

**Robert W Baird Global Industrial Conference (Virtual)**

**Werner Enterprises (WERN), November 10, 2021 10:25 a.m. CST**

**Baird analyst: Garrett Holland, Research Division - Senior Analyst**

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

Garrett Holland:

Thank you operator, and good morning everyone. My name is Garrett Holland, Senior Analyst, covering transportation and logistics at Baird. We are very pleased to have Werner Enterprises participate in our Industrial Conference this year. Werner is a leading provider of Dedicated, One-Way Truckload and Logistics services. From the company, we have Derek Leathers, Chairman, President, and CEO and John Steele, Executive Vice President, Treasurer and CFO.

We're going to dive right into Q & A, but if anyone participating on the webcast has a question, please submit it through the portal and I will relay it to management. Gentlemen, thank you for joining us today and just wanted to start by talking about the demand backdrop and what you're seeing here so far in the fourth quarter. How have volumes been trending or mileage, and how would you characterize demand as we move through the peak season here?

Derek Leathers:

Sure. Garrett, thanks for having us first of all. It's a pleasure to be here. Demand is obviously strong. It's been strong for some time. If you go back to the summer of '20 and really from then through now, we've seen volumes that more often than not have mimicked what a traditional peak season has looked like.

Certainly, by Q2 of this year, we saw prebook levels and volume levels that were very close to what a traditional peak would look like. And so, incrementally from there it's difficult; the network can only handle so much more. But that's why we spent a lot of time and work in Q3 to try to build the fleet a little bit and be better prepared for peak. From now through the end of the year, we see this peak shaping up very nicely as compared to prior peaks. Similar opportunity for project freight, similar opportunity for some premium surcharges where appropriate as we step up for our customers to try to do above and beyond contract commitments for needs that they have at this time.

Garrett Holland:

That's great. And Derek, you've done a good a job as anyone in calling this cycle as it relates to the imbalance between the supply and demand for freight capacity. What gives you confidence the strong demand here this freight cycle continues through or into next year?

Derek Leathers:

Yes, but I think several things. Honestly, I have more confidence on the supply constraints although I feel strongly about both. On the supply side, I think the driver shortage is here, it's real, it's not getting better, it's as difficult as I've ever seen. The OEM manufacturing issues are probably more real than I've ever seen. And it's a bit different ingredient to this cycle that we haven't seen in the past ones. Truckers have been undisciplined traditionally and went out and over bought capacity, over bought trucks. That's not an option right now. Most people can't even get near the replacement level trucks they need. So, you're seeing fleets age everywhere because of the disruptions and being able to get equipment.

On the demand side, you've got more workers coming to the workforce each month. You've got GDP growth that is still very strong. You've got a lot of savings rates that have increased through the pandemic. You've got an infrastructure bill that just passed that'll be a second half of next year, probably type of stimulus, but it will be one as it relates to more demand and more freight that has to move. And you've got replenished inventories really nationwide, with a choppy supply chain trying to work through replenishing them. So, you put all that together and we think this is definitely stronger for longer and certainly have confidence well in the '22 and in my personal opinion, I think this goes through '22.

Garrett Holland:

That's very helpful. Obviously, we've been navigating a series of supply chain shocks. Just interested in your thoughts and understanding now that we have the vaccine mandate with a new interpretation that exempts truckload carriers to an extent. Hoping you could help make this some sense out of all this and how it's going to impact your driver base and the industry overall.

Derek Leathers:

That's obviously a touchy subject and I feel compelled to start with the obvious, which is we are encouraging vaccinations and we were working, and corporate America, I think in general, is working aggressively to try to protect their workforce and work with their workforce to make vaccines available. We've done onsite vaccination clinics. We'll continue to do that, messaging, etc. But the mandate is a great concern to us. And so, when we saw the final ruling come out, our interpretation right away was that clearly, if outdoor work, if de minimus contact and if remote work is excluded, you just described the American truck driver basically.

Now we were glad to get confirmation on that interpretation, and they have said that solo drivers that are out there delivering the nation's freight would be excluded. We've still got work to do on team drivers and leaders that help train other drivers. We have processes in place to be able to work through this, and we agree that if we have settings where lots of drivers congregate, come together for multi-day orientation, that we need to either have testing or vaccination, and we will.

But the American truck driver has been delivering product through this pandemic that's helped the health and welfare of the entire nation. And they've done so with a lower infection rate than the general population. And I think it's because of the remote nature of the work. So, we do believe they should be excluded from the mandate. We also know that they are a group that chose to be truckers because of an independent spirit to say the least. And so, mandating things to groups like that can be disruptive, and at a time the supply chain can ill afford any more supply chain disruptions.

Garrett Holland:

That is helpful color. And to pick up on that last point, a question we're asking all the companies presenting at our Industrial Conference this year is, based on your perspective, are you confident that we're past the worst of the supply chain congestion as it impacts your business? Importantly, do you see a credible path to some normalization ahead?

Derek Leathers:

I'm not prepared to say we're past the worst of it yet. And I'd like to believe that's true. We see light at the end of the tunnel. But it seems to me that throughout this supply chain shortage, which is pretty widespread...everybody talks about ships and the impact on our direct business as it relates to OEMs, but the shortage is widespread across the consumer categories, across durables, across so many things. And I think it's a bit of a game of whack-a-mole. Every time we seem to get ahead of one of the shortage items, there's something else that sort of pops up and appears to be in shorter supply.

I think people buying or over buying and stocking inventories or excess inventories aren't helping, but I certainly understand the sentiment and we're certainly doing some of that in certain key part categories ourselves. I think it's going to be disruptive for at least the next several quarters. And it's our belief that sometime Q3 next year, you start to see more sustainable improvements in some of these supply chain disruptions, but that might be optimistic at this point.

Garrett Holland:

Interesting. And Werner faced some unique cost pressures here in the third quarter, most recently, including your parts shortage, COVID disruption, the hurricane, minimum pay guarantees and some higher insurance costs. Can you help us understand to what extent those margin headwinds are non-recurring and what headwinds continue to linger here in fourth quarter?

Derek Leathers:

Yes, sure. There's certainly a mix of some transitory costs and some ongoing things. So, first off, let's talk about our footprint. We're 60 plus percent Dedicated. Those are remote locations. They rely heavily on dealer networks for their maintenance and their uptime to be fulfilled. We found our Dedicated network in this particular case and in this particular quarter, certainly had some negative implications for us because those dealers really struggled to keep our fleet on the road and working. Those Dedicated contracts come with very teathy, appropriately teathy, service expectations. And we do what we say we're going to do. So, we moved a lot of trucks around in the quarter.

And so, it wasn't just the down truck or the truck waiting on a part, but it was the truck we brought in to make sure that we fulfill those obligations. There was a lot of money we spent to fly parts to dealers and tow trucks from dealers to our terminals. So, that type of stuff is mostly transitory. We've restocked and reloaded parts in places that we didn't traditionally feel as though we needed them because we had good strong support networks in place. And we learned some lessons. And so, we've reacted to it, and even some of the cost of reacting to it was buried in Q3, but the benefits will be in Q4.

The other part of Dedicated is we had some startups that started literally Q4, day one, so October 1<sup>st</sup> launch dates. That doesn't happen very often, but it does occasionally and so, you got all kinds of startup costs in Q3 and \$0 of revenue. Those startups are going very well, so we're very happy with how those have launched. And I think the money was well spent, and we realize and recognize that the idea is there is a community out there that wants us to manage our business 90 days at a time, but I don't think that's the right recipe for long term success.

And so, we did moves in the quarter that we thought we needed to. On the pay side, we did some long-term pay changes, so base rate changes that'll carry forward. But we also had to do some short-term, very aggressive ramping up of advertising and really cost of acquisition type stuff that runs through pay lines in various forms, bonuses and other ways, that won't recur. And so, that 20 cent year over year comparable and driver pay for Q3 won't be repeated in Q4; you'll see it start moderating.

And the last piece of the puzzle was all of the above are exacerbated if you don't get the miles. And so miles were definitely impacted in the quarter by a litany of things to include the hurricane, to include the fact that our Dedicated fleets are a little more concentrated and we did have a little bit of a COVID spike in the quarter. And then mostly, the parts shortage was the single biggest impact line where we just had too many down trucks and we operate like most people, we try to operate with a thin inventory levels to include trucks. We don't have trucks just sitting around waiting to be plugged in the game. And so, when we had down trucks, it really took a bite out of miles.

John Steele:

Then Garrett, I would add, you can see it in the overall driver numbers. We grew drivers sequentially by 3% from second to third quarter and trucks were up about 1%. So, we made an investment in drivers to help us with the Dedicated startups, to prepare ourselves to support our customers for peak season. And there was some cost associated with that.

Garrett Holland:

That's great. And just a question, fourth quarter is typically your strongest quarter. What's the typical seasonal improvement you historically experience in the operating ratio margin or EPS, Q3 to Q4 as a baseline for investors?

Derek Leathers:

I'll take that and I'm focusing here on EPS. So, from an EPS perspective, if you look historically, about a 20% improvement from Q3 to Q4. We expect that to hold up this quarter as well. We don't normally give guidance and I'm going to stay away from a specific OR or things of that nature, but 20% sequential improvement is certainly where our expectation is at. And obviously, give or take a few percentage points on either side of that, but that's what we think is in the cards.

And so far, a lot of these transitory costs that I talked about earlier, have in fact, materialized as transitory in nature. So, it's one thing to believe they're going away, it's another thing to now have a month under our belt and see them starting to moderate. And so, we feel good about the quarter.

Garrett Holland:

Oh, that's great to hear. Just turning to pricing perhaps, just interested in what you're seeing as you work through some of the early contractual bid renewals during the fourth quarter and your thoughts on what is a realistic benchmark for rates next year, just given some of the cost pressures that you're seeing?

Derek Leathers:

So, early returns on the bids, they've elevated really each quarter. As we've gone through the quarter, as we've renewed bids, the rate of increase has increased because it needed to. Driver wages have certainly increased more rapidly than originally expected. We've seen disruptions in the supply chain that cost real money for us to serve our customer and so, we have to ask for relief on that as later in cycle bids have come to bear. So, we're seeing continued progress.

We prefer to stay away from trying to predict a rate for next year, but there's, irrefutably, I think on a philosophical level, there are cost pressures that are out there that are affecting everybody across the supply chain. We're going to have to get support from our customers to continue to support them. And that's going to mean higher rates in '22. We've got the first round of bids that implement Q1 of 22 in house right now. And our actions on those bids will certainly be reflective of rising rates.

Garrett Holland:

That's helpful. And just interested in your thoughts as you put together the budget and the capital spending plan for next year in an environment where OEM production is limited, equipment prices are much higher, and the driver supply is scarce. How do you plan for capital spending next year?

Derek Leathers:

It's going to be challenged; let's start with that. The OEMs are going to be very challenged next year to produce equipment. And I think that's true of trucks and trailers. We are kind of in a hand-to-hand combat mode every day right now to get our trucks and know where they're at and make sure they arrive as close on time as possible.

I think as a general statement, first of all, we've revised down our CapEx range slightly for this year. I think that range is going to hold up pretty well for a goal post for next year. But, it's too early to know for sure and we have not published a range officially for next year because we have not yet locked in all of the equipment purchases that we might need because of the simple scarcity of the truck and trailer market right now.

Garrett Holland:

Well, that's helpful. Turning to the Dedicated business and to ask a few more detailed questions there. Just wondering if you could elaborate a bit more on the pipeline of business that you see. Obviously, the pandemic has seemed to pull forward significant demand that you're capitalizing on, year to date and especially in the third quarter. What does the pipeline look like and what is your targeted annual fleet growth for Dedicated going forward?

Derek Leathers:

So, I'll start with the pipe...the pipeline is very strong. It's as strong today as it's been and really at any point. We've said that for several quarters, but it basically continues to strengthen. I think we said on our call last quarter the fleet adds at that point were 16 new fleets. We see a pace that is staying consistent with that.

I think the real key, or the secret sauce in our view, is sifting through that pipeline and trying to make sure that we land those businesses that fit our profile. So, hard to serve, very defensible, sticky business, with winning customers that we think is a pure play Dedicated.

We're not trying to allow any capacity fleets into the network because we know those things are fragile and they tend to go away at whatever point this cycle may turn, whether that's '23 or beyond. We don't want those fleets in our network. And we have too much of a robust pipeline and too limited of a truck supply to let the wrong thing through the gates. And so, our efforts are going to be on win rates and focused analysis on what we allow through, and this relates to Dedicated truck growth.

Frankly, we're going to work to get through the gates whatever fits that very, very critical profile we're looking for. So, we don't predict in advance that Dedicated is going to grow 500 trucks or a thousand trucks or anything like that. I think our year over year, jump in here John, truck growth and Dedicated is 400 plus.

John Steele:

Yes, about 11% year over year.

Derek Leathers:

That seems to be a run rate that is sustainable going forward as far as the pipeline looks out right now, but it could bigger if more stuff fits the criteria, and, this is a very important and, if we can get our hands on the equipment. So, we will be selective. Dedicated is still our preference for growth, but we will look at One-Way. As you saw recently, both organically, our truck growth grew, and we added the acquisition of 500 trucks with ECM. So, we think we're pretty unique in the space in that our fleet is not going backwards; it's actually getting larger and better able to serve our customers.

Garrett Holland:

And could you share some specifics about the newer Dedicated business? You already talked about the 16 fleets in the past year. Has there been any change relative to the average fleet size, contract length or what that new business is being underwritten to from an ROIC or margin perspective?

Derek Leathers:

Happy to. John, you want to take that or I'll...

John Steele:

I would say that our average fleet size ranges from say 10 to 50. From a margin standpoint, in a capacity constrained market, we're trying to expand margins within Dedicated to focus on customers that demand really high service, that are complex and challenging to serve. From a return on asset standpoint, we're trying to grow our return on assets from current levels that we're reporting. So, we want better business that's harder to serve that, with customers who are winning in their verticals over the long term. They are growing and we can hopefully grow with them.

Derek Leathers:

The only thing I would add to all that, I agree with everything John said, is it's not a conscious strategy as much as we're going to go where the market takes us, if it meets all of the criteria John described. But there was a higher percentage in those 16 that were lower productivity fleets with shorter length of haul, but they fit every single criteria we're looking for. And so, it has a dampening effect on miles, and it has a dampening effect on revenue per truck per week, but it does not dampen earnings potential. And so, that's going to create a little noise in some of the results because your revenue per truck per week may not be as high, but your costs are not as high to serve either because these are low productivity fleets that involve more driver engagement and get drivers home daily in many cases, and we like those fleets quite a bit.

Garrett Holland:

And can you remind us how long it takes for the new accounts to get to the targeted run rate profitability? And to what extent do you have more flexibility to pass along these higher costs in this inflationary environment? Obviously, you want to build as much into the contract terms as possible while honoring your commitments.

Derek Leathers:

Yes, so we definitely have more flexibility and we are working more all the time to make sure startup costs are covered either through the model over the course of the contract, or with actual startup cost accessorial fees. And we do a pretty good job of that and we have traditionally done a good job. Now there are times where it's a little unique; the one particular fleet that we're very, very happy to have landed that launched October 1st is set...it was a timing thing, we did not want to push the implementation. This is something we've been working on for a long, long time. We think it has a considerable runway ahead of it. And so, it was critical to me, personally, that October 1st meant October 1st and a clean launch was going to be a clean launch.

And so, there are times where you simply make the decision to invest. I think it's worth it. It's proven itself already to be worth it. Overall. It takes 90 to 120 days probably, on average, for a fleet to really find its footing because drivers need to learn the fleet, they need to get up to the modeled productivity expectations. There's a lot of re-seating that takes place early on in a fleet because the driver that we thought was the right driver for that fleet isn't, and we don't want to lose them and force them to do a job that's not the right fit for them.

Once you get through that, somewhere in that, call it 90 to 120 day range, it starts to find its footing. That's pushed out a little longer right now, a little bit, because of how much harder it is to get the driver and how much harder it is to get the equipment. So, there are times where it could be, call it more of 180 day type run rate, but those are exceptions, not the rule, but we will deal with those and we're going to have to deal with some of those in this disrupted market right now.

Garrett Holland:

And Werner recently increased its longer term targeted operating margin for TTS to 12 to 17%. Interested in your thoughts, if you could achieve that high end of the targeted margin range, this cycle, or some of the other more company specific drivers needed to achieve that type of profitability.

Derek Leathers:

Well, to say yes to that would be, in essence, giving guidance in the short term so, I'll probably steer a little clear, but I think the guidance range change was...there's two read throughs that people should make. One, we actually shrank the size of the range, which I think is important, because we wanted to send a message that this is in fact more defensible and that we've stress tested it and modeled it in multiple ways and we are who we've always been, which is a pretty conservative messenger about what we think our capabilities are. And so, for us to say that, it's because we have faith in it, that's important.

The fact that the range itself was shifted, kind of up and to the right, is an indication of our competence and our overall resiliency of our model. And even though there was noise in Q3, I would remind folks that within that noise, it was still a record Q3 in our history. And so, we want to be clear that we have not lost confidence in the strategy that we're implementing. As a matter of fact, we're going to continue to lean into it. And we believe that the defensibility of our network, both because of Dedicated, as well as the increasingly engineered nature of our One-Way Network, has never been stronger than it is right now.

Garrett Holland:

No, that's great and just wanted to pick up on that point. What gives you confidence to preserve the lower end of that margin range when the cycle inevitably turns? And what actions do you take to run the business a bit differently if you see the pricing, demand environments start to cool off?

Derek Leathers:

I think the confidence, first and foremost, comes from the size of the Dedicated footprint, the structural arrangements within the contracts of those fleets, the difficult nature of the service that we do within those fleets and so they are hard to replicate, hard to replace. And so, we have true relationships there. The stickiness and renewal rates are in the high 90 percentiles on those fleets. And so, we feel confident that those are not able to be replicated through spot market purchasing or One-Way replacement and so the only option someone's going to have is to replace it with some other Dedicated provider.

And, when we know our ability and our capabilities relative to best in class Dedicated service, it gives us confidence of a pretty high retention level on the fleets that we have. On One-Way, it's a combination of increasingly engineered lanes and a portion of our One-Way Network that we have decided to move into longer term arrangements. And so we've got a portion of our One-Way Network now locked up in long-term agreements with index pricing that we feel is worth a little bit of pain in '22 in all likelihood, for the benefit through the cycle, of having those guarantees.

John Steele:

And Garrett, I would add, as evidence of that, from '18, which was the previous strongest freight market we'd seen in decades, to compare to 2019 when the One-Way markets saw softer rates in the overall environment, we performed with a 12.3% margin. And since that time, we've grown Dedicated a few percentage points, we've added ECM to the mix; we think we're in a stronger position to defend in a softer market now than we were back in 2019.

Garrett Holland:

That's great. And just wanted to ask a few questions on M&A and capital allocation. How is the ECM acquisition progressing relative to the deal model and what are your thoughts on the driver base so far? I know it's still a little early, but what are some of the revenue and cost synergies that you see for this business over time?

Derek Leathers:

I would say it's progressing very well right now; we're very pleased with it. Our ability to retain that driver force and workforce has actually exceeded all of our modeling going into the deal. We've actually seen growth in the ECM fleet albeit 10, 12 trucks worth, but that's pretty incredible. And I think it speaks to the Werner brand, the Werner culture, and the ECM culture.

We were very selective, obviously, it took us 65 years to do one. So, we were pretty darn confident that this was the right one, or we wouldn't have done it. But it has performed at or above expectations at this point. Synergies are working on the cost side that we've identified. I would say the only thing tracking behind schedule is equipment synergies. And that's because of the overall equipment issues that are out there. I view that as a positive because it means we have more synergies to come as we get better equipment in at our purchasing point into that fleet. We think that's good news to come in '22.

Garrett Holland:

And how would you characterize the current M&A environment for truckload deals and what's your appetite to do more transactions based on the ECM experience in the years ahead?

Derek Leathers:

The environment is robust. There are a lot of opportunities out there both through, kind of traditional pipelines, as well as, I think, us doing the ECM deal opened up the eyes in the industry that Werner is a capable, competent and open-minded participant. And so, the ability for folks to kind of reach out and us to start to have a conversation directly is there and happening, but we will be very selective. So, we are going to have to sift through that pile, just like we sift through the Dedicated pipeline.

If we find fits that we think are cultural matches, that are additive and accretive, that are best in class in their space from a service perspective, and we can bring obvious synergies to the table and maybe take some of the things that we do really well and bring that to bear so they can focus even more on their operational excellence, we'll be open minded for more to come.

Garrett Holland:

That's great. And just to touch on the Logistics business, it's performing well. And I know you made some changes there. Where do you see the sustainable growth rate for that business and what is a targeted margin range there? And what would you outline as some of the more differentiated aspects of your logistics business?

Derek Leathers:

John, why don't you go through some of the margins and growth and I'll talk about the differentiation.

John Steele:

Okay. So, we have gotten back on the growth track in Logistics. We had a strong performance quarter recently. Our goal over the long-term would be to see mid- to high-double digit growth in Logistics over the long-term and continue to grow the bottom line. Our margin was negative, our operating margin was negative a year ago in a very capacity challenged market in third quarter of '20 and expanded to 4.8% operating margin this quarter so, a big improvement overall. We're expecting margins to consistently be three to five percent and expand from there as we get more size capability. We want to be larger and more relevant and significant within Logistics as we move forward.

Derek Leathers:

And on the differentiation front, I think we have a very strong franchise right now, relative to our Brokerage Network, which is the bulk of what we do. It's the biggest single portion of our Logistics business. We are investing heavily right now with Mastery and bringing to bear some of the tools that they have within that, rolling that out across our network.

We're still building internally as part of our Werner Edge platform. Some of the optimization and sort of secret sauce that we believe will bring more transparency to our customers and some of the things that they're looking for that they're not able to get today. Intermodal is growing and doing very well and we're becoming increasingly a relevant player in that space. And lastly, but not least important, it's actually something we are heavily focused on, is we've made real strides in Power Only, and our ability to do both Power Only and popup fleet support for our existing customer base with third party capacity so that they can think of us more as a portfolio company going forward than ever before.

Our \$600 million run rate in Logistics is a very sizable operation and yet, if you think from a multiple perspective, there's virtually zero reward for that Logistics piece of our portfolio today. As it grows and continues to demonstrate consistent performance, at some point, people will wake up to the reality that this business is on its way to a billion-dollar type franchise. It's performing at market levels and it's providing the consistency and counter cyclicity to the rest of our portfolio, because it does operate a bit counter cyclical that even further entrenches the defensive nature.



Garrett Holland:

Well, that's great. Unfortunately, we're out of time for the webcast session, but just wanted to thank Derek and John and everyone on the line for joining us today and hope you have a great rest of the conference. Thank you very much.

Derek Leathers:

Thank you, Garrett. Thanks for having us, we appreciate it.

John Steele:

Thank you, Garrett.

Garrett Holland:

Thank you, gentlemen.