

## Operator

Greetings, and welcome to the Transcat, Inc. First Quarter Fiscal Year 2022 Financial Results Call. 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 markets 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. 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. 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. So, with that, I'll turn the call over to Lee to begin the discussion. Lee?

## Lee Rudow

Yes. Thank you, Mark. Good morning, everyone. Thank you for joining us on the call today. In the first quarter of fiscal 2022, we got off to a very strong start, achieving excellent results across all our key metrics.

As I walk through the highlights of the first quarter, in addition to the prior year comparisons, I'm going to compare our current performance to the first quarter of fiscal 2020 prior to COVID to

provide additional insight and context to our current performance. Let's get started. Our broad-based performance was driven by consolidated revenue growth of 23%, a first quarter record for Transcat. The quarter was highlighted by our Service segment, which continues to perform at a high level. Organic Service growth was roughly 17% as we continue to capture market share in a highly attractive, highly regulated life science market.

Throughout the pandemic, the life science market remained resilient and continues to be strong. Compared to the first quarter of fiscal '20 prior to COVID, organic Service revenue increased 12.5%. The second quarter represented our 49th straight quarter of Service growth. We also delivered outstanding margin performance in the quarter. Gross margins for Service increased 540 basis points to 31.8%.

The margin improvement is a testament to our focus on continuous process improvement, productivity and more than anything else, inherent operating leverage in our Service business as organic revenue volumes increase. Compared to fiscal '20 first quarter, prior to COVID, Service gross margins improved by 780 basis points.

Moving to Distribution. Reported revenue was up 27% on improving market trends and favorable comparisons to a significantly COVID-impacted prior year first quarter. Distribution gross margins also improved to 23.6%, a 260-basis point expansion from the prior year.

The expansion was driven largely by favorable product mix. Strong performance across both Service and Distribution led the first quarter adjusted EBITDA of \$6.1 million, up 75% from the prior year and up \$2.2 million or 55% from the first quarter of fiscal '20, again, prior to COVID. Our balance sheet remains strong with a leverage ratio slightly under 1. And it's important to note that in the quarter, we amended our credit facility to increase our revolving line of credit from \$40 million to \$80 million with very favorable terms. The increased revolver provides more flexibility to support the execution of our strategic plan, which includes capitalizing on the robust acquisition pipeline we have developed over the past couple of quarters.

All in all, our first quarter results demonstrate the talent and commitment of our team, the continued strength of our unique value proposition and the attractiveness and resiliency of the markets we serve. With that, I'll turn things over to Mark.

## **Mark Doheny**

Thanks, Lee. I will start on Slide 4 of the earnings deck, which provides detail regarding our revenue on a consolidated basis and by segment for our first quarter. Consolidated revenue of \$47.8 million was up 23% versus prior year on broad-based strength across both of our operating segments. Service segment revenue growth of 20% was stronger than we expected with 16.6% of the growth coming organically and the other roughly 3% from acquisition. As we mentioned, our highly regulated end markets, including life sciences, remained very strong.

We also saw improving trends with our customers more exposed to industrial markets and our growth level was also helped by an easier comparison to a COVID impacted prior year. Turning to distribution, revenue of \$20.2 million was up 27% versus the prior year. As Lee mentioned, we

saw improving market conditions and the recovery in our base business was the primary driver for the significant year-over-year increase. Turning to Slide 5.

Our consolidated gross profit of \$13.5 million was up 44% from prior year our gross margin expanded 410 basis points to a first quarter record of 28.3%. Service gross margin was up an impressive 540 basis points to 31.8% as we experienced significant operating leverage on our fixed costs from the high level of organic growth and our technician productivity remained strong. Distribution segment gross margin was up 260 basis points from prior year and as we mentioned, a more favorable sales mix.

Turning to Slide 6. Consolidated operating income of \$3.7 million was up \$2.7 million from prior year. Service segment operating income increased to \$1.9 million and operating margin expanded 590 basis points as a significant portion of the gross profit increase fell through to operating income. Distribution operating income of \$0.7 million improved by \$0.9 million from prior year, which was significantly impacted by the onset of the COVID-19 pandemic.

Turning to Slide 7. Q1 net income of \$3.7 million increased \$2.9 million from prior year, and our diluted earnings per share of \$0.49 were up \$0.38 from prior year, a result of the strong operating performance. The first quarter also included a favorable discrete tax benefit due to tax accounting associated with share-based awards and stock option activity. With this in mind, we now expect our full year fiscal 2022 tax rate to be in the range of 16% to 18%, which is down from our previous expectation of 20% to 22%.

Flipping to Slide 8, 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 the best measure of our operating performance and 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. Consolidated adjusted EBITDA of \$6.1 million was up 75% from prior year, and our adjusted EBITDA margin increased to 12.8%. Both segments showed strong improvement from prior year, and we were particularly pleased with our Service segment adjusted EBITDA margin, which increased 460 basis points to 17.1%.

Moving to Slide 9. Cash flow from operations, while down \$1.9 million from prior year was in line with our expectations as we paid out certain performance-based accrued employee expenses and working capital increased on the strong organic revenue growth. First quarter capital expenditures were \$1.2 million, and we continue to expect our full year fiscal 2022 capital expenditures to be in the range of \$7.5 million to \$8.5 million.

Slide 10 highlights our strong balance sheet. At quarter end, we had total net debt of \$21.9 million with a leverage ratio just below 1, and we had \$27.9 million available under our revolving credit facility. Importantly, as Lee mentioned, we did amend our credit facility to increase the revolver to \$80 million from \$40 million, along with certain other term adjustments, which included a reduction to the LIBOR floor on our revolving line of credit borrowings and a modestly reduced interest rate on the term loan. Lastly, we expect to file our Form 10-Q on Tuesday, August 3. With that, I'll turn it back over to you, Lee.

**Lee Rudow**

Thank you, Mark. As we look forward, we're pleased with the strength of our balance sheet, and we're pleased with the strong demand for our products and services. We expect our second quarter to be another quarter of growth in both of our operating segments. From a margin perspective, we continue to run ahead of schedule, but by all means, we will continue to leverage technology and process improvement to further gains and sustainable margins. Automation will continue to be a focus as we believe expanded use and adoption of automation will drive a defensible competitive advantage in the markets Transcat serves.

In Service, we are projecting similar organic growth as we just achieved in the first quarter of fiscal 2022. We expect Service gross margin expansion to moderate in the second quarter compared to what we experienced in the last couple of quarters as technician productivity comparisons are becoming much more challenging, especially starting in the second quarter of last year. For Distribution, market conditions improved in the first quarter, and we expect that to continue. We anticipate high teens growth in the second quarter when compared to prior year on improved market conditions and with comparisons to COVID-impacted second quarter of last year. I'd like to conclude with a few comments related to acquisitions.

At this time last year, we made a commitment to resource the development of a more active and impactful acquisition strategy. Today, we are pleased with the progress we've made which includes both the level and quality of opportunities we are currently pursuing. And overall, we think we're well positioned to continue to execute our strategy. In combination with improved macroeconomic conditions, our value proposition and leading place in the market in the industry, all of this should allow us to enhance shareholder value throughout fiscal 2022 and beyond. And with that, operator, we can open the lines for questions.

## **Question-and-Answer Session**

### **Operator**

Our first question is from Greg Palm with Craig-Hallum Capital Group.

### **Greg Palm**

And first off, congrats on the results again. Execution has been really impressive in the last few quarters.

### **Lee Rudow**

Thanks, Greg. Appreciate that.

### **Greg Palm**

So, revenue, I guess starting with the top line, revenue was well ahead of the guidance that you put out, I think, mid-May and obviously, our expectations. I mean is it fair to assume that you saw a big uptick in the month of June? Or how would you characterize kind of the activity or the cadence throughout the quarter?

**Lee Rudow**

I think, Greg, we saw nice patterns and nice revenue flows, both segments, really the whole quarter. We ended the year strong in fiscal '21. We had nice pipelines going into the year and they delivered and beyond. And so, we did see good revenue flows and I think they stayed steady and maybe even increase throughout the quarter. That's how I would characterize it.

**Greg Palm**

And in terms of industry growth versus share gains, how do you think about that?

**Lee Rudow**

Yes. I think what we saw -- we ask ourselves that question all the time. We're studying the data, Mark and I and the team, we look at this. It's been difficult to pinpoint exactly how much is pent-up demand versus market share growth versus industry growth. I would probably say comfortably, it's a combination of all of those things.

There's no question there's some pent-up demand. There's also no question, particularly in service, where we continue to take market share. And we know that by the competitive activities that we're involved in. So, I think it's a blend of all 3, and we'll see if it sustains, but right now things look pretty positive getting through second quarter.

**Greg Palm**

And then just in terms of M&A, I know you made some interesting changes. You talked about this in terms of the revolver. How should we think about the pace of M&A? We've been kind of talking about increasing pace for quite some time. And would you be disappointed if you didn't complete a transaction or two the remainder of the calendar year?

Or is this just sort of getting things ready for maybe a more active year in the next 12 to 18 months?

**Lee Rudow**

Right. That's a good question. So, when we look at the pipeline, let's say, prior to the renewed initiative that we started about a year ago, which I just referred to, the pipeline would always have a handful of opportunities in it that we would go through and sort of examine these opportunities for strategic fit, so on and so forth. I think when we look at it today, it probably takes about a year to go from, let's call it that pipeline, a traditional pipeline to something that we were striving for as part of our strategic plan. So here we are 1 year later, and you look at the same pipeline and what you see is just really kind of a night and day difference.

And again, I alluded to the size and quantity and the quality, it's just things we're pursuing. And I think it's ample. And so ample enough to complete our strategy and execute it. So, to answer more directly, I would be surprised, of course, if I didn't see a deal get done in this fiscal year,

let's just say, for example, I won't tie myself to multiple deals or even the calendar year. But we're in fiscal 2022, and I do see activity getting accomplished in this year, for sure.

### **Operator**

Our next question comes from Scott Buck with H.C. Wainwright.

### **Scott Buck**

First, I'm curious if there are any areas within your kind of end-user markets where maybe activity remains slow and then hasn't really kind of picked up here post-pandemic?

### **Lee Rudow**

Relative to oil and gas, let's say, on the Distribution business, we've seen a really nice recovery, but we're still not at 100% of where we were in FY '20, we may be something like 90% recovery. So, there's still a little bit of drag on that market relative to products and service. I think things are as expected, mostly life science, but we've got some nice aerospace and defense in there and industrial as well. There's been pickups across the board. So that's how I would characterize it.

### **Scott Buck**

I was curious, any changes to what has been kind of the historical strategy of bolt-on and adding either a new geographic region or a new service capability? I mean are you looking at anything outside the box? Or is it -- or should we expect more of the same?

### **Lee Rudow**

Yes. I would say all the above. And by that, I mean, there's no question that expanding our geographic footprint to be more comprehensive in areas where we have gaps, is going to be a driver. You're right about that. Expanding capabilities is going to be a driver of bolt-on we will make frequently, whenever we can find them, they just make a whole lot of sense from a strategy perspective.

And I've messaged sort of repeatedly through the last few quarters that it's important that we identify adjacent markets and expand our addressable markets where it makes sense for Transcat. And so, I think that very much is part of the strategy as well. And so, it's a combination of all of the things you mentioned.

### **Scott Buck**

And then last one for me. I'm just curious if we can get an update on the rental business. It's kind of slid out of the deck the last couple of quarters. I'm just kind of curious what the trends are there.

### **Mark Doheny**



No. Scott, it's Mark. And actually, it's really favorable trends in the rental business. And you saw the improvement in our gross margins sequentially and year-over-year. Part of that is the rental business is very strong.

It's a nice environment for the rentals business where it's difficult to get new equipment across the board in this sort of economy. So, I think that's been helpful for the rental business. So very pleased with the performance of the rental business.

### **Operator**

Our next question comes from Jeff Van Sinderen with B. Riley & Company.

### **Jeff Van Sinderen**

Let me add my congratulations. A couple of multipart questions here if you can bear with me a little bit. I understand you've seen a pick-up overall so far. But I guess, is it fair to say that you're not seeing any negative change at all in customer activity over the last month or so with the resurgence of COVID? And I guess, overall, how are you thinking about the potential impact of Delta beyond the current quarter?

Or have we just kind of reached a juncture where most customers simply must do the Service work now that slowed during COVID?

### **Lee Rudow**

Right. So, it's a good question. We have not seen any impact from Service. But remember, and we saw this throughout COVID, while it was peaking, that Service business has to get done for the most part. And so, it's a resilient business and it's highly driven by regulation, high cost of failure.

So, we wouldn't expect, Jeff, to see it in service, and we haven't seen it in service. Where you would see it talking about the variance in the Delta resurgence, where you'd see that would be on Distribution. But right now, we sit in a position where I'm not seeing it. I don't think we're seeing it. I mean our service -- our Distribution business is up, let's call that a leading indicator, right?

That would be affected first and it has not been affected so far in this fiscal year. Now could that change? I mean, yes, it could. I don't see it changing on service. It could change on Distribution, has not changed yet, not for Transcat.

### **Jeff Van Sinderen**

And then just relative to your acquisition pipeline, are you finding anything that could be transformational? Has the environment changed at all in the last couple of months? Is there anything, I guess, in the context of the COVID backdrop that's changed? And also, just kind of specifically wondering about the acquisition opportunities around the life sciences area.

### **Lee Rudow**

Right. I'm reluctant to add any more color than on the earnings script, and I'd rather not get down the road too, are we working on something transformational? I would say that it's a good pipeline. I think the opportunities are compelling. I think they're good for the business.

This is what we guided that we'd be working on, and we are working on it, and I expect to see results this year. And I'll just leave it at that. I think that's probably appropriate.

### **Operator**

Our next question comes from Gerry Sweeney with ROTH Capital.

### **Gerry Sweeney**

I wanted to circle back to revenue. Obviously, great organic growth. Are you seeing any fundamental changes out there in the marketplace, which means maybe a shift towards more outsourcing? Obviously, the labor is an issue. That could be a positive or a negative for you.

But just curious if you're seeing any fundamental shifts that may be driving some of that organic growth as well, especially since we're coming out of COVID. Usually those are times that are...

### **Lee Rudow**

Yes. It's an interesting question. I was thinking about that myself recently. And one of the things I think is occurring, and this is conjecture for sure, and this is not a fact by any stretch. But when you have events like the pandemic and similar macro events, the strong tend to get stronger.

You've heard that before and sometimes the weaker get weaker. I think Transcat has just been a really strong company for a really long time. And when you get through something like COVID, and we've done the right things, both from an outwardly reaching market perspective and marketing and delivering good services and internally where we've taken care of our employees, and we've gone over and above to make sure that they were safe and well cared for from an employee perspective.

You put that -- it just makes for a good company. And so good companies come out of pandemic strong.

And I think that's part of the longer-term success of this company is this reputation that we've built internally and externally for getting our work done and getting it done right. And I think we're reaping some of the rewards of that as you see the continued growth.

### **Gerry Sweeney**

That's helpful. I can completely understand that. Shifting gears, a little bit to margins. Maybe I'll just start with this. Can you bucket out or qualitatively, quantitative, however you would want to do it, but how much of this margin improvement maybe was mix, leverage of overhead?

And obviously, we've always talked about automation. Is any automation starting to play a role in some of that margin improvement as well?



## Mark Doheny

Hello, Gerry, it's Mark. Yes, certainly, we can provide some more color. And when you experience this sort of organic growth at almost 17% for the Service business, the vast majority of the margin improvements we saw was around that fixed cost leverage. And I think Lee mentioned in his prepared remarks that this business hasn't kind of reaffirms, that it has an inherent strong amount of operating leverage. So that was the big driver.

Technician productivities are starting to hit more difficult comps. So, there was much more modest improvement versus prior year. That was helpful. We had a slight increase on the number of on-sites versus prior year. So, it's not something that we called out as a big drag in the press release or our earnings deck.

I would continue to go back to that operating leverage on the fixed cost and continued strong technician productivity as really the drivers.

## Gerry Sweeney

And then just on the technician side, this is more out of curiosity. Can techs sort of shift from industry to industry? I mean if there's an increased demand saying life sciences and less demand in industrial or are they sort of trained up in a certain process and techniques?

## Lee Rudow

Yes. Generally speaking, all of our technicians are capable and, in most cases, are trained across the spectrum. So, whether we're doing temperature work for a life science company or a pharma company or whether we're doing temperature work for an industrial manufacturer or chemical or some sort of process. It's about the same.

There are nuances by industry, but generally speaking, the disciplines carry across the spectrum, so it's flexible.

And to the degree that someone as experienced as a technician, and that's great. But through the years, in the last 5 to 7 years, we bring people into the company, train them up, and they just need to have technical aptitude. You don't always get experienced "calibration technicians" sometimes you do, but you get guys with technical, engineering aptitudes, mass aptitudes and these guys take about a quarter or 2 to get up and running. And then we usually have them pretty productive.

## Gerry Sweeney

Congrats on a great quarter.

## Lee Rudow

Appreciate it. Thank you, Gerry.

## Operator

Our next question comes from Dick Ryan with Colliers.

**Dick Ryan**

Your comment on gross margin for Q2, the moderation. Are you talking from the absolute levels that we saw in Q1 and Q4, the roughly 32%, 33% level? Or are you still talking about moderation of the growth year-over-year, which had been 400, 500 basis points.

**Mark Doheny**

Hello, Dick, it's Mark. Yes, it's the moderation of the growth year-over-year. We think we have sustainable gross margins describing the Q1 and our guide for Q2. The comparisons on the technician productivity side get more difficult later in the year, even from Q1 to Q2. So again, while we expect some growth year-over-year in Q2 gross margins, it's not going to be to that same degree. You'll still get the operating leverage, but that technician productivity comparison is much more difficult. So that's the way to think about it.

**Dick Ryan**

And in the past, you've had comments either on OpEx or op income, anything you'd care to share on that line item?

**Mark Doheny**

Yes, if you look at our SG&A OpEx from this past quarter (first quarter), something around that level, maybe slightly up from that would probably be the best way to think about that.

**Dick Ryan**

What percent of Service is life science now?

**Lee Rudow**

It's right around 50%, Dick.

**Dick Ryan**

Let's see. One last one for me. On the CBL side, it looks like you're still kind of in that 20 count, kind of centered in the Northeast and the Southwest. What's the attitude to kind of grow that? Or is that just going to be -- is not -- is that not a primary pillar of growth?

Or how do you state the business case for the CBLs?

**Lee Rudow**

Yes. I think the CBLs, if I were -- I wouldn't focus on it, overly focus on it. We're going to grow the Service business. We have growth targets. They've always included CBLs.

They'll include CBLs in the future. But it's not as if that's what we're focused on and it's going to represent a large percentage of our growth. During COVID, there were no CBL sales, and that's completely understandable. And building up that pipeline and in the future, I'm pretty confident that's going to happen, and it will be part of our growth. But we're going to grow either way.

So, we've got transactional business. We've got sort of what we call the midsized companies, and then we have these large CBLs, I'd expect to make progress in each of the channels.

**Dick Ryan**

And congratulations on a nice quarter.

**Lee Rudow**

Appreciate that. Thank you.

**Mark Doheny**

Thank you.

**Operator**

Our next question comes from Mitra Ramgopal with Sidoti & Company.

**Mitra Ramgopal**

Congrats on great quarter. A couple of questions. First, on the margin side, I know, I think one of the things you highlighted was the technician productivity. And I was just curious, as you look at your existing workforce today, if you feel the need to maybe upgrade even further as we saw in the past, and that's obviously bearing fruit now or you're in a pretty good spot in terms of being able to meet your existing needs with what you have?

**Lee Rudow**

Yes. I would say that 17% organic growth was higher than we anticipated. And so, we weren't staffed up the way we'd want to be or that we need to be in the future to be able to maintain anywhere near that type of growth. So, when you have 17%, we're not likely to be as ready. So, what does that mean?

That means more overtime, and you've got to train up new technicians quicker. There's a little bit of drag sometimes on margin. We didn't really see it, which is a good sign, but it could be. I think we're going to continue to grow, we're going to continue to add technicians, right? And we're in that frame of mind now.

We didn't add a lot of technicians last year for the first 3 quarters. We started doing that in Q4, and we've absolutely had to do it, Mitra, in Q1. I anticipate the same thing will continue as we continue to grow.

**Mitra Ramgopal**

And then on the Delta variant, I mean, who knows how this plays out, but we're starting to see changes in policies of mass mandates in the workplace, et cetera. And maybe you could remind us in terms of your staffing, et cetera? Any concerns of if it should become a bigger issue, to be better prepared this time around versus a year ago to deal with it?

**Lee Rudow**

Yes. So of course, it was a challenge last year, but we got through it. We have a really good leadership team and management team. We tend to follow the state law. So, whatever is required, wherever we're working, we adopt those policies and some of them have been changing, and we've been changing with them.

And I think we've broadcasted that and communicated that pretty well throughout our organization. So, it gets to be not really a Transcat decision. Our employees understand that we're going to follow the local guidance and the local laws. And we're -- I think that's the best way to do it for now. So, we did last year.

It wasn't easy on anybody, of course, but I think people understood. We'll continue to do as much of the same as need be.

**Mitra Ramgopal**

And then finally, I know for some companies, depending on the industry, the sense is the pandemic has changed the thinking where a lot of their potential customers in term maybe being more willing to outsource their business than they might have been in the past as a result of what happened. I'm just curious if you're starting to see maybe increased interest or more conversations around that from potential with outsource.

**Lee Rudow**

Yes. I mean there's multiple drivers for the healthy pipelines that we have. And I'm sure somewhere within that group, there are outsourcing opportunities. I'm quite sure whether it's a result of COVID or not COVID, I mean, it would be difficult for me to characterize it. We have healthy new business go-forward pipelines.

It's really good for the business, and we're pleased to see it. I'm sure it's a combination of that and many other things. So, we'll just keep moving forward with that in mind, Mitra.

**Operator**

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

**Lee Rudow**

Okay. Well, this is Lee, and I just want to thank everybody for joining us on the call today. We certainly appreciate your continued interest in Transcat. We will be participating in the virtual Oppenheimer Technology Conference on August 11 and the Colliers Investor Conference on September 9th. So, feel free to check in on us then.

And if not, otherwise, we're always available. Feel free to check in. And we'll talk to everybody after the second quarter results. So, take care. Thank you.

**Operator**

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation. Have a wonderful day.