Covenant Logistics Group 3rd Quarter 2023 Conference Call

Mr. Grant – Good morning everyone and welcome to the Covenant Logistics Group third 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 today by David Parker and Paul Bunn.

We were pleased with our third quarter's results, which benefited from the full quarter effect of the Lew Thompson and Son Trucking acquisition in the second quarter reflected in our Dedicated segment. In addition, our Expedited segment benefited incrementally from the increase in demand for team-driver freight as a result of the closure of Yellow. However, more broadly, the overall freight environment remained challenging with few signs of immediate macro-economic improvement.

Compared to a year ago, consolidated freight revenue was down 5%. The decline is primarily attributable to the combination of little to no overflow freight handled by our Managed Freight segment and a lower tractor count in our Dedicated segment. The reduction of tractors assigned to Dedicated resulted from exiting underperforming legacy contracts partially offset by acquiring Lew Thompson and Son. The result was higher earnings on fewer trucks.

Adjusted operating income declined approximately $4.6 million or 20% compared to the prior year quarter, primarily as a result of our Managed Freight segment which declined by approximately $4.7 million.

Adjusted net income decreased 32% to $15.3 million and adjusted earnings per share decreased 26% to $1.13 per share compared to the year ago quarter. Weighted average diluted shares decreased as a result of our share repurchase program.

Key highlights include:

- Freight revenue for the quarter was the highest for any quarter of the year, surpassing the second quarter by 4%.
- The Lew Thompson and Son Trucking operation continued to perform well with our first new poultry related customer start-up in late September and a strong pipeline of additional bids.
- The average age of our fleet at September 30th improved to 23 months compared to 29 months in the prior year and 26 months at June 30th, 2023.
- Within our combined truckload segments, compared to the prior year, operations and maintenance related expenses declined by 6 cents or 21% and fixed equipment costs, including leased revenue equipment expenses, depreciation, and gains on sale remained flat on a total cents per mile basis.
- Gain on sale of revenue equipment was $0.6 million in the quarter, compared to $0.2 million in the prior year.
- Our TEL leasing company investment produced $0.28 per diluted share, compared to $0.38 per diluted share versus the year ago period.

- Our net indebtedness as of September 30th was $183.4 million, yielding a leverage ratio of approximately 1.7x and debt to equity ratio of 31.8%,
- On an adjusted basis, return on invested capital was 10.6% for the current quarter versus 17.5% in the prior year.

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

Thanks Tripp,

- The performance of Expedited during the third quarter – approximately 90.7% adjusted OR in the midst of a historically weak freight market – says volumes about the work we have done to deploy assets with the right customers, lower our cost per mile, and focus on what we can control. In the context of an 8% decline in revenue per mile, we thought a 12% improvement to utilization and lower cost per mile were significant accomplishments. The improvement in utilization was principally attributable to newer equipment in the fleet and reduced down time, which we will look to continue as year over year freight revenue per total mile comparisons are expected to continue to be challenging for the remainder of 2023 and into 2024.

- Dedicated reflected another success story centered on our disciplined approach to capital allocation. Dedicated improved its adjusted operating ratio to approximately 93.6% by effectively weeding and feeding. We reduced the overall fleet size by 170 trucks while nearly doubling adjusted operating income. Trading out approximately 400 legacy contract units for Lew Thompson and Son 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 the year over year improvement to adjusted margin and expect to continue to improve upon both this segment's size and profitability over the long term.

- Managed Freight experienced a 11% reduction of total freight revenue and 57% 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 asset-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 15% increase in freight revenue and 82% increase of adjusted operating profit compared to the prior year. The top line growth is a result of new customer startups over the last 12 months and the operating profit improvement was a result of the combination of new customer business and improved rates for existing customers. Although we were pleased with the improved profitability within this segment, we will continue to focus on improving profitability through improved labor utilization and rate increases with existing customers.

- Our minority investment in TEL contributed pre-tax net income of $5.3 million for the quarter, compared to $7.4 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 declined 8% and pre-tax net income decreased by 28% versus the third quarter of 2022. TEL increased its truck fleet in the quarter versus year ago by 42 trucks to 2,195 and grew its trailer fleet by 153 to 7,013.

  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 $61.6 million as of September 30, 2023, from our original investment of $4.9 million. In 2022, we received $14.7 million in cash dividends from TEL, and we received $9.8 million year to date in the third quarter of 2023.

Regarding our outlook for the future:

For the fourth quarter, we expect our revenue and earnings to experience a modest decline sequentially due to a cyber-attack on a major customer and the ongoing United Auto Worker strike, which has temporarily depressed load volumes and revenue per truck in our Expedited and Dedicated divisions. More broadly, however, we are optimistic that the trough of the freight cycle is behind us but remain cautious about the rate at which we will see improvements. For 2024, we believe that the first half of the year may continue to be challenging and expect capacity to continue exiting the market. Although we are all eager for the freight environment to improve, 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- by exiting underperforming capital tied to underperforming customers, investing capital to business units and customers that provides for adequate returns, improving our safety culture and investing in our people.

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