Covenant Transportation Group 1st Quarter 2016 Conference Call

Mr. Cribbs – Good morning and welcome to our first quarter conference call. Joining me on the call this morning are David Parker and Joey Hogan, along with various members of our management team.

> *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:

- With $0.21 earnings per diluted share, we achieved first quarter profitable results for the second year in a row following 10 consecutive years of unprofitable first quarter results from fiscal 2005 through fiscal 2014,
- Our asset-based divisions' revenue, excluding fuel, decreased 1.7% to $131.1 million due to a 2.9% decrease in average tractors, partially offset by a 0.5% increase in average freight revenue per truck and an increase in our refrigerated intermodal freight revenue,
- Versus the year ago period average freight revenue per loaded mile was up $.051 per mile or 2.9% and our miles per truck were down 1.0%,
- Freight revenue per tractor at our Covenant Transport subsidiary experienced an increase of 3.4% versus the prior year quarter, while our refrigerated subsidiary, SRT, experienced a decrease of 1.5%, and our Star Transportation subsidiary experienced a decrease of 1.3%,
- Compared to the year ago period, the asset-based division's operating costs per mile, net of surcharge revenue, were up approximately $.085 per mile mainly due to higher net fuel cost, employee wages, and depreciation expense. These increases were partially offset by lower casualty insurance expense and building rent,
- We recognized a loss on disposal of equipment of $0.3 million in the first quarter of 2016 versus a gain of $0.1 million in the first quarter of 2015,
- The asset-based operating ratio was 95.7% in the first quarter of 2016, compared with 92.7% in the first quarter of 2015. The 2016 period included a $1.9 million increase in fuel hedging losses compared with the 2015 quarter. Adjusting for that item, our operating margin contraction was approximately 150 basis points,

- Our Solutions logistics subsidiary increased revenue by 36.3% versus the year ago quarter. Combined purchased transportation and other operating expenses decreased as a percentage of revenue resulting in operating ratio expansion to 86.6% from 96.6% in the year ago quarter, the result being an increase of operating income contribution to $1.8 million in the current year quarter from $0.3 million in the prior year quarter,
- Our minority investment in Transport Enterprise Leasing contributed $0.9 million to pre-tax earnings or $.03 per share,
- The average age of our tractor fleet continues to be very young at 1.8 years as of the end of the quarter, basically flat to a year ago,
- Since December 31, 2015, total indebtedness, net of cash and including the present value of off-balance sheet lease obligations has decreased by approximately $60.5 million to $203.7 million,
- With available borrowing capacity of $44.3 million under our revolving credit facility, we do not expect to be required to test our fixed charge covenant in the foreseeable future.

The main positives in the first quarter were 1) deleveraging with a $60.5 million decrease in our total net indebtedness, 2) our safety efforts and favorable claims experience helped produce a greater than 33% reduction in insurance and claims cost on a per mile basis, 3) growing our team truck percentage sequentially to 37.3% from 36.1% averaged in the fourth quarter, 4) 2.9% improvement in average freight revenue per loaded mile in a materially weaker industry-wide freight market, and 5) revenue growth and improved operating profitability from our Solutions subsidiary. The main negatives in the quarter were 1) increased operating costs on a per mile basis, including unfavorable net fuel and capital costs, 2) increased non-revenue empty miles and reliance on broker freight, and 3) the deterioration in operating profitability at our SRT subsidiary, although noting that we have steadily increased our focus on planning and execution of improvement initiatives around this business unit.

Our fleet experienced a decrease to 2,607 trucks by the end of March, a 49 truck decrease from our reported fleet size of 2,656 trucks at the end of December. Our fleet of team-driven trucks averaged 979 teams in the first quarter of 2016, a 1.3% increase from 966 average teams in the fourth quarter of 2015.

Our first quarter freight was full of ebbs and flows. Our year-over-year January miles per truck was down 4.8%. This was followed by a strong February when our year-over-year miles per truck increased by 5.4%. This stronger freight market continued through the first ten days or so of March, followed by another slowdown of freight for the last three weeks of March resulting in year-over-year March miles per truck being down 3.0%.

Similar to what we experienced in January and the last three weeks of March, utilization for the first three weeks of April 2016 has underperformed the prior year. As discussed in the “Outlook” section of yesterday’s earnings release, we currently expect earnings per diluted share to be in the range of $0.28 to $0.33 for the second quarter of 2016.

There are two areas where we would like to provide additional detail concerning our expectations for the second quarter and beyond. First, our fuel hedge losses in the second quarter of 2016 are expected to cost an approximate $4.7 million, or $0.16 per share after tax. Because our fuel hedges are locked in at considerably lower prices in periods following the 2016 fiscal year (for example, approximately $0.84/gallon lower for the second quarter of 2017 and $0.92/gallon lower for the second quarter of 2018 as compared to the second quarter of 2016, respectively), such a loss is expected to be significantly less in future years based on current forward fuel price estimates. Second, we believe the start-up investment related to the addition of two major dedicated customers in the second quarter of 2016 could impact our quarterly results by up to $1.5 million, or $0.05 per share after tax. Following the second quarter, we believe the majority of the start-up investment to add these two large dedicated accounts will be complete and the ongoing profitability associated with these two new accounts will be consistent with the profitability we have achieved on similar dedicated accounts. We believe our core multi-dimensional operational business model is strong.

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