Covenant Logistics Group 2nd Quarter 2020 Conference Call

Mr. Cribbs – Welcome to the Covenant Logistics Group second quarter 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.covenanttransport.com/investors. I'm joined this morning by Chairman & CEO, David Parker, co-Presidents John Tweed and Joey Hogan, and CFO, Paul Bunn. I will now turn the call over to Paul to summarize our financial results.

Mr. Bunn – Thank you Richard and good morning, everyone. We will cover prepared remarks first, followed by Q&A.

Before I cover the normal detailed information, I would like to provide an overview of key drivers of our second quarter results because the numbers alone do not match where I think we are headed operationally or some peer results, and I am sure there is interest in that.

- During the quarter, we shut down our second largest facility (Texarkana), sold another facility, and consolidated most of our related non-maintenance personnel in Chattanooga and Greeneville. This was a significant operational, HR, and IT lift, similar to an acquisition, since the SRT business in Texarkana had been operated primarily as an autonomous solo refrigerated service offering.
- We downsized our fleet by 262 tractors (or 10.0%), and repositioned a portion of the remaining tractors between segments, which involved an immediate revenue loss but some ongoing expenses due to unpaid miles, a tail on fixed overhead, etc.
- Our dedicated operations experienced volatility due to concentration in automotive and automotive supplier businesses that were shut down for significant parts of the quarter, as well as certain other contracts that do not require a minimum load count or payment, so we had to put the trucks to work elsewhere.
- The freight environment for the quarter was very weak in April and progressively improved.
- The sum of the above is that we pushed a lot of disruption and expense into a relatively weak freight quarter. The table in our press release quantifies approximately $29.3 million in "infrequent items," including net gains and losses on asset sales and impairments, and certain shut down and severance costs. But it doesn't capture all of the related operational costs or the revenue drop off and tail on fixed expenses.
- For the third and fourth quarters, I expect some ongoing operational restructuring costs but not at the level of the second quarter, while our fixed overhead costs continue to come down and the freight environment has improved

materially quarter to date compared to the first two quarters. The sales pipeline is robust across Truckload and Managed Freight. Our team is focused on taking the steps required over the remainder of the year to exit the year best prepared for 2021.

Turning to more detailed results, notable financial results of the quarter included the following:

- Our Highway Services Truckload segment's revenue, excluding fuel, decreased 7.0% to $73.3 million due primarily to an 8.8% (or 116 tractors) average operating fleet reduction, partially offset by a 2.0% increase in average freight revenue per tractor in the 2020 period as compared to the 2019 period. Versus the year ago period, average freight revenue per total mile was down 12.6 cents or 6.7%, while average miles per tractor was up 9.3%. The main factors impacting the increased utilization were a 1180 basis point increase in the percentage of our Highway Services' fleet comprised of team-driven tractors and an improved average seated tractor percentage, as only 3.7% of our Highway Services' operational tractor fleet lacked drivers compared with 6.9% during the prior year quarter. The longer average length of haul related to the higher percentage of team-driven tractors contributed to the reduced average rate per total mile,
- Our Dedicated Truckload segment's revenue, excluding fuel, decreased 16.6% to $60.4 million due primarily to the combination of the pandemic-related second quarter automotive shutdowns at two large customers and an 8.6% (or 151 tractors) average operating fleet reduction. Versus the year ago period, Dedicated average freight revenue per total mile increased 11.6 cents or 6.4%, while average miles per tractor was down 14.3%,
- Excluding the impact of the truckload-related restructuring and other second quarter 2020 adjustments, total operating expenses, net of fuel surcharge revenue increased 7.4 cents per mile compared to the year ago period for our combined Truckload segment. This was attributable to higher per mile driver wages, non-driver wages and casualty insurance claims' costs, basically offset by lower workers' compensation and maintenance & repair costs,
- Our Managed Freight segment's operating revenue increased 10.6% versus the year ago quarter to $45.9 million. This increase was driven by a 40.3% increase in freight brokerage operating revenue to $28.4 million, partially offset by a 17.9% decrease in the combined operating revenues of TMS and Warehousing. Managed Freight operating loss was $2.9 million for an operating ratio of 106.4%,
- As a result of the second quarter decision to sell the assets of Transport Financial Solutions ("TFS"), the related results are presented as discontinued operations. This presentation nets all activity, net of tax, into a single line item, "Income from discontinued operations, net of tax." TFS's results, net of tax, provided for $0.05 per share of earnings in the second quarter of 2020 and 2019, respectively,
- We recognized $0.5 million pre-tax income from our 49% equity investment in TEL, compared with pre-tax income of $2.4 million in the second quarter of 2019, as TEL returned to profitability following reported losses in the previous two quarters,
- The average age of our tractor fleet continues to be young at 1.8 years as of the end of the quarter, down from 2.2 years a year ago,

- During the first half of 2020, we took delivery of ≈ 305 new tractors and 155 new trailers, while disposing of ≈ 781 used tractors and 219 used trailers. We reduced our operational fleet size by 398 tractors, or 13.2%, to 2,623 tractors by the end of June from our reported operational fleet size of 3,021 tractors at the end of December.
- In the second half of 2020, we expect an average operational fleet size of approximately 2,550 tractors, which we expect to allow us to maximize the utilization of our operational fleet including an improved mix of more consistently profitable freight,
- Between March 31, 2020 and June 30, 2020, total indebtedness, net of cash decreased by $52.4 million to $284.4 million. This sequential decrease to net indebtedness included net cash proceeds from the sale of real estate and excess revenue equipment,
- At June 30, 2020, we had cash and cash equivalents totaling $67.1 million, as well as available borrowing capacity of $58.3 million under our asset-based revolving credit ("ABL") facility for a total of $125.4 million in liquidity. The sole financial covenant under our ABL facility is a fixed charge coverage ratio covenant that is tested only when available borrowing capacity is below a certain threshold. Based on availability as of June 30, 2020, no testing was required, and we do not expect testing to be required in the foreseeable future.

At this time, I will turn the call over to Joey to recap a few additional items.

Mr. Hogan – Thank you for that summary Paul.

The main positives in the second quarter were 1) significant progress in our efforts to restructure our business units, terminal network, and management team to focus our talent, time and capital on areas where we believe we have the ability to grow and produce a consistent, acceptable margin, 2) executed a number of decisions and transactions consistent with our strategic plan, including the sale or exit of certain real estate, downsizing unprofitable operations, and reallocating fleet assets, 3) recognized the largest portion of strategic plan implementation costs, including certain costs that were not separately identifiable, 4) cost control execution that we expect to provide significant cost savings as we move through the remainder of the fiscal year, 5) year-over-year average freight revenue per tractor increase in the Highway Services segment, 6) TEL's return to a profitable quarter, 7) a sizeable increase to our liquidity position and 8) decreasing net indebtedness by $52.4 million during the quarter while also lowering our weighted average interest rate through refinancing and new financing efforts from our excellent financing partners. The main negatives in the quarter were 1) the revenue and related profitability lost while two of our large dedicated automotive customers experienced pandemic-related plant shutdowns for a large portion of the quarter before stepping up production late in the quarter, along with the temporary deferral of the startup of dedicated service provided to a new large automotive account, 2) the revenue and related profitability lost from managed freight service to a customer in the airline industry as the pandemic significantly reduced domestic air travel, and 3) impairment charges on tangible and intangible assets.

In relation to our strategic plan and lowering fixed costs, we have been analyzing our senior management personnel and the needs of a business our size for several months. We have felt positive about our team members but also that a flatter and less costly corporate organization was needed. We identified six SVP and higher positions that we do not expect to need going forward. Two of the positions that were eliminated have been filled by Ryan Rogers and Richard Cribbs, who will transition out of the Company over the coming weeks. We have valued their contributions, and this is one of the difficult decisions Paul talked about earlier. The severance costs are expected to be included in the third quarter as one of the ongoing costs we mentioned above.

After the quarter, we sold the assets of our Factoring business, TFS, on July 8. The transaction was valued at approximately $131 million, including $8 million of estimated earnout. We have received $108 million in cash and $14 million in stock to date. We are now involved in a dispute concerning the transaction. The purchaser asserts that, subsequent to the closing, it identified that approximately $66 million of the $103 million of net assets acquired were advances against future payments to be made pursuant to long-term contractual arrangements between the obligor on such contracts and TFS' clients for services that had not yet been performed (as opposed to advances against future payments for services that had been performed), that this fact was not disclosed to the purchaser, and the purchase of such advances was not contemplated by the purchase agreement. The purchaser and we have met to determine whether this dispute can be amicably resolved, and we have continued to exchange with them various structures to resolve the situation. We are also evaluating other options should the discussions not produce an amicable resolution. It is too early for us to determine the likely outcome of this dispute, any liability or expenses we may incur, any cash we may need to pay or invest, the impact on our total leverage, or the gain or loss we may ultimately record on the transaction compared with the $26.5 million gain we previously estimated. The facts are still being gathered, and we may or may not find a solution that is acceptable to both companies. As you might expect, we will not be taking questions on this topic.

For the balance of 2020, our main goals will be (i) to reduce our fleet size as described above and monetize a large percentage of the assets held for sale, which were $66 million at June 30, (ii) to allocate our fleet assets across our contract logistics, expedited, and higher margin irregular route operations, (iii) to significantly lower our fixed costs, and (iv) to return managed freight back to its pre-Covid margin percentage. We believe achieving these goals will position us to enter 2021 with an improved business mix, fleet profile, and cost of operation. Pursuing our plan will continue to involve difficult decisions and may result in additional strategic restructuring expenses. However, we believe the investment will strengthen our position in the U.S. logistics industry and provide for a less-cyclical business model based on more sustainable, higher margin sectors where we can add value to our partner-customers and for our stakeholders.

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