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Transcat, Inc.

Second Quarter, Fiscal Year 2024 Financial Results

October 31, 2023

CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

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Edward Jackson, *Northland Securities*

Martin Yang, *Oppenheimer & Company*

PRESENTATION

Operator

Greetings. Welcome to Transcat Inc. Second Quarter Fiscal 2024 Financial Results. (Operator instructions)

Please note this conference is being recorded.

I will now turn the conference over to Tom Barbato, CFO. Thank you, you may begin.

Thomas Barbato

Thank you, Operator, 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 Chief Operating Officer, Mark Doheny.

We will begin the call with some prepared remarks, and then we'll open up the call for questions.

Our earnings release crossed the wire after the market closed yesterday. Both the earnings release and the slides that we will reference during our prepared remarks can be found on our website, transcat.com, in the Investor Relations section.

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 R. Rudow

Okay, thank you Tom.

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

Transcat delivered strong performance across our entire business portfolio again in the second quarter of fiscal 2024. Consolidated revenue was up 11% to $62.8 million, as demand for Transcat services continued to be strong. Consolidated gross margin expanded 230 basis points to 32%, as margins expanded in both our service and distribution segments. Adjusted EBITDA, a key metric for us given our successful acquisition strategy, grew 24% from the prior year to $9.3 million. Operating cash flow in the second quarter was $8.5 million, and $16 million year to date.

Turning to our second quarter service segment performance, our differentiated suite of services continued to support performance at a very high level. We recorded our 58 straight quarter of year-over-year service revenue growth. Service revenue grew 17%, including double digit organic service growth of 10%. Recurring revenue streams and a differentiated defendable value proposition continue to foster durability and resiliency in our service growth model. We continue to benefit from strong demand throughout multiple regulated service industries that include pharmaceutical, medical device, biomedical, and as well aerospace and defense.

Service gross margin was 34% in the second quarter, which represents 140 basis point increase over prior year. Margin expansion was primarily driven by leverage on double digit organic growth, increased productivity from automation, and significant process improvements throughout our network of calibration labs.

Turning to distribution for the second quarter, gross margins expanded 340 basis points from prior year, driven by growth and an increase in mix of our high-margin rental business. Both core distribution and rentals continue to drive a significant number of leads and opportunities into our service segment, supporting consistent strong organic growth. The combination of products, rentals, along with calibration and NEXA's cost control and optimization services remains unique. We have executed well, expanding our addressable markets, and our value proposition has never been stronger.

Overall, strong performance for Transcat in the second quarter of fiscal 2024. The 24% increase in EBITDA is due in part to our ability to achieve our revenue and cost synergy objectives on the companies we acquire.

We start by identifying and acquiring companies that are good strategic fit for Transcat, but those are only the first two steps. Whether we acquire an adjacent company to expand our markets, a geographic footprint addition, or a classic bolt-on to our core calibration services, it is through integration that Transcat drives differentiation. We are very proud of the work our team has done on this front. You can see it in the results of their work as margins and profits increase. Of course, acquisitions will continue to be an important part of our overall growth strategy.

In the second quarter we acquired Axiom Test Equipment Rentals, the largest acquisition in Transcat's history, and SteriQual, a life science service company specializing in commissioning, qualification, and validation services.

Axiom is a great synergistic fit with Transcat's traditional rental business that was launched organically in 2015. Growth synergies between Axiom and Transcat's traditional rental business include go to market selling and marketing strategies with complementary inventories and customer base. We expect the combined rental business to perform well as we capitalize on what we consider a "one plus one equals three" opportunity.

SteriQual expands our addressable market within the NEXA cost control and optimization space. SteriQual also fortifies NEXA's differentiated single source solutions model, NS3.

In addition to the two acquisitions, in the second quarter of fiscal 2024, perhaps what stands out most is the completion of a public offering of our common stock, which was used to repay our credit facility. The highly successful offering displayed robust demand for Transcat stock among institutional investors who recognize, understand, and value our long-term demonstrated track record of profitable revenue growth, expansion of addressable markets, and sustainable margin improvement.

With that I'll turn things over to Tom for a more detailed view of our fiscal 2023 second quarter results.

Thomas Barbato

Thanks Lee.

I'll 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 second quarter of fiscal 2024.

Second quarter consolidated revenue of $62.8 million was up 11% versus prior year, on service segment strength and slight growth in our distribution business.

Looking at it by segment, service segment revenue growth remained very strong at 17%, with 10% of the growth coming organically and the other 7% from acquisition. As Lee mentioned, we continue to see high levels of demand in our services business.

Turning to distribution, revenue of $21.4 million grew 1% from the prior year. We continue to see growth in the higher-margin rental business, which also benefited from the Axiom Test Equipment acquisition, which closed in mid second quarter.

Turning to Slide 5, our consolidated gross profit for the first quarter of $20.1 million was up 20% from the prior year, and our gross margin expanded 230 basis points in the second quarter.

Service gross margin expanded 140 basis points. The service margin increase further demonstrates our ability to benefit from the inherent leverage in our operating model, as well as higher levels of technician productivity, supported by continuous improvement initiatives like automation and process streamlining within our networks of labs.

Distribution segment gross margin of 28.3% was up 340 basis points from the prior year, driven by a larger mix of higher-margin rental revenue.

Turning to Slide 6, Q2 net income of $0.5 million decreased from the prior year, due to a non-recurring, non-cash charge of $2.8 million for the previously disclosed amended NEXA earn-out. The NEXA earn-out agreement was amended to recognize the expanded scope of the NEXA portfolio, which includes the acquisition of SteriQual, and this change is based on current expectations of future business performance.

Diluted earnings per share came in at $0.06. The one-time earn-out charge reduced earnings per share by $0.35. We report adjusted diluted earnings per share as well, to normalize for the impacts of upfront and ongoing acquisition-related costs. Q2 adjusted diluted earnings per share of $0.60 increased $0.16 or 36% from the prior year. A reconciliation of adjusted diluted earnings per share to diluted earnings per share can be found in the supplemental sections of this presentation.

Flipping 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 business because we believe it is the best measure of our operating performance and ability to generate cash. As we continue to execute on our acquisition strategy, this metric becomes even more important to highlight, as it does adjust for one-time deal-related transactions costs as well as the increased level of non-cash expense that will hit our income statement from acquisition purchase accounting.

With that in mind, second quarter consolidated Adjusted EBITDA of $9.3 million was up 24% from the same quarter in the prior year, and Adjusted EBITDA margin expanded 160 basis points. Both segments had Adjusted EBITDA growth compared to last year.

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, operating free cash flow significantly improved, up $10 million versus the prior year. We've generated $16 million in operating cash flow in the first half of the fiscal year.

Q2 capital expenditures were $600,000 higher than prior year, and continue to be centered around service segment capabilities, technology including automation, and future growth projects.

Slide 9 highlights our strong balance sheet. At the end of the quarter, we had a total net debt of $52 million, with a leverage ratio of 1.37x, and $32 million available from our credit facility. Subsequent to the end of the quarter, the revolving credit facility was paid off using the funds from the secondary offering, which closed early in the third quarter.

Lastly, we expect to file our 10Q on November 1, and with that I'll turn it back to you, Lee.

Lee R. Rudow

Thanks Tom.

Transcat consistently delivered exceptional results throughout the past decade and through various economic cycles. We expect profitable growth and sustainable margin improvement to continue, as we increase shareholder value. We expect our successful and unique acquisition strategy to drive synergistic growth opportunities and expand our addressable markets. We expect to leverage continuous process improvement and automation, including robotics, which we are in the very early stages of developing, as key enablers to future margin expansion. In other words, we expect to get bigger, and we expect to get better. That's the Transcat way.

As we work our way through the third quarter of fiscal 2024, we are still expecting high single digit to low double digit organic service growth for the full fiscal year, and we expect gross margin expansion as well. Perhaps most importantly, we expect to develop, recruit, and retain superior management and leadership throughout our organization. It's the people at Transcat that continue to move the needle and push the Company to new heights. We expect to continue that as we journey into the future.

With that, Operator, please open the line for questions.

Operator

Thank you. (Operator instructions) Our first question is from Greg Palm with Craig-Hallum Capital Group. Please proceed.

Greg Palm

Thanks, good morning, everyone. I wanted to start with service gross margin, on an absolute basis was really strong, and I think the improvement on a year-over-year basis was the highest in some time. I guess, kind of a continuation of what you've been seeing over the years, but in terms of kind of the greatest positive impacts, where are you seeing that and should we assume that level of year-over-year improvements for the remainder of the year, or was there something kind of one-time in nature that drove some of that strength specifically in the quarter?

Lee R. Rudow

Okay thanks, I'll take that question, Greg. It's a combination of things that we alluded to. No surprise that strong organic growth is going to always help our margins. There's inherent leverage in this business model, we've talked about that through the years, and I think volume helps, volume will continue to help. To the degree that we continue to grow organically at the rate that we have, you'll see margins improve from that.

Also, automation. We are now probably in our third or fourth year of focusing on automation. We introduced it some years back, and we're picking up some momentum as well. There's no question in our minds, as we track the data that that's a contributing factor, and that will also continue to contribute we're certainly not at the end of our opportunities there.

Process improvement in general. We've done a lot of work leaning out these labs, working on our processes from the moment the product comes into our facility to the moment it leaves. I just think that, when we look at these processes and some of the improvements we've made, they're a contributing factor.

When you look forward, most of the things are going to continue, but I'm always hesitant to guide quarter by quarter on margins, because there's different factors. You got CPL, second startup, and have a short-term drag, there's other factors as well, so yes. Margins will continue to improve, we expect that, over time, and over the next few years, and it will be pretty consistent. I don't want to get into a quarter-by-quarter guidance on that, but much of what you've seen in the past I think you'll see in the near future.

Greg Palm

Okay, fair enough. Then, if I could just switch gears to distribution and talk a little bit about Axiom, what kind of overlap is there, maybe you can dive into a little bit of the potential revenue synergies that could play out. Then just in terms of rentals as a mix of total distribution revenue, where does that get you now and maybe you can just remind us of the margin structure of rental versus equipment sale.

Lee R. Rudow

I'll start—I'll let Tom talk about Axiom as a percent of total distribution revenue, but I'll talk to the synergies, Greg. There's some really great synergies with this deal, and that's why we were excited from the outset. We've got inventories of potential rental equipment on their side of the business that very much will help us with our core customer base, and it goes both ways. Our inventory and their inventory, there's some overlap but not a lot. We expect to sell our respective inventories to each other's customer base. That's a big one.

The way we go to market, Transcat is more driven by—our sales are driven by marketing, robust marketing plans, domain authority on the Web, link equities that we have, where people recognize us from a digital world. They do a lot of traditional selling. Again, this is a synergy, because we're going to use our marketing expertise to help them grow their business, and they're going to be using their "feet on the street", so to speak, salespeople to help us with ours. Two great synergies. The customer bases themselves are different. We like this deal for all those reasons.

As far as you want to address, Tom …

Thomas Barbato

I think, Greg, I mean if you think of the combined distribution business now, the rentals is 20% to 25% of the combined distribution now. We take what we had and add the Axiom business to it.

Greg Palm

Just remind us on the margin structure of rentals versus an equipment sale.

Thomas Barbato

When we had acquired Axiom, we had kind of disclosed that the margins were 55% or better on the combined rental business.

Greg Palm

Okay great. All right, I will leave it there. Thanks. Best of luck.

Lee R. Rudow

Thanks, Greg.

Operator

Our next question is from Ted Jackson with Northland Securities. Please proceed.

Edward Jackson

Thank you very much and congrats on a very very solid quarter.

Lee R. Rudow and Thomas Barbato

Thanks Ted.

Edward Jackson

I'm going to go into some weeds, sorry about that but I always do. With the transaction closing and the money that you raised, I mean it clearly wasn't in the current quarter, you're paying off the credit facility. How much money did actually come in with the deal? I think it was supposed to be $65 million or so. Then last quarter the credit facility was at $42–43 million, so when I look at your balance sheet, as we kind of think about that, how much cash is on your balance sheet, and am I correct, (inaudible) take the call it 65 and subtract out 43, (inaudible) with this and your debt's down by 43, and then the differential is in cash on your balance sheet?

Thomas Barbato

Ted, it's Tom, right? The net proceeds were about $75 million, right, because we did the initial deal at 70, and then another 10.5 under the green shoe that was done, right? We netted about $75 million. I'm going to talk round numbers: 50 of that went to pay off our credit facility, and we've got about $25 million net cash subsequent to the revolver being paid off. We've got about $4.5 million to $5 million of term debt that remains at roughly 4% interest. That'll be the only interest expense we have until we kind of tap into that cash balance.

Edward Jackson

Okay. That was very helpful. Any chance you can give me just kind of the breakdown in services between service third party and freight, at least on a percentage basis, just to let me clean up my model?

Lee R. Rudow

Yeah, it's in the Q, which we'll be filing tomorrow. I don't have that off top of my head, Ted, I apologize.

Edward Jackson

That's okay. Then, with regards to going back into the margins because margins were really—were fabulous. When I think about in particular on the distribution side of margins and the strength you had there, is it just fair to say that, with the new mix in the rental business, that that's kind of the new baseline for distribution margin on a go forward basis?

Thomas Barbato

When we did the acquisition of Axiom and we said that we expected to go forward, once we got kind of into steady state, that the distribution margins would be in the 28% to 30% range. We're kind of already at the low end of that range, and we still feel comfortable with that range for distribution in total.

Edward Jackson

Then, on OpEx, you actually had a little better leverage in there than I expected, just in terms of the different acquisitions and everything that's happened as of late. How should we think about OpEx with regards to at least kind of a step up from second quarter to third quarter, and kind of how should we think about how that scales out as we go forward?

Thomas Barbato

I think we should expect some continued investments. We've talked about some of the heavy lifting being behind us, but I think we should expect some moderate increases going forward. We continue to invest in sales, we continue to make some investments in IT and cyber security, which you just need to do. But we believe a lot of the heavy lifting is behind us, with the increases that we saw in last year, the year before.

Edward Jackson

Okay, and then one last question and then I'll get out of line. On the customer base lab front, can you talk a little bit about kind of pipeline and activity on that front?

Lee R. Rudow

I'll take that one, Ted, this is Lee. Yes, the CBL pipeline is pretty solid. In fact, I would say it's very solid, as solid as it's ever been. We expect that to continue, as long as the labor market's tight, and I'm not going to suggest we're the only company that services CBLs, but it's certainly where we have an expertise level in that, that is different than our competition. I think we're really well positioned to do well in that space. I would expect, throughout the remainder of this year and into next, that the pipeline we have will support strong growth there.

Edward Jackson

Okay. I'll get out of line. Again, congrats on the quarter. Thanks for taking the questions.

Lee R. Rudow

Thank you, Ted.

Thomas Barbato

Thank you, Ted.

Operator

(Operator instructions) Our next question is from Martin Yang with Oppenheimer & Company, please proceed?

Martin Yang

Good morning. Thank you for taking my question, Lee and Tom. Can you maybe talk about NEXA, give a sense of how the business has grown by itself and what are the synergies, especially revenue synergies, you have seen between NEXA and your calibration and distribution business thus far? Finally, maybe the outlook for the NEXA combined with SteriQual, how that overall consulting business can grow in the longer term. Thanks.

Lee R. Rudow

Okay. We acquired NEXA, it seems like about 2.5 years ago, roughly. The business has done really well. We acquired at the time a business that since doubled in size, more than doubled in size in that period of time. We think it's performing very well. There's a lot of synergies, Martin, that we've been able to leverage, take advantage of between Transcat and NEXA mostly, but there's two avenues of synergies that we've performed well. One is, we've given NEXA access to our customer base, and some of that growth, since they've more than doubled, comes from Transcat traditional customers who are interested in NEXA services. That's been very clear and evident—that's been a clear and evident synergy for us. The second one has been, when Transcat goes to the table and is trying to win a new opportunity, whether it be a CBL or a traditional onsite or a traditional body of work, we have NEXA sitting at the table with us often. Not only are we talking about winning an opportunity that we currently don't have, that our competition has, or an in-house lab is running, and with NEXA sitting by our side we're able to strengthen our value proposition. Our chances of winning increase significantly. We've won deals that we would have otherwise not won on the traditional Transcat side, because NEXA partnered with us in our proposal.

I think it goes both ways, the synergies, and we've done a really nice job. I see that continuing and maybe even improving as we go forward and get to know how to work with each other better, get to know each other's companies. This is just the early read, and the early read's been strong.

SteriQual folds up really nicely under the NEXA suite, because NEXA didn't offer commissioning services, and now they can. They do validation as well, which is something that NEXA did offer, but it advances that value proposition. Working together, we expect growth to obviously be at a higher rate, since we have more to offer, and we're not going to guide beyond that at this point, other than to say that the outlook with NEXA and SteriQual together is stronger than just NEXA by itself, because the suite of services has expanded. SteriQual is a really nice small boutique company. I think we can help them with some of the traditional ways we run and grow the business, it would be beneficial to them, and it's also been beneficial to NEXA. We expect that trend to continue for those reasons as well.

Did that answer your question, Martin?

Martin Yang

Yes. Sorry, I was on mute. Thanks Lee. One more question from me is on gross margin Axiom. Can you talk about the positive benefit on gross margin due to Axiom's integration last quarter? Then, do you expect a meaningful contribution on gross margin uplift from the full integration of Axiom in fiscal 3Q?

Thomas Barbato

Yeah, Martin, the impact in this past quarter was not significant. We only had seven weeks in the quarter, so it did positively impact distribution margins, but we'll see more of a full quarter impact in this upcoming quarter. But you know our intent is not to really talk about the specifics of margin in distribution and break it down into the individual pieces kind of on a go forward basis. We expect, as we've said before, that going forward we expect distribution margins in total to be in that 28% to 30% range. We're already in the low end of that range, so I think you can kind of take it from there.

Martin Yang

Thank you, Tom. That's all from me.

Operator

Our final question is a follow-up question from Ted Jackson with Northland Securities, please proceed?

Edward Jackson

Great, thanks. Hey, I just wanted to touch base on both automation and kind of what's going on within Ireland, with kind of the acquisitions you had in that front. You brought up automation as one of the drivers for margin. I know it's been an area, Lee, that you've been focused on, and you've been kind of slow and methodical with it. Maybe kind of an update on kinds of things that you're automating and kind of where things stand with regards to that effort, and then, behind that kind of, a progress report with regards to the penetration of the Irish market. Thanks.

Lee R. Rudow

Okay. First let's talk about automation, and a small subset of that will be robotics. Automation is a very difficult initiative to execute. We knew that going in, but we also knew that once we did it, and for each, you know, when we made progress, each element of progress that we make would (audio interference) slow going and arduous. But the results in the last few quarters, you could just see the margins, and we can track it back to the number of technicians that we have, how efficient they are. We have productivity ratings for each technician, how often are they on the bench, how effective are they when they're on the bench, how much automation are they using, how many calibrations are they doing that are redundant to the time they're spent doing automated cal, these are type of KPIs we're tracking. We know it's working and will continue to work.

What inning are we in? If I had to characterize it, I used to say we're the first, second inning. We're probably in the fifth inning of that game. We've progressed from the first, second, third inning to the fifth inning. There's still plenty of work to do.

Robotics is a subset of that, you know, the Irish company we bought is a robotics company. We are now doing mass calibrations, for example in Philadelphia in our LA labs, we have two robots in each lab. In Ireland, that robotics team, they're now working on digital multi-meters, and I think on deck is temperature and pressure after that. Again, not a fast process, but robotics is actually faster than traditional automation. Like I said, we've already got robots running.

These are things that are going to help us get to that high thirties from the mid-thirties and beyond. That's our ultimate goal. We're pleased with that progress. The Irish market itself, as far as developing it for the calibration business, we bought that very very small company, we've got some interesting plans in the works to try to grow that organically. It's really early for us to get into too many details on that, but we intend on growing our calibration business in the Irish market, and really kind of exclusively in the Irish market as far as Europe goes. That's where our cal lab is, that's where we'll do work, and that's where we'll grow organically. Unlike the NEXA business that's more scalable throughout Europe because it's just easier to grow that business and to follow our customers throughout the European footprint, calibration will be in Ireland. It's early days there, but we intend on growing it organically for sure.

I hope that's helpful, Ted.

Edward Jackson

It was. Thanks very much.

Operator

There are no more questions in the queue, I would like to turn the conference back over to management for closing comments.

Lee R. Rudow

Okay. This is Lee and thank you all for joining us on the call today. We appreciate your continued interest in Transcat. As always, we'll be participating in the Roth and the Craig-Hallum conferences in New York City on November 15 and November 16, feel free to check in on us there. If not, you're always welcome to check in on us anytime, we look forward to talking to everybody, and if we don't hear from you, we'll talk to everybody after we have our third quarter results. Thanks again for participating in today's call.

Operator

Thank you, this will conclude today's conference, you may disconnect your lines at this time, and thank you for your participation.