



Transcat, Inc.

Fourth Quarter and Full Fiscal Year 2022 Financial Results

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PRESENTATION

Operator

Greetings and welcome to Transcat Incorporated Fourth Quarter and Full Fiscal Year 2022 Financial Results.

A 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, Tom Barbato, Senior Vice President of Finance. Thank you. You may begin.

Thomas Barbato

Thank you, Rob, and good morning, everyone. We appreciate your time and your interest in Transcat.

With me here on the call today is our President and CEO, Lee Rudow, and our CFO, Mark Doheny. We will begin the call with some prepared remarks and then we will open up the call for questions. Our earnings release crossed the wire after market closed yesterday and can be found in the Investor Relations section of our website, transcat.com. The slides that accompany today's discussion are also posted 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. These 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 in the

documents filed by the Company with the SEC. 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.

Additionally, 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've provided reconciliations of non-GAAP to compared GAAP measures in the tables accompanying the earnings release.

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

Lee Rudow

Okay. Thank you, Tom. Appreciate that.

Good morning everyone. Thank you for joining us on the call today.

Fiscal 2022 was a strong year for Transcat as we delivered well-rounded financial performance across the board. Consolidated revenue was up 18% to \$205 million, a new record and milestone for Transcat as we crossed the \$200 million mark for the first time. Throughout the past year and into our new fiscal year, demand for our services and products has remained strong. Consolidated gross margin expanded 190 basis points to 28.5% and was driven by margin expansion in both operating segments. Adjusted EBITDA remains a very important metric for Transcat as we continue to execute our strategic acquisition plan to consolidate the fragmented calibration services industry.

In Fiscal 2022, Adjusted EBITDA grew 28% from the prior year to \$26.3 million. For the full year, our Service segment revenue increased 20.5% and we generated double-digit organic Service growth of 11.6%. We continued to benefit from strong demand in our highly regulated end markets including medical device and pharmaceutical manufacturing, and aerospace and defense manufacturing, these markets where the cost of failure is high and Transcat's unique high-end mission-critical service resonates the most. Our current pipeline of new service opportunities is active and growing.

In addition to our consistent Service revenue growth, we are pleased with another year of Service gross margin expansion. In Fiscal 2022, Service gross margins hit a record level by increasing 160 basis points to 31.9%. Throughout the year, we successfully acquired and integrated three companies that have increased our capabilities, expanded our addressable markets, and allowed us to further leverage our existing infrastructure.

The NEXA Enterprise Asset Management acquisition, which closed towards the end of the second quarter, continues to perform ahead of expectations. The acquisition was well-received in the market and by our current customers, and immediately supported the generation of new synergistic revenue. Both the independent NEXA new business pipeline and the combined NEXA Transcat new business pipeline continued to grow at an impressive pace.

At the beginning of the fourth quarter, we announced the acquisition of Tangent Labs. The Tangent acquisition gives us local capabilities in two new geographic markets, one in Indianapolis and the other in Huntsville, Alabama. Indianapolis has an attractive life science market and Huntsville has a large aerospace and defense market. The Tangent integration is ahead of schedule, and we are pleased with the Company's early performance.

Turning to the fourth quarter and the fourth quarter results, our Service segment continued to perform at a high level and recorded its 52nd straight quarter of year-over-year revenue growth. In the fourth quarter, we generated 20% revenue growth and 8% organic Service growth as demand in our highly regulated end markets remained strong. We reported fourth quarter Service gross margin of 33.1%. The strong momentum carried into the fourth quarter, particularly from a margin perspective, was negatively impacted by the onset of the COVID-19 variant in late December.

In January, we experienced a significant case surge causing a record number of lab technicians and administrators to be absent from work. Nearly 10% of our lab personnel was impacted. While the challenge created inefficiencies in our calibration operation throughout the entire month of January, our dedicated team rallied, put in high levels of overtime, and met the critical needs of our customers. As expected, we returned to gross margin expansion in February and March, though Service gross margins in the fourth quarter did not fully recover from January's COVID spike.

Turning to our Distribution segment, in Fiscal 2022, revenue grew 15% as demand levels recover from prior COVID-impacted periods. In the fourth quarter, distribution revenue grew 7%, even as vendor lead times and supply chain shortages made it challenging to fill open customer back orders. We anticipate the current backlog level, which is at near record levels, will create a future tailwind for distribution when supply and demand move towards a more balanced scenario.

As I said at the beginning of the call, we are very pleased with the Fiscal 2022 performance. Significant growth in revenue, margins, and EBITDA, in conjunction with impactful progress on the acquisition front, validated Transcat strategy and effectiveness of its execution. The NEXA acquisition not only expanded our addressable market and improved our already strong value proposition, but in a sense, also reframed the Transcat story.

Our Pipettes.com business, which we acquired just two years ago, continued to grow at an accelerated pace. To accommodate the growth, in Fiscal 2022, we relocated to an expanded Boston area facility. We also began work on a newly leased organic calibration lab in Southeast Florida. The new lab will take advantage of Florida's attractive and growing calibration markets. We expect the new lab to be open early to mid-summer.

Our balance sheet remains strong with a leverage ratio just over 1.7 times, which positions us well to continue our acquisition strategy throughout the Fiscal 2023 year and beyond.

With that, I'll turn things over to Mark who'll provide a more detailed look at Fiscal 2022 fourth quarter and full-year financial performance.

Mark Doheny

Thanks, Lee.

I will start on Slide 4 of the earnings deck posted on our website, which provides detail regarding our revenue on a consolidated basis and by segment for the fourth quarter and full year.

Fourth quarter consolidated revenue of \$55.9 million was up 15% as we continued to see strong demand for both our services and products. Looking at it by segment, Service revenue growth remained very strong at 20%, with approximately 8% of the growth coming organically and the other 12% from acquisition. We continued to see robust demand across our highly regulated end markets, and as Lee mentioned earlier, the NEXA business continues to perform very well, and our recent Tangent acquisition is off to a strong start.

Turning to Distribution, revenue of \$21.2 million was up 7% as we saw improved demand from prior year in our base business, and our rentals business continued to perform very well. Supply chain conditions remained very challenged and vendor lead times continued to be extended as our year-end backlog was up approximately 25% from the end of the prior fiscal year. Finally, on a full-year basis, total consolidated revenue was \$205 million, an increase of over 18% compared to the prior fiscal year, which represents a new record high for Transcat.

Our Service business grew over 20% for the full-year and importantly, we saw consistently strong demand throughout the year as we reported 20% year-over-year growth in every quarter of Fiscal 2022. The Distribution business was up over 15% for the full year as we were able to take advantage of improved demand, even with the challenging supply chain conditions.

Turning to Slide 5, our consolidated gross profit for the fourth quarter of \$16.7 million was up 19% from prior year and our gross margin expanded 120 basis points to 29.8%. Q4 Service gross margin was 33.1% and contracted 80 basis points from prior year, a result of the January COVID surge that Lee discussed earlier.

To put a little more color around the severity of this impact, our January reported technician COVID cases easily spiked to pandemic highs and increased by more than 300% from prior year in January. As a result, the increased level of overtime worked and the lower level of vacation time taken temporarily drove up our costs in the quarter. We ultimately were not able to fully recover from the January gross margin shortfall, even as we returned to margin expansion in February and March.

Distribution segment gross margin of 24.5% was up 350 basis points from prior year and was driven by strength in our high margin rentals business and a favorable sales mix. For the full year, our consolidated gross profit increased 27% to \$58.4 million, and our gross margin improved 190 basis points to 28.5%. Our full-year Service gross margin hit a record high of 31.9%, which represents an increase of 160 basis points from the prior year and an impressive 660 basis point increase from Fiscal Year 2020.

The continued improvements we have made to our Service gross margin over an extended period of time demonstrates our ability to improve our technician productivity, take advantage of the inherent operating leverage in our business model, as well as complete acquisitions which are accretive to our margins.

Turning to Slide 6, Q4 net income of \$3 million decreased 5% from prior year and our diluted earnings per share came in at \$0.40. Both net income and earnings per share were negatively impacted by increased acquisition accounting costs as well as a modestly higher tax rate compared to the prior year. Acquisitions will continue to be an important part of our go-forward strategy, so with this in mind, we have introduced an adjusted diluted earnings per share metric, which normalizes for the impact of upfront and ongoing acquisition-related costs.

Q4 adjusted diluted earnings per share was \$0.54, which represents a 4% increase compared to Q4 of the prior fiscal year. A reconciliation of our Q4 and full Fiscal Year 2022 adjusted earnings per share to diluted earnings per share and net income can be found in the supplemental section of this presentation.

Finally, our full-year net income increased 46% from prior year to \$11.4 million. As a reminder, our full-year Fiscal 2022 effective tax rate of 13.7% was aided by discrete income tax benefits, largely related to stock-option exercises. For our Fiscal Year 2023, we expect our income tax rates in the range of 22% to 24%.

Turning to Slide 7, where we show our Adjusted EBITDA and Adjusted EBITDA margin. We use Adjusted EBITDA, which is non-GAAP, to gauge the performance of our segments because we believe it is one of the best measures of our operating performance and ability to generate cash.

Fourth quarter consolidated Adjusted EBITDA of \$7.7 million was up 5% from the same quarter in the prior year. Our Distribution segment showed strong improvement from prior year, while our Service segment EBITDA declined slightly as a result of the January COVID surge and investments for future growth.

Full-year EBITDA of \$26.3 million was up 28% compared to the prior year and was driven by the significant year-over-year profit improvement in both operating segments. As always, a reconciliation of Adjusted EBITDA to operating income and net income can be found in the supplemental section of this presentation.

Moving to Slide 8. Cash flow from operations was in line with our expectations as working capital increased on the very strong organic revenue growth. Full-year capital expenditures were \$10.2 million and continued to be centered around Service segment capabilities, including automation, rental pool assets and investments to support future growth. As Lee mentioned earlier, we made several investments to improve our lab facility footprint throughout the year, and in particular, the fourth quarter. These included the relocation of our Pipettes' Boston-area facility, the relocation of our Toronto-based lab, as well as beginning work on a new organic lab in Southeast Florida.

We believe these recent investments increase our capacity and capabilities and leave us well positioned for strong future revenue growth. For Fiscal Year 2023, we anticipate Capex to be in the range of \$8 million to \$9 million.

Turning to Slide 9 and the balance sheet. At year-end, we had total net debt of \$47.1 million with a leverage ratio of a little over 1.7 times. We had \$40.1 million available from our credit facility at the end of the year. As previously announced, we acquired Tangent Labs for \$9 million at the beginning of our fourth quarter, which was largely funded from the revolving credit facility. Lastly, we expect to file our Form10-K on or around June 7.

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

Lee Rudow

Okay. Thank you, Mark.

As we enter Fiscal 2023, we are well-positioned for profitable growth, and we expect the strength of our value proposition to continue to increase. For the past 10 years through various economic cycles, and now a pandemic, Transcat has delivered consistent revenue growth and attractive margins. We attribute the long-term consistency to the inherent nature of our service business, which is driven by highly regulated recurring revenue streams. We are confident and expect this will continue.

Strong organic growth remains the centerpiece of our strategy. Our new business pipeline is very active, and this team knows how to win. In Fiscal 2023, we expect organic Service growth in the high single-digit range. We also expect sustainable Service margin improvement to continue over the longer term. Future gains will be fostered by the inherent operating leverage in our Service business model, continuous process improvement, automation, and our new build-a-tech program.

On the acquisition front, we will continue to identify and pursue acquisition opportunities that expand our addressable markets, leverage our current infrastructure, and increase the trajectory of the business. Our strong balance sheet is supportive of our acquisition strategy and our active M&A pipeline.

I'll conclude by saying that we entered our new year, Fiscal 2023, in a better position than ever to continue and even accelerate the sustainable growth journey that we've been on for the past decade.

With that, Rob, you can open up the lines for questions.

Operator

Thank you. At this time, we will be conducting a question-and-answer session.

Our first question comes from Gerry Sweeney with ROTH Capital. Please proceed with your question.

Gerard Sweeney

Good morning, Lee and Mark. Thanks for taking my call.

Lee Rudow

Good morning.

Mark Doheny

Hey, Gerry.

Gerard Sweeney

Lee, you sounded like you have some very good confidence in the organic growth going forward this year. Just curious as to how much visibility you have with your clients. Obviously, we all know it's regulated end markets, but just curious if you have scheduled months in advance, multiple (inaudible), etc.?

Lee Rudow

I get it. I get the question. So, Gerry, I think when it comes to our Service segment, we've got a fair amount of visibility into the future, at least up to probably a quarter or two. In this business, depending on the size of the opportunity, the cycle can be extended even beyond 12 months at times, but the transactional business tends to turn from quote to order in a quarter or so. So, we look at our pipelines and they can pretty much color at least a couple quarters out, if not even three quarters, so we get a pretty good feel of the pulse and good visibility in service.

It's not the case with Distribution. We have much less visibility, maybe 60 to 90 days out, but Service is different. We've got pretty decent visibility.

Mark Doheny

Well, the other piece I'd mention, Lee—this is Mark, Gerry—that it's a highly recurring revenue stream that we have, so there's a—we mentioned we monitor our retention rates pretty closely and certainly above 90%, mid-90s, so even though it's not “in the books,” it's in all likelihood going to repeat and that gives us extra confidence as we look forward quarters.

Gerard Sweeney

Got it.

Switching gears to NEXA, the asset management service is a little bit different product offering. How well does that—in the prepared remarks, you alluded to (inaudible), but could you maybe give a little bit more detail as to uptake by some of your clients, or how that's progressing, or how you're sort of rolling that out, and how we should think about that going forward?

Lee Rudow

When we acquired NEXA, what we liked was they have what they call five or six service tracks around calibration, not the calibration itself, but all the ancillary type of services. Data management, reliability, compliance, and all the other managed services around calibration did a really nice job of growing their business around the value proposition that offered those services. So, we expected them to grow at, let's just say, x rate, based upon their historical performance.

We believed when we made the acquisition that the possibility existed that they could accelerate that growth by virtue of having access to our customer base and that we could also accelerate our growth at some point in the future by having their suite of services that are so very complementary to ours, and so we've had them for under a year, about nine months or so, and that has come to fruition.

So, what we tried to convey in the press release is that we are definitely seeing our customers accepting the narrative around their ancillary services, and their services in a vacuum, so to speak—their pipeline has developed in large measure at a higher rate due to having access to our customers. So, there are synergies that are absolutely being executed, and I think—we used to comment had met and beat our expectations, and I'll stick with that, it's been going very well.

Gerard Sweeney

Got it.

Is there a competitive advantage that having NEXA brings to your offering? Could you bundle some opportunities with some of your existing or even prospective customers?

Lee Rudow

Without question. We specifically use the line and intended to use the line that our value proposition is strong and continues to get stronger. We anticipate that that value proposition is going to increase. What we mean by that is when we sit in front of a customer today, whether it be a half a million-dollar customer or three-quarters of a million-dollar customer, and we have a NEXA person at the table with us, our chances of winning that order increase and our value proposition gets stronger, and our ability to communicate the combined value—our ability to do that will help increase our growth rates, those synergistic growth rates. So yes, we absolutely believe that's the case and that's happening.

Gerard Sweeney

One final question, this maybe a little bit more for Mark, but on gross margins, I know they're down 80 basis points year-over-year. It sounds like a lot of that or all of that was attributable to the spike in COVID. Would margins have been better this quarter if you backed out some of those headwinds associated with COVID, the inefficiencies and overtime?

Mark Doheny

Yes. The good news is we saw margin expansion in February and March, and we would confidently say that that gross margin would have expanded if it wasn't for the January COVID shortfall.

Gerard Sweeney

Got it. Okay. I'll jump back in the queue. Thank you.

Mark Doheny

Thanks, Gerry.

Lee Rudow

Thanks.

Operator

Our next question comes from Greg Palm with Craig-Hallum Capital Group. Please proceed with your question.

Greg Palm

Yes. Good morning, everyone. Thanks for taking the questions here.

Lee Rudow

Hi, Greg.

Mark Doheny

Hi, Greg.

Greg Palm

I guess just maybe starting with kind of what you're seeing in real time, I'm curious if you can comment on what you're seeing in terms of revenue trends quarter-to-date within Service, and whether that is consistent with your guidance commentary for the year. Is it fair to say that those gross margin increases within Service have continued into April and at least the first few weeks of May?

Lee Rudow

Yes, so to the degree that I can add color, we guide this year—the little bit of guidance that we offer is in the range—high single-digit growth. We do that, Greg, thinking and having a fair amount of confidence that we'll be able to achieve that throughout the course of the year, organically on Service.

So, we go into first quarter, we have a nice pipeline, a new business, a nice flow of revenue. It's not going to be linear, every quarter is not going to grow at the same rate, but I think when all is said and done from the visibility we have today, we feel pretty comfortable with the high single-digit organic growth range for Service.

As far as margin goes, we've been increasing our gross margin for several years now. Again, not every single quarter, but the trend throughout sort of an annual basis has been positive for us, and we see that continuing. It's not necessarily going to be at the same rate it was, but we want to have consistent gradual improvement in our margins. We believe this business can get into the mid-30s over time. We're still confident it can do that.

We would expect this year to have some margin improvement. It doesn't necessarily mean Q1 or Q2 or Q3, but when all is said and done, we're going to be heading in the direction, sort of upward and to the right over time, to improve this operation from all the things that we listed in our commentary.

So, yes, I think we see that as a consistent message from our perspective.

Greg Palm

Okay. Good.

Digging into the new greenfield lab in Florida, I guess my first question is when you decide to do that, is it because you don't think that there are maybe any good acquisition opportunities in that region? Secondly, how much of that opening of a new lab is driven by actual customer demand. When that's open, theoretically, do you have a big sort of pipeline of business that's ready to go or do you got to sort of go win that after the case?

Lee Rudow

Yes, it's a great question.

There's a combination of factors that drive it. One without question is if we thought we could make an acquisition in that territory that made sense, that was a good value, that met our strategic goals, we probably would've done that. That is our preference, but in the case of Southeast Florida, we made the decision we just had to be there. There's enough life science business in that area that we just couldn't wait any longer.

So, it's a combination of not finding the right acquisition, but also we have anchor customers in that area, so there are several customers with meaningful volume that we are servicing somewhat inefficiently from outside of Florida. By opening up a lab, we're literally in some cases down the street from current customers with decent volume. It just made sense. I don't like to open up organic labs, but if you have enough anchor customers, and you think there's enough growth.

So, yes, we have the anchor customers, but also the entire Southeast region, really from coast-to-coast in Florida, there's a lot of opportunity to grow that business. We like what we see when we look at our pipeline of opportunities. So, existing customers, opportunities, and we didn't find the right acquisition, a combination of those three factors are what really drove us to open up an organic lab.

Greg Palm

Okay. Makes sense.

I guess, last one, can you just sort of update us on the CBL pipeline, and what your thoughts are there as we progress throughout the calendar year here?

Lee Rudow

Right. We talked about—when we entered the year, we said our pipeline for CBLs was active and we anticipated selling some of these opportunities like we had done prior to COVID. We had a very hot CBL market for the couple years just prior to the pandemic. We have a solid pipeline for CBLs, we've already won several deals so far this year that will play out and impact this year. So, I think we're sort of back on the CBL track. Now, CBLs is just one type of sale that we make. It tends to be higher volume. Just to remind people, we get very embedded. It's a very sticky sort of win with a long lifetime value.

I would say we're doing well with CBLs with wins and with pipeline.

Greg Palm

Okay. Great. All right. I'll hop back in the queue. Best of luck going forward. Thanks.

Lee Rudow

All right, Greg. Thank you.

Operator

Our next question comes from Mitra Ramgopal with Sidoti. Please proceed with your question.

Mitra Ramgopal

Yes. Hi. Good morning, and thanks for taking the questions. Just a couple for me.

Just coming back to the surge in the Omicron, on the impact in the quarter, obviously it created some inefficiencies and impacted margins, but was there also any impact in terms of revenue, given the labor shortage you alluded to and maybe not being able to get as much or all the work done as you would've liked?

Mark Doheny

Yes. I would say the demand stayed consistently strong, as Lee said in the opening comments. I will say this that the growth was higher in February and March as we worked more overtime, particularly in January and throughout the quarter. So, on an overall basis, I would say it didn't really have an impact on the revenue for the quarter. Demand was still strong there. It was just the timing of when the revenue got shipped in the quarter, I would say.

Mitra Ramgopal

Okay. No, that's great. Thanks.

On the Pipettes business, you mentioned it's growing faster than you expected, and hence the headquarter relocation, etc. Just curious how you see that business as a growth catalyst for you as you look out to the organic growth you're expecting?

Lee Rudow

Right. We like the business. We liked it when we acquired it. It fits really well with our value proposition. It's a life science-oriented business. Again, has the recurring revenue streams, the criticality that we look for. So, when we look at the Pipettes.com business, and the bolt-on to that, which was Biotech, and we

look at NEXA, we're looking at what we would call expanded addressable markets. These are markets that we didn't formally service and now we do. I think it will help message the growth that we're looking for in the business, and it opens us up to a market that we wouldn't otherwise be in. So, we like the growth rates, and they're very supportive of our overall strategy.

Mitra Ramgopal

Okay. Thanks.

Finally, I might have missed this if you mentioned it earlier, on the Distribution side, I know backlog was really strong heading into the fourth quarter, just curious as you enter now Fiscal 2023, what's that looking like?

Lee Rudow

Again, we have the backlog issue, but we look at bookings every day, and we call a booking a new business opportunity that we've won, order in hand, it needs to be shipped. Really, so far, I would characterize our bookings levels being solid and stable, and so, no big surprises. We just have a bigger backlog. As the supply chain challenges continue, we will expect at some point, we'll get those out, but we're in the same position as everybody in our industry, I would say in some cases even more favorable because of our size and our ability to make strategic buys and get some movement of product, but it's still a challenge. But we haven't seen it yet on the booking side, so the bookings have been pretty stable.

Mitra Ramgopal

Okay.

Given the labor shortage you experienced this last quarter, has that sort of made you more inclined to be aggressive in terms of hiring more in-house, or training more in-house techs?

Lee Rudow

Well, I'm not sure it's directly related to the labor shortage in January. That was very much pandemic-related. To the degree that pandemics are something we need to think about long-term, I guess the short answer would be yes, but we're always thinking about labor.

I mentioned in our script, Mitra, that this past year, after many years of planning and many years of strategizing, we started the build-a-tech program here, we call it Transcat University. It's out of our Houston lab. We've already put through, I think, 28 technicians through that program in the last two quarters, and we're going to continue to build our own technicians.

There's lots of advantages to doing that. We can teach them how to operate automation right away, which makes them operators versus full technician status. They come in at a lower cost. These are hungry people who are excited to be here and be part of the industry that we work in. To the degree we keep this program going and finding these applicants, the program has done really well, and these have proven to be productive people. I think it bodes well for us.

I also think it's a differentiator. I don't know anybody else that's doing it, especially to the degree that we are. To the degree we can build these techs, that'll help support the growth opportunities that we'll need to service and that positions us very well. It's a differentiator for us.

Mitra Ramgopal

Okay. Thanks a lot. Thanks again for taking questions.

Lee Rudow

My pleasure. Take care.

Operator

We have reached the end of the question-and-answer session. I'd now like to turn the call back over to Management for closing comments.

Lee Rudow

Thanks, Rob.

Well, thanks everybody for joining us on today's call. We appreciate your continued interest in Transcat of course.

We'll be participating at the 19th Craig-Hallum Institutional Investor Conference on Wednesday, June 1. Feel free to check in on us at that conference or sign up for a one-on-one with us. Otherwise, we look forward to speaking with everybody when we talk after our first quarter results. Thanks again for participating.

Operator

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