Covenant Logistics Group 4th Quarter 2023 Conference Call

Mr. Grant – Good morning everyone and welcome to the Covenant Logistics Group fourth 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.

Before we address the fourth quarter's results, I'd like to take a moment to reflect on the year as a whole. As challenging as it was, 2023 was a pivotal year for Covenant. We were able to demonstrate the durability of our improved business model by achieving the second-best adjusted earnings per share in company history while setting the stage for future growth and improvement through the accretive acquisitions of Lew Thompson and Son Trucking and Sims Transport. These achievements would not have been possible without the commitment from our talented people and many years of planning, execution and collaborative teamwork. As we enter 2024, we do so with a resolved commitment to forward progress on our strategic long-term plan and improving upon these results in the future.

Focusing now on the quarter. We were pleased with our fourth quarter's results despite the lingering weakness in the overall freight environment. Compared to a year ago, consolidated freight revenue was down approximately $15.3 million or 6% primarily as a result of year-over-year tractor count and rate declines in our asset-based truckload businesses, combined with little to no overflow freight handled by our asset-light Managed Freight segment, partially offset by improved utilization of our assets.

Adjusted operating income declined approximately $4.9 million or 22% compared to the prior year quarter, primarily resulting from a $6.1 million decrease in our Managed Freight segment, partially offset by a $1.2 million improvement to the profitability of our Warehousing segment, while the combined truckload operations were essentially flat.

Adjusted net income decreased 24% to $14.8 million and adjusted earnings per share decreased 22% to $1.07 per share compared to the year ago quarter. Weighted average diluted shares decreased approximately 3.5% because of our share repurchase program.

Key highlights include:

- Despite 9% rate declines and 4% average tractor count reductions, our combined truckload operations generated roughly the same adjusted operating income in the fourth quarter of 2023 as they did in 2022.
- The Lew Thompson and Son Trucking operation continues to perform well with near term opportunities to meaningfully grow the business in the first quarter of 2024.
- Our net capital investment for revenue producing equipment was approximately $91 million for the quarter, consisting of approximately $48 million in normal 2023 replacement capex, $13 million in specialized equipment capex for poultry related growth, and $30 million in pull forward of normal replacement capex originally scheduled for 2024.

- The average age of our fleet at December 31st improved to 19 months compared to 26 months in the prior year and 23 months at September 30th, 2023.
- Within our combined truckload segments, compared to the prior year, operations and maintenance related expenses declined by 11 cents per total mile or 38% and fixed equipment related costs, including leased revenue equipment expenses, depreciation, and gains on sale only increased 4 cents per total mile.
- Gain on sale of revenue equipment was $0.2 million in the quarter, compared to $1.0 million in the prior year.
- Declining fuel prices and lagging fuel surcharge recovery rates created a tailwind for our combined truckload operations which helped us overcome the negative impact of a cyber event with a major customer and the United Auto Workers strike in the quarter.
- Our TEL leasing company investment produced $0.25 per diluted share, compared to $0.21 per diluted share versus the year ago period.
- Our net indebtedness as of December 31st was $248.3 million, yielding an adjusted leverage ratio of approximately 2.0x and debt-to-capital ratio of 38.1%,
- On an adjusted basis, return on invested capital was 8.9% for the current quarter versus 17.7% in the prior year. The decline is attributable to reduced year-over-year operating income particularly from our asset-light Managed Freight segment and the increase in the average invested capital base associated with acquisitions, growth capex and pulling equipment purchases forward.

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

Thanks Tripp,

- Expedited outperformed our expectations during the fourth quarter – yielding a 91.4% adjusted OR. The negative impact of a cyber attack on a major customer in the quarter was largely offset by the benefits of fuel recovery lagging a declining DOE price. In this segment, rates have decline by approximately 12%, but utilization has improved approximately 5%. The improvement in utilization was principally attributable to more engineered routes and newer equipment in the fleet with less down time.

- Dedicated reflected another success story – yielding a 91.4% adjusted OR, representing our best quarterly results for this segment in company history. Similar to Expedited, our Dedicated operations saw a positive impact to profitability as a result of declining fuel prices, offsetting the negative impact of the United Auto Workers strike in the quarter. Over the past three years, we have worked hard to improve the profitability within this segment by exiting unprofitable business and adding profitable business. This weed and feed approach has been clunky at times, but has served us well in deploying capital towards opportunities 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 15% reduction of total freight revenue and a 69% 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. Nevertheless, the asset-light nature of the business still generates an acceptable return on invested capital at the 95.8% adjusted operating ratio achieved in the fourth quarter. 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 16% increase in freight revenue and a 428% increase of adjusted operating profit compared to the prior year, as a result of the combination of new customer startups and rate increases with existing customers over the last 12 months. 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 $4.7 million for the quarter, compared to $3.9 million in the prior year period. The increase was largely due to suppressed 2022 earnings resulting from increased depreciation taken on certain high-mileage tractors that were being prepared to sell. TEL's revenue in the quarter declined 14% and pre-tax net income increased by approximately 20% versus the fourth quarter of 2022. TEL decreased its truck fleet in the quarter versus year ago by 106 trucks to 2,131 and reduced its trailer fleet by 339 to 6,810.

  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 $66.3 million as of December 31, 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 in 2023.

Regarding our outlook for the future:

2023 provided as challenging of a freight environment as we have experienced in years and we are extremely pleased with the performance of the model and team. This is a different team and different model than "the Covenant" of 5-10 years ago.

As it relates to 2024, we see no immediate macroeconomic or industry catalyst, but believe continuing to execute on our strategic plan and capacity attritions from the market will result in incremental improvements to operating conditions throughout 2024. As a result, we believe we can surpass our 2023 results with higher adjusted earnings per share and greater free cash flow that will allow us to reduce our net indebtedness and/or exercise other capital allocation alternatives.

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