Covenant Logistics Group 3rd Quarter 2020 Conference Call

Mr. Bunn – Welcome to the Covenant Logistics Group third 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, and co-Presidents John Tweed and Joey Hogan.

In summary, the key highlights of the quarter were:

- We experienced significant sequential improvement in revenue, adjusted cost per mile, and capital efficiency, resulting from significant progress in implementing our strategic plan, as well as industry-wide factors including a bounce-back in economic activity, inventory restocking, and an ongoing shortage of qualified professional truck drivers.
- The freight environment for the quarter improved sequentially, with July being better than average and August and September both being robust from a supply/demand perspective.
- The ability to attract and retain drivers became progressively harder from July through September.
- We downsized our fleet by 293 tractors (or 10%) versus the average tractor count in the second quarter and 544 tractors (or 18%) versus the prior year quarter in an effort to focus on freight where we could earn an acceptable return on the related capital employed.
- We exited the factoring business by disposal of the related factoring assets in a transaction that generated $108 million in cash.
- We utilized the proceeds from the sale of the TFS portfolio and the sale of a portion of the aforementioned tractors that were reduced to pay-off $131 million in debt reduce our leverage to levels not seen in over 10 years.
- The third quarter of 2020 was the second best of any third quarter in the past 15 years, only behind third quarter of 2018.

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

- The quarter included several non-GAAP adjustment items that had a net positive impact of 8 cents per share related to discrete third quarter items and plus the ongoing 4 cent per share add-back of non-cash intangible amortization.
- Our Expedited truckload segment's revenue, excluding fuel surcharges, decreased 8%, primarily related to a 22% decrease (or 270 tractors) in average operating fleet compared to the 2019 period. Versus the year ago period, average freight revenue per total mile was down 14 cents or 7%, while average miles per tractor was up 28%, resulting in an 18% increase in average freight revenue per tractor. The significant fluctuations in the operating profile are the result of 1) change in mix to a more focused expedited model using a higher percentage of team-driven tractors, and 2) eliminating the majority of the solo refrigerated fleet and related cost. Expedited' s adjusted operating ratio for the quarter was 92%.
- Our Dedicated truckload segment's revenue, excluding fuel surcharges, decreased 15%% to $63.3 million due primarily to a 15% (or 274 tractors) average operating fleet reduction compared to the 2019 period. Versus the year ago period, Dedicated average freight revenue per total mile increased 9.0 cents or 5%, while average miles per tractor was down 5%. The fluctuations in operating profile are the result of focusing on dedicated freight that has a better long-term profile. Dedicated' s adjusted operating ratio for the quarter was 94%.
- Excluding the impact of the truckload-related third quarter 2020 adjustments, total operating expenses decreased 22 cents per mile or 12%, compared to the year ago period for our combined truckload operations. This decrease is a direct result of our strategic plan initiatives of downsizing our terminal network and solo-driver fleet, short term cost reductions to improve liquidity in response to COVID-19, and additional miles per tractor that more effectively spread fixed costs.
- Our Managed Freight segment's operating revenue increased 43% versus the year ago quarter to $47.6 million. This increase was driven by a 64% increase in freight brokerage operating revenue to $39.4 million, partially offset by a 12% decrease in the operating revenue of TMS as the result of the ongoing COVID impact at a large customer. The growth in brokerage was primarily "spot" or "project" freight that should remain as strong long as capacity is constrained. Managed Freight's adjusted operating ratio for the quarter was 95%.
- Our Warehousing segment's operating revenue increased 13% versus the year ago quarter to $13.6 million. Adjusted operating income for the segment increased 9% to $1.7 million. Both operating revenue and adjusted operating income increased as a result of new customer business that began operations in the third quarter of 2020. Warehousing's adjusted operating ratio for the quarter was 88%.
- We recognized $1.2 million pre-tax income from our 49% equity investment in TEL, compared with pre-tax income of $2.1 million in the third quarter of 2019, as TEL continues to rebound from a key customer bankruptcy that occurred in the fourth quarter of 2019.

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) a robust freight market across all of our service offerings, 2) a significant reduction of our net indebtedness, 3) a significant reduction in fixed costs and better cost absorption given increased asset utilization, 4) TEL's sequential improvement in earnings and 5) subsequent to the end of the quarter we were able to close a 5 year extension of our asset based revolving credit facility with favorable terms, no fees and retaining the flexibility that the facility provides. The main negatives in the quarter were 1) one of the toughest driver recruitment and retention markets in 20 years, 2) several large prior period insurance claims eroding the limits of our 9 X of 1 policy creating both a charge to write-off the remaining premiums recorded as a prepaid asset and potential forward looking exposure and volatility, 3) less excess capacity for capitalization in the spot market, and 4) the amended agreement relating to the disposition of our factoring segment resulted in returning a portion of the consideration and taking on additional risk concerning the portfolio of assets we sold. We have not recorded any reserve for potential claims under the risk-sharing mechanism to date, and any future amounts will be recognized when the requirements of GAAP for recording claims are satisfied.

As we look to the fourth quarter, we are focused on delivering superior service to our customers in what is expected to be robust peak shipping season with limited trucking capacity. Similar to the third quarter, our reduced fleet size and more focused and committed model provides limited capacity to "flex up" and take advantage of the peak spot market to the same extent we did in prior years. However, we expect fourth quarter volumes and pricing to be favorable and to support sequential margin improvement.

In 2021 and beyond, our focus will be continued execution of our strategic plan, which consists of steadily and intentionally growing the percentage of our business generated by Dedicated, Managed Freight, and Warehousing segments, reducing unnecessary overhead, and improving our safety, service, and productivity. This will be a gradual process of diversifying our customer base with less seasonal and cyclical exposure, improving legacy contracts, and investing in systems, technology, and people to support the growth of these previously under-invested areas. As we undertake this multiyear effort, I would like to remind investors that our goal is to improve our earnings and returns in a manner that is sustainable and less susceptible to upward and downward market forces. The gradual improvements we expect will be offset at times by short term forces. For example, in 2021, we expect underlying progress on efficiency and cost control, improved contract pricing, and improved safety. These benefits are expected to be offset to some extent by the return of certain cost pressures. Over time, we expect to exit the plan a stronger, more profitable, more predictable business with the opportunity for significant and sustained value creation.

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