Operator: Greetings. Welcome to the Transcat, Inc. First Quarter Fiscal Year 2020 Financial Results Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. Please note this conference is being recorded. I will now turn the conference over to Craig Mychajluk, Investor Relations. Thank you. You may begin.

Craig Mychajluk: Thank you and good morning, everyone. We certainly appreciate your time today and your interest in Transcat. With me here on the call today, I have our President and Chief Executive Officer, Lee Rudow; and our Chief Financial Officer, 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 the markets closed yesterday, it can be found on our website at transcat.com. The slides that accompany today's discussion are also on our website.

If you would, please refer to slide 2. As you are aware, we may make forward-looking statements during the formal presentation and Q&A portion of this teleconference. Those statements apply to future events which are subject to risks and uncertainties, as well as other factors that could cause 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 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 provided reconciliations of non-GAAP to comparable GAAP measures in the tables accompanying the earnings release.

With that, I'll turn the call over to Lee to begin. Lee?

Lee Rudow: Thank you, Craig. Good morning, everyone. Thanks for joining us on the call today. I will start by hitting upon some highlights for the quarter as we normally do and then turn things over to Mike to provide a more in-depth view of the financials before I return to wrap things up with an outlook for fiscal 2020 and beyond.

First quarter results demonstrated the continued successful execution of our growth strategy. We generated record sales of $42 million in the quarter, driven by both double-digit organic Service growth and strong Distribution sales. The high rate of Service growth was higher than we had expected and had an adverse impact on our Service margins, which I will touch upon in a few minutes.

Operating income was relatively flat, or would have grown absent a one-time $200,000 charge for the sale of a building we owned. Located in Montana, the building was a legacy property from an acquisition many years ago. There were some tax adjustments in the quarter, and net income grew to $1.7 million, while EPS grew to $0.23 a share in the quarter.

I will turn to our Service segment for a few moments and talk to growth and margin. Our value proposition continues to resonate and we continue to take market share from the competition, which is consistent with our plan. Segment revenue was up 16% and our organic growth rate was nearly 12% in the quarter. The 12% organic growth was a result of strong performance across most Service revenue channels, including large client-based lab wins in the quarter, growth from our existing customer base and solid growth in the Canadian market, which, if you recall, was a drag on results most of last year. We believe Canada has turned the corner and expect to see the positive results continue throughout the fiscal 2020 year when compared with the fiscal 2019 Canadian results.

Relative to Service margins, among other metrics, we are tracking an interesting new data point to get a better understanding of our productivity. In the first quarter of this year versus the first quarter in the prior year, we experienced a 33% increase in the number of work hours for new technicians who have been with Transcat for under one year. The increase impacts our margins as it takes a newer tech more time to complete calibrations. The hiring, onboarding and training of new technicians amidst double-digit organic growth and overall strong Service growth remains a challenge, but it's one that is receiving a lot of attention and focus.

To that point, I'd like to talk about the acquisition, effective last Friday, of Infinite Integral Solutions and their CalTree software. CalTree is a unique software that provides a series of calibration benefits, including a robust programming base for the automation of single function test equipment. Single function test equipment represents about 25% to 30% of what we currently calibrate. By acquiring CalTree, we have an opportunity to both accelerate the pace of driving greater Service segment efficiencies and aid productivity improvement by automating calibrations throughout our network of labs.

This is especially important and impactful in an environment where the company is onboarding a large number of new technicians. The ultimate goal, of course, is enhanced Service margin to accompany our strong growth rate. At present, we're testing the software on various automation applications. Our goal is to roll-out the automation software on a limited basis in the fourth quarter timeframe and into next year.

Moving on to Distribution, we generated sales growth that was broad-based across most of our channels. While there were some mix variances on the gross line, we saw improved operating leverage. Our rentals business continues to perform very well, up more than 34% in the quarter. We also benefited from significant level of sales activity relating to alternative energy and used equipment, both of which tend to vary from quarter-to-quarter. All in all, we continue to like our Distribution plan and the unique role it plays supporting our Service growth, and we will continue to execute the plan as the year progresses.

With that, I'll turn things over to Mike.

Michael Tschiderer: Thanks, Lee, and good morning, everyone. I'll start on slide 4, which provides detail regarding our revenue. As we mentioned, we have started the fiscal year very strong with record first quarter consolidated revenue of $42.4 million. This represents an increase of almost 16%, or $5.7 million, over the first quarter of fiscal 2019.

Service segment revenue increased 16% to $22.4 million, inclusive of revenue from Angel's Instrumentation, which we acquired in August 2018. This marks the 41st consecutive quarter of year-over-year revenue growth. As we previously communicated, the immaterial revenue from the acquisition of Gauge Repair Service, effective on April 1, 2019, which was the first day of our current fiscal year, was a bolt-on to our Los Angeles facility and will not be called out separately when we talk about organic growth versus total revenue growth.

Organic growth for the quarter for the segment was a very strong 11.9% as we continued to take market share, especially in the highly-regulated life sciences sector and other regulated sectors, such as aerospace and defense. To put that growth in perspective, our stated goal is to achieve organic growth rates in the mid- to high-single digits, so anything in the double digits is certainly exceeding our expectations.

When combined with acquisitions, the Service segment has met our double-digit revenue growth expectations as demonstrated on a trailing 12-month basis and on a compounded rate basis since 2016.

Distribution sales increased more than 15% to $20 million and was driven by broad-based demand. Highlights, as we noted, included the rental business, which was up 34% to $1.2 million, and higher alternative energy and used equipment sales. Those can be lumpy as Lee mentioned.

The Service segment gross margin was still pressured in the first quarter, especially by the investment around new technicians that were hired to support our strong revenue growth. These new technicians take time to train, develop and become productive. We also had some startup cost and inefficiencies on certain other large multi-year, outsourced client-based lab contracts that we won in the past year.

And with our strong growth, we also saw an increase in the amount of work we outsourced to other companies and managed for our customers as part of our value proposition. This outsourced work generally has a lower margin profile and, as a percentage of total service revenue, outsourced revenue grew 90 basis points quarter-over-quarter to 15.2% of total service revenue.

Various initiatives associated with process improvement, productivity and automation, which Lee spoke to, are expected to abate these pressures as we move through the fiscal year and over the long-term.

Distribution gross margin was down, due to some changes in the channel mix for the quarter and in comparison to a very strong first quarter last year; however, we did have an 11.6% increase in gross profit dollars and saw good leverage with segment operating margin expanding 60 basis points to 6.1%.

We continued to make investments in technology infrastructure and our operational excellence initiatives, but our total first quarter operating expenses, expressed as a percentage of revenue, still decreased 20 basis points to 19.1%.

And, of note, included in the operating expenses was the roughly $200,000 loss on the sale of the company-owned building in Montana, the only real estate that we own. Absent this, we would have seen greater growth on the segment and consolidated operating income lines.

On slide 6, we show our bottom line results, which increased 20% to $1.7 million, or earnings of $0.23 per diluted share. While we had expected a significantly lower first quarter tax rate versus the full-year effective tax rate, it ended up actually being a benefit in the quarter.

The tax impact of share-based payment awards that are recorded on an in-quarter discrete basis was greater than expected, due to a few things. Largely, the first quarter pre-tax income being lower than anticipated, our stock price on the award date increasing the tax benefit windfall related to certain stock awards, and additional stock options being exercised in the quarter.

Our effective tax rate for total fiscal year 2020 is now expected to range between 21% and 22%, which includes federal, various state and Canadian income taxes. This is a decrease of 100 basis points from prior guidance.

Moving to slide 7, we show adjusted EBITDA and adjusted EBITDA margins. Among other measures, we do 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 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 provided reconciliation of adjusted EBITDA to our closest GAAP measures, which are operating income and net income.

On a consolidated basis, quarterly adjusted EBITDA was up 3% to $3.9 million, while the adjusted EBITDA margin contracted 120 basis points to 9.3%, largely due to the gross profit constraints in the Service segment.

Slide 8 provides detail regarding our balance sheet and cash flow. At quarter-end, we had total debt of $22.4 million, with $21.7 million available under our revolving credit facility. Our debt level was up $1.4 million since the end of fiscal 2019, and our leverage ratio was up slightly to 1.22. We calculate this leverage ratio as the total debt on our balance sheet at a period-end divided by the trailing 12 months adjusted EBITDA, including giving credit for any acquired EBITDA. Other companies may calculate such a metric differently.

Capital expenditures were $1.4 million in the first quarter and were primarily focused on customer-driven expansion of Service segment capabilities and acquiring pool assets for the growing rental business.

As noted on slide 9, we still expect fiscal 2020 CapEx to be approximately $7.8 million to $8.2 million. The majority of the incremental capital spend in excess of fiscal 2019 levels is planned for growth-oriented opportunities within both of our operating segments. Maintenance CapEx is anticipated to be similar to this past year at approximately $1 million to $1.5 million. We continue to believe we have sufficient liquidity for any investment opportunities that meet our strategic criteria.

And lastly, we expect to timely file our Form 10-Q on or about August 7. With that, I'll turn it back to you, Lee.

Lee Rudow: Okay. Thanks, Mike. All signs continue to point to strong Service revenue generation throughout fiscal 2020. Organic Service growth remains a priority, as we believe we will continue to capitalize on our ability to win in the market. New business and acquisition pipelines remain strong and active and, as we move forward, we look to balance our acquired and organic growth level. In parallel, we're working to find the sweet spot between growth and improved margins.

As we move forward, we continue to believe we have a grounded view of what needs to be done. In addition to operational excellence, which includes a number of important productivity enhancing initiatives, we believe automation is part of the solution. We expect the acquiring of Infinite Integral Solutions and its CalTree software will provide a boost to automation and accelerate improvement heading into the future.

We continue to move forward with confidence that we're doing the right things to secure and leverage our unique position in the market.

With that, operator, we can open the lines for questions.

Operator: Thank you. Our first question is from Dick Ryan with Dougherty & Company. Please proceed.

Dick Ryan: Thank you. Congratulations on a good quarter. Lee, obviously, the organic growth in Service was pretty impressive, and you mentioned that was across most Service channels. Were there any markets that didn't really perform in the quarter?

Lee Rudow: None that I would highlight. When we look at the way we go to market, we have a life science strategy that includes things like validation and laboratory equipment. We have energy. We have general manufacturing and process. We really are strong across the board. Certain markets just did really well, like life science has done historically, at least in the recent past. I would not read any weakness into that. It's pretty much strong across the board.

Dick Ryan: Okay. You mentioned lab wins and some startup costs. I think you have to go back to Q3 when you talked about some significant lab wins. Can you bring us up to speed as to how many labs you are currently operating in and what does that pipeline look like?

Lee Rudow: Right, in Q3, we talked about the large number of client-based labs that we had landed in the year. Just as a refresher, we typically win one or two of these deals a year. Perhaps there has been a year where we have won three. Last year, I believe it was maybe six or seven. It was in mid- to high-single digits, which is really a higher rate and that continued. For the start of fiscal 2020 again, we've seen two or three more client-based labs, so it continues to be an opportunity. It continues to be a strength for us. I think one of the drivers is the labor market. A lot of these in-house labs were big manufacturers and it is difficult for them to find technicians. I have 350 technicians. They have five. If they lose one, or one retires, or jumps onboard another company, they have serious risk around compliance, so they turn to a company like Transcat and say, “This is just not a problem we want to deal with anymore.”

I think that's what's driving it. We're lucky, because we might be the only company, or we're certainly part of a small number of companies, that could handle that sort of business; albeit with pressure on the margins in the short run, but we can pick it up and we should be successful. That is what we have been doing.

Dick Ryan: Okay. Are you having any retention issues with technicians?

Lee Rudow: No. Our turnover rates have actually gotten better in the first quarter of this year versus the first quarter of last year. There is always some turnover that we have to deal with, but I would not point to that as any contributing factor. The number of new techs, for the most part, is because we have new business.

Dick Ryan: Okay. And Mike, you mentioned that, inclusive of the couple hundred thousand dollar loss on the building, operating expenses were about 19%. Should we still look at that in maybe the low 18% range going forward?

Michael Tschiderer: Yes, I think that's still where we think we'll be, Dick.

Dick Ryan: Great. Thank you.

Michael Tschiderer: Okay, thank you Dick.

Operator: Our next question is from Chris Sakai with Singular Research. Please proceed.

Chris Sakai: Hi everyone. Just a question on the acquisition of IIS. Do you have a target as far as how it will improve margins going forward and add to revenue?

Lee Rudow: Hi Chris, this is Lee. We do not have targets around how it's going to add to revenue. The idea behind IIS, as I mentioned, is really to drive automation. If you want to picture how automation impacts the company, I would look at it this way. You have a technician that typically would run through a calibration, but they take 30 minutes. Now, they can hit a button or two. Once we get it programmed and up and running with the software, they'd be able to hit a button and it will self-calibrate. And while they're doing that, they can turn around and do another calibration, or call it an incremental calibration. That's how automation works.

The benefit of automation over time is that we get more productive and it even helps new technicians. Since we have a lot of new technicians, if we can teach them how to push a button and automate versus actually doing the manual calibration, that's an advantage for us. There's about 25% to 30% of the work that we do today that lends itself to this kind of automation. Now, getting up and running with this is going to take time. Each variable, such as pressure, you need to program for that; and then, go on to temperature and program for that; and then, go to the flow characteristics and program for that. It is sequential, sort of progressive in nature. It will not all happen at once. It will happen over time, but we feel pretty good about our ability to get this done as we move forward.

Chris Sakai: Okay, great. And then, one last thing on the property in Montana, why was it sold and why did you take the $200,000 loss on it?

Michael Tschiderer: This was a building that came to us with an acquisition we made in 2011. The building was now vacant as we do not have any operations in Montana. We've had it on the market for a while and it just didn't make any sense to keep paying maintenance. Also, from a risk avoidance point of view, it did not make sense to have a property that was vacant by itself like that. That kind of a non-cash loss was really the write-off of any of the remaining book value versus the sales price, Chris, so we did it once and got rid of it. We do not have any other properties similar to that.

Chris Sakai: Oh, okay. All right. Thanks, and I look forward to next quarter.

Lee Rudow: You got it. Thanks, Chris.

Michael Tschiderer: Thanks, Chris. Take care.

Operator: We have reached the end of our question-and-answer session. I would like to turn the conference back over to management for closing remarks.

Lee Rudow: Okay. This is Lee. Thank you all for joining us on the call today. We appreciate the continued interest in Transcat. We'll be participating in two investor conferences in September, the Dougherty Conference in Minneapolis on September 5 and the Sidoti Conference in New York City on September 25. So, feel free to check in with us at those events, or reach out to us any time. Otherwise, we'll talk to everybody after our second quarter results. We appreciate you participating on the call.

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