Covenant Logistics Group 4th Quarter 2022 Conference Call

Mr. Grant – Good morning everyone and welcome to the Covenant Logistics Group fourth quarter 2022 conference call.

As a reminder:

> *This call will contain forward-looking statements under the Private Securities Litigation Reform Act, which are subject to risks and uncertainties that could cause actual results to differ materially. Please review our SEC filings and most recent risk factors. We undertake no obligation to publicly update or revise any forward-looking statements.*

A copy of the prepared comments and additional financial information is available on our website at www.covenantlogistics.com\investors. I am joined on the call by David Parker, Joey Hogan and Paul Bunn.

Before jumping into the quarter, I'd first like to take a moment to reflect on 2022 as a whole, as it was a remarkable year for us in many ways. It marked the second consecutive year of record revenue, earnings, capital returns and safety results. We repurchased approximately 20% of the outstanding stock of the company and acquired a small but highly profitable specialized truckload carrier, all while maintaining moderately low debt leverage. We also made progress on our operating model through improved contracts in our Dedicated segment and grew the core business in our asset light segments, comprised of Managed Freight and Warehousing.

Although the tail winds of a strong freight cycle may well be behind us, we believe the combination of our improved operating model and strong balance sheet has us well positioned for the future. Our company today is much improved, and we are grateful to all our team members, whose dedication and commitment made this possible.

Focusing now on the fourth quarter. On an adjusted basis, we believe our team performed well during a market in transition. Consolidated revenue was essentially flat compared with the fourth quarter of 2021, while improved revenue per tractor and brokerage margin more than overcame significant inflationary costs to generate a better adjusted operating ratio and higher adjusted net income. Through acquiring and successfully growing AAT, working with long-term customers to improve the stability of contracted capacity in our Expedited fleet, and selectively downsizing our least efficient Dedicated operations, we did more with less. On an adjusted EPS basis, the impact of our capital allocation toward share repurchase was considerable, with adjusted EPS growing 28%.

These results were earned in a difficult environment. Freight rates were up year-over-year but are under sequential pressure. Freight volumes turned negative prior to the fourth quarter and are continuing to feel soft. In addition, cost inflation and availability of equipment and parts continue to provide headwinds. Looking ahead, we expect difficult year-over year revenue and income comparisons for the first time in many quarters. In this environment, our playbook remains consistent, and our urgency is high.

The primary adjustments to our reported results revolve around our tractor fleet – particularly a group of underperforming leased units that needed to be removed from operations due to negative driver, customer, and cost considerations. Several factors transpired in the quarter, including: receiving over half of our 2022 new tractor order in the period, delaying lease turn-ins due to parts availability for trade prep on used tractors whose lease terms have expired, and parking additional leased tractors with future lease maturity dates which have been the source of significant operational cost headwinds throughout the year. The abandonment of these units in the

period before the expiration of the lease has caused us to write-down the right-of-use asset in the period and accrue any estimated future disposal costs on these units, resulting in a lease impairment charge. Although costly in the quarter, we believe this is our best opportunity to start the new year in the most cost-effective manner possible.

Key highlights for the quarter include:

- Adjusted net income increased 8% to $19.5 million and adjusted earnings per share increased 28% to $1.37 per share compared to the year ago quarter. As a percentage, earnings per share growth outpaced net income growth due to the shares acquired throughout the year under our share repurchase program.
- During the quarter, we purchased approximately four hundred and fifty thousand shares, bringing the total to 3.4 million for the year,
- Total freight revenue declined by 4.4% to $255 million compared to the 2021 quarter,
  - Our asset-based truckload's freight revenue grew 11% with 76 fewer trucks,
  - Our asset-light managed freight and warehouse segments combined freight revenue declined by 22% primally because of the combination of a muted peak season and reduced volumes of overflow brokerage freight compared to the prior year,
- Truckload related cost headwinds continued to play a major role in our results for the quarter, increasing 20 cents per total mile on an adjusted basis compared to the prior year quarter.
  - Salaries and wages, maintenance, and insurance all contributed to this increase.
  - Gain on sale of equipment was $1.0 million in the quarter, compared to $0.1 million in the prior year.
- On the safety side, we are proud to report that our DOT accident rate per million miles for the year was a new company record, beating last year's previous record by approximately 6%. Despite two consecutive years of favorable safety results, unfavorable development from a small number of prior period claims contributed to almost a 6 cent per total mile increase in insurance expense compared to the prior year quarter,
- The average age of our fleet at December 31st was 26 months, a 3 month reduction from September 30th. For 2023, we have been able to increase our original tractor order, and we anticipate sequential improvement to the average age of our equipment throughout the year,
- Our TEL leasing company investment produced $0.21 per diluted share, compared to $0.23 per share versus the year ago period,
- Our net indebtedness at December 31st was $46.4 million, yielding a leverage ratio of .34x and debt to equity ratio of 10.9%,
- Return on invested capital for 2022 was 15.3%. versus 12.8% in the prior year.

Now Paul will provide a little more color on the items affecting the individual business segments:

Thanks Tripp, taking a moment to dive deeper into what drove the consolidated results for the quarter.

- Starting with our Expedited segment, freight revenue grew 26% compared to the prior year quarter as a result of the combination of a 16% rate improvement and operating 67 additional trucks. The increase in trucks was related to the small acquisition we had in the first quarter and the loosening driver market, allowing us to seat more tractors. We were pleased with Expedited's rate and utilization in the quarter, which was improved by FEMA freight in October that resulted from hurricane Ian. Cost headwinds from increased salaries and wages, maintenance, and insurance continued to play a major impact in the quarter and condensed margins. We believe the combination of our work to resolve a significant number of prior period claims and the impact of the equipment replacement plan will help improve costs in this segment going forward. Driver pay remains stable at the present time.

- Our Dedicated segment had a 5% reduction in freight revenue compared to the 2021 quarter as a result of a 143 or 10% reduction in the average number of total trucks in the period, offset by a 5% increase in revenue per truck. Although we were pleased with both the year over year and sequential improvement to adjusted margin, we fell well short of our profitability target primarily because of the same cost increases which are impacting our Expedited segment. The fleet reduction we've experienced in this segment is a product of two factors: intentionally exiting unprofitable business and reducing fleet counts with existing customers based on reduced volumes. We continue to work diligently to improve margins in this segment by improving our customer mix, contractual terms with legacy customers and operating a younger, more efficient fleet.

- Managed Freight experienced a 30% reduction of total freight revenue and 20% reduction of consolidated adjusted operating profit. The significant reduction in revenue was the product of less overflow freight from our asst based Truckload segments, a reduction in Peak revenue, offset by FEMA freight brokered in the current quarter compared to the prior year. We were pleased with the fact that Managed Freight was able to hold margins for the quarter, but we are now experiencing a much more aggressive environment with competitors aggressively competing for volumes at the expense of margin. We anticipate significant margin compression in this softening environment.

- Our Warehouse segment, although the smallest of all of our business segments, saw a 31% increase in freight revenue compared to the prior year, resulting from the startup of 4 new customer startups for the year, the largest of which became operational in December. We are pleased with the top line growth we've achieved in this segment and the team has done a phenomenal job in executing these startups which are both intense and time consuming. However, despite the topline growth in this segment, we've seen sequential deterioration in margins throughout the year. Our focus for 2023 will be to continue to grow this segment and restore profitability to mid to high single digits through improved labor utilization and rate increases with existing customers.

- Our minority investment in TEL produced pre-tax net income of $3.9 million for the quarter, compared to $5.2 million in the prior year period. Although the fourth quarter is typically soft for TEL it was especially soft due to an adjustment to accelerate depreciation on a specific group of equipment that is expected to be sold in the near term. The adjustment negatively impacted the quarter's results by approximately $1.5 million. TEL has a strong track record of producing gain on sale of equipment throughout good and bad cycles and we believe this adjustment is isolated to a specific quantity of similar make and model equipment. TEL's revenue in the quarter grew 47% and pre-tax operating profit decreased by 22% both versus the fourth quarter of 2021. TEL increased its truck fleet in the quarter versus year ago by 243 trucks to 2,237 and grew its trailer fleet by 654 to 7,149. After receiving more than a $7 million distribution during the quarter, our investment in TEL, included in Other Assets in our consolidated balance sheet was $55 million. TEL focuses on a) managing lease purchase programs for clients, b) leasing trucks and trailers to small fleets or shippers and c) aiding clients in the procurement and disposition of their equipment through a robust equipment buy and sell program. Due to the business model, gains and losses on sale of equipment is a normal part of the business and can cause earnings to fluctuate from quarter to quarter.

Regarding our outlook for the future:
There's no doubt that 2023 will be a challenging year. But it's also a year that our team has been anticipating and working hard to prepare for. We view it as a test to the resiliency of our operating model and an opportunity to identify areas where we can improve it. As such, our primary focus remains on continued forward progress to our long-term strategic plan.

We are also focused on aggressive improvements to our operating cost profile. With our equipment replacement plan and strong safety results, we see opportunities to improve costs in the short term through improved fuel economy, and reduced operations and maintenance and insurance costs in a freight environment that will pressure both rates and margins. There's a lot of work for us to be ready for. We expect market headwinds from a softer market during contract renewals as well as continued inflationary pressures. However, based on company specific factors – the investments we have made in the sales team, the small acquisition, share repurchases, the equipment upgrade plan and reduced insurance casualty costs resulting from our improved safety results, we expect less earnings volatility than in prior periods of economic weakness. Over the last 5 years, our customer base has been strategically shifted to less cyclical industries through our full-service logistics focus. Even with a heavy equipment investment year, we expect our cash generation, low leverage, and available liquidity to provide the full range of capital allocation opportunities to benefit our shareholders.

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