Covenant Logistics Group 2nd Quarter 2023 Conference Call

Mr. Grant – Good morning everyone and welcome to the Covenant Logistics Group second quarter 2023 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 and Paul Bunn.

We are pleased with our results for the quarter, which showed comparative resilience in the midst of a very soft freight environment. Consolidated freight revenue was down 9% compared to a very tough prior year comparable when the freight environment peaked. The decline related primarily to operating approximately 11% fewer weighted average tractors in our truckload operations and less overflow freight handled by our Managed Freight segment due to lower overall demand.

Adjusted operating income fell approximately $12 million or 43% compared to the prior year quarter, primarily as a result of our Expedited and Managed Freight segments which declined by approximately $7.5 million and $6.5 million, respectively, offset by an increase of approximately $2 million in our Dedicated segment.

Adjusted net income decreased 44% to $14.4 million and adjusted earnings per share decreased 34% to $1.07 per share compared to the year ago quarter. Weighted average diluted shares decreased as a result of our share repurchase program.

Key highlights for the quarter include:

- All four of our business segments, including Expedited, Dedicated, Managed Freight and Warehousing, achieved sequential improvement in profitability in the second quarter.
- The acquisition of Lew Thompson and Son Trucking, Inc., a dedicated contract carrier comprised of approximately 200 tractors, specializing in poultry and live haul transportation. We have been pleased with the operational results to date and are excited about the growth opportunities that lie ahead.
- Within our combined truckload segments, operations and maintenance related expenses declined on a cents per total mile basis by 6 cents or 21% and fixed equipment costs, including leased revenue equipment, depreciation, and gains on sale, remained flat compared to the prior year.
- The average age of our fleet at June 30th remained flat sequentially at 26 months compared to March 31, 2023, largely due to the equipment acquired from Lew Thompson and Son Trucking. For the remainder of 2023, based on our current equipment order, we anticipate sequential improvement to the average age of our equipment.
- Gain on sale of revenue equipment was $2.0 million in the quarter, compared to $0.4 million in the prior year.
- Our TEL leasing company investment produced $0.29 per diluted share, compared to $0.33 per share versus the year ago period.
- Our net indebtedness at June 30th climbed to $187.2 million in the quarter primarily as a result of the acquisition, yielding a leverage ratio of approximately 1.7x and debt to equity ratio of 33.1%,

- On an adjusted basis, return on invested capital was 13.0% for the current quarter versus 17.6% 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 declined 7% compared to the prior year largely due to a 6% reduction in the average fleet. Rates declined by just over 10% but were offset by almost a 10% improvement in average total miles per truck compared to a year ago. The improvement in utilization was principally attributable to newer equipment in the fleet and reduced down time. While we were pleased with the segment's utilization improvement, we recognize that year over year freight revenue per total mile comparisons will continue to be challenging for the remainder of 2023. While cost headwinds from salaries and wages and fixed equipment costs compressed margins, they were somewhat offset with improvements to variable based equipment costs for the quarter.

- Our Dedicated segment experienced an 8% reduction in freight revenue compared to the 2022 quarter as a result of a 217 or 15% reduction in the average number of total trucks, offset by an 8% increase in revenue per truck. Despite the addition of the Lew Thompson and Son Trucking fleet, the overall fleet reduction in our Dedicated segment aligns with our strategy of exiting unprofitable or underperforming business and replacing it when opportunities arise that meet our profitability and return requirements. We were pleased with both the year over year and sequential improvement to adjusted margin and expect to continue to improve upon this segment's profitability over the long term.

- Managed Freight experienced a 21% reduction of total freight revenue and 76% reduction of consolidated adjusted operating profit. The significant reduction in revenue and operating profit was primarily the product of little to no high-margin overflow freight from our asst-based Truckload segments. The brokerage environment remains highly competitive with numerous brokers aggressively competing for volumes at the expense of margin. We anticipate continued margin pressure in this environment.

- Our Warehouse segment saw a 37% increase in freight revenue compared to the prior year, resulting from the startup of new customers during the previous 12 months. 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 significant topline growth in this segment, we've seen only a 10% improvement in adjusted operating profit compared to the prior year. Although we were pleased with the sequential profitability within this segment, we will continue to focus on improving profitability to mid-single digits through improved labor utilization and rate increases with existing customers.

- Our minority investment in TEL contributed pre-tax net income of $5.4 million for the quarter, compared to $7.1 million in the prior year period. The decline was largely a result of reduced gains on sale of used equipment compared to a year ago. TEL's revenue in the quarter grew 11% and pre-tax net income decreased by 26% versus the second quarter of 2022. TEL increased its truck fleet in the quarter versus year ago by 210 trucks to 2,283 and grew its trailer fleet by 84 to 7,031. 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. Our investment in TEL, included in Other Assets on our consolidated balance sheet, has grown to $66 million as of June 30, 2023, from our original investment of $4.9 million. In 2022, we received $14.7 million in cash dividends from TEL, and we are anticipating approximately $19.8 million to be received during the second half of 2023.

Regarding our outlook for the future:
As we enter the third quarter of the year, we are optimistic that the trough of the freight cycle is behind us but are cautious about the rate at which we will see improvements. Regardless of how the freight economy responds, our primary focus remains on the long term, by continuing to invest in areas that provide opportunities for us to make forward progress on our strategic plan- the acquisition of Lew Thompson and Son Trucking and our investments in new revenue generating equipment, people and technology are examples of this.

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