Operator: Greetings. Welcome to Transcat, Inc. Second Quarter Fiscal Year 2020 Financial Results Conference Call. At this all participants are in a listen-only mode. Question-and-answer session will follow the formal presentation. Please note this conference is being recorded.

I will now turn the conference over to your host Craig Mychajluk, Investor Relations. You may begin.

Craig Mychajluk: Thank you, and good morning everyone. We certainly, appreciate your time today and interest in Transcat. With me here on the call today, we have our President and CEO, 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 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 the actual results to differ materially from where we are today. These factors are outlined in the news release as well as the 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 have 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 the discussion. Lee?

Lee Rudow: Okay. Thank you, Craig. Good morning everyone. Thanks for joining us on the call today. At the close of business yesterday, we reported second quarter results which were highlighted by record revenue of $41.8 million and an increase in consolidated operating income of more than 40% over the second quarter of the prior year.

We attribute the record revenue to the strength of our value proposition, which is clearly resonating in the market, and we are equally pleased with the progress we're making to improve margins in both operating segments. Consolidated gross margin was up 150 basis points and consolidated operating margin was up 170 basis points.

Getting to our Service segment in the second quarter, Service revenue increased 18% and organic growth exceeded expectations, increasing 15%. Second quarter represented our 42nd consecutive quarter of year-over-year quarterly growth. We gained market share in life sciences and generated strong performance across most channels, including client-based labs, Canada and growth from our existing customer base.

Turning to the Service margins for a moment, we improved our Service margin profile as segment gross margins increased 140 basis points, demonstrating the inherent leverage in our Service segment as we improved our processes and systems. We attribute the incremental drop through gains primarily to early results of ongoing technology and productivity focused initiatives.

In addition, in the second quarter, our efforts to improve hiring onboarding and training of our new technician showed through in our results, as technician productivity across the organization improved, including our client-based labs. This is an area that continues to be important and one that we will continue to focus on, given our expectations around growth and productivity.

On July 19th, we acquired Infinite Integral Solutions, a small Canadian software company specializing in unique software to automate calibration through its unique CalTree platform. As we touched upon last quarter, our first goal is to automate single function closed-loop calibration. These calibrations represent approximately 30% of what we calibrate and, in time, we expect that the automation of these calibrations should enhance our margin profile.

At present, we're in the process of both validating and programming the software. The process is a time consuming one, but we continue to be excited by the potential the software has to improve our efficiency and productivity.

In addition to automation, we're leveraging technology and the continued development of C3, our proprietary asset and calibration management software. C3 provides a portal for our customers to manage their cost, control and compliance need. The software is easy to use, enhances the customer experience, both of which have led to high adoption rates. We believe the use of C3 has led to strong retention rates, which is an important component of our organic growth.

Moving on to Distribution. This segment continues to perform well. While overall Distribution sales were slightly down, both gross and operating margins increased versus the prior year second quarter. We attribute the increase to a positive mix, which included a 32% increase in our rental business.

From a differentiation perspective, the Distribution segment continues to reinforce and promote our strong brand and continues to be a valuable source of lead to drive organic Service revenue growth.

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

Michael Tschiderer: Thanks Lee and good morning everyone. Today, I'll be starting on Slide 5 of the company deck, which provides detail regarding our revenue on a consolidated basis, as well as by our two business segments, our Service segment and our Distribution segment.

As we mentioned, we had another very strong quarter with consolidated revenue of $41.8 million, which represents a record level for a Transcat second quarter. This was an increase of more than 7% over the prior year second quarter or 5.5% when excluding acquired revenue.

As a reminder, we had one month of revenue from Angel's Instrumentation, acquired effective August 31, 2018, in last year's second fiscal quarter. Also as previously communicated, the April 2019 acquisition of Gauge Repair Service will not be called out separately when talking to organic versus total revenue growth, given the immateriality of that acquired revenue.

While we had a number of highlights, one that stands out was the Service segment performance. Revenue for that segment increased 18% percent to $23.5 million, which reflects double-digit growth in both the U.S. and Canada.

Coming off double-digit organic Service growth in the first quarter, we delivered even stronger results in the second quarter, achieving over 15% organic growth this quarter. This was due in part to continued market share gains in a highly regulated life science sector and other regulated sectors, such as aerospace and defense.

Distribution sales were down about 4% to $18.3 million, which primarily reflects lower non-core reseller sales. Our rental business continues to perform well and helped augment our Distribution sales and margins. Rental sales were up 32% to $1.3 million in the quarter.

Service segment gross margin improved 140 basis points from early progress on our various productivity initiatives, including, as we mentioned, the improved efficiency technicians achieved as they on-board, start being trained and begin to learn our processes and systems.

As we have discussed in the past, the focus in the Distribution segment is on improving gross profit dollars and gross margin percentage by focusing on higher value, higher margin opportunities or by differentiating ourselves from our competition in the Service segment by providing sales leads every day for Service opportunities.

In spite of the lower sales, this quarter's Distribution gross profit increased more than 2% and gross margin expanded 150 basis points, due to the mix of products sold, including the solid growth in rentals.

Our consolidated revenue growth and strong gross profit performance outpaced our continuing investments in the business as total operating expenses as a percent of revenue decreased 20 basis points to 17.7%.

As a result, as shown on Slide 6, we saw operating leverage with consolidated operating income growth of more than 40%, with operating margin expanding 170 basis points to 7.3%. Both segments achieved meaningful operating margins. We are happy with the results we delivered year-over-year, but 40% operating income growth should not be expected on a regular basis.

On Slide 7, we show our bottom line results, which increased nearly 60% to $2.4 dollars or earnings of $0.32 per diluted share, which was up $0.12. These results were aided by the solid operating results and increased discrete income tax benefits related to share-based awards and stock option activity.

As a result, we have lowered our expected income tax rate for fiscal year 2020 to now range between 18% and 19%. That includes federal, various state and Canadian income taxes. This range is a decrease of 300 basis points from prior guidance.

Moving to 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 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 the closet GAAP measures, which for us is our operating income and net income.

On a consolidated basis, quarterly adjusted EBITDA was up more than 19% to $4.8 million, while adjusted EBITDA margin expanded 120 basis points to 11.5%, reflecting good results from both segments, especially in Service.

Slide 9 provides some detail regarding our balance sheet and cash flow. At quarter end, we had total debt of $24.7 million, with $18.9 million available under our revolving credit facility. Our debt level was up $3.7 million since the end of fiscal 2019 and among other things reflects $600,000 Canadian paid for the initial portion of the purchase price of the July 19 acquisition of Infinite Integral Solutions. The total purchase price could be $1.4 million Canadian if certain performance milestones are met. We also spent $500,000 of cash to fund the release of certain purchase agreement hold backs from the August 2018 Angel's acquisition.

Our leverage ratio at quarter end was 1.32 and is calculated as the total debt on the balance sheet at 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.

Year to date, capital expenditures were $4 million and primarily focused on customer driven expansion of Service segment capabilities in acquiring more assets for our ever growing rental business.

As noted on Slide 10, we still expect fiscal 2020 CapEx to be approximately $7.8 million to $8.2 million, with the majority being used for growth. 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 and or about November 5th.

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

Lee Rudow: Okay. Thank you, Mike. Looking forward, we expect to have record revenue and record profits in fiscal 2020. We expect double-digit growth in our Service business, with strong performance at the local, national and enterprise levels and outsourcing of client-based labs. Both new business and acquisition pipelines remain active. Our focus on operational excellence and productivity will continue as we believe they will both benefit growth and operating margins over the longer term. All of these programs are a byproduct of our commitment to leveraging technology as a competitive advantage.

So with that, Operator, we can open a line for questions.

Operator: [Operator instructions] Our first question comes from Dick Ryan of Dougherty & Company. Please proceed with your question.

Dick Ryan: Thank you. Congratulations on a good quarter. Very good to see the margins coming through. So Lee, on client-based labs, were there any wins in the quarter and how does that pipeline look going forward? I think you've added some impressive wins over the last couple of quarters, so how does that look going forward?

Lee Rudow: Dick, I'll characterize it like this. The pipeline relative to client-based labs is still pretty impressive and pretty strong, so we anticipate some of the growth rates that we've seen in the past to continue in the future. In the quarter itself, depending on timing, we might have closed one. I won't get specific, but I think, relative to your question, it's a strong pipeline that we see continuing. So that's good news.

Dick Ryan: And what's driving their interest in your offering is that the software that's out not kicking in yet or is it just the breadth of your technicians and capabilities?

Lee Rudow: Right. I think it's a combination of things. First and foremost would be, you have to be well positioned to be able to capitalize on these kinds of opportunity when they present themselves. We've been around this space for years and we've developed a really good reputation on the quality side, so I think, as labor tightens and continues to be an issue with all companies, it’s driving these companies to rethink whether or not it's worth a try to maintain these labs and find technicians. It's what we do day in and day out. It’s our core competency, not theirs. I think being well-positioned for this type of economy in macros is really what I would attribute the growth to.

Dick Ryan: Great. What's driving the double-digit growth in Canada?

Lee Rudow: So, if you recall when the Canadian market slowed down a bit over the last year and a half or two years, we continued to say that we hadn't lost Canadian customers; what we lost was volume from our current customer base. The customers are still doing business with us, but because of the volatility in trade agreements, terrorism and such, the economy is just sort of slowed and held back. And now that some of that's behind them and the volatility has sort of settled down, we're seeing the same volumes continue from our current customer base.

That's good news. That's what we anticipated. What we messaged early on was that we didn’t see it as a long term problem, but more of a short term volatility problem, and it's kind of playing out that way.

Dick Ryan: Okay. Great. And on the margin questions, and not necessarily this quarter but next year even, when you step back longer term, I would imagine there's only so much more growth that can be seen on the Distribution side of things. But I think if you go back three or four years, Service was in that 27%, 28% kind of gross margin range. Are those reasonable targets for Service? As you know, we look out over the next two or three or four year business model?

Lee Rudow: Absolutely. I agree with your characterization on Distribution and we have said time and time again that we expect margins, like you characterize, over time to improve/. When you say 26%, 27%, 28%, yeah, that's in line with what we're thinking as well and we see that as achievable.

Dick Ryan: Okay. One last one for me. Any retention issues on your employees on the technician side?

Lee Rudow: No. There really isn't. We've actually seen an improvement over the last three or four quarters We've designed some programs around retention and training and development and they all seem to be working fairly well, because our rates of turnover have really declined. I just think we got ahead of it with them and targeted programs that work.

So I don't see that as an issue now. I mean, labor in general is an issue at a high level, but I think we've managed it really well.

Dick Ryan: Okay, great. Thank you.

Lee Rudow: Thanks.

Operator: Our next question comes from Chris Sakai from Singular Research, Please proceed with your question.

Chris Sakai: Hi. I just wanted to know about how much Canada contributed to revenue, and what, if anything, you anticipate as growth coming from Canada in future. I wanted to hear your thoughts on that.

Mike Tschiderer: Chris, like we described, we did have double-digit growth in Canada, as well as in the US and it'll vary depending on the growth that we see across the consolidated business. Canada is about 10% of our revenue. It's a similar profitability profile, so you'd expect if you're doing modeling to see that continue along those same number basis.

Chris Sakai: Okay. Great. And then, with the acquisition of Infinite Integral Solutions, when will we start seeing benefits from that?

Lee Rudow: Chris, this is Lee. I would expect that for the next couple of quarters we're going to be validating, going through some programming, protocols with that software. We'll start to get engaged with it in one or two of our labs probably in the fourth quarter timeframe. I'm not sure I would expect any kind of margin movement based upon that, but we should pick up some significant momentum over the next couple of quarters. I would think that sometime next year we'll be talking to it and will provide updates relative to the margin impact from implementing it. So, a couple of quarters from now is probably the best way to put it.

Chris Sakai: Okay, great. Thanks.

Operator: We have reached the end of the question-and-answer session. I will now turn the call back over to management for any closing remarks.

Lee Rudow: Well, thank you all for joining us on the call today. We appreciate your continued interest in Transcat. Mike and I will be participating at the Roth industrials & Technology Conference in New York City on November 13th, so feel free to check in on us at the conference, or you can reach out to us at any time. Otherwise, we look forward to talking with you all again after our third quarter close. Thanks for participating.

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