Covenant Transportation Group 3rd Quarter 2018 Conference Call

Mr. Cribbs – Good morning and welcome to our third quarter conference call. Joining me on the call this morning are David Parker and Joey Hogan.

This conference call will contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those contemplated by the forward-looking statements. Please review our disclosures in filings with the Securities Exchange Commission, including, without limitation, the Risk factors section in our most recent Form 10-K. We undertake no obligation to update or revise any forward-looking statements to reflect subsequent events or circumstances.

A copy of our prepared comments and additional financial information is available on our website at www.covenanttransport.com/investors. Our prepared comments will be brief and then we will open up the call for questions.

In summary, the key highlights of the quarter were:

- Our Truckload segment's revenue, excluding fuel, increased 25.7% to $168.4 million due primarily to a 547 (or 21.6%) average truck increase and a 6.1% increase in average freight revenue per truck in the 2018 period as compared to the 2017 period, partially offset by a $2.7 million year-over-year reduction in intermodal revenues. Of the 547 increased average trucks, 428 average trucks were contributed by the Landair acquisition as Landair contributed $18.4 million of freight revenue to combined truckload operations in the third quarter of 2018,
- Versus the year ago period average freight revenue per total mile was up $.277 per mile or 16.4% and our average miles per tractor were down 8.9%. Truckload rates were impacted favorably and utilization was impacted unfavorably by the impact of the Landair operations on the combined truckload segment. Landair's shorter average length of haul and dedicated contract, solo-driven truck operations generally produce higher revenue per total mile and fewer miles per tractor than our other truckload business units,
- Versus the prior year quarter, freight revenue per tractor at our Covenant Transport subsidiary experienced an increase of 8.4%, our Southern Refrigerated Transport ("SRT") subsidiary experienced an increase of 18.1%, and our Star Transportation ("Star") subsidiary experienced an increase of 4.2%,
- The Truckload segment's operating costs per mile, net of surcharge revenue, were up approximately $.179 per mile compared to the year ago period. This was mainly attributable to higher employee wages, casualty insurance claims costs, and the impact of the Landair truckload operations' higher cost per mile model. These increases were partially offset by lower net fuel costs and net depreciation expense as we recognized a small gain on disposal of equipment totaling $0.3 million in the third quarter of 2018 versus a loss of $0.7 million in the third quarter of 2017,

- The Truckload segment's adjusted operating ratio was 92.6% in the third quarter of 2018, compared with 95.1% in the third quarter of 2017,
- Our Managed Freight segment's total revenue increased 80.9% versus the year ago quarter to $46.3 million from $25.6 million. Of the $20.7 million of increased total revenue, Landair contributed $20.4 million of revenue to combined Managed Freight operations in the third quarter of 2018. The Managed Freight segment's adjusted operating ratio was 90.5% in the third quarter of 2018, compared with 90.3% in the third quarter of 2017. The result was an increase of Managed Freight operating income contribution to $4.2 million in the current year quarter from $2.5 million in the prior year quarter,
- Our minority investment in Transport Enterprise Leasing contributed $2.1 million to pre-tax earnings or $.08 per share,
- The average age of our tractor fleet continues to be young at 2.3 years as of the end of the quarter, slightly up from 2.2 years a year ago,
- In connection with the July 3rd acquisition of Landair, we expended $83.0 million in cash and assumed $15.5 million of Landair's outstanding debt, which we have paid in full. Between December 31, 2017 and September 30, 2018, total balance sheet indebtedness, net of cash increased by only $17.6 million to $216.0 million. At September 30, 2018, our stockholders' equity was $326.2 million, for a ratio of net debt to total balance sheet capitalization of 39.8%, which compares favorably to the 40.2% ratio as of December 31, 2017, even with the cash expended for the Landair acquisition. In addition, our leverage ratio has improved to 1.5x as of September 30, 2018 from 1.9x as of December 31, 2017.

The main positives in the third quarter were 1) the successful strategic addition of Landair, meeting our stated objective of entering into closer relationships with our customers and getting deeper in the supply chain, 2) improvement in the operating profitability at each of our Truckload segment subsidiaries, 3) an approximate 10% increase in average freight revenue per truck for our Truckload segment, excluding Landair's truckload operations, versus the same quarter of 2017, and 4) improved year-over-year earnings from our investment in Transport Enterprise Leasing. The main negative in the quarter was the increased Truckload operating costs on a per mile basis, most notably the unfavorable employee wages and casualty insurance claims costs, partially offset by lower net fuel costs and improved net depreciation expense.

Our fleet experienced an increase to 3,077 trucks by the end of September, a 445 truck increase from our reported fleet size of 2,632 trucks at the end of June. Of the 445 truck increase, 413 of those trucks were operated at Landair which we acquired in July. A large portion of the remaining growth was a 36 truck (or 13.0%) increase of independent contractor trucks to 312 trucks by the end of September from 276 trucks at the end of June. Our fleet of team-driven trucks averaged 880 teams in the third quarter of 2018, a small increase from 878 average teams in the second quarter of 2018.

We expect the overall balance of business conditions to remain favorable through the fourth quarter of 2018 and into 2019. Freight demand has been, and remains, strong across our business units and indications from our holiday peak season customers indicate robust expectations for the fourth quarter. From a capacity perspective, attracting and retaining highly qualified, over the road professional truck drivers remains our largest challenge. Low unemployment, alternative careers, and an aging driver population are creating an increasingly competitive environment. In this environment, we continue to work actively with our customers to improve driver compensation, efficiency, and working conditions while providing a high level of service and generating acceptable financial returns. We intend to continue to allocate our assets where the returns are justified and use our managed freight units to supplement our internal capacity.

Along with the Landair acquisition, we have increased our capital allocation to organically grow our dedicated truckload, 3PL, and other managed freight solutions. As of September 30th, 2018, the percentage of our truckload fleet operating under dedicated contracts was approximately 1,535 trucks, representing 50% of our fleet. This compares to a year ago when only approximately 827 of our trucks, or 32% of our fleet, operated under dedicated contracts. We believe the dedicated contract fleet provides a stronger partnership with our customers as we integrate deeper into their supply chains, offers more consistent and seasonally-manageable freight volumes, reduces earnings volatility of the cyclical freight economy, and provides a favorable drivers' experience for professional drivers who desire greater consistency.

For the fourth quarter, we will remain a major participant in the holiday peak shipping season and anticipate our consolidated adjusted operating ratio and consolidated adjusted earnings per diluted share to improve compared with the fourth quarter of 2017. However, due to changes in team versus solo-driver mix, dedicated versus irregular route capacity, and managed freight capacity, as well as the impact of the Landair transaction, we are not offering more specific earnings guidance.

Thank you for your time and we will now open up the call for any questions.