Covenant Transportation Group 4th Quarter 2017 Conference Call

Mr. Cribbs – Good morning and welcome to our fourth quarter conference call. Joining me on the call this morning are David Parker and Joey Hogan.

> *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 Form 10-Q. We undertake no obligation to update or revise any forward-looking statements to reflect subsequent events or circumstances.*

A copy of our prepared comments and additional financial information is available on our website at www.ctgcompanies.com/investor-relations. Our prepared comments will be brief and then we will open up the call for questions.

In summary, the key highlights of the quarter were:

- Our asset-based divisions' revenue, excluding fuel, decreased 2.0% to $144.8 million due primarily to a 1.1% decrease in average freight revenue per tractor,
- Versus the year ago period average freight revenue per total mile was up $.060 per mile or 3.3% and our miles per tractor per week were down 4.2%,
- Freight revenue per tractor at our Covenant Transport subsidiary experienced a decrease of 1.8% versus the prior year quarter, and our Star Transportation ("Star") subsidiary experienced a decrease of 5.4%, while our refrigerated subsidiary, SRT, experienced an increase of 4.8%,
- The asset-based division's operating costs per mile, net of surcharge revenue, were up approximately $.013 per mile compared to the year ago period. This was mainly attributable to higher employee wages and purchased transportation expense. These increases were partially offset by lower net fuel and insurance costs,
- We recognized a loss on disposal of equipment of $0.8 million in the fourth quarter of 2017 versus a loss of $0.7 million in the fourth quarter of 2016,
- The asset-based operating ratio was 91.9% in the fourth quarter of 2017, compared with 93.4% in the fourth quarter of 2016,
- Our Solutions logistics subsidiary increased revenue by 42.6% versus the year ago quarter. Purchased transportation increased as a percentage of revenue, while other operating expenses decreased as a percentage of revenue resulting in operating ratio contraction to 91.5% from 90.4% in the year ago quarter. With the increased revenue, the result was an increase of operating income contribution to $3.1 million in the current year quarter from $2.5 million in the prior year quarter,

- Our minority investment in Transport Enterprise Leasing contributed $0.8 million to pre-tax earnings or $.03 per share,
- The average age of our tractor fleet continues to be young at 2.1 years as of the end of the quarter, although up from 1.8 years a year ago,
- For the year ended December 31, 2017, total indebtedness, net of cash and including the present value of off-balance sheet lease obligations has decreased by approximately $6.7 million to $220.1 million.

The main positives in the fourth quarter were 1) SRT operating profitably for the quarter, 2) a 10.4% year-over-year increase in the average tractor fleet at our Star Transportation subsidiary, 3) year-over-year revenue and operating income growth from our Solutions subsidiary, and 4) our tangible book value per basic share increased 24.4% to $16.11 from $12.95 a year ago. The main negatives in the quarter were 1) a 1.1% decrease in average freight revenue per truck versus the same quarter of 2017, and 2) increased operating costs on a per mile basis, including unfavorable employee wages, and purchased transportation, partially offset by lower net fuel and insurance costs.

Our fleet experienced an increase to 2,559 trucks by the end of December, a 9 truck increase from our reported fleet size of 2,550 trucks at the end of September. Our fleet of team-driven trucks averaged 912 teams in the fourth quarter of 2017, a 5.7% decrease from 967 average teams in the third quarter of 2017.

Although freight demand was extremely strong throughout the quarter, the 460 basis point decline in the team percentage of our truck fleet to 35.7% in the fourth quarter of 2017 compared to 40.3% in the fourth quarter of 2016 resulted in a year-over-year reduction in our overall truck utilization during the quarter. In early January, to combat our declining team fleet, we announced a new $40,000 Teaming Bonus program at our Covenant Transport expedited subsidiary aimed at teams and solo drivers willing to convert to teams. The bonus is payable upon driver teams reaching certain mileage milestones over their tenure and we expect it to assist with both the formation of teams and retention over time. Although the new program does not go into effect until February 1, 2018, we are encouraged by the initial response from both our current and potential professional drivers.

We continue to evaluate the most effective level of participation in the peak season and the manner of allocating our assets and coordinating third-party capacity. As logistics needs continue to evolve related to e-commerce and omnichannel growth, the duration of what is considered peak season has shortened over the last few years and now is approximately a five-week period beginning the week of Thanksgiving and ending on Christmas Eve. The shortened duration reduces the revenue opportunity versus previous years. Additional peak season challenges include, but are not limited to, procurement of temporarily increased trailer pool needs as well as additional logistics cost for transition and placement of trailers, unpredictability of shipper cancellations, expanded operational employee staffing, and the volatile pricing of acquiring outside carrier capacity. Even though remaining our most profitable quarter of each year, the results of the past two peak seasons have been disappointing, especially considering the planning time and strain this period places on our organization, and creating carryover expenses into our first quarter each year. As we plan our 2018 peak season, we remain committed to provide peak capacity for our customers, however will need to challenge our pricing models to insure we are appropriately rewarded for our efforts related to this valuable annual shipping period.

For 2018, we are forecasting sequential operating income improvement throughout the year. We believe the combination of an improving economy, tightening truckload supply dynamics, industry regulatory changes including the ELD mandate and its enforcement, depleting inventories, year-over-year net fuel expense savings from our improved fuel hedge positions, and further operational progress at SRT should deliver increased pre-tax earnings for the full year of 2018. In addition, we expect earnings improvement from the estimated favorable effective tax rate impact from the Tax Cuts and Jobs Act. We are currently estimating our 2018 effective income tax rate to be in the range of 24.0% to 27.0%. We expect year-over-year average freight revenue per truck to be positive by a mid to high single digit percentage, inflecting more positively later in the year as a large portion of annual contractual rate revisions are implemented during the second quarter of 2018. Our expectation of positive year-over-year pretax income includes higher employee wages for each quarter of 2018. We also expect a decline in the operating income of our non-asset based logistics service offering to partially offset the forecasted operating income improvement for our truckload service offering. Within the non-asset based logistics service offering, we expect some margin deterioration resulting from higher purchased transportation expense and we have planned investments in strategic employees, as well as a new transport management system to enhance our supply chain services and growth potential. From a balance sheet perspective, with net capital expenditures scheduled to be below normal replacement cycle, along with positive operating cash flows, we expect to further reduce combined balance sheet and off-balance sheet debt over the course of fiscal 2018.

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