed my first two years at Transcat in the CFO role, I couldn't be more excited about the opportunity to lead our day to day operations across the Company. In fact, with Tom on board since January, I've been able to spend more and more time with the various operational teams recently. It really is a talented and dedicated team and one that I would put up against any in the industry. We have been experiencing accelerated organic and acquisitive growth recently, and as Lee mentioned, we believe this is only the beginning. In my new role, I look forward to ensuring this growth continues over the long term, and we do it profitably with focus on needle moving key initiatives, such as automation, process improvement in our network of labs and achieving synergies from our acquired companies.

With regard to acquisitions, as Lee also mentioned, we closed on Cincinnati based Alliance Calibration at the beginning of June, and it is clear there is excitement on both sides. One relevant item to share is that the prior owner of Alliance told us, "It is very apparent that Transcat has done this before as the communication and integration activities have gone amazingly well." I mentioned this as it is a testament to the maturity level of Transcat's acquisition and integration program. We identify quality companies to acquire, and then we integrate them in a very timely and disciplined fashion following a playbook that has been developed and refined for years.

We also closely track their financial performance versus our original evaluation model assumptions to ensure we are meeting or exceeding sales and earnings projections in overall rates of return approved by our Board of Directors. In fact, for two years, post-acquisition, we update our Board every quarter and not only the acquired company's financial performance, but also on synergies achieved as well as how the overall integration is progressing. This is difficult work, but we have some of our most talented individuals leading these efforts, and this gives us confidence that we can continue to successfully execute on our acquisition strategy going forward.

With that, I'll turn it over to Tom to go through our first quarter financial results in a little more detail.

Tom Barbato

Thanks, Mark.

I'll start on Slide 4 of the earnings deck posted on our website, which provides detail regarding our revenue on a consolidated basis and by segment for the first quarter. First quarter consolidated revenue of $54.7 million was up 14% as we continue to see strong demand for both our services and products. Looking at it by segment, service revenue growth was very strong at 23% with approximately 9% of the growth coming organically and the other 14% from acquisition. We continue to see robust demand across our highly regulated end markets that NEXA business continues to perform very well, and the tangent acquisition which closed in Fiscal Q4 2022 maintained a strong start.

Turning to distribution, revenue of $20.8 million was up 3% despite global supply chain conditions remaining very challenged and some vendor lead times continuing to be extended. We continue to see good demand levels, which is reflected in our backlog being up 17% from the end of the prior fiscal quarter to a record high of $9 million.

Turning to Slide 5, our consolidated gross profit for the first quarter of $16 million was up 19% from the prior year, and our gross margin expanded 100 basis points to 29.3%. Q4 service gross margin was 32% and expanded 20 basis points from the prior year. Distribution segment gross margins of 25% were up 140 basis points from prior year and was driven by strength at our high margin rentals business in a favorable sales mix.

Turning to Slide 6, Q1 net income of $3.1 million decreased 16% from prior year, and our diluted earnings per share came in at $0.40. Both net income and earnings per share were negatively impacted by increased acquisition accounting costs as well as higher tax rate compared to the prior year. As a reminder, in the prior fiscal year first quarter, we had a significant impact from a favorable discrete tax benefit due to tax accounting associated with share-based awards and stock option activity, which resulted in negative tax expense for the quarter. In the current fiscal quarter, we saw similar type of benefit, but not to the magnitude of the prior year. The tax rate for the current quarter was approximately 10.9% compared to negative 5.6% in the prior year. The increase in tax rate had an unfavorable impact of $0.08 per diluted earnings per share. We continued to expect the Full Year Fiscal 2023 tax rate to be in the range of 22% to 24%.

Acquisitions will continue to be an important part of our go-forward strategy. So, with this in mind, in our Q4 2022 earnings call, we introduced an adjusted diluted earnings per share metric, which normalizes for the impact of upfront and ongoing acquisition related costs. First quarter adjusted diluted earnings per share was $0.54, which represents a 2% decrease compared to Q1 of the prior fiscal year. Keep in mind that the adjusted diluted earnings per share was also impacted by the $0.08 per share due to the year over year decrease in the discrete tax benefit that I spoke to earlier. A reconciliation of our Q1 2023 adjusted diluted earnings per share to diluted earnings per share and net income can be found in the supplemental section of this presentation.

Turning to Slide 7, where we show our Adjusted EBITDA in Adjusted EBITDA margin. We use Adjusted EBITDA, which is a non-GAAP measure to gauge the performance of our segments because we believe it is one of the best measures of our operating performance in ability to generate cash. First quarter consolidated Adjusted EBITDA of $7.3 million was up 20% from the same quarter in the prior fiscal year. We saw a strong growth in both our Service and Distribution segments during the first quarter. As always, a reconciliation of Adjusted EBITDA to operating income and net income can be found in a supplemental section of this presentation.

Moving to Slide 8, cash flow from operations reflects the impact of increased inventory as a result of opportunistic buys we have made to counter the effects of extended lead times and price increases. Capital expenditures were $2.4 million in the quarter, and continue to be centered around Service segment capabilities, including automation, rental pool assets, and investments to support future growth.

Turning to Slide 9 in the balance sheet, at quarter end, we had a total net debt of $51.3 million with a leverage ratio of 1.83X. We had $36.3 million available from our credit facility at the end of the quarter, and as previously announced, we acquired Alliance Calibration for $4.7 million at the beginning of June, which was largely funded from the revolving credit facility.

Lastly, we expect to file our 10-Q on or around August 8.

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

Lee Rudow

Okay. Thank you, Tom.

As I alluded to earlier, we're well positioned for profitable growth and we believe our value proposition has never been stronger. Of course, driving execution will be the key. While there's a bit of uncertainty in the current economic climate, the Transcat business model's positioned to perform well. Our service revenue is anchored by recurring revenue streams in highly regulated markets. We maintain a demonstrated track record of sustained growth through various economic cycles. We are confident and expect this will continue.

Strong organic growth remains at the heart of our strategy. We expect organic growth to be in the high single digit range for the balance of the Fiscal 2023 year. We will continue to identify and pursue acquisition opportunities that expand our addressable markets, geographical footprint and capabilities. Acquisitions remain an important part, an important component of our growth strategy and increase the trajectory of our business. We have a strong balance sheet to support the conversion of our active M&A pipeline. We will continue to drive continuous process improvement and automation to generate sustainable service margin improvements into the future.

With that Operator, we can open the line for questions.

Operator

Thank you very much.

We have our first question from the line of Greg Palm with Craig-Hallum Capital Group. Please go ahead.

Greg Palm

Yes, thanks. Congrats to both Mark and Tom and congrats on the good quarter here. Lee, I'm curious, just what are some of the near term priorities given this change? You laid out some of that, but in terms of the day to day, but wanted to give you the chance to dive into some of this a little bit deeper, if you can.

Lee Rudow

Well, Greg, I specifically mentioned the words unique time of opportunity for Transcat, and I think that is absolutely the case. When I think about that and what it means in reference to your question, I think the M&A pipeline is active and with NEXA on board, our value proposition as strong as it is, I would just think we have to execute super well. We've done well in the past, and there's really an opportunity to kind of take it to the next level.

Having Mark take the COO role, it's definitely going to give me the time and opportunity to get out into the field and to make sure that what makes us unique is understood by every employee that we have, every salesperson it's conveying our value prop, every customer that needs to hear it, and so I'm kind of looking forward to that. It's more of my roots by nature. I like getting out into the field, and this is really just the best opportunity to do that from a time perspective. So, that's really what it's all about.

Greg Palm

Okay. Makes sense. In terms of the service margins, if I heard you right, well, I guess even before that, maybe update us on CBLs, but I think if I heard you right, it sounded like there were some start-up costs associated with the opening of a CBL or multiple, I guess I missed exactly what it was, but maybe go into that a little bit deeper. Then can you quantify what that impact was specifically?

Lee Rudow

Right. In the first quarter, coming out of the—what we'll call an intense COVID period where things are just subsiding a bit, we were able to get back on track with what we would call a more normalized pipeline for client-based labs and actual wins for. So, we had several sizable wins in the first quarter and we actually just started those jobs midway through the quarter. So, if you recall on our past, just in 2019, just before COVID, whenever we have two or three new CBLs in a quarter, or even for that matter in a year, four or five perhaps, there's always a natural drag at the beginning. You got to send a lot of people. The upstarts are kind of complex and take some time, but remember CBLs, client-based labs have a high lifetime value. They're very sticky, very profitable, and they're absolutely part of our growth strategy.

But, in the short term, whenever you land, let's say two or three or four in a quarter, you are going to have a short term drag on margin. It usually takes about a quarter or two, depending on how large it is or the complexity of each individual client based lab, but it's a couple quarters before you kind of get out of that initial phase and into what is with a more normalized profitability. So, we definitely experience some of that.

The impact in the first quarter, I'm not going to put an exact number on it. We've got some general ideas and it definitely impacted the quarter. Yet, we still were able to increase margin, which is the good news. So, we'll benefit down the road from the CBLs from a margin perspective.

Greg Palm

Can you say whether those were new or existing customers? Then is it fair to assume based on your pipeline that you'll likely open up new sites as we progress throughout the year?

Lee Rudow

I will say with complete clarity that every CBL that's been new was completely new to us, all new logos, which is really good news, because we always have the opportunity to expand our current customer base and we will do that, but the first quarter wins were all new.

Greg Palm

Got it. More to come throughout the year or not necessarily?

Lee Rudow

Yes. I mean, the pipeline certainly supports that possibility.

Greg Palm

Okay. Good. All right, I'll leave it there. Thanks, and good luck going forward.

Lee Rudow

All right. Great. Take care.

Operator

Thank you. We have next question from the line of Scott Buck with H.C. Wainwright. Please go ahead.

Scott Buck

Hi, good morning, guys. Thank you for taking my questions. Just a little more on the CBLs. Lee, could you tell us how many active CBLs you guys have now? Then, I guess what is the average revenue of a CBL once it's up and running and how many more opportunities are out there like this?

Lee Rudow

So, we probably have in the low 20s now in terms of numbers CBLs from a size perspective. They can run anywhere from $500,000 on the low end—$400,000 or $500,000 to a couple of million today in our current platform. The pipeline for CBLs beyond what we've already won in the first quarter is, I would call healthy.

Scott Buck

Okay. Appreciate that color. That's on nice shout out on the rental business and the release and in the commentary here, are you seeing folks opt for rentals over purchases based on inflationary pressures on pricing, or what's driving the strength in rentals?

Tom Barbato

Yes, Scott, this is Tom Barbato. I think the supply chain issues that we're struggling with, our customers are struggling with as well, and rentals is a good option for them to get the product when they need it to support their activities. So, I think that's probably having as much of an impact as anything right now.

Scott Buck

Okay. I appreciate that, Tom. Then last one for me, maybe just a reminder on where your comfort level is around leverage given kind of the M&A conversations that we've heard on the call so far.

Lee Rudow

So typically, I think our banking covenants call for around three times, but we've always been comfortable. We've always been a little under levered, but we've had it up to 2.5, 2.6 and we're kind of comfortable in that range. We'll probably get comfortable at three, but our more normalized comfort levels around 2.5-ish.

Scott Buck

Okay. Perfect. Well, I appreciate the time guys. Thank you so much.

Lee Rudow

Take care.

Operator

Thank you. We have next question from the line of Gerry Sweeney with ROTH Capital. Please go ahead.

Gerry Sweeney

Yes. Good morning. Thanks for taking my call. I had a question on organic growth and maybe you could give a little bit more detail or nuance. Obviously very solid organic growth. I always thought the next acquisition on the asset management side is a differentiator. CBLs makes sense bringing them in-house, but maybe just describe what's driving some of this growth. Sounds as though you're taking share. Are you hitting just size and scale on a national basis, driving additional clients towards you versus competitors? Just want to understand more what's going on on that front.

Lee Rudow

I think the number one contributor to organic growth is the strength of our value proposition, and it doesn't happen overnight. I mean, we have worked literally a decade on this, it started with our orientation towards life sciences at a time when others weren't doing it and it was kind of a unique approach to the market. It's understanding the high cost of failure and how to communicate how we mitigate that and how we add value to that process from a compliance perspective, and then it kind of evolves into formulating our sales team so that they can properly convey those benefits. That takes time and that takes a year.

So, when you get to an environment that we're in now, we've got size, we've got scope, all these investments that we've made in terms of assets and people are all out in the market creating that differentiated service solution. Now we're calling it a Single Source Solution, and a big part of the Single Source Solution, Gerry is NEXA. So, we go to the customer that we used to offer calibration services to, and now we offer everything that's adjacent to calibration services in addition. So, we can go to a client that used to spend $1 million with maybe one of our competitors or in-house and say, "Hey, we can show you how to get your cost down to $800,000," save them 20%. Do this, this discrete step and that discrete step, and this will yield the results that you're looking for. We can express that I think like no other and we have this value proposition that supports it.

That's going to be the driver for strong organic growth. I mean, not every single quarter necessarily, but over time that's a winning value proposition. It's taken us a long time to get there. We've had gradual improvements along the way, but that's the driver. It's going to be the value proposition well communicated. Then of course you have to (multiple speakers).

Gerry Sweeney

Sure. Then just talking about NEXA, is there another "NEXA" out there that could increase your value proposition even more and as this scenario that you're thinking about looking at as you continue to go forward?

Lee Rudow

It's actually a great question. Acquiring NEXA showed us and proved to us that we can do well in expanded adjacent markets to our core calibration, but what it also did and probably even more important is it shows us that this is an area that can be expanded. So, the growth on the core calibration businesses, X, and the growth on the NEXA consulting Single Source Solutions is Y. So, we're trying to get our arms around exactly what the growth potential is, but it is real, and it is significant, and it is additive and incremental to what we used to do. So, we're kind of putting that all together. Remember, it's only been 9 months, 10 months. It hasn't been a year for NEXA and their business is doubled. So, that's a good indication for us that we're heading down the right path.

Gerry Sweeney

This may sound a little bit off topic, but I think is important to the discussion, but how many discrete customers do you have? Because I look at that as almost a channel that you can leverage with additional sort of ancillary businesses or services.

Lee Rudow

On the service side, it's probably in the range of 35,000 to 40,000.

Gerry Sweeney

Okay. There's a big channel that you can sort of mine if you bring in additional adjacent services.

Lee Rudow

There is, correct. That's how we see it.

Gerry Sweeney

Got it. I appreciate it. Congrats on a great quarter and thanks for taking my call.

Lee Rudow

You're very welcome. Take care, Gerry.

Operator

Thank you, ladies and gentlemen, we have reached the end of the question-and-answer session, and I'd like to turn a call back to Lee Rudow for closing remarks. Over to you, sir.

Lee Rudow

Okay. Thank you all for joining us on the call today. We certainly appreciate your continued interest in Transcat. Transcat will be presenting at the up and coming Oppenheimer Conference. That's on August 10th. Feel free to sign up for a one on one with us the Management team, or you could just log in to our presentation. Otherwise we'll check back with everybody after our next quarter results. Take care. Thank you for joining us.

Operator

Thank you very much, sir. Ladies and gentlemen, this concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.