Covenant Transportation Group 4th Quarter 2018 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. 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 21.9% to $176.5 million due primarily to a 562 (or 22.0%) average truck increase and a 1.7% increase in average freight revenue per truck in the 2018 period as compared to the 2017 period, partially offset by a $1.7 million year-over-year reduction in intermodal revenues. Of the 562 increased average trucks, 430 average trucks were contributed by the Landair acquisition as Landair contributed $19.2 million of freight revenue to combined truckload operations in the fourth quarter of 2018,
- Versus the year ago period average freight revenue per total mile was up $.252 per mile or 13.4% and our average miles per tractor were down 10.4%. 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 2.4%, our Southern Refrigerated Transport ("SRT") subsidiary experienced an increase of 15.7%, and our Star Transportation ("Star") subsidiary experienced an increase of 5.4%,
- The Truckload segment's operating costs per mile, net of surcharge revenue, were up approximately $.177 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 $0.1 million in the fourth quarter of 2018 versus a loss of $0.8 million in the fourth quarter of 2017,

- The Truckload segment's adjusted operating ratio was 90.5% in the fourth quarter of 2018, compared with 91.9% in the fourth quarter of 2017,
- Our Managed Freight segment's total revenue increased 83.6% versus the year ago quarter to $67.5 million from $36.8 million. Of the $30.7 million of increased total revenue, Landair contributed $21.4 million of revenue to combined Managed Freight operations in the fourth quarter of 2018. The Managed Freight segment's adjusted operating ratio was 90.6% in the fourth quarter of 2018, compared with 91.5% in the fourth quarter of 2017. The result was an increase of Managed Freight operating income contribution to $6.0 million in the current year quarter from $3.1 million in the prior year quarter,
- Our minority investment in Transport Enterprise Leasing contributed $2.3 million to pre-tax earnings or $.09 per diluted share in the fourth quarter of 2018, compared with a $0.8 million contribution to pre-tax earnings or $0.03 per diluted share in the prior year quarter,
- The average age of our tractor fleet continues to be young at 2.2 years as of the end of the quarter, slightly up from 2.1 years a year ago,
- In connection with the July 3rd, 2018 acquisition of Landair, we invested approximately $106.5 million, including an $8.2 million tax gross up payment in connection with a post-closing Internal Revenue Code Section 338(h)(10) election for which we expect to receive a future net cash benefit in excess of the tax gross up payment. Between December 31, 2017 and December 31, 2018, total balance sheet indebtedness, net of cash increased by only $14.3 million to $212.7 million. At December 31, 2018, our stockholders' equity was $343.1 million, for a ratio of net debt to total balance sheet capitalization of 38.3%, 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 1.4x as of December 31, 2018 from 1.9x as of December 31, 2017.

The main positives in the fourth quarter were 1) successful integration steps completed related to Landair, 2) improvement in the operating income at each of our Truckload segment and Managed Freight segment subsidiaries, 3) an approximate 5% increase in average freight revenue per truck for our Truckload segment, excluding Landair's truckload operations, versus the same quarter of 2017, 4) improved year-over-year earnings contributed from our investment in Transport Enterprise Leasing, and 5) reducing our leverage ratio to 1.4x. 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 3,154 trucks by the end of December, a 77 truck increase from our reported fleet size of 3,077 trucks at the end of September. A portion of this growth was a 15 truck (or 5.0%) increase of independent contractor trucks to 315 trucks by the end of December from 300 trucks at the end of September. Our fleet of team-driven trucks averaged 866 teams in the fourth quarter of 2018, a 1.6% decrease from 880 average team-driven trucks in the third quarter of 2018.

Our earnings outlook for 2019 is positive. We expect to deliver adjusted earnings per share improvement for the first quarter of 2019 as compared to the first quarter of 2018. For the full year, we expect adjusted earnings per diluted share to increase modestly over 2018, based on the favorable impact of a full year of contribution from Landair's service offerings, partially offset by investment in growing the Managed Freight segment. From a balance sheet perspective, with net capital expenditures scheduled at normal replacement cycle, along with positive operating cash flows, we expect to reduce combined balance sheet and off-balance sheet debt over the course of fiscal 2019.

Our outlook is based on our expectation of a relatively balanced freight environment measured over the entire 2019 year, with the potential for intra-period volatility in response to national and global events. We believe these conditions are consistent with U.S. economic growth of 2.0% to 2.5%, modestly growing industrial production, balanced inventories, and mid-single digit percentage increases in revenue per total mile across our truckload business. The freight market in January has thus far been consistent with our expectations, but not as strong as January 2018, nor the majority of 2018. Beyond the general freight environment, we believe company-specific improvement opportunities exist as we continue to execute on our strategic direction to grow our contract logistics service offerings including dedicated contract truckload, warehousing and transportation management services ("TMS"). We expect that the growth of our dedicated contract truckload service offering will come somewhat from a re-allocation of capital from our transactional over-the-road ("OTR") truckload service offering, most specifically from the less profitable solo-driven refrigerated OTR service. In addition, we expect to continue to invest in the organic growth of our freight brokerage services, which could pressure Managed Freight profit margins until revenue growth catches up with the investments. Even with these changes, attracting and retaining highly qualified, professional truck drivers will remain a significant challenge, and we will continue to work actively with our customers to improve driver compensation, efficiency, and working conditions while providing a high level of service. In the aggregate, the goals of our capital allocation strategy are to become increasingly embedded in our customers' supply chains, to reduce the cyclicality and seasonality of our business and financial results, and to enhance our long-term earnings power and return on invested capital.

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