

Operator: Greetings. Welcome to the Transcat, Inc. Third Quarter Fiscal Year 2021 Financial Results Conference Call. [Operator Instructions] Please note that this conference is being recorded.

I will now turn the conference over to your host, Craig Mychajluk, Investor Relations for Transcat. 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 today we have our President and Chief Executive Officer, Lee Rudow; and our Chief Financial Officer, Mark Doheny. After formal remarks, we will open the call for questions. If you do not have the news release that crossed the wire after markets yesterday, you can find it at our website at transcat.com.

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

I'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.

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

Lee Rudow: Thanks, Craig. Good morning, everyone. Thank you for joining us on the call today. Some of you have already met and spoken with Mark, but being that this is his first earnings call with Transcat, I'd like to introduce him before we move on to the third quarter results.

Mark was named CFO in November, succeeding Mike Tschiderer, who retired at the end of the calendar year. The transition went very smoothly. Mark is well versed in our business and strategy and is an excellent addition to the executive team. We anticipate Mark's extensive background in M&A and operations will be of great value in the execution and acceleration of our strategic plan, including the continued investment in technology and technology-based infrastructure.

Turning to our third quarter results. We are pleased by our performance, especially given the continued adverse conditions caused by the COVID-19 pandemic. The team's responsiveness and dedication throughout the pandemic has been impressive, and the business continues to effectively provide critical support and service to many essential businesses, including the research, manufacturing and distribution of the COVID-19 vaccine.

In the third quarter, we achieved consolidated top line growth, driven by 12% growth in our Service segment, 5.9% of which was organic. This growth represents our 47th consecutive quarter of year-over-year Service growth. That is nearly 12 years. The business continues to demonstrate resiliency and our unique value proposition continues to resonate. Pipettes.com, which we acquired in February last year, continues to perform well. And together with the recently acquired BioTek Services has strengthened our life science service portfolio and geographic footprint. It is our expectation that the two complementary businesses will be integrated quickly and achieve both sales and operational synergies over the next several quarters.

The Service segment continues to deliver outstanding margin performance. In the quarter, gross margin increased 590 basis points, and operating margin increased 570 basis points. The increase in Service margin was primarily driven by higher technician productivity and operating leverage on organic service growth.

Distribution revenue was down 8.6% versus the prior year. We anticipate that Distribution will continue to be negatively impacted by the current pandemic. Our focus will remain on capitalizing on our unique position in the market by leveraging every distribution interaction and every distribution lead to organically grow our Service business. On the rental front, the channel performed very well, up 12% in the third quarter.

Operating income for the third quarter exceeded expectations and increased by 20% over the same prior-year period. To date in fiscal 2021, we have achieved outstanding cash generation of \$15.6 million, driving the reduction of debt, supporting continued investment in technology, infrastructure and growth opportunities.

And with that, I'll turn the things over to Mark.

Mark Doheny: Thanks Lee and good morning, everyone. It is great to be with you all today, and I hope that you are keeping safe and doing well. I am certainly excited to have joined the Transcat team at such an exciting time in the company's history, and I look forward to contributing to our continued growth and success.

I will start on **Slide 4** of the earnings deck, which provides detail regarding our revenue on a consolidated basis and by segment. Consolidated revenue of \$44.1 million was up 2% from prior year, and we showed growth for the first time this fiscal year, a notable achievement given the ongoing impact of the pandemic.

Turning to the segment performance. As Lee mentioned, strong Service segment growth of approximately 12% was one of the highlights of the quarter, with about half of that segment's growth coming organically and the other half from acquisition growth.

With regard to the acquisition growth, about \$1.3 million of revenue came from pipettes.com and a little under \$100,000 came from BioTek. As you know, BioTek closed toward the end of our fiscal quarter. I will mention that we are approaching the one year anniversary of our acquisition of pipettes.com, which was acquired on February 21 of last year. This will, of course, impact the level of our year-over-year acquisition growth beginning in our fiscal fourth quarter.

Turning to Distribution. Segment sales of \$19.3 million were down approximately 9% from prior year, which was in line with our expectations. As Lee mentioned in his opening remarks, this segment continues to be significantly impacted by the pandemic as certain end markets continue to be soft.

Turning to **Slide 5**. Our consolidated gross profit was up 13% from prior year, and our gross margin expanded 250 basis points to 25.5%.

Service was up an impressive 590 basis points to 27.9% on continued traction from our technician productivity initiatives, tight cost controls, operating leverage on our costs that are more fixed in nature, as well as strong performance at pipettes.com, which has a higher-margin profile.

Distribution segment gross margin was down 150 basis points from prior year, which reflects the lower volume and reduced co-op advertising and rebate programs as vendors continue to look for ways to lower their costs.

Turning to **Slide 6** and our overall operating performance. Consolidated operating income of \$2.5 million was up 20% from prior year and exceeded our expectations. Service segment operating income increased over \$1.5 million and expanded 570 basis points as a significant portion of the gross profit increase fell through to operating income.

Distribution operating income of \$0.6 million was easily our best quarter of fiscal year 2021, but was still down \$1 million from the prior-year quarter, largely on the lower gross profit.

Turning over to **Slide 7**. Third quarter net income increased 19%, and our diluted earnings per share of \$0.23 were up \$0.03 from prior year, a result of our strong operating performance. Our effective tax rate was just north of 23%, and we continue to expect our full fiscal year tax rate to range between 22% and 23%, which includes federal, various state and Canadian income taxes.

On **Slide 8** is where we show our adjusted EBITDA and adjusted EBITDA margin. Among other measures, we use adjusted EBITDA, which is non-GAAP, to gauge the performance of our segments because we believe it is a good measure of our operating performance and our ability to generate cash. A reconciliation of adjusted EBITDA to operating income and net income can be found in the supplemental section of this presentation, which, as a reminder, is posted on our website.

Consolidated adjusted EBITDA was up 12% in the quarter, and our adjusted EBITDA margin was 10.4%. We were particularly pleased with the Service segment's 80% increase in adjusted EBITDA to \$3.4 million or 13.9% of sales.

Moving to **Slide 9**, where we provide some detail regarding our cash flow. Year-to-date net cash provided by operations nearly doubled to \$15.6 million and was a function of our improved EBITDA and reductions to working capital. Year-to-date capital expenditures were \$4.3 million, and were largely focused on technology infrastructure, Service segment capabilities and rental pool assets.

With regard to capital expenditures, we now believe our full fiscal year 2021 CapEx will be in the range of \$6.0 million to \$6.5 million, which is a more narrow band versus the \$5.5 million to \$6.5 million range we had communicated at the end of our fiscal second quarter.

Slide 10 highlights our strong balance sheet. At quarter end, we had total net debt of \$23.4 million, which was down \$6.4 million from fiscal 2020 year-end. With this reduction, our leverage ratio also came down and was 1.24. This is calculated as the total debt at the period end divided by the trailing 12 months adjusted EBITDA, including giving credit for any acquired EBITDA. We had \$26.8 million available under our revolving credit facility at the end of the quarter.

Lastly, we do expect to file our Form 10-Q tonight after the market closes. And with that, I will turn it back over to you, Lee.

Lee Rudow: Thank you, Mark. As we progress through the fourth quarter and into fiscal 2022, we will continue to focus on the execution of our strategic plan. We expect the combination of mid- to high single-digit organic growth and acquired growth to drive overall double-digit Service growth. Consistent with our strategy, we expect the bulk of our Service growth to be generated in regulated industries, including life sciences, and aerospace and defense.

Throughout fiscal 2021, operational excellence and technology have helped drive significant improvement in our Service gross margin. We expect the margin expansion to continue over time as we increase the level of technology, including automation into our network of 42 calibration labs.

We also expect emphasis to continue on the development and acquisition of talent across all levels of the organization to shepherd Transcat through our next phase of growth.

And I will close with an update on our acquisition program. As anticipated, our M&A pipeline is very active. Our acquisition objectives are supported by a strong balance sheet and our ongoing investments in the development of integration tools. Both will enable us to execute and capitalize on an increased number of opportunities going forward.

While we are seeing some upward trend in historical multiples, there is no shortage of opportunities that are within parameters we believe are competitive, accretive and offer attractive internal return rates.

As we stated in our earnings release, we expect consolidated operating income in the fourth quarter of fiscal 2021 to be similar to the fourth quarter of fiscal 2020. Our stability and strong performance in an environment that continues to be challenging, reinforces our strong position in the markets we serve.

Looking ahead, we believe the combination of our talented team, our strong balance sheet and our demonstrated ability to execute our strategic plan positions Transcat to perform well as we drive hard to the finish line in fiscal 2021 and beyond.

Operator, with that, we can open up the line for questions.

Operator: [Operator Instructions] Our first question is from Greg Palm with Craig-Hallum Capital Group.

Greg Palm: Congrats on the good quarter. So maybe we start with the Service segment and the return to organic growth. Curious if you can maybe go into a little bit more details on the primary drivers of that? I mean is it outsized growth in life sciences? Is it just a continued recovery elsewhere? Maybe there is some share gains in that?

Lee Rudow: Yes, Greg, I think it is kind of a combination. I would characterize it as some flow-through on pent-up demand. The first crop of quarters in service were more flat. We knew we had a nice pipeline. We were having good conversations. So some of that flow through came about and general sales level activity has increased. Our pipelines are solid on the organic side of the business. And I'm not at all surprised that in this fiscal year we would see some of that growth. So I think you will see it continue for the most part, in the next few quarters. But that's how I would characterize it.

Greg Palm: Yes. Do you get the sense that there is still a decent chunk of pent-up demand out there? And I guess, what's your confidence level that you can sustain this kind of mid- to high single-digit organic growth rate, even in sort of a challenging and volatile end market scenario where we're still in?

Lee Rudow: Yes, I think it is relatively high. I mean the one thing that leads me to make that kind of comment is we have a number of large opportunities that have been working their way through the pipeline throughout the pandemic. While we won a number of them, they are still an interesting number of opportunities still out there. I think we are going to win our percentage of those and we have a high confidence level. And that, in addition to pent-up demand and in addition to just general levels of calibration picking up based upon pipeline activity. I think the combination of those three things drive our confidence level and make the statements we do around the organic growth.

Greg Palm: Okay, good. Last one; we are almost a year into this pandemic and I'm curious what sort of long-term trends are starting to emerge within service? I am thinking along the lines of maybe there is more pickup in delivery versus periodic on-site or in-house. So I am just kind of curious how much of some of these new trends that might stick? And what are the P&L implications, if any?

Lee Rudow: It is an interesting question. I am not ready to comment on any long-term changes as a byproduct of the pandemic. I mean we have all learned to manage our businesses accordingly. There have been less on-sites, even less pickup and delivery, more people sending stuff to us, and I think we are going to return to normal rates in time. And the one thing that we didn't see this year was the trajectory continue on our growth in CBLs. We had a two-year period, as you recall, Greg, where we landed a healthy number of new CBLs, client-based labs, and they are larger opportunities. While they are in the pipeline, they just virtually stopped during the pandemic. That I would anticipate would return at some point in the near future. And so other than that, I think the business will return to a normal state at some point. No long-term lasting effects that I would identify today.

Operator: And our next question is from Kara Anderson with B. Riley Securities.

Kara Anderson: I jumped on a little bit late. So sorry if you already discussed this. But can you talk about the nature of the BioTek acquisition and how it seemed to be? Why you saw that small company as an attractive calibration service?

Lee Rudow: Absolutely. The best place to start is with pipettes.com. About a year ago we acquired that business in February. Basically both companies, BioTek and pipettes do pipettes, not exclusively, but it is the lion's share of the work that they produce.

The difference between them and why we were interested in BioTek is because pipettes.com is generally a Boston-based operation that does most of its work in the New England region and does very little, if any, on-site work. If people want to send pipettes from anywhere in the country, they can send to them, but most of their work comes from New England.

BioTek is a small company, you are right, but the entire company is based on on-site services for pipettes. So when you look at the sort of road map and you say, well, if we can combine the BioTek on-site service with what we call the depo, New England-based pipettes.com, you've really got a powerful combination. And that's why we talk about sales synergies and getting to them fast.

And there's even cost synergies in this one because you're going to combine these operations, and there are probably some redundancy in the administration of the combined business. So it was small and we never would have bought it as a stand-alone but as a bolt-on to pipettes.com makes a lot of sense for us.

Kara Anderson: And are there any other technical capabilities that you are looking for, where you can do these kind of acquisitions where you just find other ones to build on and you just build out a new category, if you will?

Lee Rudow: One of our three drivers when we look at acquisitions in general is to increase our capabilities or bring on expertise we don't have today. That is a main driver in addition to expanding our geographic footprint, and just in general, bolting on operations when they are close in vicinity of an infrastructure that we already have in place.

So yes, there is a list, and it's not appropriate to go into the details on this call, but you have got disciplines and variables and parameters that we do not measure today that we actually outsource. We have about 85% to 90% of our own work, but we still outsource, Kara, about 15% of that work. And all calibration companies do that. Nobody does 100% because the economies of scale and such.

But yes, I would think that we always look at that list whether it's flow or different technologies that are new that come out, we always want to look to bring them on board and make them core. One way to do that is through acquisition, when it makes sense.

Kara Anderson: Got it. And then just one last relatable question about M&A. Are you seeing a change in the size of opportunities at all?

Lee Rudow: So a part of our pipeline, which I alluded to on the call, is very robust. Part of that pipeline, I would characterize as fitting sort of our core historic pipeline, our sweet spot, much of the same, if you will.

I would also say that what makes this pipeline a little bit different is we are starting to see activity levels and opportunities present themselves at sort of the next level upstream in terms of size. That is something we thought that we would encounter. And in fact, we are. So it's kind of a combination of the historic sort of pipeline and trends and some new somewhat larger opportunities as well.

Mark Doheny: And just to add to that, adding Jim Jenkins four months ago to really dedicate a lot of his time to developing that pipeline and the relationships that we need to has really improved the pipeline and a lot of areas, even in the last 120 days since I've been here, Lee.

Lee Rudow: Good timing with the market making that investment.

Operator: And our next question is from Scott Buck with H.C. Wainwright.

Scott Buck: Lee, you mentioned earlier in the call the kind of mix in the Service segment between mail-in and on-site. Can you remind us what the margin differential is between some of those different components?

Lee Rudow: The largest, in terms of profitability and the profile that is most attractive to us is our depot work. We call it in-house or depot, and that is when a customer, Scott, sends their equipment to us because there is very little incremental cost. Just imagine 10 units coming into a lab. You do not have to spend capital. You do not have to hire people to do it, it kind of flows through at that high incremental tech revenue.

Another service level we have is pickup and delivery. That work is picked up at the customer's location and brought back to the lab. So that does have the same profitability profile to the in-house work, except we have to go pick up and deliver, so additional increased costs to get that done, but not a lot.

Then we have on-site work, where we send a crew of people and a pool of assets to a customer's location. These are periodic on-sites, it might be 3 technicians for a week or it might be one technician for a day. It really varies. But you have your assets sort of isolated and captive to that customer at that time. And you've got technicians out doing the work. So that profile is a little bit more expensive, but something we're always interested in and one really important way to grow the business.

Then we have client-based labs. This is where we have our technicians 3, 4, 5, 10, sometimes 15 technicians that show up every day at a customer's location. That is where they work. They very rarely ever go to a Transcat core lab. And we have assets there. Sometimes it is a customer's asset, sometimes we own the assets. That's high-volume work. Many of these are high six figures into seven figures. The margin profile is a little bit less by a couple of hundred basis points, but it is a very sticky part of our business, high lifetime value. In fact, to date, in the 8 or 9 years I have been here, we have never lost one of these client-based labs that we started. And so you exchange a little bit of margin for that stickiness over time. Those are the four main service levels and the margins associated with it.

Scott Buck: Great. That is very helpful. Second, how do you think about long-term margin targets in the Service segment? I know you are undergoing some technology improvements and additional automation. Over the next five years, can margins in this segment get to mid-30s?

Lee Rudow: I think mid-30s is not an unreasonable target at this point. We started this campaign of margin improvement in technology back when we were; I want to say it was 24% gross margin. We talked about a two to three year journey, or several year journey to get closer to 30%. And so we are there. It will not be every quarter that we are 30%. We have done higher, while this past Q3 a little bit lower, but we are in that range.

I think when we look at the business and the margin profile and what we have on top in terms of investments, I think we are thinking the same as you suggested. Mid-30s is not unreasonable. It is not going to happen overnight. It is not going to happen every single quarter. But I think we'll be up and to the right, heading to that range over the next couple of years, for sure.

Operator: And our next question is from Mitra Ramgopal with Sidoti.

Mitra Ramgopal: First, I just want to get a sense, Lee, as you talked about the investments you are making in technology, how far along are you on that front in terms of where you would like to be? And as it relates to adding technicians, how has the market been in terms of being able to recruit without having to necessarily overpay? And is it really a reflection of the visibility or the comfort you have in the business as you look out over the next couple of years in terms of making these additions.

Lee Rudow: Well, from a technology perspective, Mitra, we have been on a three-year journey of starting from an infrastructure that really lacked some of the technology advancements that we needed. We have been working day and night to catch up, and I think the team has done a really good job. We have hired some really good people who have a good idea of where we are, where we need to go and

how we are going to get there. So I've been very impressed with the team effort around technology, but there is still a lot to do.

Yes, we love the margin improvement. We love some of the tools that we have built for integration. But if I were to use the analogy of a baseball game, I'd say, we are probably in the fourth inning at best in technology, so a lot of upside there, and we're looking forward to it.

Technician availability, well, with flat organic growth for the first couple of quarters we certainly were not aggressive about going out and getting technicians. We had the right number. We had the capacity to service that work.

The pipeline is healthy. We saw organic growth in the third quarter. We anticipate organic growth for the most part going forward, so we will need to hire technicians at some point. I think that is perfectly fine. That is part of our game plan to do so.

I am not worried about the long-term organic growth potential of the business so that it would hold me back from hiring. I think we will hire as appropriate to manage the growth. I think the type of tools we have in technology in place today, there is a lot of data that we didn't have a couple of years ago around productivity, capacity planning, and these are the tools we talk about.

This is where you see the margin enhancement. But these tools also help us identify when and where to put technicians and at what is the optimal time to do that. That data availability has helped us make those decisions, so we have a high level of confidence we will get it right.

Mitra Ramgopal: Okay. And then quickly on the life science business. I was just wondering if you are seeing any heightened interest or conversations because of the pandemic maybe driving, given development for vaccines and other things. Just curious if you are getting any tailwind out of that.

Lee Rudow: It is difficult to tell because we were always life-science oriented. We do business with most pharmaceutical companies and med device, that is always part of our normal business. But I understand what you are asking, Mitra. I would say for the most part, the sort of stable environment in terms of revenue this year, it is just been core life science business.

No question we are dealing with pharmaceutical companies that are involved with vaccines. But I don't think it's been all that much in terms of incremental. I think it is just the business that we do. These companies have held up. These companies have been stable and resilient, and so we have been stable and resilient.

I think when COVID passes and we get beyond it, I think its upside for our business because the general industrial market is going to open back up. So we've done really well in life sciences, but I think there is upside to the general market returning.

Mark Doheny: And I would just mention, too, there is pockets within life sciences, for example, the pipettes.com business, that's definitely been impacted in a very favorable way over the last 11 months since we have owned them. So we have pockets of it.

Operator: And our next question is from Dick Ryan with Colliers.

Dick Ryan: Lee, switching to maybe distribution, are you seeing any opportunities in that part of the business? I know oil and gas has been negatively impacted, but are you seeing any positive or any suggestions of positive momentum emerging?

Lee Rudow: Moderate at best. We do see a little bit. We actually had a lot of back orders leaving the third quarter and entering the fourth quarter that sort of COVID-related supply chain slowdowns. Some of that will help the fourth quarter. But your question is more about the general environment.

I think there will be some pent-up demand on the industrial side for distribution, but it is not like we've seen a ton of it yet. We do anticipate it coming. The business has been what it has been, off single digits

now from last year, but it is stable. And we're going to continue to leverage those interactions. That is really what we focus on, Dick.

Dick Ryan: Okay. Maybe one Mark's direction. OpEx, you probably had some savings early on with less travel and other pandemic limitations. Are any of these costs kind of coming back into the fold, and maybe how should we look at OpEx going into fiscal '22?

Mark A. Doheny: That is a great question. We spend a lot of time on understanding, especially the service gross margin, as an example, how much is sustainable and how much could potentially be, hey, we are not traveling as much. Maybe we are not spending as much in certain areas. There is a little of that going on, I would say. When we do start traveling again, there will be some costs, but it is really not meaningful.

Going into next year, yes, you could see a little bit of an uptick in some of those sort of discretionary costs, travel probably being the biggest one as we get to a normal operating environment. But it is not something I would highlight as a big driver of our operating income and gross profit improvements. That is how I would answer that.

Operator: [Operator Instructions] And our next question is from Chris Sakai with Singular Research.

Chris Sakai: Just had a question on distribution gross margin. I wanted to know if you could shed some light on when you might see some improvement.

Mark A. Doheny: That is a tough one to call. You have a couple of things happening there. Of course, the lower volumes, which we talked about due to the market and our vendors have reduced their co-op advertising and rebate programs as well. So we are working closely with them. When you look at the year-over-year change in margins, that is the biggest contributor to the decline.

So depending on how things progress with the pandemic, it is tough for us to plan any big bounce backs on that at this point. I know our teams on the distribution side are working closely with the vendors to see what opportunities there are that would help the margins.

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

Lee D. Rudow: Okay. Thank you all for joining us on today's call. We appreciate your continued interest in Transcat. Feel free to check in at any time with me or with Mark. We look forward to talking to everybody again after the fourth quarter results come out. Again, thanks for participating.

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