Covenant Logistics Group 1st Quarter 2023 Conference Call

Mr. Grant – Good morning everyone and welcome to the Covenant Logistics Group first quarter 2023 conference call.

As a reminder:

> *This call will contain forward-looking statements under the Private Securities Litigation Reform Act, which are subject to risks and uncertainties that could cause actual results to differ materially. Please review our SEC filings and most recent risk factors. We undertake no obligation to publicly update or revise any forward-looking statements.*

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, Joey Hogan and Paul Bunn.

First, I'd like to start by welcoming the Lew Thompson & Son Trucking team to the Covenant family. We pursued this acquisition because it aligns with our strategic plan of becoming a nichier, well diversified service provider in a market that is less sensitive to typical freight cycles. Lew Thompson & Son Trucking's reputation for providing first class service to their customers in the poultry industry, combined with opportunities for future growth added to the attractiveness. Our goal is to maintain their service standard and to provide the financial support required to allow our combined team to grow in their home territory and in territories that they do not currently operate. Their results will be included in our Dedicated segment's operations. Consistent with our focus on profits and return on capital, through the first quarter, we had reduced the Dedicated fleet by 200 trucks since the first quarter of 2022 by exiting low-return contracts. With today's action, we are re-growing our fleet with Lew Thompson's approximately 225 trucks, which are expected to generate a double digit return on invested capital and immediate accretion to our earnings per share.

Now, focusing on the first quarter's results. Given the softness in the freight environment, we are pleased with our results and how our team responded in a market that quickly transitioned. Compared to a year ago, consolidated freight revenue was down 9%. This decline was expected and related primarily to less overflow freight handled by our Managed Freight segment due to lower overall demand. The Dedicated segment also experienced reductions in freight revenue, primarily as a result of our efforts to carve out underperforming contractual business.

Adjusted operating income fell approximately $12 million or 48% compared to the prior year quarter, primarily as a result of our asset-light Managed Freight and Warehousing segments which declined by approximately $10 million and $1 million, respectively. On the truckload side, we were pleased with the resiliency of our year-over-year margins, particularly in Dedicated which improved its margin compared to any reportable period in the prior year.

Adjusted net income decreased 43% to $12.9 million and adjusted earnings per share decreased 31% to $0.93 per share compared to the year ago quarter. Weighted average diluted shares decreased as a result of our share repurchase program.

The primary adjustment to our reported results excludes the approximately $7.6 million pretax gain on sale of a Tennessee based terminal during the quarter. Proceeds on the transaction were approximately $12.4 million.

Key highlights for the quarter include:

- Within our combined truckload operations, operations and maintenance related expenses declined on a cents per total mile basis by 2 cents or 6%. Fixed equipment costs, including leased revenue equipment, depreciation, and gains on sale, decreased year over year by over 3 cents per total mile or 9% as a result of our equipment replacement plan.
- Gain on sale of revenue equipment was $1.1 million in the quarter, compared to $0.2 million in the prior year.
- The average age of our fleet at March 31st was 26 months, flat sequentially compared to December 31, 2022. For the remainder of 2023, based on our current equipment order, we anticipate sequential improvement to the average age of our equipment,
- Our TEL leasing company investment produced $0.31 per diluted share, compared to $0.30 per share versus the year ago period,
- Our net indebtedness at March 31st was $65.0 million, yielding a leverage ratio of .40x and debt to equity ratio of 14.9%,
- Return on invested capital was 19.8% for the current quarter versus 15.7% in the prior year.
- We purchased approximately six hundred and ten thousand shares in the quarter, representing approximately 4.5% of the outstanding shares as of December 31, 2022.
- Giving effect to the Lew Thompson transaction, we expect net indebtedness of approximately $165 million, a leverage ratio (measured by net indebtedness / run rate adjusted EBITDA) of approximately 1.2 to 1.1, and $60 million of remaining liquidity, including cash and availability on our line of credit.

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

Thanks Tripp, taking a moment to dive deeper into what drove the consolidated results for the quarter.

- Starting with our Expedited segment, freight revenue grew 1% compared to the prior year despite a 2% reduction in the average fleet. The increase was largely driven by a 4% improvement in average total miles per truck, offset with an approximate 1% decrease in average rate per total mile compared to a year ago. While we were pleased with the segment's utilization improvement, we recognize that year over year freight revenue per total mile comparisons will become increasingly challenging as we progress throughout the year. While cost headwinds from salaries and wages and insurance condensed margins, they were somewhat offset with improvements to both fixed and variable based equipment costs for the quarter. Our aggressive equipment replacement plan which was initiated in the second quarter of 2022 is beginning to payoff. We expect this trend to continue as we progress throughout the year and the average age of our fleet sequentially declines.

- Our Dedicated segment experienced a 10% reduction in freight revenue compared to the 2022 quarter as a result of a 194 or 14% reduction in the average number of total trucks, offset by a 5% increase in revenue per truck. The fleet reduction in our Dedicated segment aligns with our strategy of replacing unprofitable or underperforming business with business that meets our profitability and return requirements. We were pleased with both the year over year and sequential improvement to adjusted margin and expect to continue to improve upon this segment's profitability.

- Managed Freight experienced a 29% reduction of total freight revenue and 89% reduction of consolidated adjusted operating profit. The significant reduction in revenue and operating profit was primarily the product of little to no high-margin overflow freight from our asst-based Truckload segments. In addition, our results include an approximate $2.0 million cargo related claim in the period. The environment is highly competitive with numerous brokers aggressively competing for volumes at the expense of margin. We anticipate continued margin pressure in this environment.

- Our Warehouse segment, although the smallest of all of our business segments, saw a 41% increase in freight revenue compared to the prior year, resulting from the startup of 4 new customers during the previous 12 months. We are pleased with the top line growth we've achieved in this segment and the team has done a phenomenal job in executing these startups which are both intense and time consuming. However, despite the topline growth in this segment, we've seen sequential deterioration in margins. Our focus for 2023 will be to continue to grow this segment and restore profitability to mid-single digits through improved labor utilization and rate increases with existing customers.

- Our minority investment in TEL contributed pre-tax net income of $5.9 million for the quarter, compared to $6.8 million in the prior year period. The decline was largely a result of reduced gains on sale of used equipment compared to a year ago. TEL's revenue in the quarter grew 25% and pre-tax net income decreased by 11% versus the first quarter of 2022. TEL increased its truck fleet in the quarter versus year ago by 128 trucks to 2,201 and grew its trailer fleet by 404 to 7,116. 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. 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. Our investment in TEL, included in Other Assets on our consolidated balance sheet, has grown to $61 million as of March 31, 2023, from our original investment of $4.9 million. In 2022, we received $14.7 million in cash dividends from TEL, and we anticipate a similar amount during 2023, although we have no confirmations at this time.

Regarding our outlook for the future:
There's no doubt that 2023 will be challenging. While we are pleased with our first quarter's results, we also see opportunities to improve upon them and are working diligently to do so. In this environment, we are intensely focused on cost savings to improve our operating cost profile. However, our primary focus is remains on the long term, by continuing to invest in areas that provide opportunities for us to make forward progress on our strategic plan- our investments in new revenue generating equipment, people and technology are examples of this.

For the remainder of the year, we expect market headwinds from a softer market as well as continued inflationary pressures. However, based on company specific factors we expect less earnings volatility than in prior periods of economic weakness. We have worked hard to strategically shift our customer base to less cyclical industries through our full-service logistics focus. Even with a weak freight market, we expect our cash generation, moderate leverage, and available liquidity to continue to provide a full range of capital allocation opportunities to benefit our shareholders.

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