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Wolfe Research analyst: Scott Group

Werner Enterprises: Derek Leathers, Chairman, President and CEO. John Steele, EVP and CFO.

Scott Group:

Hi, everyone. Welcome back, it's Scott Group from Wolfe Research. Really happy to be joined by Werner Enterprises. We've got Derek Leathers, Chairman, President and CEO and John Steele CFO. It's Wednesday, May 26, it's 11:45 AM Eastern Time.

Thank you, Derek, thank you, John, for being here. We're going to jump right into questions. Maybe Derek just catch us up on the environment that you're seeing right now in the second quarter. Talk about demand and utilization trends and then we've got lots of questions to get to. And if anyone else, anyone listening in has any questions, type those in and we'll get to them.

Derek Leathers:

Sure, Well, first off, thanks for having us Scott; we appreciate you spending time with us today. As far as demand, it stayed strong. I mean, there's, we all see it, and know the statistics, but capacity remains tight. Demand has continued to accelerate; we've seen continuation of the depleted inventory levels that we've been talking about for a while. We had a lot of down time in the first quarter caused by weather and now that we're back flowing with good weather and good demand, we are able to see some more robust utilization in the quarter. Overall, it feels at this point still, there's plenty of room left for this to run just based on the combined impact of low inventory levels, the school constraints, increased retirements, and just general COVID concerns I think that have caused team capacity and other types of capacity to be a little more constrained this year versus a year ago.

Scott Group:

OK, great, so you mentioned the improvement in utilization. Is it realistic or reasonable that we should expect utilization to be positive on a year over year basis? It sounds like certainly sequential improvement, but how do you think in year over year, from a utilization standpoint?

Derek Leathers:

Yes, I mean, we're going work hard to regain where we were in utilization Q2 year over year. There are some headwinds to that. There's less teams out there running today, simply due to ongoing concerns. It's sort of the impact of COVID. That's a negative. But on the One-Way side, when I'm referring to utilization, I'm talking about One-Way Truckload, we're seeing a little better weather footprint through the quarter so far, demand is there, teams are running, our up time is strong. So, we think it's a fair kind of bogey to talk

about, being back to where we were a year ago and even above it year-over-year from a utilization perspective.

Scott Group:

OK, great. So, I wanted to just get your views on sort of the duration of the cycle. It's a conversation that everyone likes to have in the truckload industry. So what are the key things that you're watching for to identify that maybe the cycle feels a little less strong? Are you more focused on supply things, is it demand things and, I mean, at the end of the day, what's your view on the sort of sustainability, duration of this cycle?

Derek Leathers:

Yes, so I always start on the supply side. I think that's something that we have; industry level knowledge. We live and breathe it every day and so we understand maybe what's happening on the supply side and on that front, I think you've had slight uptick in retirements over the course of a 12-month period due to COVID. That's real and sustainable; those folks aren't coming back out of retirement now, even if they're vaccinated. You've had constrained capacity at schools and new entrants into the market. You've had the CDL constraints that are well documented, and you have an increasing, kind of uptick in the Drug and Alcohol Clearinghouse that's causing further kind of supply constraints.

The other things we look at closely is builds on the OEM level, more so than orders. Although orders matter, orders are extremely elevated. The builds are very constrained, and we don't see an end in sight. We work closely with our OEM partners and we've been able to navigate it so far this year and our trucks have arrived and we're implementing those into our fleet to as expected. But all indications on the back half will be a lot rockier than the first half was. So, given that that's the environment we're in, we just don't see builds getting to most of the publicly-held beliefs. The number we've been kind of targeting is about 285, and I know, I think your number is 294, so not far off from what you're talking about. But that's where I think that kind of settles in for the year based on what we're hearing and seeing. And so, the supply side seems kind of structurally constrained; I think that carries well into 22.

The demand is robust. GDP growth 5, 6, maybe 7% when the dust all settles. Some return to services versus products, but products are so elevated at this point, and with \$4 trillion sitting on the sideline in bank accounts across America, we think demand stays strong going forward. So, a long way to say, in our view, it's some, worst-case scenario, we think it's middle of 22; more likely scenario its something later than that.

Scott Group:

OK. So, you're not, just to unpack some of the supply side comments, you're not expecting any meaningful uptick in builds the rest of the year?

Derek Leathers:

I'm not, no. I mean, I could be proven, wrong, but at this point, my belief is that they're doing a good job. I mean, we're, I'm not knocking the OEMs; they are working their tails off to try to keep parts and supply, but it's bigger than the chip issue. And I think there's other issues that will follow that'll start to accumulate over the course of the year, that will keep builds down.

Scott Group:

And it's, I mean, it's so much broader than just the auto and truck OEM industry. There's supply chain shortages everywhere, for every industry.

Derek Leathers:

Everywhere, everywhere. No doubt about it.

Scott Group:

To that point, do you feel like when you talk with customers, are they making any progress on inventory levels, or is it still getting incrementally worse just because the demand environment is so good?

Derek Leathers:

Yes, so for the majority, it's actually worsened. If you look at same store sales, I think seven of our top 10 retailers have already released and same store sales have outpaced inventory growth. So, it's actually gotten slightly worse. There are a few that have made some progress. I think some of that even though can be deceptive, because there's been a little bit of pull forward for fall inventories is our understanding, for holiday and other large project shipments that are in the numbers. But if you go to the stores today, you can kind of get a sense pretty fast how lean inventories are and these are some of the best in class retailers out there that are doing better than most, but it's still a struggle.

Scott Group:

Then what about from a, from a driver standpoint? How big of an impact do you think we've just seen, the combination of COVID itself but also all the stimulus checks? How much of a factor do you think that's been and as we get more and more vaccines and at some point stimulus starts to moderate, do you view, when do you think drivers really start coming back to the industry?

Derek Leathers:

Yes, so I'm a little bit of a contrarian on this view as it relates to stimulus in particular. I don't know that I buy that there's a lot of drivers that are sitting on the sideline taking stimulus checks, mostly because driverpay is high enough now that it is one of the few sort of blue collar industries where pay is far out in front of

what you could make through the stimulus mode. There's many other places where that's not the case, but drivers would be leaving a lot of money on the table to take stimulus over an actual driving job right now, and that would have been the case for the last year.

The other reason is it has got a lot to do with their psychological build. These are folks that really do respond when there's a need. And, we saw available to dispatch rates at the highest in 10 years during the early months of COVID because drivers wanted to be out and deliver, and they want to keep America moving. So, I don't think there's a lot there. Where there will be some help is, we're seeing a lot of inefficiencies that ship locations, and consignees, and places like that, where their labor challenges are competing against government stimulus. And so if we could get some people up to fully staffed at docks across America, you could start to see a little bit of productivity gain. But that's not going to move the needle by any kind of serious margin, but it would add some efficiency to the network.

Scott Group:

What are you specifically seeing from a seated, unseated tractor count right now?

Derek Leathers:

And so, we've been fortunate. Our retention rates are really strong right now, so we're retaining our existing drivers very well. The front door is very challenged, so it's the toughest driver hiring market I've seen in my career. But with that said, because of the Dedicated profile of our fleet, and that's 65% of our fleet, roughly in Dedicated; those are higher paying jobs with very specific job characteristics. And so you have a little better opportunity to go out and hire a driver when you can tell them exactly what they're going to be doing, and that the pay rate is pretty lucrative compared to maybe an over-the-road job. So, we don't have unseated tractors any more today than we would in any other point. We also manage that very, very well I think relative to not taking trucks into the fleet if we don't have drivers ready to be in those trucks. And so, it's managing the front door on trucks, it's managing the gains on sale and the sale pile of trucks. And what's in the middle is really those ready to assign. And that number's about where it's been, traditionally.

Scott Group:

So, clearly, doing better than most. Are you in a good spot where you can actually start growing the fleet and hit that guidance of 1 to 3% fleet growth this year?

Derek Leathers:

Yes, we haven't given up on the guidance. So we did change other guidance metrics at the end of Q1. We didn't change that one because we're going to keep working and chipping away at it. It is an uphill battle. If it happens, it will be in the back half. It won't be in the short-term. We've got more schools coming online this year; four more between now and the end of the year. Those will add some relief. We've seen a little bit better results as of late on the experienced driver market with some of these Dedicated jobs. But it is, if

we get to the range, it's going to be in the low end of the range, but we're not given up on the range just yet.

Scott Group:

Let's talk pricing for a little bit now. What is the contract pricing environment you're seeing right now? We heard yesterday 10 to 15%?

Derek Leathers:

Yes. So, every deal is different, obviously, depending on where the starting point is. But I think as an average way to think about it, contract renewals started in the high single digits early in the year and quickly accelerated into the double digits, mid double digits. And we've seen, certain renewals that need to be at a much higher rate than that just based on the freight characteristics. But by and large, I would say that's a good range to think about that, 10 to 15. We issued guidance of 13 to 16% year over year for Q2 and we're very comfortable that we'll be at the high end of that range.

Scott Group:

OK, high end of that range, OK, great. And so where are, as contract rates keep resetting higher, where are spot rates now? Are spot rates still well above, even those higher contract rates or are we starting to see that spread compress a little bit?

Derek Leathers:

Yes, so they are still above contract rates; I'll start with that. The spread compresses, but then it takes another week for, all of a sudden, spot to find a new level. So, it's hard to talk about it with any confidence other than to say spots are still going to outpace contract. We think that continues for a while. We think spot is; there's a lot of freight migrating from spot into contract as shippers are doing more mini bids and more bids in general to try to get out of that spot market and into contract. And it's about being selective with what we put it into the network and how we think about redesigning our network with this robust trading environment.

Scott Group:

In terms of your guidance Derek, you've talked about, you just said high end of that 16% yield growth in second quarter. You guys don't have any guidance for the back half of the year, but maybe just talk directionally; the comps get tougher, but just given the momentum, would you expect to see continued double digit yield growth in the back half of the year?

Derek Leathers:

Yes, we feel it's a little early right now for us to try to be too specific on the back half. We will give an update, obviously, at the Q2 earnings call on that. We do quite a bit of project work in ours, so although we don't participate in the spot market very much at all, we do a lot of project work in the back half of the year and those discussions are starting now. They'll continue over the next 60 days, and by the time we release Q2 earnings will be in a better position. The comps do get tougher; you're right, but the momentum right now, rate renewals is, is very robust. And so, it's just a little too early for me to feel comfortable committing to a number on that.

Scott Group:

And maybe, then, it's way too early to ask this, but, if you had to take a guess around 2022, next year's contract pricing environment, given when you know now in your views that this is going to remain really tight what would be your best guess?

Derek Leathers:

Yes, it is early. I think you will see incremental contractual gains again next year, based on everything we're looking at. What that number settles in at is hard to say. If I was going to give just a broad-brush statement; mid-single digit type number, but that's give or take 3 to 4%, so that's a wide range and so, we'll see how it plays out.

Scott Group:

OK, and we heard similar sort of numbers yesterday. What about on the Dedicated side? I think your guidance was 3 to 5% revenue per truck per growth week in the second quarter, I know first quarter was a little worse than that, because of weather. Are we back in that guidance range for the second quarter? Could it be better than that just given how good the environment is?

Derek Leathers:

Yes, we're back in the range in the second quarter. First quarter was entirely impacted by weather. We took a very strong safety-first stance in the first quarter and simply shut the fleet down for a longer period than we have in my entire career here, but we stand by that decision. We think it was the right thing to do. And that's what impacted revenue per truck per week.

Dedicated is going to be that stable, incremental margin expansion type business for us over time. And it's interesting, Scott, you put out some LTL pricing information, I think just a couple of days ago. And I was digging into that pretty closely and really, that looks an awful lot like what inside our building Dedicated looks like over the course of that same timeline. It just incrementally gets better, you don't see the fall backs, you don't see the cyclicity. And so, although the number doesn't sound impressive, you can see what they're able to do in that environment in LTL with that kind of incremental through-the-cycle gain and that's exactly what we're working on and doing and performing here at Werner.

Scott Group:

So maybe just to follow up on that, I know you don't report it to us, but I'm guessing you look at it. Do your Dedicated margins, do they just keep improving kind of every year?

Derek Leathers:

So, there is some cyclical, but it's much, much reduced over anything you would see in One-Way and over time, they have gotten better. And what I think is very attractive to us about Dedicated is we can do that. So that's through efficiency gains, modeling and optimization improvements, increased opportunity for slip seating. When you retain business at a 97% level, you can get better at doing the business. And why all of that matters is it's not necessarily at the expense of the customer. So we can become more efficient and find incremental gains in our Dedicated margins, without always having to be, kind of back at the door, asking for more money. And so that's why that business gets retained at the level it does and that's why, over time, we believe so much in that business.

Scott Group:

So when I look at, you're going to have record margins this year. Is that more so being driven by the over-the-road One-Way or Dedicated relative to prior peaks and things like that?

Derek Leathers

Well, it's driven by both, for sure right, and so I think it's important to say that. One-Way clearly has more room to improve in a market like this than Dedicated does, but One-Way is significantly smaller than Dedicated so if you take all that and put it into the mix, it's relatively equal between the two, but One-Way on a percentage basis will be improving more rapidly.

Scott Group:

Right, then to stick along these lines, if we want to try and make the comparison between Dedicated and LTL in terms of more of like a slow and steady pricing every single year kind of environment, like the mix is, you're now over that 60% mix with Dedicated. Do you want to keep growing that mix? Would you get to 70% Dedicated? Would you go even higher than that over time?

Derek Leathers:

Yes, we're going to be very careful as that mix grows as we go forward, but we do believe there's still more runway. So, we had believed for some time that 65% was about, kind of as far as you can take that and still have a viable One-Way product and a viable surge capacity and all of those things. As our engineers have done a better job and used more data analytics and data science, that we've figured out other ways to surge

and provide that service to our customers, we now feel like we can start to approach 70%. So we have more runway there. North of 70 would be an iterative, we'll revisit that as we get closer to 70.

Scott Group:

OK, let's just talk about the margin guidance. The long-term guidance is 11 to 16%. This environment is just phenomenal. I think you've talked about the high end of that range this year. Is there a potential to be above the high end of that range this year just given how good this pricing environment is?

Derek Leathers:

Yes, there is potential. I mean, we've said that we are comfortable saying that we expect to be in the high end of that range this year. We're certainly aiming our internal focus targets, expectations, etc. to deliver on that and there is an opportunity to be outside of the range this year in TTS, yes.

Scott Group:

Maybe let's bring John into the discussion a little bit and talk about along the lines of margin, just some of the cost, cost inflation and then maybe some cost reduction opportunities. So maybe John, talk about what you're seeing from a driver pay standpoint, talk about cost inflation outside of drivers and maybe just, are there opportunities to be reducing costs in other places right now?

John Steele:

Yes, driver pay is up 6 to 7% so far this year, and there's a lot of pressure in the driver markets. There's potential for further increases in driver pay, probably not on an across-the-board basis, but on a selective basis. Fuel has been a challenge. We're on the kind of fuel price roller coaster where this year has been increasing and compared to last year, fuel prices were decreasing. The gap is pretty wide. We're managing through that pretty well, but fuel is a challenge. The other areas that I see for cost pressure are driver recruiting, which is directly tied to the driver market, health insurance as people return back to going to the doctor and having non-emergency surgeries, travel and entertainment as COVID vaccinations increase and we get back to operating the business the way we did in the past. We're absolutely working hard on cost efficiencies where we can, but it is a more inflationary environment so it's a little more difficult to find large home run, triple type opportunities but we're continuing to implement our procurement strategy as we can and find some singles and doubles.

Scott Group:

We heard from some of the smaller truckload carriers about, I think one said 20% driver pay, one said 30% driver pay. Why do you think, such, a, why do you think you guys are in such a better place?

Derek Leathers:

I think there's a few things driving it. One, at 65% of your fleet's in Dedicated, those are higher paying jobs to begin with. They have great stability to begin with and they have absolute kind of commitment to a time at home and lifestyle balance. You couple that with big capitalized fleets that have state-of-the-art equipment is attractive versus a small carrier, that maybe it was unable to even get equipment so far this year with how tight things have been. There's a lot of things that force their hand to be driven exclusively by pay, whereas we have multiple tools in the toolkit. So, I think that's the biggest reason that it's just a different business, small carrier versus large. Our pay is competitive going into this tightness. We've raised it some, but not to that extreme, because we haven't had to because our drivers are happy with how they're being treated. We've got a very, very driver-focused culture here.

Scott Group:

I want to get a little bit more strategic here. One of the things that you're hearing more and more about is this growth in Power Only or trailer pool businesses. Why is this happening now and how big of an opportunity is this for you guys?

Derek Leathers:

Well, I think it's happening now because you need a certain level of cooperation from shippers and the best way to get that is a tight market. And so, when the market is as tight as it is, things we've been pitching for years and years as asset-backed Logistics companies, companies like ours and others that are that are asset heavy, but yet have a strong, robust Logistics offering, have been trying to explain the benefits of this for a long time. But you need a market like this for that acceptance to really gain a foothold.

We think it's the most efficient brokerage model out there, because shippers don't have to deal with rainbow trailer fleets. They can dip into a large Werner trailer fleet, load all the trailers, and then just hold us accountable for making sure it gets to its final destination on time and safely. So, we think all that stuff really sets itself up well. We think there's a lot of runway there, and yes, it's a growth opportunity. Yes, it means we will carry more trailers than maybe we traditionally have, and if you think about it as a truck to trailer ratio, it might look like you're over trailered, but it doesn't count or factor in those Power Only trucks that are part of the fleet really, and that is sort of captive capacity within our network. We're doing more of it and we'll do more of a going forward.

Scott Group:

How big of a business could this become for you?

Derek Leathers:

Well, we want to grow our Logistics business on a consistent basis. Going forward, Brokerage will be the driver of that, and within Brokerage, Power Only is going to be a major driver. So how big? It's probably a

little too early to tell, but certainly when you think about a roughly half billion-dollar Logistics business out there, a little smaller than that today, but pretty close. And you think about that glide path to 750 million or a billion a few years further out, Power Only, if done properly and if the tools and systems that we're developing do what we believe they will, will be a lion's share of that future growth, as we go forward.

Scott Group:

When I think about the advantages of a large fleet versus smaller fleets or mom and pops, I think that trailer to truck ratio, 3 to 1 that give or take, that you have, is an advantage over small carriers. Is there a risk that this Power Only basically, helps level the playing field by giving the small mom and pop carrier access to more trailers, and so, ultimately, it ends up adding capacity to the industry and takes away some of your competitive advantage over the small guys.

Derek Leathers:

I mean, there is some of that, potentially. But the reality is, in every one of these locations where we're talking about this Power Only growth, they're doing significant 10, 15% of their network today with non-asset brokers. And if that is displaced, who turn around and work with all these small carriers anyway and work with them and provide those freight opportunities to them. If we do it in a more efficient way with Power Only solutions and have that carrier sort of captive inside of our network operating in a more efficient footprint, I think it's more of a displacement, or the risk is against those non asset players more so than what it is for us as an asset trucker in addition to a Logistics company.

Scott Group:

OK, Derek, you've just taken over as Chairman of the Board, congrats on that. What strategic changes if any, do you think we should expect going forward at Werner?

Derek Leathers:

I mean, I think the biggest thing would be, its evolution, not a revolution. I think you've seen a lot of change at Werner since 2017. I think you can expect to see iterative improvements and furthering of some of those cultural shifts towards greater accountability, expectation of excellence, a best in class mindset; we'll have more of that. A little more aggressive stance on the balance sheet than what we've traditionally had; a little more open mindedness to potentially M&A and capital deployment than we have had in the past. But, the core of who we are and what we are is going to stay the same. Safety focused, above all else, service sensitive company, that does what we say, for our customers, and gains traction in a sustainable way through the cycle.

Scott Group:

So on that, with the balance sheet, right, if our math is right, if you went from basically nothing to 1 times debt to EBITDA over a two year period and combine that with the free cash flow you generate, I think you can buy back like 20% of the stock in two years, is that something you would consider?

Derek Leathers:

So, I would just say this, when we think about capital, all options will be on the table. So buybacks will be on the table, you've seen us make moves with the quarterly dividend; two quarters in a row now, actually. M&A, as I mentioned before, is on the table and something that we will be looking at where we think it makes sense and it's additive and accretive to our business. And I doubt that it would be just a one pillar kind of strategy. If you, if you were to ask me, you know, I think you'll see a combination of all of those things over the coming years.

Scott Group:

And when you think about acquisitions, is it truckload, is it something more tangential? I mean, do you have a goal of trying to do something large outside of trucking that, that maybe, makes the perception of Werner being less cyclical? I know we've got another carrier that seems, who said I'm doing something outside of trucking to just sort of change the perception, is that something you think about, care about?

Derek Leathers:

Yes, well, you have to care about the perception, but I think, my stance, and maybe I'm a little old-fashioned, but the best way for the perception to change is for us to keep delivering, as we have been for multiple quarters in a row through multiple cycles now, and eventually the perception will come around.

What we think about when we think about M&A is something that is additive to our portfolio, so it makes us better; either accelerate something we're already doing, but increases that market share in a way that we think is better done than organic options. Something that is geographic, in terms of strengths in our network that we feel we need to add to. It could be on the asset side. We're certainly open minded on the Logistics side, as well. There's some opportunities for some well ran, startup type organizations that really lack the capital to get to where they need to go, that somebody like Werner could bring to bear that capital and really make it accretive for our shareholders in the short-term. So, it's a pretty broad spectrum. We've worked diligently to develop a screening methodology for all of those types of opportunities that I'm describing. And we'll be very careful. The first one won't be some, perception breaking deal, but changing kind of moment, because I just think that would be not the right move for us. We'll walk before we run.

Scott Group:

We've just got a couple of minutes left, so let's, maybe quickly, just the last couple of things. What do you think is the future for your business? Is it more likely battery electric, fuel cell and when do you think this can become any meaningful percentage of the fleet?

Derek Leathers:

Yes, our stance is that it's still a little too early to pick a winner. Right now, we feel probably most comfortable with the path that electric is on, based on current state, which is not ready for prime time, but is making iterative steps and improving all the time. But also, the infrastructure obstacles are a little less on that side than hydrogen fuel cell and other things that might be. But we're open minded to both. We will be prototyping hydrogen before the end of this year. We've already got prototype electric trucks in the fleet. None of the above are ready for prime time yet in our view. And I think that evolution is still a few years outmost optimistically, and then if it doesn't develop as quickly as we'd like it to see, it could be further than that.

Scott Group:

Then what about autonomous? Where do you see the best use? And then realistically, when do you think you can have a truck operating on the road without a backup safety driver?

Derek Leathers:

Yes, I think that's going to be a journey as well. The tech is developing very rapidly. The OEM tech that they're putting out is getting better all the time. The startup operations and sort of new entrants TuSimple and Embark and others are developing and progressing all the time, but I think the obstacles are really bigger than just the tech. It's figuring out, as you said, where could you operate these, where could you do it safely? Where would there be both regulatory and legislative and public perception environments where it would be most accepting?

I think it's a few years out before you see even a piloted or copiloted autonomous truck operating within our network, but our ability to pilot and test and monitor outside of our network is here now and so, that type of testing will continue. In the meantime, we think we're going to continue to see gains on driver amenities that come out of it and driver support functions in the existing trucks as they go from level 2 to 3, and so on. And a truck without a driver delivering commercial freight, I think you'll see some fringe or marginal applications of that in that type 2025, 2026 timeframe but it's, still a lot of hurdles to get through before we get there.

Scott Group:

All right, we got to wrap it there. Thank you so much, Derek. Thank you, John, Really appreciate it.

Derek Leathers:

Thank you. Thanks for having us.