



**Transcat, Inc.**

**Third Quarter Fiscal Year 2022 Financial Results**

**February 2, 2022**

## C O R P O R A T E P A R T I C I P A N T S

**Lee Rudow**, *President, Chief Executive Officer*

**Mark Doheny**, *Vice President, Finance, Chief Financial Officer*

## C O N F E R E N C E C A L L P A R T I C I P A N T S

**Greg Palm**, *Craig Hallum*

**Scott Buck**, *HC Wainwright*

**Mitra Ramgopal**, *Sidoti*

## P R E S E N T A T I O N

### Operator

Greetings and welcome to the Transcat Incorporated Third Quarter Fiscal Year 2022 Financial Results Conference Call.

At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Mark Doheny, Chief Financial Officer. Thank you, Mark, you may begin.

### Mark Doheny

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. We will begin the call with some prepared remarks and then we will 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](http://transcat.com), in the Investor Relations section. The slides that accompany today's discussion are also posted 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. 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 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 have provided reconciliations of non-GAAP to comparable GAAP measures in the tables accompanying the earnings release.

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

### **Lee Rudow**

Okay, thank you, Mark. Good morning, everyone. Thank you for joining us on the call today.

In the third quarter of Fiscal 2022, we continued to demonstrate the successful execution of our strategy by delivering strong service sales, by expanding our addressable markets through strategic acquisitions that increase our capabilities, expertise and geographic footprint. In addition, our continued focus on effective capital allocation and structure combined with operational excellence and strong execution led to another quarter of margin expansion.

Consolidated revenue increased 16% to \$50.9 million, a third quarter record for Transcat, and consolidated gross margin expanded 130 basis points to 26.8%. Adjusted EBITDA, a very important metric for us given our level of acquisitive growth, grew 20% from the prior year to \$5.5 million.

Our service segment continued to perform at a high level and recorded its 51<sup>st</sup> straight quarter of year-over-year revenue growth. Our new business pipeline remained strong throughout the third quarter and delivered growth of 22%, which included double-digit organic growth of 10%. Service growth was driven by our ongoing success in the highly regulated end markets we serve, including life sciences. We continue to take market share by investing in and delivering our differentiated value proposition. Services are designed to minimize risk for our customers who generally operate in environments where the cost of failure is high. We believe Transcat's attention to quality and state-of-the-art capabilities and our investment in leadership and expertise is second to none in the calibration industry. Transcat's motto continues to be Trust in Every Measure.

In addition to strong service revenues in the third quarter, we expanded our service gross margin 180 basis points to 29.7%. Given the inherent inefficiencies created by the holiday season in the third quarter, we are particularly pleased with nearly achieving a 30% gross margin. Another interesting data point in comparison between the current third quarter service margin to our third quarter gross margin only two years ago, margins have increased 770 basis points. The margin increase is a testament to our continuous improvement model and inherent operating leverage of our service business.

Turning to our recent acquisitions, NEXA Enterprise Asset Management, which we acquired on August 31 of last calendar year, is off to a great start. NEXA adds another differentiated, high growth life science business to our service platform. Their five service tracks optimize calibration and asset management programs focusing on preventative maintenance, reliability, quality, compliance, and data migration. NEXA's leadership team both in the U.S. and in Ireland are impressive. Together, we are confident we

will capitalize on the synergistic growth opportunities and expanded market development opportunities that are clearly available as we work together.

On December 31, we closed the acquisition of Tangent Labs. The Tangent business fits perfectly into our service segment's operational footprint and expands our geographic footprint in two new locations: Indiana, which is an attractive life science market especially in medical devices, and Huntsville, Alabama, which has a large aerospace and defense market.

Turning to distribution, distribution revenue grew 7% in the third quarter. While modestly below our expectations, the business performed well despite continued supply chain challenges that extended vendor lead times. Still, incoming orders in the third quarter were strong and we enter our first fourth quarter in a solid position with a record \$9 million in backlog, up \$3.3 million from the prior year. Our balance sheet remains strong with a leverage ratio of just under 1.5 times.

With that, I'll turn things over to Mark for a more detailed look at our financial performance for the third quarter.

### **Mark Doheny**

Thanks, Lee. I will 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 third quarter.

Consolidated revenue of \$50.9 million was up 16% versus prior year in service segment strength and the continued recovery of our distribution business. Looking at it by segment, service revenue growth remained very strong at 22%, with 10% of the growth coming organically and the other 12% from acquisitions. As Lee mentioned, the NEXA business is performing well and drove the majority of the acquisition growth in the quarter.

Turning to distribution, revenue of \$20.7 million was up 7% versus the prior year. We saw improved market conditions across our base of business compared to a prior year quarter that was impacted by the COVID-19 pandemic; however, as Lee also mentioned, vendor lead times extended even further as we progressed through the quarter, and this did impact our growth rate which we had expected to be above 10%. The good news is the orders were strong and in line with our expectations, increasing our backlog to a record \$9 million.

Turning to Slide 5, our consolidated gross profit of \$13.6 million was up 21% from prior year, and our gross margin expanded 130 basis points to 26.8%. Service gross margin expanded 180 basis points and hit a third quarter record of 29.7%. As we leveraged our fixed cost from the high level of organic growth, our technician productivity remained strong, and we benefited from accretive gross margins from our recent acquisitions. Distribution segment gross margin of 22.5% was flat to prior year and in line with our expectations.

Turning to Slide 6, consolidated operating income of \$2.4 million was down 6% from prior year. It is important to note that both consolidated and service segment operating income were unfavorably impacted by approximately \$700,000 from purchasing accounting of the NEXA acquisition. Of this \$700,000, approximately \$400,000 is intangibles amortization expense which is largely related to the value of acquired customer relationships. This will continue to be expensed at approximately the same rate on a quarterly basis going forward.

The other \$300,000 was amortization of the acquired NEXA backlog. As we discussed last quarter, per purchase accounting rules we are amortizing the acquired backlog of approximately \$500,000 over the first five months post acquisition, which reduces revenue and therefore gross profit and operating income.

The backlog will be fully amortized after January, so this will only impact one month of our Fiscal fourth quarter. Distribution operating income of \$700,000 improved from the prior year third quarter, which as mentioned was still being impacted by the pandemic.

Turning to Slide 7, Q3 net income of \$1.6 million decreased 7% from prior year, and our diluted earnings per share came in at \$0.21. Both net income and EPS were unfavorably impacted by the NEXA acquisition accounting I just described. We expect our full year Fiscal 2022 tax rate to be in the range of 14% to 15%, which is unchanged from our previous expectation.

Flipping to Slide 8 where we show our Adjusted EBITDA and Adjusted EBITDA margin. We use Adjusted EBITDA, which is non-GAAP, to gauge the performance of our segments because we believe it is the best measure of our operating performance and 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 the increased levels of non-cash expenses that will hit our income statement from acquisition purchase accounting. With that in mind, consolidated Adjusted EBITDA of \$5.5 million was up 20% from prior year, and our Adjusted EBITDA margin increased to 10.7%. Both segments showed strong improvement from prior 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 9, cash flow from operations was in line with our expectations as working capital increased on the very strong organic revenue growth. Year-to-date Capex through the end of the third quarter was \$5.9 million compared to \$4.3 million in the prior year and continued to be centered around service segment capabilities, technology including automation, and future growth projects.

Slide 10 highlights our strong balance sheet. At quarter end, we had total net debt of \$38 million with a leverage ratio of a little under 1.5 times. We had \$48.3 million available from our credit facility at quarter end, and as previously announced, we acquired Tangent Labs for \$9 million at the very beginning of our fourth quarter, which was largely funded from our revolving credit facility.

Lastly, we expect to file our Form 10-Q later today.

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

**Lee Rudow**

Okay, thanks, Mark.

In the fourth quarter of Fiscal 2022, we expect both our operating segments to finish strong. Capitalizing on our unique value proposition and taking market share in the highly regulated industries in which we compete, we expect fourth quarter service revenue growth to be in the high teens. We also expect service gross margin to be in the range of 35% as we leverage the typical January through March increase in service volume. In addition, we expect to continue to organically develop our recently expanded addressable markets of pipette services and enterprise asset management services. Distribution revenue in the fourth quarter is expected to grow high single digits.

Our strong balance sheet continues to be supportive of our active M&A pipeline. The acquisition team has done an outstanding job identifying, completing and integrating three deals in Fiscal 2022, and Transcat has developed a reputation for getting the right deals done the right way, the Transcat way, and that means focusing on growth, synergies, and leveraging the talent we acquire.

From a margin perspective, we look to continue to demonstrate the sustainability of our margin gains. Current and future investments in automation, process improvement and technology are designed to continue to expand our margins over the longer term.

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

**Operator**

Thank you. Our first question is from Greg Palm with Craig Hallum. Please proceed with your question.

**Greg Palm**

Yes, thanks. Hey Lee, hey Mark, how are you guys doing?

**Lee Rudow**

Good, well, Greg, thanks.

**Greg Palm**

Just starting with the vendor lead times, I'm curious if you can pinpoint, I don't know if that was omicron related. It sounded like it was just overall supply chain, but can you pinpoint exactly what happened there? Have you seen maybe any difference in January or year-to-date?

**Lee Rudow**

Yes, it's much of the same, Greg, that we've been talking about for the last couple quarters, and really similar to what you see throughout the industrial marketplace, just a typical slowdown in getting orders from the vendor, and from the vendor's vendor in many cases, to us, but we have seen a bit of improvement, I would say over the last couple weeks. We're starting to see I think it's heading in the right direction, so we're not overly concerned. We'll get the orders out hopefully in the fourth quarter, might even have some upside in the first quarter, but the orders are there to deliver for sure.

**Greg Palm**

Specifically within distribution, any product lines that it was most specific to, or is it just sort of across the board more of a general comment?

**Mark Doheny**

This is Mark, Greg. It's across the board, but I would say particularly acute in some of the electronics, heavy electronics and higher end electronics. We probably saw it more there, some of the stuff that's, you know, we don't sell a huge amount of, so I think it's across the board, like you say, but particularly acute in the high end electronics equipment.

**Greg Palm**

That makes sense. Then what about new business pipeline, can you talk about that a little bit? Maybe just an update on CBLs would be helpful as well.

**Lee Rudow**

Right, well, the new business pipeline is exactly where we want it to be - it's strong, it's as strong as it's been in my recent memory. We indicated during the last quarter's call that we saw the pipeline building for CBLs, which makes sense as we get past the pandemic, and we are seeing those opportunities come to fruition. It's a solid pipeline, and it's especially solid around CBLs, and so I think we expect to have our fair share of that market as things normalize. We feel pretty strong about it, pretty well.

**Greg Palm**

Okay good. All right, I'll leave it there. Good luck, thanks.

**Lee Rudow**

Okay, take care.

**Mark Doheny**

Thanks Greg.

**Operator**

Thank you. Our next question is from Scott Buck with HC Wainwright. Please proceed with your question.

**Scott Buck**

Hi, good morning, guys. Thanks for the time.

First question for me, I'm curious if you could give a little color on what the incremental opportunities are to expand margin on—or further expand margin on the services side. It seems like this quarter was mostly volume driven, but are there any other kind of incremental pieces that you think could push full-year margin to mid 30s or even high 30s over time?

**Lee Rudow**

Right, yes, Scott, this is Lee. Yes, we will always—as volume increases, we will get that inherent leverage - that's always going to be a positive for us, but we're deep into developing our automation platform, which we've really been talking about for the last couple of years. It's a slow moving but ongoing initiative that over time has an opportunity to really give a lift into our margins, and we do see getting to higher rates, the mid 30s as you mentioned, and automation will participate.

There's also opportunities on the technology side to improve processes and improve some of the tools that we're using, and all these things ultimately drive margin - what products go to what labs, how we batch those calibrations and how we get them through our labs, there's opportunities to pick up efficiency there as well. We're doing different training programs with our technicians to get them on board and get them ramped up faster, training developed more efficiently - all that leads to efficiencies around margins, so yes, there is a runway there and over time, we expect to see continuous improvement.

**Scott Buck**

Great, that's really helpful, Lee. Second, could you provide a little bit of help around the backlog? I think this is the first time you've given the distribution backlog number, at least in some time. How should we think about that in terms of cadence and when that should actually flow through the P&L?

**Mark Doheny**

Yes, you're right, we do disclose it, of course, in the Q every quarter, but because it was such a meaningful number, we did disclose it. The way to think about that, Scott, is there's not a big backlog reduction baked into what we're thinking for the fourth quarter because we're still concerned about the supply chain, like we said in the first few weeks, it may have gotten a little better. But that's up roughly—a little over \$3 million from prior year, so that's the way to think about how, at a minimum, the supply chain is impacting us.

We would expect hopefully some this quarter and next quarter and beyond to have upside to subsequent quarters here, just because of the uncertainty in the supply chains, and not going to be precise about that right now.

**Scott Buck**

Sure. No, I appreciate that, Mark.

Then last one from me, given how active you guys have been on the acquisition front over the last, you know, six months or so in what sounds like continues to be a healthy pipeline, can you remind us how you think about ROI on these acquisitions?

**Lee Rudow**

Yes, of course we model our potential returns and how we look at ROI and ROIC all the time, and so we take these models, we build models around how the businesses are performing at the time we purchase them, and that has to be obviously very—we look at that carefully. We bake in what we're going to do with the business and potential synergies that are in the business, and we build models into the future looking at discounted cash flow, and we come up with an IRR that's acceptable.

For us, a minimum IRR is usually in the 15% to 17% range, but typically we look much higher than that, but that's kind of a threshold for consideration from our perspective.

**Scott Buck**

Okay, perfect. Again, appreciate the time, guys. Thank you very much.

**Lee Rudow**

Yes, no problem. Thanks Scott.

**Operator**

Thank you. Our next question comes from Mitra Ramgopal with Sidoti. Please proceed with your question.

**Mitra Ramgopal**

Yes, hi. Good morning. Thanks for taking the questions.

First one on the distribution side, I know you mentioned it came in a little lighter than you were expecting, but just looking in terms of the year-over-year numbers and where you were maybe a year ago, it seems like you've certainly improved well off of the lows, and just wondering how you see it going forward. I



know you have a good backlog to work off, but longer term if you think this business is stabilized and you have more visibility now.

**Lee Rudow**

Yes, I appreciate the question, and we're not concerned about our distribution business. There's a supply chain challenge that's relatively short term that we're dealing with, that everybody is dealing with. We will continue to work through that as best we can. The business is stable, the margins are good. Really, the distribution business, Mitra, has done exactly what we wanted it to do for the last three or four years. We put a game plan in place in 2016, socialized it with our shareholders and said, look, we want this business to be stable, we're not looking to grow it. We could if we wanted to, but it's not strategic for us.

Our story is about service, expanding our margins, organic growth, acquisitive growth, and continuing to do really well in that service industry, and that's what we've done. That's what our story is about. Distribution is a factor. We don't have any concerns about that at the present time. We'll keep plowing through the short term challenges and continue to drive the strategic focus to service.

**Mark Doheny**

Yes, I think it's important that this supports our service business ...

**Lee Rudow**

Yes, absolutely.

**Mark Doheny**

The (inaudible) we're generating, we're still comfortable that that distribution business is a differentiator in the marketplace for us.

**Lee Rudow**

Exactly. As a reminder, we don't know of another company in the service business that does what we do, the way we do it, that has a supporting distribution business, so we've got a lot of open doors as a by-product of selling products, and that's doing exactly what we wanted it to do, so that's really good.

**Mitra Ramgopal**

No, that's great. Thanks.

You were able to, speaking of margin expansion, improve both gross margin and overall op margin, and we're seeing a lot of companies struggling right now with labor costs, supply disruptions, etc. Just curious if you're just not seeing that impact, or just given your model, you're able to more than offset or mitigate it.

**Lee Rudow**

Well, labor costs for Transcat are going to go up like they are for everyone - that's the environment in which we are working. So far, we haven't had issues passing that onto the customers and getting the right price that we need relative to our labor going up, so we're in a good spot. In our industry we've been in a good spot so far, and we don't see anything on the horizon that's going to change that.

Over time, we'll keep a close look on our labor costs, but yes, there is pressure, we're reacting to it like most good companies are, and so far we've been able to pass that along to the customer without a major concern.

**Mitra Ramgopal**

Thanks, and then finally on the NEXA acquisition, you mentioned integration coming along nicely. Just curious if you're already starting to generate some cross-selling opportunities. Any update on that would be great.

**Lee Rudow**

Yes, well, we are, and we are at a faster rate than we even anticipated. Almost from day one, opportunities surfaced that we thought they would be helpful in helping us land, and I think within the first 30 days of the acquisition, we had material wins by virtue of working together, and it's going both ways. We have set up NEXA nicely with some of our customers and vice versa, so I don't think—not to get overly optimistic, but the early read has been stronger than we could have anticipated. I think it's been really, really powerful, so let's keep working it. The management teams work well together, we recognize that synergies are there between our companies, just like when we acquired them, so everything is going according to plan. It's been positive.

**Mitra Ramgopal**

Okay, thanks for taking the questions.

**Lee Rudow**

No problem.

**Operator**

Thank you. There are no further questions at this time. I would like to turn the floor back over to Lee Rudow for any closing comments.

**Lee Rudow**

Well, we appreciate everybody joining us on the call today and your interest in Transcat. We'll be participating in the Roth conference on March 14 and 15, and the Sidoti Spring Virtual Conference on March 23 and 24. If you're attending those conferences, please feel free to check in with us, otherwise we look forward to talking to everybody again after our fourth quarter results.

Again, thanks for participating in the call. Take care.

**Operator**

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