Covenant Transportation Group 2nd Quarter 2018 Conference Call

Mr. Cribbs – Good morning and welcome to our second 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 divisions' revenue, excluding fuel, increased 12.5% to $145.0 million due primarily to a 14.2% increase in average freight revenue per tractor, partially offset by a $3.3 million year-over-year reduction in intermodal revenues
- Versus the year ago period average freight revenue per total mile was up $.239 per mile or 14.7% and our average miles per tractor were down 0.4%,
- Versus the prior year quarter, freight revenue per tractor at our Covenant Transport subsidiary experienced an increase of 13.1%, our Southern Refrigerated Transport ("SRT") subsidiary experienced an increase of 18.3%, and our Star Transportation ("Star") subsidiary experienced an increase of 10.0%,
- The Truckload division's operating costs per mile, net of surcharge revenue, were up approximately $.076 per mile compared to the year ago period. This was mainly attributable to higher employee wages, casualty insurance claims costs, and acquisition-related expenses. 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 $0.4 million in the second quarter of 2018 versus a loss of $2.1 million in the second quarter of 2017,
- The Truckload operating ratio was 91.9% in the second quarter of 2018, compared with 98.2% in the second quarter of 2017,
- Our Managed Freight division increased revenue by 53.4% versus the year ago quarter. Purchased transportation increased as a percentage of revenue, while other operating expenses decreased as a percentage of revenue resulting in operating ratio contraction to 90.9% from 90.5% in the year ago quarter. With the revenue growth, the

result was an increase of operating income contribution to $2.3 million in the current year quarter from $1.6 million in the prior year quarter,

- Our minority investment in Transport Enterprise Leasing contributed $1.8 million to pre-tax earnings or $.07 per share,
- The average age of our tractor fleet continues to be young at 2.1 years as of the end of the quarter, slightly improved from 2.2 years a year ago,
- Between December 31, 2017 and June 30, 2018, total indebtedness, net of cash and including the present value of off-balance sheet lease obligations decreased by $56.2 million to $163.9 million. This subsequently increased to approximately $269.0 million pro forma for the acquisition of Landair and its subsidiaries announced July 5, 2018.

The main positives in the second quarter were 1) significant improvement in the operating profitability at our Covenant and SRT Truckload subsidiaries, 2) a 14.2% increase in average freight revenue per truck versus the same quarter of 2017, 3) generating an additional $31.3 million of cash to deploy towards the Landair acquisition, as well as utilizing previously unencumbered revenue equipment to fund the balance resulting in low-cost financing and increasing our future earnings, cash flows and potential revolver availability on a post-transaction basis, 4) improved year-over-year earnings from our investment in Transport Enterprise Leasing, and 5) our tangible book value per basic share increased 31.8% to $17.09 from $12.97 a year ago. The main negative in the quarter was the increased Truckload operating costs on a per mile basis, including unfavorable employee wages and casualty insurance claims costs as well as Landair acquisition-related expenses, partially offset by lower net fuel costs and improved net depreciation expense.

Our fleet experienced an increase to 2,632 trucks by the end of June, a 56 truck increase from our reported fleet size of 2,576 trucks at the end of March. A large portion of this growth was a 27 truck (or 10.8%) increase of independent contractor trucks to 276 trucks by the end of June from 249 trucks at the end of March. Our fleet of team-driven trucks averaged 878 teams in the second quarter of 2018, a 1.8% decrease from 894 average teams in the first quarter of 2018.

We expect the overall balance of business conditions to remain favorable through the second half of 2018 and into 2019. Freight demand has been, and remains, exceptionally 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. The market for used tractors and trailers is expected to generate moderate gains on our dispositions of equipment over the remainder of the year. 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.

Our acquisition of Landair was aligned with our stated 2018 strategic initiative of becoming closer to our customers. Along with the acquisition, we have increased our capital allocation to organically grow our dedicated truckload, 3PL, and other managed freight solutions. Immediately subsequent to the Landair transaction in early July, the percentage of our truckload fleet operating under dedicated contracts was approximately 1,400 trucks, representing 46% of our fleet. This compares to a year ago when only approximately 650 of our trucks, or 25% 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.

From an earnings perspective, we expect our consolidated operating ratio for the third quarter to be similar to our consolidated operating ratio for the second quarter, but with the addition of revenue from Landair's operations. For the fourth quarter, we expect to remain a major participant in the holiday peak shipping season and anticipate our consolidated operating ratio and consolidated 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 availability, and managed freight capacity, as well as the need to complete purchase accounting entries relating to the Landair transaction, we are not offering more specific earnings guidance. In addition, our prior comments about expectations for the second half of 2018, including percentage rate improvements versus prior periods, are superseded.

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