

Operator: Greetings, and welcome to the Transcat Inc. Second Quarter Fiscal Year 2017 Financial Results Call. At this time, all participants are in a listen-only mode. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Mr. Deborah Pawlowski, Investor Relations for Transcat. Thank you. You may begin.

Deborah Pawlowski: Thank you, Melissa, and good morning, everyone. We certainly appreciate your time today and your interest in Transcat. I have here with me today our President and CEO Lee Rudow and our Chief Financial Officer Mike Tschiderer. After our formal remarks, we are going to open up the call for questions.

If you don't have the news release that crossed the Wire after markets closed yesterday, that can be found on our website, which is www.transcat.com. The slides that accompany today's discussion are also found there.

So, if you would, please refer to slide two. 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 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. Please review our forward-looking statements in conjunction with these precautionary factors.

I would like to point out, as well, that during today's call, we will discuss some 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 our non-GAAP information to comparable GAAP measures in the tables accompanying the earnings release and in the slides.

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

Lee Rudow: Okay. Thank you, Deb. Good morning, everyone. Thank you for joining us on the call.

Overall, we're pleased with our second quarter results and our progress year-to-date. We continue to drive towards the goal of \$175 million to \$200 million in revenue and we continue to stay focused on driving increased margins overtime and at that volume.

Let me give some of the highlights for the quarter, then I'll turn things over to Mike for a more in-depth review of the financials, before I get back to provide some outlook for the rest of year.

As I stated a moment ago, second quarter execution produced strong financial results for both segments. We achieved record revenue of \$34.5 million, up 17%. Higher revenue and gross profit resulted in operating income growth of 15%, EBITDA margin expanded 150 basis points and, as a percentage, EBITDA increased 38% for the quarter, 46% for the year.

Second quarter service revenue showed steady progress with 19% growth, a blend of organic and acquired growth. Life science growth in the quarter was particularly strong as it stayed true to our growth strategy and leverage our value proposition in the highly regulated FDA space. We did experience a decline in service revenue in Canada directly related to softness in the Canadian aerospace market. The softness was partially offset by growth in Canadian life sciences, driven by a recent acquisition of Dispersion Laboratories in Montreal.

In the U.S., organic growth was impacted a bit by capacity restraints in a couple of our key labs. Generally speaking, we see capacity as more of a timing issue, more short-term in nature, and we ended the quarter with a strong pipeline of organic activity. The quarter represented our 30th consecutive quarter of year-over-year service growth as we continue to take market share, both organically and through acquisition.

On the acquisition front, we continue to prove that our consolidation strategy works when we acquire companies that fit our strategic target and profile. Excalibur and Spectrum are great examples of hitting the target, as both of them have positively impacted both of our operating segments. And moving forward as we get beyond integration, which is underway and on track, we expect margin expansion as we realized both sales and cost synergies and as overall volume expands as a result of these deals. I'll also add that our acquisition pipeline remains strong and we continue to target future opportunities that fit our strategic objectives.

As we move onto Distribution, the Distribution segment in the second quarter saw a rebound in sales. Year-over-year sales in the quarter increased 15%. The Oil and gas sectors remain weak, but sales were bolstered in part by strong alternative energy growth. The strategic pivot to rentals and used equipment, as well as the positive results from our SKU expansion program, all contributed positively to a strong second quarter performance.

Strong order volume at September has also continued into the third quarter and we're cautiously optimistic that the channel continues as we're seeing significant increases in calls, quotes and general web traffic.

So, with that, let me turn things over to Mike to discuss the financial results, and I'll come back to talk to our outlook.

Mike Tschiderer: Thanks, Lee, and good morning, everyone.

Please note that, when considering our year-over-year comparisons, the second quarter of our fiscal year 2017 that ends at March 25, 2017 and the six month year-to-date results include the acquisitions of Anmar Meteorology in September 2015, Spectrum Technology in January 2016, Dispersion, based on Montreal, that was in January 2016 and Excalibur Engineering, which was acquired at the beginning of this fiscal year on April 1st.

I will be referring to some of the slides that we posted on our website throughout this discussion, starting on slide four. Our record quarter was driven by a significant growth in revenue in both segments. Service segment revenue was up 19% to a second quarter record of \$16.9 million, which includes the acquisition-related growth. On a trailing 12-month basis, which we believe is more indicative of a long-term progress of the Service segment, revenue was up nearly 20%.

As Lee mentioned, we are encouraged by the results of the Distribution segment this quarter. Sales increased 15% over the prior year second quarter, more supported by incremental sales from Excalibur, the expansion of the high emerging rental businesses both Transcat's and Excalibur's and strong orders from the alternative energy markets.

On slide five, consolidated operating income increased 15% to \$1.6 million, while operating margins were flat. We expect operating margins in both segments to increase as we continue to integrate our recent acquisitions and get the expected sales and cost synergies.

Service segment gross and operating margins were negatively affected by softness in our Canadian markets and lower than desired U.S. organic revenue, as Lee described. The operating margin in Service also reflects an increased allocation of general and administrative costs of approximately \$130,000 and higher selling costs in the quarter. We allocate our G&A cost based on a consistent methodology that uses prior year segment revenue percentage as the allocation

basis. Each quarter in fiscal 2017, we'll have approximately \$130,000 to \$140,000 more G&A expense allocated to the Service segment than was allocated to that segment in fiscal 2016. This will also give the Distribution segment favorable comparisons each quarter by the same amounts. There is no impact on consolidated results from this cost allocation.

Distribution margins expanded with segment gross margin up 80 basis points to 22.2% and operating margin up 100 basis points to 4.5%. In Distribution, we benefited from higher revenue, more favorable customer mix, including the higher margin rental equipment sales, and from the reduced allocation of G&A costs that I just described above.

On slide six, we talk about adjusted EBITDA and adjusted EBITDA margin. We use adjusted EBITDA, which is a non-GAAP measure, because we believe it is a good gauge of performance as a measure of operating cash flow for each of our segments. I do encourage you to look at the reconciliation of adjusted EBITDA to the closest GAAP measures that we have provided, which are operating income and net income.

Adjusted EBITDA growth was strong for both segments in the quarter. For Service, it increased 25% to \$2 million and, as a percentage of segment sales, it was 11.9%, up 60 basis points. In the Distribution segment, adjusted EBITDA was \$1.3 million, up 64%, and, as a percentage of that segment's sales, it improved 230 basis points to 7.4%.

On slide seven, higher revenue was somewhat offset by incremental expenses that we've mentioned previously here. And as a result, second quarter net income increased 2% to about \$900,000. Diluted earnings per share were consistent at \$0.12 per share. We continue to expect our tax rate to range between 34% and 36% in fiscal 2017.

Slide eight provides detail regarding the strength and flexibility of our balance sheet. We do generate strong cash from operations and, as you can see, compared with the capital spending on the slide, we deliver free cash flow. Our trailing twelve month ROIC, or return on invested capital, was 7.9%. For us, ROIC uses the trailing 12-month operating income after taxes divided by the trailing 12-month invested capital, with invested capital being the sum of our total debt and our total equity. We continue to be disciplined in our capital deployment, with the objective to consistently generate returns in excess of our cost of capital. ROIC is a non-GAAP calculation. You should not consider this information in isolation or as a substitute for results prepared in accordance with GAAP.

CapEx was \$2.5 million year-to-date. That was primarily for assets for our rental business, to expand our Service segment capabilities and for IT maintenance and IT growth. We continue to expect our fiscal 2017 capital expenditures to be between \$5 million and \$5.5 million for the year.

During the quarter, we paid down \$2.5 million in debt. At the end of the second quarter, we had \$15.6 million of availability under our revolving credit facility and had approximately \$24 million in total outstanding borrowings. We continue to believe that we have ample cash for operations and have dry powder for any acquisitions that meet our strategic criteria.

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

Lee Rudow: All right, thank you, Mike.

Let me wrap up where we are after completing our first two quarters in fiscal 2017. I'll start with Service. We continue to expect double-digit revenue growth and we remain optimistic about what we see in the business. We're integrating our recent acquisitions and are pleased with the early performance of those deals. We'll continue to work on sales and cost synergies to drive higher margins. We feel good about our organic Service pipeline, as well as the acquisition pipeline and the opportunities that lay ahead. Our targeted life science market continues to

present opportunities for growth, as we take market share from the competition, and we continue to leverage our expanding lab network and addressable markets, as we make our mark as a leader in our industry.

Pertaining to Distribution, like I stated before, we like our performance in the second quarter, driven by a blend of organic initiatives on our traditional Distribution business and our pivot to higher-margin rental and used equipment. It's nice to see a higher level of orders and increased level of activity from the market; we hope it continues.

I'll conclude with our expectations for solid third quarter and fourth quarter results. On a comparative basis, in Q3, we'll contend with a prior-year reversal. In other words, last year's reversal, a performance-based compensation expense, was related to the impact of the softness in the oil and gas market. That said, we expect solid consolidated operating earnings growth in Q4 and for the full year.

So, with that, I'll turn things over to the operator. We can open the line for questions.

Operator: Thank you. At this time, we'll be conducting a question-and-answer session.
[Operator Instructions]

Thank you. Our first question comes from the line of Chris Reynolds with Neuberger Berman. Please proceed with your question.

Chris Reynolds: Good morning.

Lee Rudow: Morning, Chris.

Chris Reynolds: I have a quick question about your acquisition activity. It's been very successful and it's obviously enhancing your growth. Do you anticipate continuing to make acquisitions over the next year or so, or do you think the acquisition activity will slow down a little bit as you integrate what you've announced so far? Then I have a second question.

Lee Rudow: Hey, Chris; this is Lee. I absolutely do see the acquisition activity continuing on an ongoing basis. The pipeline that we're working today is pretty robust, as we say, as strong as ever. I think there are opportunities out there. While we're integrating the high-level of activity that we encountered and engaged with last year, I don't see any kind of long-term event that will prevent us from acquiring companies. The important thing is that they fit, that they're strategic as we've done in the past. I think it's really important that we get it right. Our track record has been positive and we're going to stay on that path and continue with that strategy.

Mike Tschiderer: I'll just add one thing related to that. We are disciplined buyers. We are very strategic in what we look for, where we look for it and what we'll pay, and those criteria do resonate with the activity that we've seen out there, so we still think it's a good market for acquisitions.

Chris Reynolds: Okay, and my second question relates to the international markets. You've made acquisitions in Canada and you have business in Puerto Rico, but are there other opportunities outside of those international markets for growth, and do your customers on the Distribution side perhaps place orders for equipment that may be utilized overseas?

Lee Rudow: I'll address the Distribution part of the question first. There are identifiable sales that we make domestically that end up in global markets, but it's a pretty small part of what we do. It has been pretty consistent through the years, so I don't see it as all that material.

As far as positioning ourselves globally or expansion into global markets on the Service end of the business, Chris, we've remained focused on domestic markets for two reasons. One, it's low-hanging fruit for us. I mean, as long as we are experiencing solid organic growth and there

are opportunities to acquire within North America, we're going to continue to make that our primary focus. Now, I will say that, in-time, it's not beyond the realm that we will expand in the global markets. The way we would do that at a very high level is on the coattails of a customer, or an opportunity that drives you there and takes you there, where you have sponsorship from day one. That tends to be how it works and that may very well happen at some point, but it's not part of our current strategic plan. It's something that we will address when that opportunity presents itself.

Chris Reynolds: Okay. Terrific, thank you.

Lee Rudow: Welcome.

Operator: Thank you. Our next question comes from the line of Dave Rode with Stifel. Please proceed with your question.

Dave Rode: Good morning.

Lee Rudow: Good morning Dave.

Mike Tschiderer: Hi, Dave.

Dave Rode: Congrats on a nice quarter. I'd like to follow-up a little bit on his first question and tie it into where you see the rental and used equipment businesses going. When this transformation started some 14 or 15 years ago, when you identified the opportunities to attempt to grow aggressively through acquisition particularly on the Service side, it took a good 7 or 8 years. There were major hiccups in the economy back in '07, '08 and '09 to allow you to get the right metric to make these acquisitions. People were more interested in selling after that economic pickup occurred. I just wanted to throw out, are you starting to get the word out; are you getting contacted now, rather than have to be as aggressive as you were back in the day; are more opportunities just kind of coming your way by nature of talk in the industry and things like this?

Lee Rudow: That's an interesting question and I would say that, over the last 24 to 36 months, we have seen more people reach out to us in terms of companies that are potentially interested in selling to Transcat than we have in the past. So, you are right at the beginning. We are very proactive and what momentum we were able to create was sort of self-generated. I don't want to say its 50-50, still probably 60% or 70% more outreach on our part, but we are seeing an increased level of people that reach out to us. That's through networking and every press release they see that says we are active in the acquisition market.

So, it has become a little easier in that respect. I would also say that last year, particularly with the softness in oil and gas and industrial output being low and the U.S. strong dollar and all the derivative effects of that, it was a great time to acquire companies for all the obvious reasons. We took advantage of that. I think that was a good strategy and I would do it again.

The market has not changed all that much, so we're still seeing enough sluggishness in output and the strength of the dollar continues to be strong. I think there are opportunities this year like there were last year. I haven't seen any change and I would anticipate that we would be the type of company that would take advantage of that opportunity.

The last thing I would say relative to your question is, we have entered into the used and rental markets, and we like the margin profiles of those markets. We are seeing growth in those markets, particularly with rentals. We just entered the used equipment in April, so it's really too soon to make a general statement, but I would say that we see acquisition opportunities on

those fronts, as well at the traditional service business that we've acquired into, and so we will take a look at these opportunities as they present themselves relative to rentals and used.

Mike Tschiderer: Dave, I'll just add one other thing to at least the first part about the acquisitions. I do think we have some positive synergies now, because we've done deals and the deals have worked out for the buyers. We're known as a good buyer and some of the ones that we've seen come across our desk now are from some of those other buyers in the companies that we bought previously. It's a small community, so in addition to the outreach, we've had brokers call us who brought us deals in the past. Now, there are other ones out there, so it's kind of building on itself.

Dave Rode: Thanks. Again, in the used equipment and the rental business, I know it's embryonic for you right now there in certain areas, but I'm just interested in more color, if you will, to learn more. It seems as though, by adding that to the company, it almost created a three-legged stool, with the service, with product, and now with the used and rental business opportunities, which potentially gives you a more solid foundation to move forward.

Do you know if there was a mix on the ElectroRent Company that was acquired by Platinum Equity recently? Were they pure rental, were they used equipment, were they a mix of such? Do you know what their makeup was?

Lee Rudow: I don't know the specific breakdown, Dave. I do know that they're primarily a rental company, and when you're in the rental business, almost by default you're going to be in the used equipment business, as well. They go hand in hand. To the best of my knowledge and from what I've read in the past – and we used to look at comps - their primary driver is the rental business. The two are very closely associated and linked out of necessity.

Dave Rode: Okay. Thank you.

Lee Rudow: You're welcome.

Operator: Thank you. [Operator Instructions]. Our next question comes from the line of Steven Stern with Stern Investment Advisors. Please proceed with your question.

Steven Stern: Thank you and good morning. Congratulations on another good quarter. My question is, looking at the interest expense line for the last two quarters, it's expected that interest will go up as you expand the rental and finance acquisitions. As explained in the past, operating cash flows pay down those bank lines that finance those two activities; however, are we at the stage now where perhaps some longer-term debt on the balance sheet could give us some stability by reducing the need on the bank lines, which right now are very inexpensive because of variable low rate? It would allow us to lock in low financing for 10, 15 or 20 years into the future, a base in long-term capital or long-term debt. Has that been looked at?

Mike Tschiderer: Yes, Steven. This is Mike. We have looked at that and have had some very productive discussions with our bankers, as well as other bankers, about the potential opportunities. I think the important thing right now, as you said, it's very cheap money right now. We have a very good facility, where it's a very low rate; it's a LIBOR plus, so it is variable.

But the way it's structured, we have some really good grid protection. We have, though, talked to them about fixed rates, as well as do we want to do some kind of a swap agreement. And we've just concluded, at least in the short term, that we don't need to do that unless we start to really hear something more immanent from the FED about what rates are going to do. But we do keep it in the front of our mind as we look at our balance sheet structure for sure.

Steven Stern: Thank you.

Lee Rudow: Thank you, Steve.

Operator: Thank you. There are no further questions at this time. I'd like to turn the floor back to Mr. Rudow for any final remarks.

Lee Rudow: Okay, thank you. I want to thank everybody for joining us. We always appreciate your continued interest and support. For those of you who are going to be or who are in the greater New York City area, we're going to be at the Sidoti Emerging Growth Conference on November 1st. So, if you are interested in meeting up with us, let us know and we'll certainly carve out some time. We're also going to be at the Southwest IDEAS Conference in Dallas on November 16th and, again, we'd welcome the opportunity to meet with anybody that has an interest in meeting with us. As always, we appreciate everybody being on the call today. Thanks for joining us and take care. Have a nice day.

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