Covenant Logistics Group 3rd Quarter 2022 Conference Call

Mr. Hogan – Welcome to the Covenant Logistics Group third quarter 2022 conference call.

As a reminder:

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 and our current year Form 10-Qs. We undertake no obligation to publicly update or revise any forward-looking statements to reflect subsequent events or circumstances.

A copy of the prepared comments and additional financial information is available on our website at www.covenantlogistics.com\investors. I am joined on the call by David Parker, Paul Bunn, and Tripp Grant.

Despite the challenges of negative GDP growth, overstocked inventories, and industry-wide overcapacity that have increased over recent months, combined with major inflationary pressures, we remain grateful to our teammates for producing record adjusted earnings per share for any third quarter in our history. On a consolidated basis, adjusted net income was up 31% and adjusted EPS was up 49% on the strength of revenue growth, flat adjusted operating margin, growing contribution from TEL, and a 12% reduction in our diluted share count resulting from our ongoing share repurchases. Return on capital for the trailing four quarters was 23% compared with 12% for the trailing four quarters in 2021.

On the truck side, we were pleased with how our utilization and rates held sequentially from the second quarter, but the impact of delayed deliveries of new equipment and escalating costs of parts, maintenance, and other line items compressed our margins in the quarter. Our managed freight group did a great job in holding margin despite reductions in overflow freight from the truck side and our warehouse team withstood cost headwinds associated with new customer business and investments in additional warehouse capacity for future growth. The contributions of the AAT acquisition (which operates in a less economically sensitive market), TEL, Dedicated, and stock repurchases provided most of the improved earnings per share despite a weaker market compared to the historically strong market a year ago.

In summary, the key highlights of the quarter were:

- Freight revenue grew 6.5% to $267 million compared to the 2021 quarter,
- Adjusted earnings per share increased 49% to $1.52 per share from the year ago quarter,
- Our asset-based truckload's freight revenue grew 15% versus the third quarter of 2021 with 53 fewer trucks,
- Our "asset light" managed freight and warehouse segments combined freight revenue shrank by 5% compared to the third quarter of 2021,
- On the safety side, our DOT accident rate was the lowest third quarter on record, 11% lower than third quarter of last year, but development of a small number of prior period claims contributed to almost $.03 per mile increase in insurance expense,
- Gain on sale was only $200 thousand compared to $900 thousand in the year ago quarter,
- Our TEL leasing company investment produced another record quarter, contributing $0.38 per diluted share, or an additional $0.24 per share versus the year ago period,
- We purchased another 1.0 million shares during the quarter bringing the total to 3.0 million through September 30th,

- Due to the strong cash flow in the quarter and the sale of the California terminal, our net indebtedness decreased by almost $29 million after utilizing $27.5 million of cash on share repurchases,
- We finished the quarter with a leverage ratio of .23x, debt to equity ratio of 7.8%, and return on invested capital of 23.3%.

Now Paul will provide a little more color on the items affecting the business units:

- For the quarter, our Asset light businesses (comprised of managed freight and warehouse) were 38% of total freight revenue and 41% of consolidated adjusted operating profit. For the managed freight business while we believe revenue will be stable, we expect margin compression into a softening environment. Our warehouse revenue stream has accelerated due to the impact of 3 startups for the year, receiving the full revenue impact in the third quarter. We expect the startup and unoccupied lease costs to decline in the fourth quarter, improving margins. The asset light group remains a priority for growth, focusing on talent acquisition and technology enhancements.

- The Expedited division was 34% of consolidated freight revenue and 48% of adjusted operating profit in the quarter. It grew its revenue 26% versus the year ago quarter due to strong revenue per truck improvements, growth of 80 trucks, with the first quarter acquisition contributing to revenue growth nicely. Increased salaries and wages, equipment and maintenance costs, and insurance costs continue to be a major headwind in the year. Sequential operations and maintenance costs were significant in the quarter, but we feel the third quarter was our peak from a cost perspective on equipment and maintenance costs due to an aggressive replacement plan between now and the end of 2023. Driver pay remains stable at the present time.

- The Dedicated division was 28% of consolidated freight revenue and 11% of adjusted operating profit in the quarter. Revenue per truck grew 14% versus the year ago quarter while cost increases in salaries and wages, equipment and maintenance, and eroded some of our progress on margin improvement. We missed our sequential OR improvement goal for the quarter mainly due to the increased costs during the quarter. We continue to work diligently to improve margins through fleet reductions (reduction of 60 trucks in the quarter), equipment upgrades and asset allocation to more profitable accounts and or divisions.

- Our minority investment in TEL continues to produce strong, positive results. TEL's revenue in the quarter grew 45% and pre-tax operating profit increased by 125% both versus the third quarter of 2021. TEL increased its truck fleet in the quarter versus year ago by 279 trucks to 2,153 and grew its trailer fleet by 492 to 6,860. After receiving more than a $7 million distribution during the quarter, our investment in TEL, included in Other Assets in our consolidated balance sheet, remained at $58 million. TEL focuses on a) managing lease purchase programs for clients, b) leasing trucks and trailers to small fleets or shippers and c) aiding clients in the procurement and disposition of their equipment through a robust equipment buy and sell program. TEL contributed a total of $.38 per share to our overall results or an additional $.24 versus the year ago quarter. Due to the business model, gains and losses on sale of equipment is a normal part of the business and can cause earnings to fluctuate from quarter to quarter.

Regarding our outlook for the future:

As we said in the release, we expect the remainder of the year to include continued moderating freight demand, greater driver availability and continuing cost inflation. We expect fourth quarter adjusted earnings per share to be similar to the third quarter, bringing the full year to approximately $6.00 per share.

For 2023, we believe there will be market headwinds from a softer market during contract renewals as well as continued inflationary pressures. However, based on company specific factors – the investments we have made in the sales team, the small acquisition, share repurchases, the equipment upgrade plan and reduced insurance casualty costs resulting from our improved safety results, we expect less earnings volatility than in prior periods of economic weakness. Over the last 5 years, our customer base has been strategically shifted to less cyclical industries through our full-service logistics focus. We predicted last quarter that 2023 will be a breakout year for Covenant, and we remain confident in our plan. Even with a heavy equipment investment year, we expect our cash generation, low leverage, and available liquidity to provide the full range of capital allocation opportunities to benefit our shareholders.

Lastly, I've been honored and humbled to serve Covenant for 25 years and am excited about the leadership team that we've been able to assemble… the best we've ever had. Over the last five years, the model has been retooled under David's leadership and Paul will do a great job leading the company in his new role. I'll still be around to assist the team in whatever I can do to help, it's just time to hand the reins to the next generation and let them run.

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