

Operator: Greetings, and welcome to the Transcat Fourth Quarter and Full Fiscal Year 2018 Financial Results Call. I would now like to turn the conference over to your host, Mr. Craig Mychajluk, Investor Relations for Transcat. Thank you. You may begin.

Craig Mychajluk: Thank you, and good morning, everyone. We certainly appreciate your time today and your interest in Transcat. With me here on the call, we have Transcat's President and CEO, Lee Rudow; and our CFO, Michael Tschiderer.

After formal remarks, we will open up the call for questions. If you do not have the news release that crossed the wire after markets closed yesterday, it can be found on our website at transcat.com. The slides that accompany today's discussion are also on our website.

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

I'd like to point out as well that during today's call, we 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 the call over to Lee to begin the discussion. Lee?

Lee Rudow: Thanks, Craig. Good morning, everyone. As in the past, I'll start with an overview of our fourth quarter and our overall performance for the year. Mike will provide a more detailed look at the financials, and then I'll wrap things up with an overview of our strategy moving forward.

Certainly, we are pleased with the strong finish to fiscal 2018 and our solid performance throughout the year. The strength of our value proposition and the effective execution of our strategic plan drove record revenue in both our Service and Distribution segments. We ended fiscal 2018 with \$9 million of operating income, an increase of 14%; adjusted EBITDA of \$16.3 million, an increase of 12.7%; and net income of \$5.9 million, an increase of 31%. Operating margins expanded 160 basis points in the fourth quarter and 30 basis points for the full fiscal year. Our fourth quarter consolidated revenue was \$42.5 million, up 10% from the same period the prior year, and fiscal 2018 consolidated revenue was \$155 million, up 8% from the prior fiscal year.

We generated strong cash flow from operations that was used in part to reduce debt by \$4.5 million, and in parallel, to launch our new operational excellence and infrastructure enhancement initiatives. As we enter fiscal 2019, we believe we are well positioned to continue to move those important longer-term programs forward.

Let's turn for a moment to our Service segment. We continue to enhance our competitive position in our Service segment by increasing both our capabilities and capacity, particularly in the highly regulated life science space. As a result, we drove significant gains in both medical device and pharmaceutical manufacturing as well as gains throughout the aerospace and general industrial manufacturing and testing market.

Our fourth quarter growth in Service revenue represented our 36th consecutive quarter of year-over-year growth, which is 9 straight years. As reported, and when normalized for the 53 versus

52-week period, we achieved our mid-to-high single-digit organic service growth target with revenue growth of 6% in Q4 and 7% for the full fiscal year.

From a productivity perspective, we continue to drive operational excellence into the organization with the development of our processes, systems and automation tools. While there was some shorter-term noise in the fourth quarter that slightly impacted the Service gross margin, we expect to see improvement in productivity as we get further down the road with our longer-term operational excellence investments. Importantly, you can see the inherent operating leverage in this segment as Service operating margin expanded 80 basis points to 11.0% in the fourth quarter.

Turning to Distribution. We are very pleased with our performance both in the fourth quarter and the full fiscal 2018 year. Our record revenue of \$77.7 million was driven by an overall strength in the U.S. industrial market and strong performance throughout our diversified channel, including core distribution and rental. Margin improvement in Distribution was driven by an increased mix of higher margin rental revenue and the successful launching of our strategic pricing initiatives throughout our core channel.

With that, let me turn things over to Mike.

Michael Tschiderer: Thanks, Lee, and good morning, everyone. Before getting into the details of our financial results in the accompanying slides, a quick reminder that fiscal year 2018 was a bit different, in that it was comprised of 53 weeks instead of the usual 52, with the extra week falling in the fourth quarter of our fiscal year. This happens once every 5 or 6 years depending on the calendar as our fiscal year ends on the last Saturday of March. The last time before fiscal 2018 that our reported fiscal year had 53 weeks was fiscal 2012, and it does not occur again until fiscal 2024. We will talk here about normalizing for the 53rd week, but it's not possible to precisely calculate the impact on revenue and costs because of the nature of our business.

Starting on Slide 4 where we provide detail regarding our revenue. We delivered record consolidated revenue of \$42.5 million in the fourth quarter, while full year revenue increased 8% to a record \$155.1 million. When attempting to normalize for the extra week, consolidated fourth quarter revenue was up approximately 4% versus fourth quarter 2017, and full year revenue was up approximately 6% compared with the prior year. That is on a consolidated basis.

The Service segment continued to perform well with normalized all-organic revenue growth of approximately 6% in the quarter and 7% for the year. Reported Service revenue increases were 12.4% for the quarter and 8.9% for the full year. This growth reflects new business from the life science space and also general industrial manufacturing. Since fiscal 2014, the Service segment has grown at a compound annual growth rate of 13%. Gross margin for the Service segment was negatively impacted by the mix of the services that we performed during the quarter, and some severe weather in March that impacted our Northeast facilities for a few days, as well as our customers, causing some delays in providing services, not a loss of business though.

Our Distribution segment also performed well this fiscal year with revenue up \$4.9 million to a record \$77.7 million. Broad-based customer demand and an extra week during the fiscal year drove that increase. Rental revenue still makes up a small percentage of the Distribution segment as a whole, but as we have demonstrated, diversification into this business has provided an attractive margin profile, and importantly, continues to differentiate us in the marketplace. Rental revenue for fiscal 2018 grew to almost \$3.6 million, a year-over-year increase of 52%. Distribution gross margin for the fourth quarter expanded 190 basis points to 22.6%, and for the full fiscal year was up 60 basis points to 22.5%.

Even with investments in our technology, infrastructure and operational excellence initiatives, our total annual operating expenses, expressed as a percentage of revenue, decreased 50 basis points to 18.3% of consolidated revenue. As a result of our prudent cost control, combined with higher sales, we saw good operating leverage in the quarter and the full year. You can see details on Slide 5.

Fourth quarter consolidated operating income increased nearly 37%, and operating margin expanded 160 basis points to 8.3%. For the full year, consolidated operating income was up nearly 14% from the prior year to \$9 million, and our operating margin improved 30 basis points to 5.8%.

Slide 6 shows our fiscal year 2018 bottom line, which was highlighted by record net income of \$5.9 million, or earnings of \$0.81 per diluted share. This was an increase of 31% over the prior fiscal year. The sharp increase in net income on both an annual and quarterly basis reflects improved operating results as well as the positive impact from the U.S. tax act enacted in December 2017.

One day before the end of our third quarter we recorded an old and new blended tax rate for the fourth quarter and full year fiscal 2018. The tax act favorably impacted our reported fully diluted earnings per share by \$0.06 in the fourth quarter and \$0.10 per share for full fiscal 2018. Looking ahead, our income tax rate for full fiscal year 2019 is expected to be in the range of 25% to 27%. This combined rate includes a full year of the lower federal rate, various U.S. state income taxes and Canadian income taxes on our Canadian operations.

Moving to 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 evaluate and compare 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.

On a consolidated basis, quarterly adjusted EBITDA was up 26% to \$5.3 million, while adjusted EBITDA margin expanded 150 basis points to 12.5%. Full year consolidated adjusted EBITDA increased almost 13% to \$16.4 million with a margin that improved 50 basis points to 10.6%. Both of our segments helped drive these results.

Slide 8 provides the detail regarding our balance sheet and our cash flow. We generated cash from operations of \$9.9 million in fiscal 2018, which was used to fund our growth-focused investments and further reduce our debt. Fiscal 2018 capital expenditures were \$5.9 million, and used primarily for customer-driven expansion of certain Service segment capabilities, including expanding our mobile calibration fleet; for RF and electronic assets for aerospace, defense and life science markets; and purchases for a pool of rental assets.

We expect fiscal 2019's CapEx to be approximately \$7.0 million to \$7.5 million. The majority of this incremental capital expenditures in excess of fiscal 2018 spend levels are largely planned for IT infrastructure investments to drive our operational excellence initiatives. Approximately \$4 million is expected to be focused on Service segment capabilities, and another approximately \$2 million is anticipated to be spent on rental pool assets. Maintenance CapEx is anticipated to be similar to this past year at approximately \$1.0 million to \$1.5 million.

At our fiscal year-end, we had total debt of \$22.9 million with \$21.3 million available under our revolving credit facility. Our debt levels are down \$4.5 million since the end of fiscal 2017, and our fiscal year-end leverage ratio also decreased down to 1.4x. We calculate this leverage ratio as our total debt on the balance sheet at a period end divided by the trailing 12 months adjusted EBITDA. Other companies may calculate such a metric differently. We continue to believe we have sufficient liquidity and dry powder for investment opportunities that meet our strategic criteria. And lastly, we expect to timely file our Form 10-K on or about June 8.

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

Lee Rudow: Okay. Thanks, Mike. Let me wrap up by taking a few minutes to talk about our ongoing strategy to emphasize the opportunities we see for our business. Our value proposition continues to be strong and unique and resonate in the market. The combination of our service and value-added Distribution business and our ability to effectively leverage their complementary nature is a big driver of our strong performance over the last couple of years, and we see that continuing. Our business development team has performed well, driving mid-to-high single-digit organic Service growth. But we

think there's a real opportunity to get even better and to take more market share. As we have recently talked a lot about, the opportunity we have on the systems side is being addressed with a concentrated effort over the next couple of years to upgrade our systems and software and to drive technology as a competitive advantage. Over time, we expect the investments to drive more productivity and efficiency. While it will not happen overnight, our confidence is high that we will see the anticipated mid-to-longer-term productivity improvement and associated margin expansion.

From an acquisition strategy perspective, the calibration services market continues to be fragmented. And acquisitions, both making them, and driving organic growth after the acquisition is completed, will be an important element of our growth strategy.

Our acquisition plan is supported by healthy cash flow and our demonstrated track record and expertise to effectively consolidate the service market. Our acquisition plan is both disciplined and strategic, and we believe we are the only company in our space actively acquiring with the end goal of comprehensive integration. That means we drive to execute the sales and cost synergies from the acquisitions we make, and we believe that is unique in the market. As we enter fiscal 2019, the pipelines associated with both organic and acquisitive growth are very strong.

I'll conclude by saying we remain confident in our direction and believe we will continue to be well positioned to capitalize on future growth opportunities. We also expect to be able to continue to generate positive short-term results simultaneous to better positioning the company for the longer term.

So with that operator, we can turn the call over for questions.

Operator: Our first question comes from the line of Matt Koranda with Roth Capital Partners.

Matthew Koranda: Congratulations, great quarter. I think you guys mentioned, in the Service segment, there was some work potentially delayed or pushed out due to some of the inclement weather in the Northeast. Do you have a sense for the magnitude of the revenue impact there? And then how does that sort of flow? Does it get pushed right back into the June quarter or just help us understand that a little bit more.

Lee Rudow: Right, Matt, this is Lee. Good question, but we cannot come up with an exact number. What I can tell you is that throughout maybe two or three of our Eastern region labs, there was a day or two shut down, and there were delays in pickups from customers. A lot of our customers were not open to send us equipment. We think we are in the range of \$200,000 to \$300,000 of revenue that really ends up being timing at the end of the day. But the way that works is, of course, the fourth quarter is our strongest quarter and March is our strongest month within the quarter, and everything builds. So when we lose our productivity in that last week it has that kind of an impact. We would expect to see a comeback. But the way the business is generally put together, that tends to flow through and drop right to the bottom line. So that is what we meant by noise in some of the margins, as fourth quarter kind of came to a close. But I see this as timing for the most part.

Matthew Koranda: Got it. Okay. That is helpful, Lee. And then in terms of mix of in-house versus outsource revenue in the Service segment, was that what impacted margins in the quarter? I think you guys mentioned some unfavorable mix, was there anything else to call out?

Lee Rudow: I would say that when we talk about unfavorable mix, it's a combination of things. Outsourcing does play a role, and that number can go up and down throughout the year, but it tends to stay pretty consistent over the longer period of time. When we talk about mix, we are also referring to the blend between on-site services, permanent on-site services, and core depot work, and that can change month-to-month or quarter-to-quarter. In any given period of time, you can see some basis point fluctuation due to any one of those three things, or a combination of all of them.

Matthew Koranda: Okay. Got it. That is helpful. I noticed the incremental operating margins though in Service were pretty strong. I think, they were flowing through basically like 25% incremental margin. Is that sort of the way to think about the margin expansion opportunity as we head into fiscal '19? I just wanted to get a sense for how you guys are thinking about the margin expansion opportunity in Service.

Lee Rudow: When we talk about the margin expansion opportunity in Service based upon the investments we are making for efficiency and productivity, operational excellence, we are really looking more at the gross line. I think over time, we will see it in both the operating and the gross line. You're going to see it in the operating line when we acquire companies and we integrate these companies. Our operating margin will tend to expand because, of course, we actually operate these companies, for the most part, with the infrastructure we have in place. There are some step function adds along the way. It's the gross margin where you're going to see the company get more effective and more efficient at what we do, as the automation kicks in, and some of the operational excellence. So I would say, gross margin is what we are looking for over a longer period of time, and I would anticipate that you would see that in fiscal '19 as well.

Matthew Koranda: Got it. Any color on just the programs you have in place for this coming year in terms of operational excellence, and what you've got in store?

Lee Rudow: I can give you some color. We are working to automate some of our critical processes. By automation, we mean the length of time it takes to actually do a calibration has decreased by the fact that you push a button and it runs through a sort of program environment versus a manual one. That is one example. We are working on different modules as adjuncts to our current system to help us price and quote more effectively. In the shorter period of time, we have customer requirements, which we call special handling. We are working on modules to allow us to understand special handling needs in a more appropriate time frame, and as needed. This helps us with the integration of acquisitions. This even helps us in getting our core customers work through the system. And there are a myriad of additional programs that we are working on. We have a matrix, what we call our engine, which really tells us what we can do and where we can do it, what our capacity is at any given time. The flow of information through, into and out of that matrix is being improved through programming. These are the types of things that we think will impact the gross margin over time.

Matthew Koranda: Got it. That is helpful color. In terms of the acquisitions in the pipeline, is there any way to characterize the size of the concerns that you would look at, at this point in time? And do you feel comfortable that there's enough availability on the revolver to execute on those? In the meantime, while you look for those opportunities, are we going to just deploy the incremental cash flow over the next couple of quarters toward paying down the revolver? Is that how to think about it?

Lee Rudow: Right, let me address the pipeline and what we think we are going to see from an acquisition perspective. I'll let Mike chime in on the revolver and our line and cash flows. I would anticipate Matt, the type of acquisitions we are likely to be engaged with this year are going to follow the same profile as in the recent past. Our sweet spot continues to be any company that has anywhere from \$0.5 million a year up to \$5 million or \$6 million in revenue. That is still our sweet spot. Now we are more than capable of acquiring larger companies, and I think it's not unrealistic to assume that at some point, something like that could happen. And we are always looking for larger deals. There are regional players and national players. But there are not as many of them, so those opportunities do not come about as often. But in the meantime, the pipeline is pretty full with opportunities that fit our sweet spot as it has in the past. I would anticipate that same profile and size is what you'll see in the near future.

Michael Tschiderer: Yes, and as far as funding Matt, it probably would be, in the short term, more of the same. We generate cash flow, we would use it for CapEx and to pay down debt. We have about \$22 million availability under the revolver for acquisitions, with pretty flexible terms as far as what can be used for acquisitions. And do not forget, if we ever had something that was a game-changer, we still have a \$50 million shelf out there too. That is sitting there in case we wanted to look at something from the equity side versus the debt side. But we think we have plenty to do, based especially on the kind of things that we will be looking at, which like Lee indicated, it's kind of that bread and butter of smaller segments.

Matthew Koranda: Okay. Very helpful, guys. One more from me, and then, I promise, I'll jump back in the queue here.

On the Distribution side, my question really centers around rental opportunity and then the revenue there. Is there kind of a rule of thumb for the growth that \$2 million in CapEx could potentially drive

for you guys in fiscal '19? I mean, is the rule of thumb something like \$2 million in CapEx drives \$1 million of incremental rental revenue or something like that? Shorthand would be helpful for us.

Michael Tschiderer: Sure. Yes, there are kind of some rules of thumb, even though we are still breaking the mold a little bit because of our rapid growth. We are certainly not in at steady state yet. We can look at the growth we have had over the past few years and the CapEx we spent on that. When you compare to the \$2 million that we have kind of slotted for rentals this year, you would expect growth of probably not at the 52% that we had now, but it could be more of a 30% growth. So 30% on top of \$3.6 million is \$1 million. So it's probably close to what you are kind of noodling around. I would say, it's probably a little bit closer to \$1.5 for \$1 of revenue. Not 2 for 1 like you were just kind of throwing out there.

Operator: Our next question comes from the line of Dick Ryan with Dougherty & Company.

Richard Ryan: Congratulations on a good quarter guys. Lee, on your commentary around share gains within the Service sector, can you give us a little more color on that? Is that across all the revenue buckets or anything in particular within Service?

Lee Rudow: Dick, it is across several buckets. As I mentioned in the narrative, we definitely have had some significant gains and wins relative to the pharma world and medical devices. And these are net new companies to us of a significant size, and also some growth from our existing customer base. When I talk about the opportunity to get better on the business development side, I'm talking primarily of getting more out of our current customer base. We think we have got a real good system that we have deployed recently and it's showing some significant early gains, and we like that. I think, you'll see more of that. We also have had a number of wins in the general industrial and aerospace markets, which, if you recall, we anticipated was going to happen because we made some investments in the high-end RF and electronic capabilities the prior year. So we did see that coming, and we saw our ability to compete in that space get better. When it gets better, and you see it coming, you ought to execute against it. We have done pretty well. It does go across, and it's more diversified. In the past, we were particularly strong in life sciences. That is going to continue by design. But I think we have done a nice job this year in general industrial manufacturing and some of the high-end electronic arenas that we invested in to compete.

Richard Ryan: Great. Do you have a breakdown of what life sciences has contributed to the Service? I think it was like 43% last year.

Lee Rudow: It was 43% last year. I think it's going to be close to that. It may even actually go down a percentage or 2. I'm not 100% sure. Maybe Mike has some commentary. Looks like some of our growth has come from outside.

Michael Tschiderer: Yes, I think it will be pretty close. And I think some of that growth has been kind of in parallel steps. I'd expect it to be within a point, either direction of that 43%.

Richard Ryan: Okay. And with the new hires that occurred over the last year, where are they on the productivity ramp? Has that pretty much worked its way through?

Lee Rudow: Yes, I think the new hires that predominantly came in the first quarter have worked their way through to become more productive. As we talked about, Dick, it takes a couple of quarters to get these guys up and running. But they'll continue to get better over a period of a couple of years. So there's continual improvement with this group. I think the challenge moving forward will be to have the right number of technicians for the growth we anticipate. Getting them in on a timely manner is always tricky. But we try to learn from the past and get better in the future. Our ability to do that well will be seen in the margin.

Richard Ryan: Okay. And on the oil and gas side, is that just the service sector impact? Or is it distribution on that as well? And what are you seeing with the bump in oil prices here?

Lee Rudow: Right, so it will be seen in both segments, but primarily in Distribution. We sell a lot of instruments into the oil and gas market, upstream, midstream, downstream, so that should be favorable. We also see it almost with a lagging sort of impact and effect, in the Service business as well. So rising

oil prices can only be good for us and that is the way we look at it. After 2016, we are certainly in a much better position today if there would be softness again. You always have to anticipate that, but I think, it is favorable going forward.

Operator: Our next question comes from the line of Christopher Hillary with Roubaix Capital.

Christopher Hillary: You mentioned in your prepared remarks that you saw some opportunities for strategic pricing. Could you share some more thoughts you have on that?

Lee Rudow: Sure. That is primarily today on the Distribution side of the business. What we were able to do over the last year is create a program that provided more details than we have had in the past on price points that we sell our Distribution products on. For example, if something were to remain in inventory beyond a certain time period, or we were to lose a certain number of quotes at a certain price point, we'd have greater visibility than we have had in the past to adjust that. That is really helpful tool that has allowed us to make some moves that have helped the margin in the past couple of quarters. I see that continuing. I also see that as a tool that, over time, could be used in our Service segment as well.

Michael Tschiderer: Yes, and I think the key to that is the quote piece. Because the ones we sell, well, those are the ones we know about. The especially interesting piece, are the ones we lose, and why did we lose those. Is it pricing? Is it a mix? Being able to compare that data is very helpful. If you have a quote and you have it in stock, what does that mean compared to the data you're able to get for pricing. We are able to kind of adjust on the fly based on what we are seeing for demand rather than just looking backward at known results.

Lee Rudow: And it clearly falls into the operational excellence initiatives that we have been pushing for the last year or so.

Christopher Hillary: Okay. And then, you also mentioned there might be some opportunities to go from the mid-single to high single-digit growth. Is there something in particular that would drive that potential higher growth rate that you're seeing as you start the year?

Lee Rudow: Are you talking about in the Service segment growth? I'm assuming.

Christopher Hillary: I think so. Again, it was in your prepared comments about you have the chance to push it up to that high single?

Lee Rudow: Correct. I would go back to some of the leadership that we brought into the company in the last year or so, and the way we are approaching trying to maximize the growth from our current customer base, in combination with new customers and our new capabilities. As we have expanded our capabilities, Christopher, over the last year or so in the high-end electronics and we have a new Senior Director of Business Development we have hired. Incrementally, the combination of our capabilities, the way we are going to market, the leveraging of our current customer base, I think, it's a combination of all those things and our current pipeline that leads us to believe that we have room to get better and increase our business. We are comfortable with mid-to-high single digits, but there's a range there, and I see us driving towards the higher end of that range. We certainly have the ability to do that.

Christopher Hillary: Okay. And then one last sort of top-down question. There has been some signs, macro-wise, that there could be a better environment for capital spending and investment here in the U.S. Capital stock, and then obviously, there are some incremental incentives from the higher cash flow from the lower tax rates and the incentives on depreciation. Any chance that you see a combination of those things specifically driving some business? Or does that remain sort of a big picture thing that does not quite show up on the day-to-day?

Lee Rudow: It's hard -- Mike can explain. The thing is, it's hard to know for sure, but I would anticipate just using reasoning and common sense that the more capital our customers have, the more they will invest. The more that is invested in tooling, processes, and increasing manufacturing bodes well for our business. I think it's going to be an impetus to growth. The timing on that, the exact numbers are hard to give out, but I see it as a positive.

Michael Tschiderer: Yes, it is. You have to connect a few dots. Intuitively, it makes perfect sense that if there is cash available and companies are spending it, whether it be for CapEx or if they are investing it in their plants or people or something, it's going to get more business to us. I think we will probably see that in hopefully continued strong U.S. industrial output and sector productivity warnings.

Lee Rudow: We keep a close eye on U.S. industrial output and that tends to be an early indicator of how both our segments may do.

Michael Tschiderer: Yes.

Operator: There are no further questions at this time. I'll turn the floor back to management for any final comments.

Lee Rudow: Okay. We certainly appreciate everybody participating on the call today and your ongoing interest in Transcat. Feel free to reach out to us if you have any further questions. We are certainly available and make ourselves available, and we will talk with everybody again after our first quarter results are released. Again, thanks for your time. Take care.

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