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Transcat, Inc.

Third Quarter Fiscal Year 2024 Financial Results

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CORPORATE PARTICIPANTS

Thomas Barbato, *Chief Financial Officer*

Lee Rudow, *President and Chief Executive Officer*

CONFERENCE CALL PARTICIPANTS

Greg Palm, *Craig-Hallum*

Scott Buck, *HC Wainwright*

Martin Yang, *Oppenheimer & Company*

PRESENTATION

Operator

Greetings and welcome to Transcat, Inc. Third Quarter Fiscal Year 2024 Financial Results. (Operator instructions).

As a reminder, this conference is being recorded.

It is now my pleasure to introduce Tom Barbato, Chief Financial Officer. Thank you, you may begin.

Thomas 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'll begin the call with some prepared remarks, and then we'll open the call up for questions. Our earnings release crossed the wire after markets closed yesterday. Both the earnings release and the slides that we will reference during our prepared remarks can be found on our website transcat.com in the Investor Relations section.

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. These 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 in the documents filed by the Company with the SEC. You could 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 provide reconciliations of non-GAAP to compared 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.

Transcat continues to make excellent progress on key initiatives across our entire business portfolio. The operating results for the first three quarters of fiscal 2024 have been outstanding.

Turning specifically to the third quarter, consolidated revenue grew 14% to $65.2 million, driven by strong demand for our broad suite of services. Consolidated gross margin expanded 350 basis points to 32.1% and was driven by margin expansion in both our Service and Distribution segments. Adjusted EBITDA grew 39% from prior year to $9.1 million.

Let me spend a few minutes on each of our operating segments. We'll start with Service.

Consistent revenue growth continues to be fostered by recurring revenue streams and highly regulated markets, strong customer retention, and a differentiated value proposition. Transcat has built a very strong reputation for execution and delivering services that consistently meet the needs of our demanding customers. We continue to reside where the cost of failure is high, and our services are a critical component of our customers processes.

Today, approximately 60% of our Service business comes from the highly regulated Life Science sector. Because of the criticality of our services, this is not an easy place to be, but it’s where we want to be. It's where our tagline calibrated by Transcat resonates the most.

In the third quarter we grew overall Service revenue by 15%, 9% was organic growth. This represents the fifty-ninth straight quarter of year-over-year service revenue growth. We have grown in the high single digits or better for each of the last two years and we anticipate doing the same in fiscal 2024.

In addition to revenue growth, we continue to focus on margin expansion. Strategically, we focus on operational excellence, which includes increased levels of automation, robotics, and process improvements. In the third quarter, service gross margin increased 250 basis points versus prior year to 32.5%. As always, margin gains are supported by strong organic growth and the associated operating leverage that's inherent in our Service segment.

Turning to Distribution, the growth of our Rental business, further accelerated by the Axiom acquisition, drove gross margin expansion of 530 basis points from prior year third quarter. In fact, the transformation of our Distribution segment by growth in rentals has driven approximately 1,000 basis points of gross margin expansion since 2016. A continued mix change towards rentals provides further opportunities to improve distribution margins as we enter fiscal 2025 and beyond. Internally, we say, “All roads lead to calibration,” and our Distribution and Rental businesses continue to be an important generator of leads for our Calibration services business.

Overall, as we mentioned in the earnings release, we are extremely pleased with our performance in the third quarter of fiscal 2024. Our Adjusted EBITDA increase of 39% highlights Transcat's ability to deliver on the high expectations our shareholders have for consistent revenue and margin growth.

Furthermore, the strong performance of recent acquisitions demonstrates the effective allocation of capital. We have successfully identified, acquired, and integrated dynamic companies that align with our strategy, and our disciplined approach drives differentiation. Our integration process enables new acquisitions such as the recent deal with Axiom to very quickly be accretive to the overall Company.

We ended the third quarter well positioned financially with strong operating cash flow generation and balance sheet capacity, both of which allow us to actively pursue the M&A opportunities that comprise our current robust acquisition pipeline.

With that, I'll turn things over to Tom for a more detailed review of our third quarter financials.

Thomas Barbato

Thanks, Lee. I'll start on Slide 4, the earnings deck posted on our website, which provides detail regarding a revenue on a consolidated basis and by segment for the third quarter of fiscal 2024.

The third quarter consolidated revenue of $65.2 million was up 14% versus prior year on Service segment strength and growth in our Distribution business. Looking at it by segment, Service revenue growth remained very strong at 15% with 9% of the growth coming organically and the other 6% from acquisition. As Lee mentioned, demand remains strong in the Services segment as our differentiated value proposition continues to resonate well with our customers. Turning to Distribution, revenue of $23.7 million grew 10% from the prior year. We continue to see growth in the higher margin Rental business, which also benefited from the Axiom Test Equipment acquisition.

Turning to Slide 5. Our consolidated gross profit for the third quarter of $20.9 million was up 28% from the prior year, and our gross margin expanded 350 basis points in the third quarter. Service gross margin expanded 250 basis points. The Service margin increase further reflects our ability to leverage organic service growth, higher levels of technician productivity in our differentiated value proposition. Distribution segment gross margin of 31.5% was up 530 basis points driven by a larger mix of higher margin Rental revenue, including impacts from the previously mentioned Axiom acquisition.

Turning to Slide 6. Q3 net income of $3.3 million increased 109% from prior year driven by strong operational performance and also benefited from a material reduction in interest expense. As a reminder, early in the third quarter, we completed what we believe to be a successful secondary offering, which allowed us to pay down our revolving credit facility in full, which drove the significant reduction in interest expense. Diluted earnings per share came in at $0.38, up 81% versus the same period in the prior year. We report adjusted diluted earnings per share as well to normalize for the impacts of upfront and ongoing acquisition related costs. Q3 adjusted diluted earnings per share of $0.56 increased $0.21, or 60% from the prior year.

Flipping into Slide 7 where we show our Adjusted EBITDA and Adjusted EBITDA margin. We use Adjusted EBITDA, which is non-GAAP, to gauge the performance of our business because we believe it is the best measure of our operating performance in ability to generate cash as we continue to execute on our acquisition strategy. This metric becomes even more important to highlight as it does adjust for one-time deal related transaction costs, as well as increased levels of non-cash expenses that will hit our income statement from acquisition purchase accounting.

With that in mind, third quarter consolidated EBITDA of $9.1 million was up 39% from the same quarter in the prior year, and Adjusted EBITDA margin expanded 250 basis points. Both segments had Adjusted EBITDA growth compared to last year. As always, a reconciliation of Adjusted EBITDA to operating income and net income can be found in the supplemental section of this presentation.

Moving to Slide 8. Operating free cash flow significantly improved from last year as cash from operations was $12.9 million higher than prior year. Third quarter capital expenditures were $800,000 higher than prior year and continue to be centered around Service segment capabilities, technology, including automation, investments in our Rental asset pool, and further growth projects.

Slide 9 highlights our strong balance sheet. At quarter end, we had total net cash of $30.5 million with a leverage ratio of 0.12x and the full $80 million available under our credit facility.

Lastly, we expect to file our Form 10-Q on January 31.

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

Lee Rudow

Thanks, Tom.

The future remains bright for Transcat. Transcat's portfolio of services is both deep and broad, and positions Transcat as a true leader in the highly regulated industries we serve. Our focus on the customer experience is a top priority as we strive to increase our long-term competitive advantage. As we work our way through the fourth quarter of fiscal 2024, we continue to be positioned to deliver high single-digit to low double-digit organic service growth for the full fiscal year.

Over time, we also expect continued and sustainable gross margin expansion. We believe the service segment has a substantial runway ahead for growth, both organically and through acquisition. Our active and diverse acquisition pipeline enables strategic, accretive acquisitions that drive synergistic growth opportunities and will be a key component of our go-forward strategy.

As I closed last quarter's earnings call by saying at Transcat we expect to get bigger, and we expect to get better. That's the Transcat way.

With that, we can open up the call for questions, Operator.

Operator

Thank you. (Operator instructions). Our first question comes from the line of Greg Palm with Craig-Hallum. Please proceed with your question.

Greg Palm

Hi. Morning, everyone. Thanks for taking the questions and congrats on the results here.

Lee Rudow

Thanks, Greg.

Thomas Barbato

Thank you. Thanks, Greg.

Greg Palm

I wanted to start with gross margins, particularly in distribution. Can you quantify the mix tailwind from Rentals, and also trying to get a sense for what the positive impact was from, whether it's exiting or de-emphasizing some of the lower margin, reseller sales as well. I don't know if you can quantify either of those or talk about that a little bit more in detail.

Thomas Barbato

Yes, Greg. We're not prepared to go into that level of detail. What we will say, though, is that the focus on rentals continues to pay returns for us. The acquisition of Axiom, that we did back in August, has really gone well. The integration has gone well. I think we're ahead of the integration curve on that one a bit. But, as mix continues to change, going forward, and mix continues to shift more towards rentals, we'll expect to see margins continue to move up into the right—in the Distribution segment.

Greg Palm

Okay. Any reason not to extrapolate what you saw this previous quarter to what you expect going forward? That distribution margin was obviously well ahead of what you've been expecting, but I'm not sure if there's anything one time in there, or if it's just sort of the benefit of everything that you've been working for over the past couple of quarters?

Lee Rudow

Yes, Greg, I wouldn't characterize this as any one-time event that drove it. When we think about Rentals, you think about mix, and in any given quarter in a 90-day increment of time, you're going to have a positive or sometimes a bit of drag, based upon that mix. We had a positive mix this past quarter. We may have a positive mix the next quarter.

I think Tom's point is, over time, as the Rental mix becomes a higher percentage of our overall distribution, we expect margins to continue to expand. That's what we expect. Quarter-to-quarter you may see another quarter like this one. We may be closer to 30%. But I think the bigger more important picture is over time Rentals will continue to drive margins up, as that becomes a greater part of our distribution mix.

Just for a lot of new shareholders we have, the strength of our brand is really an anchor for all of this, and we started the rental business back in 2016. I mentioned the thousand point gain on margin, but we had the perfect infrastructure, we had the perfect position in the marketplace. It was sort of the colocation of all these factors that helped us launch and drive this business. Now, it's a more mature business, and we understand it, and there's acquisition opportunities. You got the combination of organic and inorganic. I think we're positive for our outlook, but the quarter-to-quarter timing, we don't want to get too specific. We just don't have that kind of insight.

Greg Palm

Understood. Makes sense. As it relates to M&A, can you talk about how the pipeline has evolved over the last few years? I'm really curious if your appetite around the type, the kind of acquisitions, the size, has that changed meaningfully recently? Maybe last couple of quarters?

Lee Rudow

I think that's an accurate way to look at it. We guided the market a few years ago softly. We hired a Vice-President of Business Development to be more aggressive looking for these types of opportunities that would be strategically a good fit for the business. We have integration teams in place, due diligence teams in place. We're geared up and ready to pick up the pace and even the size of deals. We showed that a little bit with Axiom. I think the pipeline that exists today also reflects that sort of an outlook.

I would expect the potential there, as we go into the future, to see bigger deals, but this is not something that should be a surprise, this is something we've been talking about for years, building up to the point where we are today.

Thomas Barbato

(Multiple speakers) I was just going to emphasize what Lee said. We've got a really good process, and we make good decisions, and we've demonstrated that consistently over time. Our intent is to continue to stick to our process and the deals will happen when the deals happen.

Greg Palm

Yes. Okay. I will leave it there. Best of luck going forward. Thanks.

Lee Rudow

Thanks, Greg.

Operator

Our next question comes from the line of Scott Buck with HC Wainwright. Please proceed with your question.

Scott Buck

Hi. Good morning, guys. Appreciate the time, Lee, a little bit more on M&A. I'm curious what you're seeing in terms of pricing when you guys talk to folks, and maybe what you're seeing from competitors in the market? Are they getting more aggressive on the acquisition front as well?

Lee Rudow

Scott, we have seen in the last couple years more activity on the PE side, in terms of outreach to potential acquisitions. But literally, I think, and I'm comfortable saying this, today it's very hard for us to point towards an acquisition that we wanted to make, that we weren't able to make, whether it be price or some other factor. PE is in the space, but we understand it, this is all we do, right? We're intimate with these companies. We know the owners; we know the process. I think it's very differentiated, which is what I tried to allude to in my earnings call. So far, it hasn't had an impact on any company that we can point to that we've wanted to acquire. I don't see that changing anytime soon. There are some companies that have been acquired in the space, but they're ones that we've left behind, because they didn't meet the criteria of our discipline process.

Scott Buck

Great, that's helpful. My second one, could you talk a little bit about what drives customers to the Rental business versus acquiring equipment, and how sustainable that really is, or whether we're just kind of in a peak macro environment that drives people to make that decision rather than another.

Lee Rudow

Right. Well, some of the factors include, and I say first and foremost, an urgent unexpected need. When you think about rentals, you're thinking about someone who needs equipment right now and didn't necessarily see it coming, so they turn to the rental market. That would be a primary mover. You also have the difference between CapEx and OpEx, and as you go through different economic cycles, the macros, this thing will cycle in and out as well a little bit, but those two sometimes balance each other off.

I think the third factor is the way we market rentals. We have become over the last, I'm going to say half a decade, the last three to five years, really adept at marketing. Getting into the digital world with our brand, with our offerings, with our diverse value proposition, and Rentals is part of it. I think Rentals connects to Service, Service connects to Rentals, Distribution is in between both. So, it's that unique combination that we bring to market. I think if you factor all three of those in, the macros, the urgent unexpected need, and the way we go about trying to grow our Rental business. Those are the three factors. I don't see any major changes on the horizon that would change our way of thinking in terms of the consistency of that business.

Scott Buck

Great. I appreciate that. That's it for me, guys. Congrats again on the quarter.

Lee Rudow

Okay. Thanks Scott.

Thomas Barbato

Thanks, Scott.

Operator

Our next question comes from the line of Martin Yang with Oppenheimer. Please proceed with your question.

Martin Yang

Hi. Good morning. Thank you for taking the questions. I have two. First on CapEx. You referenced the need to increase for Rental assets. The CapEx in 3Q, as a pickup (phon) quarter-over-quarter, is that associated with your expansion on the Rental business. Should we see that as the goal for a run rate or another step-up as a more normalized CapEx after the acquisition?

Thomas Barbato

Yes. I think, Martin, some of that—I was specifically referencing the year-over-year increase that we saw in Q3, and certainly Rentals played a role in that. As we continue to grow the Rental business, we'll continue to see an additional investment required in that space. It's just the nature of that business, right? You've got to have the assets in order to grow the business. But it'll be done in a very well thought out methodical way with a focus on assets that are going to drive the highest returns.

Martin Yang

Got it. Thank you, Tom. My next question is on the lead generation potential between Rental and Distribution. Is one more effective than the other? For example, is Rental business a better lead-gen tool than Distribution?

Lee Rudow

I wouldn't characterize it that way, Martin, and I'm not sure we're prepared to rank the two. Clearly, with Distribution, people are buying test equipment. At some point we'll have a need to have back test equipment serviced. There's just such a natural connection there, and some of them need the calibration done right up front in order to put into service. It's hard to get better than that.

But with our Rental customers, to the degree that we're picking up test equipment users that we wouldn't otherwise have as a customer, if we didn't have a Rental program; yes, that will be incremental. To the degree that our Rental customers are a byproduct of our Distribution customers, our installed base, then it would be not incremental, and I'm not sure it's any better than our core distribution.

I think they're both important, but you just got to love the connection between the Distribution, and there's a really close connection from Distribution to Rentals.

Martin Yang

Thank you, Lee. Just a quick follow up. For both Rental and Distribution, are the equipment in both services recalibrated before you deliver to your customers?

Lee Rudow

One of the things that makes us unique in our Rental program is when we get equipment in from our Rental customers, we calibrate everything, of course, and that's easy for us to do. I think it's easier than some of our competitors. But yes, all equipment is checked, calibrated before it goes out to the next customer. In some cases, our customers who are renting equipment need equipment that is accredited, so we go through the uncertainty calculations as well. That would all be part of our service.

Martin Yang

Got it. Thank you, Lee That's all for me.

Lee Rudow

Okay. Appreciate it, Martin.

Operator

There are no further questions in the queue. I'd like to hand the call back to Management for closing remarks.

Lee Rudow

This is Lee. Thank you all for joining us on the call today. We appreciate your continued interest in Transcat. Feel free to check in with us really at any time, otherwise, we will talk to everyone after we send out the fourth quarter results. Thanks again for participating.

Operator

Ladies and gentlemen, this does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time and have a wonderful day.