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Transcat Inc.

Third Quarter Fiscal Year 2025 Financial Results

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Greg Palm, *Craig Hallum*

Edward Jackson, *Northland Securities*

Martin Yang, *Oppenheimer*

PRESENTATION

Operator

Greetings and welcome to Transcat Incorporated's Third Quarter Fiscal Year 2025 Financial Results.

At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the call over to your host, Tom Barbato. 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, Mike West. 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 markets closed yesterday. Both the earnings release and the slides that we'll 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 cautionary 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

Thank you, Tom.

Good morning, everyone and thank you for joining us.

Fiscal 2025 third quarter consolidated revenue was up 2% to $66.8 million; however, organic service revenue declined 4% from prior year third quarter. Last quarter, we talked about the NEXA solutions channel and that our expectations were that softness in that channel would continue through the current fiscal year. This continues to be our view, and the team is focused on pipeline development and getting new solutions deals across the finish line.

What we did not anticipate in the third quarter was the December decline in core calibration service demand following in October and November, which was largely in line with expectations. We discovered that the midweek Christmas holiday drove extended manufacturing closures in the back half of the month. Essentially, this affected the incoming calibration service work in two ways. In the front end of December, many of our customers ramped up manufacturing to meet demand up to and through the holiday shutdowns. The intensified production makes it difficult to send in equipment for calibration. In the back end of December, extended holiday facility closures and reduced staffing levels contributed to a reduced volume of incoming equipment through the end of the calendar year, so timing contributed to the December service shortfall. As one would expect, service revenue picked up significantly in January as a result of pent-up demand from December.

Stepping away for a moment from the quarterly performance, on December 10 we acquired Martin Calibration. We were very excited to get this deal done as Martin satisfies all of our strategic acquisition requirements. With annual revenues more than $25 million, Martin gives Transcat a strong presence in the midwest, including Minneapolis, Chicago and Milwaukee, as well as Tempe, Arizona and Los Angeles, California. Martin's flagship lab is in Minneapolis, an area rich in medical device and life science. This is a region that relies heavily on quality calibrations and related services and solutions.

From a bolt-on perspective, we anticipate the ability to leverage our current operational infrastructure by combining our Arizona and L.A. labs with the Martin facilities that are in very close proximity. From a capabilities perspective, the two companies are very complementary. Martin brings a higher level of expertise on the mechanical and dimensional side and represents an ideal match with Transcat's advanced capabilities on the temperature, pressure and electrical side of the business. In addition to the cost synergies you would expect over time with bolt-on acquisitions, we expect to drive service growth by leveraging the expanded combined capabilities of both Martin and Transcat. The integration process is off to a great start as we work to optimize the early returns on this exciting, coveted opportunity.

Turning to distribution, revenue grew 7% in the third quarter; in December, however, due to the extended closure of many of our customers, our rental channel experienced a similar decline in demand as our core calibration services channel. The rental revenue decline in December resulted in a distribution segment mix change that negatively impacted distribution service margins.

Before I turn things over to Tom, I want to point out that the Transcat team has consistently delivered excellent results over an extended period. We have a demonstrated track record of driving growth and productivity. Our team is working to overcome the near term challenges we've encountered the last couple quarters, and this primarily pertains to the year-over-year softness of the solutions channel. From a traditional calibration services channel perspective, we currently have a very strong pipeline of new high probability opportunities, and as we close out fiscal 2025, we are prepared for a strong fiscal 2026.

With that, I'll turn things over to Tom for a more detailed look at the third quarter financial 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 third quarter of fiscal 2025.

Third quarter consolidated revenue of $66.8 million was up 2% versus prior year, driven by growth in distribution. Looking at it by segment, service revenue grew slightly. A 3.8% organic decline was offset by growth from acquisitions. As Lee mentioned, service revenue was negatively impacted by the unexpected extended December holiday closures at our customer sites, as well as the anticipated year-over-year decline in the Transcat-NEXA solutions channel.

Turning to distribution, revenue of $25.2 million grew 7%, driven by strong product sales and rental growth.

Turning to Slide 5, our consolidated gross profit for the second quarter of $19.7 million was down 6% from prior year. Service gross profit declined 8% versus prior year. Continued leverage from higher levels of technician productivity could not offset the headwinds caused by lower organic revenue levels. Distribution segment gross profit of $7.3 million was down 2% as margins were pressured in third quarter due to mix.

Turning to Slide 6, Q3 net income of $2.4 million was down $1 million versus prior year. Diluted earnings per share came in at $0.25, down $0.13. We report adjusted diluted earnings per share as well to normalize for the impacts of upfront and ongoing acquisition-related costs. Q3 adjusted diluted earnings per share was $0.45.

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 best measures 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 transaction costs as well as the increased level of non-cash expenses that will hit our income statement from acquisition purchase accounting.

Third quarter consolidated Adjusted EBITDA of $7.9 million was down 13% from the same quarter in the prior year as extended December holiday closures and the expected solutions revenue softness negatively impacted third quarter EBITDA. 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 cash flow and operating free cash flow were both higher year-over-year. Q3 capital expenditures were $1.4 million higher than prior year and continued to center around service segment capabilities, rental pool assets, technology, and future growth projects. The spend was in line with expectations.

Slide 9 highlights our strong balance sheet. At quarter end, we had total net debt of $40.8 million with a leverage ratio of 0.97x. We had $39.5 million available from our credit facility, and as previously announced, we acquired Martin Calibration for $79 million in fiscal Q3, paid in combination of $69 million in cash and $10 million in Company stock. Lastly, we expect to file our Form 10-Q on February 5.

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

Lee Rudow

Okay, thanks Tom.

As we wind down the fourth quarter, we expect fiscal 2025 organic service revenue to be in the low to mid single digits, once adjusted for the 53 week in fiscal 2024. Of course, that is below our expectations, and as I mentioned earlier, it's driven by the softness—primarily driven by the softness in our solutions channel that negatively impacted our organic growth rates in fiscal 2025. We're certainly looking forward to improved solutions performance in the year ahead.

Relative to our core calibration business, we have a strong pipeline and momentum. Both are building as we get ready to embark on fiscal 2026. We believe organic service growth in fiscal 2026 will be more in line with our historical performance. We will continue to focus on the full integration of Martin Calibration. Working together, we expect to capitalize on the numerous opportunities we have for both service growth and productivity gains.

I've shared my vision for the Company over the years, which includes strong organic service growth, an industry-leading value proposition, inherent service operating leverage, lower cost of goods sold and SG&A over time, driven by process improvement, automation and other productivity-improving initiatives, strong operating cash flow, and sensible expansion of addressable markets. We still believe in our vision, our goals and our ability to achieve them. We're excited for the fiscal year ahead.

With that, Rob, you can open the line for questions.

Operator

Thank you. At this time, we'll be conducting a question-and-answer session. If you'd like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you'd like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star key. One moment please while we poll for questions.

Our first question comes from Greg Palm with Craig Hallum. Please proceed with your question.

Greg Palm

Yes, good morning. Thanks for taking the questions here. I wanted to start, I guess with the near term outlook. Understand some of the timing around the holidays. You still—and it sounds like things picked up in January, but you still took down the full-year guide. I'm just curious, if it was timing, just things slipping from December to January, you won't expect that guide to come down, but it did, so was there sort of more of a deferral, or I guess, what's kind of the incremental weakness here relative to what we were talking about three months ago?

Lee Rudow

This is Lee, I'll start, and maybe Tom can add some color as well. Yes, we had the slowness in December. We spoke to many of our customers during and after the slowdown, so we confirmed that that was taking—that took place and impacted the numbers. Business has generally gotten very busy in January, so we made some of that back.

Just looking at the full year, looking at the solutions impact, continued impact, we're just—we're confident that we'll be in the mid single-digit range for organic growth, generally speaking. There's been—you know, there has been some relative delays in some orders, and we think with high probability that we expected to close in Q3, some will close at the back end of Q4, maybe early into fiscal year in April, but we're just being conservative in the guidance.

Greg Palm

Yes, okay. Can you maybe just give us a little bit more color on the visibility in the pipeline and really tie this back into expectations for next year? Last quarter, I think you were confidently talking about returning to high single digit organic growth. I think the commentary is a little bit more vague, understandably so, but any comments on visibility, pipeline, timing around some of the closures? That'd be pretty helpful.

Lee Rudow

Yes, right now, our core calibration pipeline is very strong. It's about as strong as I probably have ever seen it, which is good. There's a couple of big opportunities, for example where we've gotten verbal confirmation, yes, we're going to go with Transcat, we're going to proceed according to these terms and this timing. Some of those have been delayed, which has affected our softer guidance, trying to get our arms around exactly when some of these jobs are going to start. There's a variety of reasons why you have delays like this. We can get into some of them if you like, but generally speaking, the pipeline is very strong. I think that's the most important point.

For us, it's a matter—and they have to come to fruition, of course, and that doesn't always happen, but we feel pretty good about where we stand going into the year, into the timing. I think when we talk about—we're a little vague for Q4, but when we talk about next year, particularly in the back half, Greg, as some of these things come to fruition, we're feeling pretty good about the level of activity that we're seeing, so not a lot has changed. I think when we look at the solutions business improving throughout next year and we combine that with the pipeline activities, the macros appear to be pretty strong, and there's no reason to believe that we shouldn't be back to more historic levels in terms of sales.

Greg Palm

Got it, okay. That was going to be my next question or final on this level of thinking, just making sure that nothing structural has changed, whether it's large numbers or something else. But historically you've demonstrated, and you've talked about this high single digit, low double digit organic growth profile for the service business, and understand a couple of hiccups recently. Anything, as you look ahead over the next handful of years, there's nothing that gives you hesitancy in your ability to sort of match those targets?

Lee Rudow

Absolutely not. We have to keep things in perspective. We've had a lot of growth over a very, very long time, quarter after quarter after quarter. Nothing has changed. Still, we have recurring revenue streams; still, the business is driven by regulation; there hasn't been any competition that we've noticed that is taking market share or doing anything differently. We're still in a really good position, and when you just take a little bit of a broader perspective on the sales engine, which from our perspective continues to get better, there's always tweaks that you can make, there's always technology that you can implement to make the sales process and other processes better. We're working on all those things.

To have a couple of quarters that you're in the mid single digit growth as opposed to high, or even low double digits, that's to be expected. You can't win every game the same way, but we are a really good team, a really good plan. The fundamentals are the same, and we expect that over the long term and even the midterm, we expect strong performance from this Company. I can't point to anything today that would stop me from believing that, so we expect a good year and the pipeline going into the year supports it. We'll see. You never know 100%, but I like the fundamentals, nothing's changed, and we've just got to get over a couple quarters of softness that, for the most part, that we have identified the areas that need to be addressed, so we feel pretty good about the upcoming year, yes.

Greg Palm

All right, thanks Lee.

Lee Rudow

No problem, Greg. Thanks.

Thomas Barbato

Thanks Greg.

Operator

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

Edward Jackson

Thanks very much. Good morning. I've got a list of questions. Let's start with the NEXA-Transcat services, and maybe get an update with regards to the actions that you've taken so far and the actions that are left to put that business back where you want it to be.

Lee Rudow

Yes, so from a solutions perspective, it's something we're talking a lot about. There's two ways to look at the solutions business. One is as a standalone business that offers five or six service tracks in the ecosystem for calibration, and that business has to be profitable, and that business has to grow. Those are our expectations.

There's also, Ted, the benefit that you get from the solutions business in terms of organic growth for our calibration services business, because they also sit at the table with us, literally and figuratively, when we're trying to win new business. They're a differentiator. Their suite of services make our calibration business in some cases more affordable and helps our customers accomplish and complete their goals.

We like the business, we just needed better pipeline development and needed a different way to sell, and needed our marketing team involved while we're doing all these things. Unfortunately, the nature of that business is you're just not going to turn around in a quarter or two. It takes a few quarters. We think we're doing all the right things. The pipeline is better today. That's a fact than it was when we discovered that we needed to work on it, and I think we'll get it to be an improved business, stable and growth in time. I'm not overly concerned with it, it's still a relatively small business, but we expect that it will be, I'm going to say back on track next fiscal year, and earlier the better.

Edward Jackson

Okay, thanks. Then just shifting over to more just some model questions, like service gross margins, the lowest it was since third quarter of '23. I know volume was a big impact there, but we're expecting to see a rebound in the fourth quarter and carry forward into '26. Can you give us some kind of view on what you would expect your service margins to be next quarter and how we would think about that for next fiscal year?

Thomas Barbato

Yes, I think, Ted, as we've talked and gone through models, I would expect Q4 to be more in line, to be kind of flat year-over-year, and then continue to grow as we look into fiscal '26 and beyond.

Edward Jackson

Then shifting over to distribution, you did see—I know you said it said it was a loss, but there was a little bit of recovery from last quarter. How do we think about that, you know, fourth quarter '25, '26, and then can you provide some kind of—you know, did we get the recovery (inaudible) that we expected with regards to some of the rental stuff? Maybe an update on that front, too.

Thomas Barbato

Yes, so let me take that in pieces, right? From a margin standpoint, certainly we've talked in the past about being consistently above 30% on the distribution side and growing from there as the mix towards rentals continues. I think if we—you know, we certainly would have been there if we didn't see the slowdown in rentals that Lee referenced in the back half of December. Then as we look ahead, certainly that 30% threshold is one that we're—we feel that we should be able to achieve. Then as I said, as we see a better--a bigger mix towards rentals, we should see some growth from there.

Becnel (phon) was certainly better sequentially in Q3 versus Q2, and we expect it to be better in Q4 sequentially than Q3.

Edward Jackson

Okay, and then—I lost my train of thought. I wanted to hit something else on your earlier answer on the margin. I'll come back to it, maybe it'll come into my head.

How about just on pro forma earnings? How should we think about—you've just done a pretty large size acquisition. How should we think about the amortization of intangible assets within your pro form earnings, and also acquisition deal costs for fourth quarter and FY26?

Thomas Barbato

Why don't I follow up with you on that, Ted? I don't have the numbers in front of me right now, but I know when we talked about the model after the acquisition, I think we had done that update, but I could follow up with you via email.

Edward Jackson

Yes, I'm just double-checking. Then shifting over to working capital, your receivables were up, inventories were down, payables were up, the turns all filed, all that kind of stuff. Can you give us a view on what's going on with some of those working capital levers and how you see them playing out for the next few quarters?

Thomas Barbato

I think we should see a move kind of consistent with the growth in revenue. We'd had a—we've been focused on inventory levels all year, and I think you've seen the improvements we've made since the beginning of the year from an inventory standpoint. In accounts receivable, part of the growth, right, is just bringing on a business, and as we bring on these bigger businesses, we're bringing on the accounts receivable that goes along with that. You saw that addition coming from the Martin acquisition in December. But I think over time, we've seen those working capital numbers kind of flex, accordingly, based on the inorganic and organic growth that we've experienced.

Edward Jackson

Okay, that's it for me. Thank you very much.

Lee Rudow

Thanks Ted.

Operator

As a reminder, if you'd like to ask a question, please press star, one on your telephone keypad. One moment please while we poll for questions.

Our next question comes from Martin Yang with Oppenheimer. Please proceed with your question.

Martin Yang

Hi, thank you for taking my question. My first question is on distribution. Would you attribute the weakness in distribution this quarter to the same reasoning you described for services, and how uniform are those two segments performing based on those seasonal patterns?

Lee Rudow

What we referred to, Martin, in the earnings call script was the rental business, as part of the rental channel, as part of the distribution. That was impacted the same way that the calibration services, so that is to say that we saw a decrease in demand throughout the month, particularly in the back half. That's what we were referring to, and of course as you have that, as rentals becomes—as rentals was lowered in the quarter, that changes the mix, the overall mix to heavier—it's weighted heavier towards core distribution, which has lower margins. It has both an impact on margin, which is significant, but also in volume. That's the effect that you saw on distribution, and yes, it was similar to service in the month of December, rentals, that is.

Martin Yang

Got it. Then when we look at overall distribution on a year-over-year basis, can you tell us about respective growth rates for rental versus non-rental?

Thomas Barbato

You know, I think Martin, what we've said—what we've said historically, and it still plays out here, is that we expect our core distribution to decline slowly over time. Then we expect the rental business to grow at a similar rate to service and what we've seen historically with service, like high single digits. That's the goal, and that's the trajectory we've been on over the past couple years.

Martin Yang

Got it. My next question is regarding your comment on what happened in December. Is there any other seasonal patterns every quarter or other certain times of the year that could give you surprises like the past December?

Lee Rudow

Not really. There are certain patterns in a business. Typically, volume for services is higher in our fourth quarter, which is January through March, and typically distribution, core distribution, not rentals, is a little bit stronger in our third quarter. There are some patterns that seem to repeat, Martin, year-over-year.

I think what happened this year—again, when you have a holiday on a Wednesday, and you never know exactly how people react. It's just for whatever reason, which I don't think we saw as much in the past, so maybe it's an anomaly, maybe it's a pattern, don't know yet. But having a holiday land on a Wednesday, people shut down that week and then things extend to 10 days and so on and so forth.

I don't know of—you know, we've been doing this a long time, and typically there aren't patterns like that. I'm not sure if this is a pattern or a one-off, but either way, it caught us a little bit off-guard in terms of modeling and forecasting. I guess that's the best way to answer.

Martin Yang

Got it, thank you Lee. That's it for me.

Lee Rudow

Okay, thanks Martin.

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

Okay, this is Lee. Thank you all for joining us for the call today. We appreciate your continued interest in Transcat.

We will be attending the Oppenheimer Tenth Annual Emerging Growth Conference, which is February 26. For those of you who are attending that conference, feel free to call on us, check in on us, and maybe sign up for a meeting time. Otherwise, you're free to contact us anytime after that conference, and we'll be speaking to everybody again for our Q4 results.

Thank you. Thanks again for joining us. Take care.

Operator

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