

Operator: Greetings and welcome to the Transcat Second Quarter Fiscal Year 2018 Financial Results Conference Call. At this time, all participants are in a listen-only mode. An interactive question-and-answer session will follow the formal presentation. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Ms. Deborah Pawlowski. Thank you. You may begin.

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

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

So if you would, please refer to Slide 2 in the deck. 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 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 at the SEC's site, which is www.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 would 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, I will turn the call over to Lee to begin the discussion. Lee?

Lee Rudow: Thank you, Deb. Good morning, everyone, and thanks for joining us on the call today. We're going to follow the same format we have in the past. I will hit upon some highlights for the quarter and then Mike will provide a more in-depth review of our financials and I'll come back and wrap things up with an outlook for fiscal 2018.

We generated \$35.9 million of consolidated revenue, up 4.2% over the second quarter of fiscal 2017. Results were somewhat muted by Hurricanes Harvey and Maria. As a result, operating income for the quarter was down slightly. Before I get into the Service segment performance, I want to give some context to the impact hurricanes had on our business in the quarter.

Our Houston lab is our largest lab that operates three shifts a day. As we mentioned in our news release, while the lab sustained minimal damage and our employees are safe, there was significant disruption over several weeks with our staff, our customers and supply chain. And while the recovery is well underway, the storms contributed significantly to the low productivity and gross margin in the quarter. It's difficult to determine the exact impact in the quarter because of the nature of our Houston lab operations. The lab is our standards lab, a feeder lab, if you will, that supports our entire lab network in addition to servicing the local Houston customers. It makes it difficult to exactly quantify the indirect impact of the temporary shutdown that took place. We had customers' equipment that we couldn't work on in some cases. We didn't receive, because

the roads were closed, and certainly, we saw the noticeable ripple impact throughout the organization.

Our Puerto Rico lab is significantly smaller than Houston and generates less than 2% of our annual total revenue. Given the timing of Hurricane Maria, it had limited impact on our Puerto Rico lab in the second quarter. That said, we do anticipate a prolonged recovery for that region, but the impact is still expected to be minimal when you compare it to Houston. At the present time, we're working through our various insurance coverages, including business disruption insurance to quantify the impact and the appropriate recovery.

Let's move on to the performance of the Service segment as a whole. In the second quarter, the segment continued to deliver solid organic growth of 7.6%. We've now achieved 34 consecutive quarters of year-over-year Service growth, that's every quarter for 8.5 years. We continue to take market share. We continue to retain and grow our base business. The solid revenue growth was primarily comprised of new life science business with secondary growth in general industrial manufacturing, which includes both the defense and aerospace market.

From a margin perspective, in addition to the impact of the storms, we're managing through some shorter-term constraints with new labor-associated productivity. We hired 33 new technicians in the first six months of fiscal 2018. And that's compared with an average of 14 technicians over the same period for the three previous years. So we're laser focused on productivity and we expect improvements in the near future.

As we talked about last quarter, this is not a bad challenge to have. That is, we're ramping up labor and productivity to keep up with growth. I'll talk a bit more about productivity in a few minutes after Mike reviews the financials in more detail.

Let's move on to Distribution. Segment sales for Distribution were up about 1%. Overall, the segment performed well throughout the diversified channels that includes core distribution and rentals. Distribution was also impacted by the hurricanes, but to a lesser degree than Service, and we've experienced a quick recovery. We've had a solid start to the third quarter, high levels of activity and new quotes and orders in both segments. So we feel pretty good about the recovery that's taking place.

And with that, let me turn things over to Mike to walk through some of the results, and I'll come back to talk about the outlook.

Mike Tschiderer: Thanks, Lee, and good morning, everyone. I will be starting on Slide 4 of the deck we posted, where we show our revenue performance by segment and on a consolidated basis. And starting with our Service segment, we are pleased with the 7.6% organic revenue growth that we had for this segment. This was in line with our goal of mid to high single-digit organic growth rates. And notably, this was achieved despite the adverse impact from Mother Nature.

Hurricane Harvey disrupted our largest lab, Houston, as we mentioned. The Houston facility sustained only minimal damage and thankfully all our employees are safe. But the lab operations were impacted by disruptions to the staff, customers and supply chain. Also, in the last few days of our second quarter that ended on September 23, Hurricane Maria severely impacted the island. Again, we had minimal property damage from the storm and our people are safe. But the recovery in Puerto Rico is expected to impact us for the next several quarters if the recovery and rebuild are as slow as has been talked about. However, our operations in Puerto Rico are small, accounting for less than 2% of our total revenue. So a prolonged return to normal operations is not expected to have a material impact on our results from operations or our financial position.

Also, as we mentioned, our second quarter results do not include any amounts for potential recovery from various insurance coverages we have in place in Houston and Puerto Rico. Still, as noted on Slide 4, the Service segment continues to deliver solid results over the long-term, with double-digit growth over both the trailing 12-month period and on a CAGR basis since fiscal 2014.

Our Distribution segment had a fifth consecutive quarter-over-quarter period of revenue growth. And even more impressively, over trailing 12-month comparable basis, the segment was up nearly 15%. We attribute that performance to our diversification strategy into rentals and used equipment, as well as technology-based investments, including enhanced e-commerce capabilities, web-based marketing and improved domain authority and web placement.

Our relatively new independent sales rep channel that came as a benefit of our April 2016 acquisition of Excalibur Engineering has also been performing well with sales of new equipment.

From a macro perspective, we are benefiting from an improved industrial market, although in the second quarter our growth was somewhat muted as we saw less shipments to Texas as a result of the hurricane there and some softness in orders and timing delays in shipments to alternative energy customers.

Moving on to a Slide 5, Service segment gross profit and margin were negatively impacted by the effect of Hurricane Harvey, both directly from the disruption of operations in Houston plus we believe a ripple effect in other markets. We estimate the impact from the direct loss of business and the ripple effect from Houston being a large reference lab as between 20 and 50 basis points of gross margin in the quarter and between 40 and 90 points of operating margin for the quarter. These ranges exclude any impact from insurance proceeds that may be received.

We also did see, as Lee mentioned, carryover from the short-term labor productivity limitations at some of our labs due to our sales growth and the need for training and ramping up of new techs. Our labor force has increased substantially.

As reported, total Service gross margin was 23.7% in the second quarter, down 70 basis points due to the factors just described. Distribution gross margin saw a 50 basis point decline, resulting from sales mix changes coupled with a decrease in vendor rebates due to the timing of when we placed inventory stocking orders.

Administrative expenses were up \$447,000 to \$2.7 million during the second quarter, which reflected our continued investment in operating infrastructure and operational excellence initiatives. However, even with this increase, our total operating expenses were 18.6% of consolidated revenue, which was down 10 basis points year-over-year. As a result, operating income decreased \$120,000 and operating margin was down 50 basis points to 4.1%.

On Slide 6, 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 Service and Distribution 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 reconciliation of adjusted EBITDA to the closest GAAP measures, which for us, are operating income and net income that we have provided. Quarterly adjusted EBITDA was consistent at \$3.3 million over the reasons we've discussed. Adjusted EBITDA margin was down 40 basis points to 9.2%.

On Slide 7, second quarter net income was \$781,000, or \$0.11 per diluted share. The effective tax rate for the quarter increased slightly to 34.2%. We still expect our effective tax rate to range between 34% and 36% for full-year fiscal 2018.

Slide 8 provides detail regarding our balance sheet and our cash flow, which support our growth strategy. Year-to-date capital expenditures were \$3.9 million and were primarily for assets for customer-driven expansion of Service segment capabilities, including mobile calibration fleet investments and aerospace and defense sector assets. We also made planned purchases of rental business assets in the quarter.

Total CapEx is still expected to be approximately \$6 to \$6.5 million for full fiscal year 2018, with expenditures focused on similar investments, as well as on IT infrastructure to drive our operational excellence initiatives. Of the CapEx plan for fiscal 2018, approximately \$1 million to \$1.5 million is for maintenance or existing asset replacements.

At quarter-end, we had total debt of \$29.7 million, with \$8.3 million available under our revolving credit facility. We paid down \$2.3 million of debt during the quarter. Our leverage ratio decreased and is 2.0 to 1 at quarter-end, a ratio we are comfortable with. We calculate our leverage ratio as total debt on the balance sheet at quarter-end divided by the trailing 12 months adjusted EBITDA. Other companies may calculate such a metric differently. We believe we have sufficient liquidity and ample dry powder for any investment opportunities or acquisitions that meet our strategic criteria. Finally, we expect to timely file our Form 10-Q on or around November 3.

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

Lee Rudow: Thanks Mike. I'll conclude by saying that our strategy and focus has not changed. Prospects for both our Service and Distribution segments are bright. The value proposition between our segments continues to be unique and resonates in the market. We continue to expect mid to high single-digit organic growth in our Service segment and the Service pipeline is very strong.

We expect the Hurricane Harvey impact to lessen as the third quarter progresses. Although there may be some lingering revenue and margin headwinds, both segments appear to be recovering well.

We're making progress on our labor front and expect to see productivity improvements in the third quarter. Our operational excellence team is also focused on productivity improvements in the short run in parallel to their longer-term multi-year effort across the organization. We still believe and expect significant margin leverage as operational excellence initiatives progress.

We continue to work on improving the effectiveness and efficiency and our processes, databases and systems, as we look to eliminate redundancy and improve our analytics. Over time, we expect to be even more competitive to take market share, and improve our scalability, predictability, profitability as well. In other words, we plan to drive a better business model.

Acquisitions remain an integral part of our growth plan. And looking out over the next two to three years, we still believe we're on target to achieve our \$175 million to \$200 million in revenue.

So with that, operator, we can open the lines for questions.

Operator: Thank you. At this time, we will be conducting a question-and-answer session. Our first question is from Dick Ryan from Dougherty & Company. Please go ahead.

Richard Ryan: Thank you. So, Lee, you gave us Puerto Rico, it was less than 2% of revenue. Can you give us some sort of perspective what Houston represents for the Service segment?

Lee Rudow: I will say that, as I'd mentioned, Houston does run multiple shifts and is a feeder lab. It is probably twice the size of most of our labs. And it's certainly dominant in terms of the revenue it produces directly and indirectly. We're not going to breakout each lab revenue on this call, but it is significant. This is how I would put it. Mike, would you add any color to that.

Michael Tschiderer: No, because it is a feeder lab and a reference lab, sometimes the work that is actually sent there may get credited to the lab where it comes from.

Lee Rudow: Right.

Michael Tschiderer: So it is hard to just look at the Houston and the impact of Houston because of the nature of the lab.

Richard Ryan: How do you see that recovering the Services directly around Houston versus the feeder capability throughout the other labs. Is the feeder side coming back or would that come back sooner than the direct Houston impact?

Lee Rudow: So that's a great question. The feeder volume will come back immediately and it has. And the Houston area itself is going to be a little bit harder to predict. I will say that we definitely saw significant recovery in October. There was an uptick both locally, and of course, we expected the uptick to be through the feeder network.

So we're feeling pretty good. I mean, without question there will be some lingering impact. Longer-term, it may have a positive effect perhaps. But in the short-term, it's going to be hard to predict other than to say, if October is an indicator that we can rely on, we're feeling much better about it.

Richard Ryan: Okay. Now the productivity issues, is that tied mainly to the new hires or was there some other productivity issues that crept into the equation?

Lee Rudow: I would say that, while we always look to improve our core productivity and if there is opportunity for improvement, that's why we're launching operational excellence. The majority of the issues that we feel like we had and where we could have done better, Dick, is on the new hires.

And not just the new hires themselves, but when you hire 33 new technicians, what happens is, you have to pull some of your senior techs to do the training. And so the direct impact is that they're not as productive because they're new. The indirect impact or you can call it direct as well is that you slowdown some of your senior techs.

So it's hard to differentiate between that impact and that affect versus could production have been better in any given quarter. So I'm pretty confident to say the bulk of it, the lion's share was going to be related to the new hires directly and indirectly. But there's opportunity to improve our productivity, and that's why we're investing like we are in operational excellence in our processes, in our procedures, because we think productivity can improve. I think you're going to see that productivity proven in the third quarter.

So, and that will lend itself more to the new technicians being independent and productive and senior technicians allowed to do more work having afforded the time. You should see that in the third quarter because of that. Longer-term, productivity improvements will be based on some of the operational excellence initiatives we have in place.

Richard Ryan: Okay. And the mid to high single-digit, is that what we should look at for fiscal 2018 over fiscal 2017?

Lee Rudow: You're referring to organic growth?

Richard Ryan: Yes.

Lee Rudow: Yes, absolutely.

Richard Ryan: Service.

Lee Rudow: Yes, Service. On the Service segment, we're confident that we can and expect certainly to reach those levels.

Richard Ryan: And just one last one sticking with Service. You mentioned taking share, can you give us some perspective as to where and what industry segment that's occurring?

Lee Rudow: Primarily, we target life science. And the bulk of our growth has been life science, as I alluded to in the script. Though we've done well in defense and aerospace as there has been an uptick. But I think that our value proposition around life science continues to get better. It was already good relative to our competitors. I think it's getting better. And I think that's the reason why we're confident and we're achieving some of these growth levels. And we achieved 7.6% growth, but again that was muted by just some obvious impacts from the storm.

So you would have been even higher than that, maybe even close to maybe 10%. And so we're pretty comfortable that the proposition on the Service side and our ability to communicate it and sell to it is effective enough to hit those targets.

Mike Tschiderer: Yes, and I'll just add one thing to that. You can apply based on the range of the estimates that we are giving for the gross margin that the organic Service revenue growth would have been probably in the mid-8% to the mid-9% with those same ranges of estimated direct and indirect losses because of the storms, Dick.

Richard Ryan: Okay, great. Thank you.

Michael Tschiderer: Okay. You're welcome.

Operator: There are no further questions, I'd like to turn the floor back over to management for any closing comments.

Lee Rudow: Okay. Well, thank you all for joining us on the call. We certainly appreciate your interest and your time in Transcat, and we are certainly available for further questions or follow-up if there's any interest. Take care. Have a nice day.

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