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Transcat, Inc.

First Quarter Fiscal Year 2025 Financial Results Conference Call

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CORPORATE PARTICIPANTS

Thomas Barbato, *Chief Financial Officer*

Lee Rudow, *President & Chief Executive Officer*

CONFERENCE CALL PARTICIPANTS

Gregory Palm, *Craig-Hallum Capital Group*

Edward Jackson, *Northland Capital Markets*

Martin Yang, *Oppenheimer & Co.*

PRESENTATION

Operator

Greetings, and welcome to Transcat, Inc. First Quarter Fiscal Year 2025 Financial Results Conference Call.

At this time, all participants are in a listen-only mode. A brief 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.

It is now my pleasure to introduce your host, Mr. Tom Barbato, Chief Financial Officer.

Thank you, Mr. Barbato. 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 will open up the call for questions.

Our earnings release crossed the wire after markets closed yesterday. Both the earnings release and the slides that will be referenced 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 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 their earnings release.

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

Lee Rudow

Yes, thank you, Tom.

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

Transcat delivered strong performance across our entire portfolio in the first quarter of fiscal 2025 as we continue to demonstrate our ability to effectively execute our strategy and to drive differentiation throughout our business platform.

Consolidated revenue was up 10% to $66.7 million, driven by continued demand for our services as well as strong rental performance. Consolidated gross margin expanded 310 basis points to 34%, was driven by significant margin expansion in both our Service and Distribution segments.

Adjusted EBITDA in the quarter grew 20% from prior year to $10.2 million.

Service continued to perform at a high level and recorded its sixty-first straight quarter of year-over-year revenue growth; that's more than 15 straight years. In the first quarter of fiscal 2025, Service revenue grew 10% overall and 6.4% organically. We continue to focus on recurring revenue streams with highly regulated industries that include life science, and aerospace and defense, and internally, we rally around the theme of get bigger and get better.

To that point, Service gross margins in the first quarter grew 150 basis points versus prior year to 34%. Our consistent Service gross margin improvement over time reflects our ability to drive continuous process improvement throughout our operation. Specific drivers of Service gross margin improvement include increased productivity through higher levels of automation, and technical training, as well as system and software enhancements. As we talked about in the past, the constant driver of Service margin gain is the inherent leverage in the operating model as Service revenue grows.

Turning to Distribution and Rentals, gross margins expanded 620 basis points from prior year, driven primarily by the higher-margin Rental business which now includes both Axiom, which we acquired in August almost one year ago, and Becnel, acquired this past April at the start of our first quarter.

The integration with Axiom has been excellent, and on the Becnel front, we're off to a strong start, making early, meaningful progress. In fact, in the first quarter since the acquisition of Becnel, we can already point to several synergistic service opportunities that we've encountered from the Becnel customers. While this was anticipated to occur at some point, a strong early start is great news.

Becnel is a very well-run company that has cultivated a loyal customer base, most of which are heavy users of instrumentation and calibration services. In addition to its rental platform, Becnel offers a very profitable growing operator-based service model that we anticipate will contribute to Service margin expansion over time.

Overall, we're pleased with our strong start across the business in fiscal 2025, the 10% growth we generated in consolidated revenue, the 310-basis-point expansion in consolidated gross margin, and a 20% growth in Adjusted EBITDA. It's all a testament to the strength of Transcat, our brand, and the uniqueness of our value proposition.

Transcat continues to be recognized and rewarded for the delivery of our risk-mitigating services across high-cost-of-failure manufacturing environments. Customer retention has been, and continues to be, a hallmark of Transcat and a major contributor of our consistent top-line performance over time.

Lastly, the first quarter of fiscal 2025 is also benefited from the expansion of addressable markets, which contributed significantly to both revenue and margin growth. We ended the quarter with a strong balance sheet, and we are well positioned to execute our growth initiatives, including the acquisition of companies that enhance our geographic footprint, expand our current capabilities, expertise and markets.

With that, I'll turn things over to Tom to provide additional detail on the first quarter financials.

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 first quarter of fiscal 2025.

First quarter consolidated revenue of $66.7 million was up 10% versus prior year, as both segments experienced consistent demand. Looking at it by segment, Service revenue growth remained solid at 10%, 6.4% of the growth coming organically and the remainder from acquisition.

Turning to Distribution revenue of $22.9 million grew 11%, as we continue to see strong performance in the higher-margin Rental business.

Turning to Slide 5, our consolidated gross profit for the first quarter of $22.7 million was up 21% from the prior year, and our gross margin expanded 310 basis points to 34%.

As Lee mentioned, we are very pleased with our year-over-year Service gross margin expansion of 150 basis points. The Service margin increase further demonstrates the inherent leverage in our Service model and our ability to drive higher levels of automation and technician productivity.

Distribution segment gross margin of 33.9% was up 620 basis points, driven by strong Rental performance.

Turning to Slide 6, Q1 net income of $4.4 million increased 49% from prior year and our diluted earnings per share came in at $0.48, up $0.10 per share. Net income growth was driven by strong Q1 performance and the reduction of interest expense as the majority of our debt was paid down in Q3 of last year, leveraging the proceeds from our secondary offering.

We report adjusted diluted earnings per share as well to normalize for the impact of upfront and ongoing acquisition-related costs. Q1 adjusted diluted earnings per share was $0.68, up from $0.52 per share in the prior year. A reconciliation of diluted earnings per share to adjusted diluted earnings per share can be found in the supplemental section 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 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 increased levels of non-cash expense that will hit our income statement from acquisition purchase accounting.

With that in mind, first quarter consolidated Adjusted EBITDA of $10.2 million was up 20% from the same quarter in the prior year, and Adjusted EBITDA margin expanded 130 basis points. Both segments had double-digit 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 cash flow improved from last year to $8.9 million for the quarter. Q1 capital expenditures were $900,000 higher than prior year and continued to be centered 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 cash of $19.1 million with a leverage ratio of 0.1x. We had $80 million available from our credit facility. As previously announced, we acquired Becnel Rental Tools for $50 million just after the end of the first—fiscal year, paid in a combination of $32.5 million Company stock and $17.5 million in cash.

Lastly, we expect to file our Form 10-Q on August (inaudible).

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

Lee Rudow

Thank you, Tom.

Transcat has successfully delivered on the expectations we have set and communicated over a very long period of time. Expectations include consistent organic Service revenue growth, gross margin expansion, and in recent years, solid free cash flow. We've also expanded our addressable markets and strengthened our industry-leading value proposition through a significant number of accretive acquisitions in our core and adjacent markets.

As always, effective and timely integration represents the key differentiator and has set Transcat apart. Throughout the remainder of 2025 and beyond, we are confident this will continue.

Fiscal 2025, we expect organic Service growth in the high single-digit to low double-digit range when normalized for the extra week in fiscal 2024. We expect gross margin expansion throughout our portfolio of businesses and business channels. We have a robust and diverse acquisition pipeline that will enable opportunities to both expand our core services and addressable markets and ultimately increase the trajectory of the business. Of course, the ultimate focus will continue to be on generating sustainable long-term value for our shareholders.

As we look ahead, we remain excited about the direction Transcat is headed and our ability to execute what we believe is a differentiated and defendable strategic plan.

With that, Operator, we can open the line for questions.

Operator

Thank you.

We will now be conducting a question-and-answer session. If you would 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 would like to remove your questions from the queue. For participants using speaker equipment, it may be necessary to pick up your headset before pressing the star keys. One moment, please, while we poll for questions.

The first question comes from the line of Greg Palm with Craig-Hallum Capital Group. Please go ahead.

Gregory Palm

Hey, all. Good morning. Thanks for taking the questions here. Wanted to maybe dig into the segment-related results a little bit to start things off. On Services, the organic growth number was a little bit light of your full year guide, certainly, what we're accustomed to over the past couple of years. Just, can you dig into that a little bit? Was it timing? It suggests that if you're going to get to high single-digits, low double-digits, it obviously accelerates from this level for the remainder of the year. Just a little bit more color there would be helpful to start.

Lee Rudow

Sure, Greg, this is Lee. I'll take that. No, I wouldn't read into the 6.4% organic growth too deeply. Service remains strong in terms of demand and demand remains strong. There is going to be fluctuations in this business. We've always talked about that, fluctuations that aren't necessarily reflective of our expectations, particularly long-term. We didn't change our guidance because we still think that the pipeline and the demand is there, and we would expect to be in that range for the fiscal year. No, we're not—it's not something we think about too much as we look at 90-day increments of time. We've never really looked at the business that way. No, I'm not concerned.

Gregory Palm

Yes. Any end markets within that segment that jumped out either from a positive standpoint or maybe a little bit weaker than expected, at least for the quarter?

Lee Rudow

No, I think everything is pretty consistent with our expectations. When you look at the business that was generated the growth and the pipeline, it's pretty much in line with the highly regulated industries that we serve. You've got aerospace and defense in a big way producing, and same with life sciences. I think that's consistent with the past and that's what we expect.

Gregory Palm

Yes. Okay, good. Shifting gears to Distribution, by our math, I think organic growth was negative and certainly the reported growth was driven by acquisition-related contribution. Can you just give us a little bit more sense on what's happening in Distribution? For Rental specifically, how much is that at this point in terms of overall mix? Are you willing to give us a ballpark number?

Lee Rudow

Generally speaking, we have guided towards this, and we look at Distribution a little bit differently, obviously, then we did years ago. We have invested in our strategy to grow the Rental business. We've done that organically and through acquisition. You do see acquired revenue, but you also see, on the Rental side, organic growth, which has been pretty impressive. We like where we are in Distribution for that reason. Margins are up. Profits are up. We did expect that core Distribution, over time, may decrease and the mix may change, and a percentage of the business is going to increase towards Rentals. We like that. That's strategic for us, and we'll keep that going. We have low margin in what we used to call reseller business in the core Distribution channel, and it's just not something that we spent a lot time thinking about or investing in. We expect that number to tweak its way down over time, but to be supplemented and substituted for the higher-margin, higher-growth Rental business. We're going to continue down that path. We like it.

Gregory Palm

Is it fair to say that you're maybe walking away from some of that business on purpose, that low-margin business, or is it just more of a, hey, we're not really putting any resources focus on it, so it may just dwindle all the time?

Lee Rudow

Yes, I think the latter. We're not going to walk away from the business. We never walk away from our customers when they have needs, but we're certainly not allocating additional incremental resources to low margin, let's say, for example, like I just pointed out, resale business or channels that aren't as profitable. We're allocating resources towards the high-margin Rental business. We don't lose much in terms of that ever-important connection. In fact, we don't lose anything, in my opinion, in the connection between Services and the Rental business, same customers and we always want to get that crack in that door so that we can walk through and try to gain Service business. Nothing has changed in that respect, Greg.

Gregory Palm

Understood. Okay. I will leave it there. Thanks for the time.

Operator

Thank you. Next question comes from the line of Ted Jackson with Northland Securities. Please go ahead.

Edward Jackson

Thanks very much. Good morning.

Lee Rudow

Hi, Ted.

Edward Jackson

I'm going to just jump over into, let's talk about Services gross margins, because it's a clear bright spot for Transcat and something you should be proud of, and I know you are. Can you maybe flush out what's driving a lot of the margin improvement? In the press release, you talked about productivity improvements, and you talked about automation, and maybe put some meat on the bones with regards to some of the projects and the programs that you are using to drive that margin improvement and things in terms of projects and programs in the future that will continue to drive it going forward. I think I have a follow-up after that. Thanks.

Lee Rudow

Yeah. This is Lee. I'll take a stab at this, and Tom can make sure I don't miss anything, because there are a lot of things in play here, and I'll try to capture and highlight some of the big ones. Automation is important. We launched this initiative, I want to say, maybe three, four years ago. At least that feels about right. For the first couple of years, people would ask me, how far along are you? I'd say, we're in the first inning, second inning. I think today I would characterize that as we're in the fourth inning. We used to have automation in terms of percentage of our calibration. We don't get into a lot of detail around that, but mid-low single digits, and now it's in the 20%-plus range. There's a lot of automation that's taking place and it's arduous and it's difficult. There's a lot of programming, but once you get it done, then you can capitalize on it over a long period of time, and that's what we're doing.

There's still runway there that's significant. We're steady progress. We're pleased with it. We always want it to be faster than it is, but it's making a dent in the initiative and we're increasing margin. It's an inflection point in this business. That operating leverage, and as you get organic revenue growth over time, aside from a step function investment here or there, that's going to improve your margin. That's definitely playing a role. We've done a lot of work. We have a new Chief Operating Officer, and we've really dug into the labs and trying to make them more efficient, improve processes, and we've really made some gains in terms of how we get products through our lab onto the bench, off the bench, built quicker, better turnaround times. These are all things that eventually lead their way to margin and also lead their way to stronger organic growth, because you have a higher level of customer satisfaction with better turnaround times. These are all the things we're working on, and I think they all contribute. Tom, maybe...

Thomas Barbato

The other thing I would just add is that when we talk about productivity and automation and the benefit that we see in margins, there's also another benefit that we get, is it puts less dependency on additional resources to get the incremental work done, which I don't want to lose sight of because technicians are our most important asset, and being able to do more work with the same number of people is extremely valuable. I just want to make that point as well.

Edward Jackson

That's good, because, Tom, that's a great segue into my next question, and that has to go with labor and your labor needs. I think you might have gotten into it a bit. As Transcat continues to get big, it clearly means that you need more technicians. There's always been an issue in terms of your ability to getting that kind of labor, and that's why you started your training program, so you could develop your own talent, grow your own wood, if you would. Where is that in terms of an issue for Transcat? Maybe an update with regards to some of your training programs and the technicians that you put through it? Maybe you answered it already, but what—where do you see that in terms of your needs and choke points going forward?

Lee Rudow

Ted, I've been in this business for coming up of 40 years. Technical labor has always been an issue. It always will be an issue. You're right, that's why we started Transcat University. That's why we decided we have to train our own technicians, and if and when we do, and we are doing it, it'll be a differentiator because we'll have labor when and where we need it. Now, that's not always the case, and it's not as easy as I make it sound, but we're—we try to position ourselves better than the competition so that we can compete better, and we can win more, and we can win the jobs that we want.

Always a challenge, no question, but in there, also lies the opportunity. If you can overcome it and you can get this kind of training program going and that—and I expect that program to get better and better over time, more efficient, more effective over time. Still relatively new, but I like the returns, we like the returns, and I see that as continuing. Now there are other ways, too. We talk about, as Tom mentioned, the more automation you do, the more you go from tech to operator. One day there'll be more robotics, which takes you from operator to robots. There's all kinds of things that you can do. Longer term, we're focused on those things, but when you allocate resources, the best place is to make sure you have the labor where and when you need it. That's what we're doing with Transcat University. I see that continuing.

Edward Jackson

Okay. My last question is just on—it's a topic that used to get mentioned a lot and it doesn't really come up quite as often but just on the customer-based labs. Can you give us an update on I don't know, how many CBLs you have at this point? What the pipeline looks like? What's going on with that in terms of a growth driver for Service revenue for you over the coming quarters, years? Thanks.

Lee Rudow

I would characterize our client-based labs as steady. We still have in the mid to upper 20s as a round number for the number of locations we're actually in with embedded technicians with an embedded lab. At different times, that business ebbs and flows, and it's usually a byproduct of labor shortages and our customers' inability or their challenge they have with finding the labor they need when they need it. Right now, we have a pipeline with a significant number of CBLs in them, but when you look across our pipeline, our portfolio, we've got everything from transactional to core small, core medium, core large, strategic, and then CBL. It's just one of the six service channels. They tend to be larger accounts, but I think that I would say it's steady and stable is how I describe that. It's not on the uptick, but it's not declining either. It's in a steady state.

Edward Jackson

Okay. All right. Hey, thanks very much. I'll talk to you guys soon.

Lee Rudow

Okay.

Thomas Barbato

Thanks, Ted.

Operator

Thank you. Next question comes from the line of Martin Yang with Oppenheimer & Co. Please go ahead.

Martin Yang

Hey, thanks for taking my question. Lee, I wanted to ask you about your updated view on your addressable market. In the past, you have updated numbers such as $1.6 billion for U.S. calibration services. Now with a bigger Rental business, asset management, as well as decommissioning services, how do you think about your Service addressable market in the U.S.? Do you have an updated number for us?

Lee Rudow

In terms of addressable markets, in general, first, let's make clear that when we expand our addressable markets, we're always going adjacent to what we do. We want to stay in pretty close proximity to our core business, which is calibration services. Today, we're always looking to expand where it makes sense for the business, where we get recurrent revenue streams, where there's a demand, where there's regulation. You saw that with Becnel. If there's a margin play, you saw that with Axiom. With NEXA, you saw a combination of value prop enhancers around calibration.

I think, Martin, there are opportunities to expand our addressable markets to the house next door and sometimes maybe the house right next door to that. We're going to stay disciplined. We've always been disciplined around our acquisition strategy, and that's not going to change. It's something that we talk to the Board about. It's required from us, and our shareholders expect that. There are more addressable markets. We expect to tap into them. They are likely to be the house next door because that's the way we approach it. Certainly, we look for all the attributes that are part of our acquisition strategy; geographic expansion, margin enhancers, adding expertise. These are some of the things that we'll continue to focus on when we look to expand our markets. I hope that added some clarity for you.

Martin Yang

Got it. Thank you. My next question is about gross margins. When you look at the two different segments, they are almost at parity now. How do you think about the difference in margins or the convergence of gross margins between two segments in the medium to longer term?

Lee Rudow

Tom, help me out with this one, but we've guided towards Service gross margins being in the mid- to upper-30%s for now. We have pretty good sightlines, as Tom would say, to get to that range and to continue the improvement in margins over time. I don't like to really talk about it quarter-to-quarter. There's some quarters where we have outstanding results like this one, and there's some where you may be flat and some where you may have 20 basis points, but over time, we see that continuing because there's a lot of runway left on the initiatives around that. Of course, the inherent leverage that we talk about.

In Distribution, the margin increase is driven by Rentals. We know that and we like it, and we go back to 2016, we didn't have that business, and Distribution was a low 20%s, 20% business. That's changed drastically for the better. It even surprises us to a certain degree. If you go back five or six years ago, would we have seen the parity between the two margins? I would have not bet on that. Through creativity, through being—allocating resources, properly, getting the right leaders here, we've made something really significant out of that business, and it has scalability, which we like, and it's connected to Service. I think that margin will increase over time. Also, as the percentage of Rentals, it becomes higher within Distribution, which we expect it to do. Tom...

Thomas Barbato

I would agree with that. I would just—we got to keep in mind that in August we'll lap the Axiom acquisition. Some of that lift that we're getting from last year's August Axiom acquisition will go away. On a go-forward basis, I would expect that the two margins will track in a similar fashion going forward.

Martin Yang

Got it. Thanks, Tom. Thanks, Lee.

Thomas Barbato

Yes.

Operator

Thank you. Next question comes from the line of Ted Jackson with Northland Securities. Please go ahead.

Edward Jackson

Hi. I just have a follow-up question driven by the last line of questioning. When you look at the historic trends of the business and the seasonality of it, typically, Transcat sees the second quarter margin, particularly as it relates to Services revenue, stronger than the first quarter. Do we expect that to be the same this year?

Thomas Barbato

Yes. We're not expecting, Ted, anything really significantly different in our—from a seasonality standpoint. I think it would be safe to assume that.

Ted Jackson

Okay. That was my one question. Thank you very much.

Operator

Thank you. A reminder to all the participants that you may press star one to ask a question.

Ladies and gentlemen, there are no further questions at this time. I would now like to turn the floor over to Lee Rudow for closing comments.

Lee Rudow

Okay. Thank you all for joining us on the call today. We certainly appreciate your continued interest in Transcat. We will be attending the Oppenheimer 27th Technology, Internet & Communications Conference. It's going to be on August 12. Feel free to sign up to talk to us then and reach out. Otherwise, you can really check in with Tom or me at any time. If we don't hear from you, we look forward to talking to everybody again after our second quarter results, and thank you again for participating. Take care.

Operator

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