Operator: Greetings, and welcome to the Transcat, Inc. Second Quarter Fiscal Year 2019 Financial Results Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Craig Mychajluk, Investor Relations.

Craig Mychajluk: Yes. Thank you and good morning, everyone. We certainly appreciate your time today and your interest in Transcat. With me here on the call, we have Transcat's President and CEO, Lee Rudow, and our CFO Mike Tschiderer. After formal remarks, we'll open up the call for questions. If you do not have the news release that crossed the wire after markets closed yesterday, it can be found on our website, 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 would like to point out as well that during today's call, we'll 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 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: Thank you, Craig. Good morning, everyone. Thank you for joining us today on the call. We'll follow the same format as we have in the past. I'll review some of the highlights for the quarter, Mike will provide a more in-depth review of the financials, and I'll come back to wrap things up with an outlook for the back half of the fiscal year and beyond.

Second quarter results were strong across-the-board as both operating segments performed very well. Consolidated gross margin was up 80 basis points to 23.5%, operating income increased 49% to $2.2 million, while operating margin was up 150 basis points to 5.6%. The increased profitability in both segments worked its way to our net income, which nearly doubled to $1.5 million. We generated strong cash flow from year-to-date operations of $4.9 million. Consistent with our plan, we expect to allocate cash to foster organic and acquired service growth and longer-term technology investments to drive productivity gains.

Looking specifically at Service, organic Service revenue growth was 7.6%. We're particularly pleased with the organic Service growth in the U.S., which came in at a little over 9%. These numbers exclude the Angel's acquisition, which we acquired on August 31, 2018. While not included in our 9% organic growth in U.S. service, Angel's September results are included in our reported numbers. We have now achieved 38 consecutive quarters of year-over-year Service growth. That's every quarter for 9.5 years. We continue to take market share from the competition as well as in-house labs and OEMs. This is particularly true in the life science space, which is consistent with our growth trends over the past few years. The Service segment demonstrated operating leverage as segment operating income grew 42% and operating margin improved 140 basis points. We enter our third quarter with strong pipelines, both on the new business front as well as the acquisition front.

Let's turn to our Distribution segment. Distribution delivered strong revenue, profits and delivered on our stated goal of driving differentiation in the market and lead generation for our Service segment. Distribution sales were up 7.3% in the quarter, which included 15% increase in our rental business.

Distribution gross margins were up 110 basis points to 22.8%. Distribution operating margins were up 170 basis points.

I'd like to take a moment to talk about some of the progress we've made on the acquisition integration front. We continued to develop a tool set to more quickly integrate our acquisitions to our operating systems. In parallel, we've made meaningful progress on the physical integration of the last 3 bolt-on acquisitions. The map on **Slide 4** details the physical integration of these last 3 bolt-on acquisitions. We fully executed the consolidation of Excalibur's Irvine, California facility with our LA lab, which is located in Fullerton, California. Dispersion's life science business in Montréal has moved into our Canadian headquarters in Montréal. And finally, NBS Calibration in Phoenix has moved into our Phoenix facility.

I'd also like to call your attention to the most recent acquisition of Angel's Instrumentation, represented by the green marker, in Northern Virginia. With approximately $4 million in annual revenue, Angel's represents a geographic expansion for Transcat as well as expertise in the adjacent maritime calibration market. We believe the integration of Angel's is on track, and we're pleased to welcome Angel's employees to the Transcat team and the Angel's customers to our network of customers that recognize Transcat as a leading provider of products, services and solutions to the test measurement control market. As we've mentioned in the past, there is ample opportunity to expand geographically as we look to expand into Florida, Georgia, Northern California, Minnesota, Maryland and Dallas, among some other areas.

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

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

I'll start on **Slide 5** of the deck, where we provide some detail for our revenue for the second quarter of fiscal year 2019. That quarter ended on September 29, 2018. Our full fiscal year 2019 ends on March 30, 2019. Consolidated revenue for the quarter was $38.9 million, up 8.2%. As Lee mentioned, we completed the Angel's Instrumentation acquisition, effective after business close on August 31, so our reported results include 1 month of the Angel's acquisition. Excluding the acquired September revenue of approximately $300,000, our consolidated organic revenue grew 7.4%. We had Service segment revenue growth of 9.1% to $19.9 million, which was driven by strong organic growth of 7.6%, when excluding Angel's revenue. This organic growth rate was in line with our expected range of mid- to high-single digits, and we continue to expect to achieve our organic revenue growth goals for the full fiscal year of 2019. We're also pleased to see the gross margin expansion in Service too. In our Distribution segment, revenue increased 7.3% to $19 million. The increase reflects higher demand from core industrial customers and includes rental revenue growth of 15% to $1 million of rental revenue for the quarter. In addition to providing an attractive margin profile, we believe rentals continue to differentiate us in the marketplace.

Consolidated gross margin expanded 80 basis points. Total operating expenses were up $0.3 million to $7 million, which reflected our continued investment in operating infrastructure and operational excellence initiatives. And expressed as a percentage of revenue, operating costs were down 70 basis points to 17.9%.

As a result, as shown on **Slide 6**, operating income increased 49% and operating margin expanded 150 basis points to 5.6%. You may recall that our fiscal 2018 second quarter gross and operating margins were negatively impacted by hurricanes Harvey and Maria, especially our Service segment. As a reminder, we had estimated last year's hurricane impact to range between 40 and 90 basis points of Service segment operating margin for that prior year second quarter. The operating leverage achieved in our Service segment more than made up for that impact with segment operating margin expanding a total of 140 basis points to 5.7%. So even with considering the estimated impact of the hurricanes on fiscal 2018 second quarter, service operating margins would still have expanded by approximately 50 to 100 basis points. Distribution segment operating margin expanded 170 basis points to 5.5%. This includes 110 basis point improvement in gross margin resulting from favorable customer mix, vendor rebates and certain pricing initiatives.

Slide 7 shows the net income on a trailing 12-month and quarterly basis. Net income nearly doubled to $1.5 million in fiscal 2019 second quarter, which equates to earnings of $0.20 per diluted share, an increase of $0.09 per diluted share. In addition to our improved operating results, the significant increase in net income in both the trailing 12 months and quarterly basis also reflects the positive impact from the U.S. Federal Tax Cuts and Jobs Act that was enacted in December 2017, which was in the third quarter of our fiscal year 2018. The effective tax rate this quarter was 24.9% compared with 34.2% in the second quarter of last fiscal year. Our effective tax rate includes U.S. Federal taxes, various state taxes and taxes on our Canadian operating entities income. Our income tax rate for full fiscal year 2019 is still expected to be in the range of 25% to 27%.

On **Slide 8**, we show adjusted EBITDA and adjusted EBITDA margin. Among other measures, we use adjusted EBITDA, which is a non-GAAP measure, to gauge the performance of our segments, because we believe it is a good measure of our operating performance and is used by investors and others to evaluate and compare performance of core operations from period to period. I do encourage you to look at the supplemental slides that provide a reconciliation of adjusted EBITDA to the closest GAAP measures, which for us are operating income and net income. On a consolidated basis, quarterly adjusted EBITDA was up 22% to $4 million, while adjusted EBITDA margin expanded 110 basis points to 10.3%. Both segments contributed to this increase, with Service up 17% and Distribution up 30%.

Slide 9 provides detail on our balance sheet and cash flow. We generated cash from operations of $4.9 million through the first 6 months of the fiscal year, which was used, in part, for our acquisition of Angel's, to fund our growth focused investments and to drive operational excellence initiatives. As previously disclosed, we acquired substantially all the assets of Angel's for $4.7 million, before purchase agreement holdbacks of $1 million expected to be released over the next 12 months. At the end of second quarter fiscal 2019, we had total debt of $25.3 million outstanding with $17.7 million available under our revolving credit facility. Our debt levels are up $2.4 million since the end of fiscal 2018, primarily due to the use of cash for Angel's acquisition. Our fiscal 2019 second quarter leverage ratio is 1.34. We calculate this leverage ratio as the total debt on our balance sheet at period end divided by the trailing 12 months adjusted EBITDA. The trailing 12 months of pro forma EBITDA of acquired companies is used in the leverage ratio calculation as provided for in our revolving credit facility. Other companies may calculate such a leverage metric differently.

Year-to-date capital expenditures were $3.7 million and primarily focused on customer-driven expansion of Service segment capabilities in acquiring assets for the rental business. Our anticipated capital expenditure plan for fiscal 2019 remains in the $7 million to $7.5 million range. And on **Slide 10**, we provide a breakdown of the various focus areas for CapEx spend expected for full year fiscal 2019. We continue to believe we have sufficient liquidity and a strong balance sheet to fund investments that meet our strategic criteria. And lastly, we expect to timely file our Form 10-Q on or about November 6.

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

Lee Rudow: Okay. Thank you, Mike. I'll close by reviewing our 3 key strategic goals as we continue to build Transcat for the long term. Number one, driving operational excellence and leveraging technology as a competitive advantage. Operational excellence remains at the forefront of everything we do as we fortify our infrastructure with technology, people, and improved processes and systems. We continue to make progress towards longer-term opportunities related to driving productivity, automation and ultimately higher margins in our service labs and throughout the organization. Number two, generating double-digit service growth through a blend of organic and acquired activity. And number three, leveraging the combined operation of our Distribution and Service segments to provide a significant competitive advantage in the market. The combined operation is a differentiator that continues to strengthen our value proposition and make Transcat unique. All in all, we're energized by our vision and our plan as Transcat remains well positioned to do great things in our industry.

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

Operator: (Operator Instructions) Our first question comes from Matt Koranda, Roth Capital Partners.

Matthew Koranda: I wanted to start out with the Service growth outlook. In Lee's commentary and I think in the release, it says that your goal is to drive double-digit Service segment revenue growth, which I think is a little higher than the usual commentary of high-single digit. Is that factoring in acquisitions? Or are you indicating any fundamental change in the organic growth outlook for the Service segment?

Lee Rudow: When we made that statement, Matt, we were referring to the combined growth of organic and acquired, so we stick to the mid- to high-single digits. That remains the same, but we'll layer in acquisition activity, most recently Angel's, so yes, when we typically talk about double-digit growth, it includes both.

Matthew Koranda: Okay, perfect. And then, in terms of Angel's, I think if you back into it, it contributed something like $300,000 in about a month. Is it safe to drag that out times 12 to get to a rough annual contribution or is there seasonality or things we need to take into account for modeling that on a go-forward basis?

Michael Tschiderer: Yes, Matt. You may remember when we announced the deal, we said that it had annual revenue of about $4 million. So the $300,000 approximate for the month of September has a little bit of seasonality in there. We still expect it to be at that $4 million run rate.

Matthew Koranda: Okay. And then margin contribution, I would assume it's relatively similar at the Service segment, but is there anything to call out there in terms of the way we should think about that?

Michael Tschiderer: No. Their margins would probably be a little bit higher than what we might report. When you combine it with us, I'd focus more on the bottom lines and maybe even EBITDA between what we paid, what the annual revenues are. It was within the range of what we disclosed that we buy companies for, which is 4x to 6x multiple and kind of imply what the EBITDA would be and fill it in from there with some typical margin assumptions.

Matthew Koranda: Okay, that's helpful. On the purchase agreement holdbacks, just to get a sense, what are the catalysts to get the holdbacks removed, and over what time frame is the additional $1 million going to be paid out?

Michael Tschiderer: There are 3 different businesses, Matt. One is the $470,000 indemnification holdback, which is the typical breaches of representations and warranties. That one would be paid out within 30 days after the anniversary of the closing. The remainder is two separate ones. Two somewhat significant contracts that were coming up for renewal in October, and they had some different revenue profiles. We'll be paying those out as the contracts are signed and as revenues actually build under those contracts. One is probably going to be within 90 days of closing; and then, the other one would be after the anniversary, so probably a year from now.

Matthew Koranda: Okay. On the Distribution segment, gross margins and the incremental margins continue to look really solid there. Is there anything to call out this quarter in terms of additional vendor rebates that swung things in an abnormal way? And maybe could you also talk about mix and price, since I think those are the 3 buckets that you typically call out in terms of margin drivers there?

Lee Rudow: Right, okay, Matt. I think we were pretty pleased with the volume that the Distribution segment produced at 7.3%, so that was solid. That segment continues to show stability and strength. From a margin perspective, we continue to drive optimization of pricing and mix has been favorable. When I say that, I'm referring to core end user business, which has been rock solid and that's where we'll achieve higher margins. The reseller business becomes a smaller and smaller part of our business by design. I think, to a certain degree, we would expect that to continue. We have not seen any indicators that would lead us to believe otherwise. I would not model in continued growth in margins or growth rates above what you've seen, but I think we would expect Distribution to continue to perform well in like pattern to the first half of the year.

Michael Tschiderer: Yes, the last half of last year was pretty strong in Distribution, so I expert that quarter-over-quarter percentage growth to be less than the 7.3% we had here, but still solid. And to your question on rebates, there was a little bit of acceleration. Part of it was, we were able to bring in some inventory ahead of price increases to obtain both some purchase and sales rebates, because of a strong growth that we've had in those products.

Matthew Koranda: Okay. That fits with my next question relatively well, which is, are there any additional headwinds we should be factoring in, in terms of pricing from your vendors in Distribution or is that essentially pretty much all offset with pricing action on your part?

Lee Rudow: To date, it's been offset. We've had some price increases, some sort of inflationary pricing, I think, based upon the tariffs from certain key manufacturers, but we raised our prices in accordance with that, and it's been passed along and has been accepted by the market. So far, we really have not had any headwinds as a result.

Matthew Koranda: Perfect. Last one on the rental business. Any help there in terms of total revenue expectations for the rest of this year? I'm mainly interested in whether that 15% growth rate you had this quarter is sustainable through the rest of the year. You had some tough comps from last year, but can we sustain that 15% growth rate for the remainder of the year here?

Lee Rudow: Yes, I think we can. You are right. It kind of ramped up in the last half of last year, especially the third quarter of last year, which was positively impacted by the hurricanes. We saw rental business go up, especially in the Houston area, because of that catastrophe, but I think 15% is still achievable.

Operator: Our next question comes from Dick Ryan, Dougherty & Company.

Dick Ryan: Lee, last quarter, you mentioned the high level of Service wins. Can you talk about what your experience was in Q2, kind of the timing of how those wins flow through the process?

Lee Rudow: Sure. You're right, we did talk about the win level, which was strong in Q1. We expected it to play out into a favorable growth rate in Q2 and we experienced that. And so, to your direct question, I would say that wins in Q2 were steady and strong, and I would expect that, as we play out through Q3 and Q4, we'll hit our expectations. We would expect to achieve the mid- to high-single-digit organic growth, based upon current pipelines and current wins. I feel pretty good about that.

Dick Ryan: Okay. Then, when you look at the second half of the year, typically, Distribution ramps or peaks in the Q3 time frame and Service kind of peaks in Q4. Is that seasonality still the right way to look at it for this year?

Lee Rudow: Yes, I would expect that. If you look back historically, Q3 has been strong for Distribution. I do not see any early indicators whatsoever at this point that would lead me to believe differently. For more than 30 years in the business, calendar year first quarter has been strong for Service. As we’ve talked about in the past, that is based upon a lot of new equipment being bought at the end of calendar year, based on “use it or lose it” budgets, and that plays out into a strong first calendar quarter in Service. I would expect that would be true this year as well, Dick.

Michael Tschiderer: Just one thing before your next question, Dick. I would just remind you that, yes, we do expect them to be stronger, but as we've said before, you have to remember fiscal year '19 is a 52-week year compared with '18, which is a 53-week year.

Dick Ryan: That's right, that's right, thank you, Mike. You talk about the differentiator of having Distribution and Service. Have you started seeing the lead generation show up from the Distribution side over to the Service labs?

Lee Rudow: Yes, I think we have, and I think we do. We talk about that as a differentiator, because it is. Of the 4 national Service companies, we're the only company that has that $85 million Distribution pipeline. This year, the leads from that pipeline have set record levels. Some of that is the macros and the natural growth in the Distribution business that's doing well, and some of it is based upon the cumulative marketing activities and technology activities around trying to leverage these 2 segments together. We spend a lot of time and focus on how to maximize that potential. I think we're doing well in that respect and the leads are up, but I would not want to suggest that there is not a macro impact as well. Nevertheless, we'd expect that to continue.

Operator: (Operator Instructions) Our next question comes from Chris Sakai, Singular Research.

Chris Sakai: You had an operating margin expansion both in the Service and Distribution segments. What were the main factors that led to this expansion? Are they sustainable going forward?

Lee Rudow: This is Lee, Chris. We were pleased with the margin expansion. I think it's a variety of factors and, Mike, chime in if I miss any of these.

Some of the expansion in margins is based upon the inherent leverage, in particular related to the Service business. As volumes increase, we would expect more income to drop to the bottom line, or for the bottom line to grow at a faster rate. That's kind of general expectations around the Service business.

I think we've done some really good work in the Distribution business. We talk about systems and people and processes and trying to run a better business, and I think we've seen some of the benefits of those campaigns roll in through pricing optimization, which has helped margins on Distribution.

On a go-forward basis, with the investments that we're making in technology and some of these operational excellence areas, I would expect margins to increase over time, but it won't be linear. We're in the 26% range now and then we'd expect it to be at 27% or 28%, and we feel comfortable that, in a reasonable amount of time, say over the next 2 to 3 years, we should be in that 30% range for Service. Again, there will be bumps along the way and we will not necessarily show those increases every quarter, but over the longer haul, these operational excellence campaigns should drive Service margins up.

From a Distribution perspective, you'll see some of that, but nowhere near the gains that we expect in margin on the Service side. The margins are probably going to be similar to where they are now. The growth in that business will be more GDP related.

So we're doing a lot of work in both segments, but I think the Service margin arena is where you're going to see some of the gains over time.

Chris Sakai: Okay, great. And then, as far as future acquisitions go, will that be in the Service or Distribution segment?

Lee Rudow: We focus our acquisition strategy primarily on the Service segment. That's not to say that we would not entertain or from time-to-time acquire a company in the Distribution space, but the majority, almost to a company, with the exception of maybe one that pops into my head, have all been Service related, and I think you're going to see that pattern continue in the future. Service is our primary growth engine, and so, when we look at growth, we're going to look at both acquired and organic growth on the Service business for that reason.

Chris Sakai: Okay, great. And then, as far as future financing goes for acquisitions, can you comment on how these acquisitions will be paid for?

Michael Tschiderer: Sure, Chris. We historically use cash or our debt facility, so reverse equity offerings. You may recall that we actually did do a $50 million shelf registration in December of last year. We do not have any plans to use that, but it's nice to know that it's there. Between the availability that we have on our debt facility, as well as in equity, we think we have a strong balance sheet to do any acquisitions, just a matter of how we want to fund them.

Operator: Ladies and gentlemen, we have reached the end of the question-and-answer session. I'd like to turn the call back to management for closing remarks.

Lee Rudow: Okay. This is Lee. We appreciate you all being on the call today. Thank you for joining us, and we appreciate your interest in Transcat. Feel free to reach out to us at any time. Mike and I will certainly entertain all the calls that we get. We look forward to talking with everybody after our third quarter results come out. So have a nice day.

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