Covenant Transportation Group 4th Quarter 2019 Conference Call

Mr. Cribbs – Good morning and welcome to our fourth 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 and our current year Form 10-Qs. 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 the call for questions.

In summary, the key highlights of the quarter were:

- Our Truckload segment's revenue, excluding fuel, decreased 13.4% to $152.8 million due primarily to a 10.4% decrease in average freight revenue per truck, along with a 105 (or 3.4%) average truck decrease in the 2019 period as compared to the 2018 period,
- Versus the year ago period average freight revenue per total mile was down 24.2 cents or 11.3%, while average miles per tractor was up 1.1%. A portion of the reduction in freight revenue per total mile was planned, as we have steadily increased the percentage of our assets allocated to dedicated truckload or other year-round service offerings, leaving a smaller percentage to participate in the more volatile peak season, which secures significantly higher rates for a few weeks. The other primary factors impacting the decreased average freight revenue per total mile were continued capacity and demand imbalance and a reduction in certain of our customers' peak season team capacity needs this year. The main factor impacting the increased utilization was an improved average seated truck percentage, as only 1.5% of our operational truck fleet lacked drivers compared with 3.0% during the prior year quarter,
- The Truckload segment's operating cost per mile, net of surcharge revenue, was down approximately 3.3 cents compared to the year ago period. This was mainly attributable to lower employee wages and group health claims costs, partially offset by higher net fuel expense, workers' compensation claims costs, and outside professional advisory fees,
- Our Managed Freight segment's revenue, excluding fuel, decreased 15.5% versus the year ago quarter to $57.0 million from $67.5 million. The primary factor to this reduced revenue was a reduction in certain of our brokerage customers' peak season capacity needs this year,

- Due primarily to the bankruptcy of one of Transport Enterprise Leasing's ("TEL") customers, our consolidated net income included a $0.4 million pass-through loss (or $0.02 per diluted share) from our minority equity investment in TEL compared to the inclusion of a $1.7 million pass-through gain (or $0.09 per diluted share) in the fourth quarter of 2018,
- The average age of our tractor fleet continues to be young at 2.0 years as of the end of 2019, down from 2.2 years as of the end of 2018,
- During the fourth quarter, we took delivery of 47 new tractors and disposed of 256 used tractors, and at December 31st had approximately 625 tractors ("excess tractors") removed from our operating fleet that are either in the process of being prepared or have already been prepared and are held for sale; we expect to dispose of most of the excess tractor units in the first half of 2020,
- Between December 31, 2018 and December 31, 2019, total lease-adjusted indebtedness, net of cash increased by approximately $50.0 million to $304.6 million. At December 31, 2019, our stockholders' equity was $350.1 million, for a ratio of net lease-adjusted indebtedness to total capitalization of 46.5%, compared to a 42.6% ratio as of December 31, 2018. In addition, our leverage ratio has increased to 2.4x as of December 31, 2019 from 1.5x as of December 31, 2018.

The main positives in the fourth quarter were 1) consistent profitability from our Landair dedicated truckload and managed freight businesses in a difficult freight economy, 2) decreased Truckload operating costs on a per mile basis, and 3) a $24.2 million quarterly decrease in our net lease-adjusted indebtedness. The main negatives in the quarter were 1) the pass-through loss from our investment in TEL, 2) the 10.4% year-over-year decrease in average freight revenue per truck for our Truckload segment, 3) the operating margin declines of our expedited and solo refrigerated service offerings, and 4) the large amount of excess non-operating equipment at year-end that results in higher indebtedness and related expense until sales proceeds are realized.

Our operational fleet size experienced an increase to 3,021 by the end of September, a small 13-truck increase from our reported fleet size of 3,008 trucks at the end of September.

From a financial perspective, we expect operating cash flows, and our leverage ratio to improve for fiscal 2020 compared with fiscal 2019. We expect financial improvements to be weighted toward the second half of the year, as year-over-year comparisons in consolidated average freight revenue per total mile and margin performance in certain irregular route Truckload operations are expected to be negative for at least the next several months. Our expectations for improving performance throughout 2020 are based on assumptions of (i) declining truckload industry capacity (due to, among other factors, a continuation of falling new truck production, competitors exiting the industry, and tighter federal drug testing regulations), (ii) continued U.S. economic expansion, (iii) the successful disposal of excess real estate and revenue equipment, and (iv) the reallocation of assets to more profitable operations. The timing and magnitude of these factors will impact our results.

For 2020, we are intensely focused on accelerating our plans to become increasingly embedded in our customers' supply chains, reduce the cyclicality and seasonality of our financial results through growth in our higher margin, yet less volatile services, and to enhance sustainable long-term earnings power and return on invested capital for our shareholders through disciplined strategic planning and execution. Our operational focus areas are as follows:

- In our Truckload operations, we are seeking to tighten our one-way irregular route Truckload freight network, to re-allocate capacity from solo-driven refrigerated to more profitable dedicated and dry-van opportunities, to decrease real estate and revenue equipment capital costs per mile, and to reduce other controllable costs. Regarding the dedicated Truckload service offering, we have recently been awarded significant new long-term business that is scheduled to be operational beginning within the second quarter of 2020.

- In our Managed Freight operations, we have attained excellent customer retention rates in our more profitable warehousing, transportation management and factoring service offerings. We expect continued growth with these customers, as well as with new customer opportunities. We have a strong sales pipeline in these offerings for which we have targeted growth and have already secured some long-term awards for our warehousing services that are scheduled to begin late in the first quarter or during the second quarter of 2020.

From a balance sheet perspective, with net capital expenditures scheduled well below normal replacement cycle, along with positive operating cash flows, we expect to reduce net lease-adjusted indebtedness over the course of fiscal 2020.

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