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Baird Analyst: Garrett Holland

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

Garrett Holland

We really appreciate your interest here. And we're thrilled to have Werner Enterprises and management participate at the conference again this year. From the company, we've got Derek Leathers, Chairman, President and CEO; John Steele, Executive Vice President, Treasurer and CFO. Special congratulations to John on his upcoming retirement. I know he is all in on the financial plan and operations here at Werner until then, but we're thrilled to have the team and we're just going to head right into Q&A to kick things off.

Derek, maybe for folks that aren't as familiar with the Werner story, help us set the table. Explain how this business has evolved over the past five years. I thought you had a good slide in the recent acquisition deck, just reviewing the changes. But help us understand, those key moves and how they position the company for a more resilient performance through the cycle?

Derek Leathers

Yes, sure. So we are a company that has evolved quite a bit. We've been around sixty-seven years, credible, conservative, consistent company. Went public in 1986. But I became CEO in 2016 and really myself, and the team really embarked upon a journey at that time.

And it was about making a company that was more durable. One that was more resilient through the cycle, redeploying capital in a way that further diversified our portfolio. And really focusing and leaning into our strengths and at the same time understanding what we weren't.

And so, in that five-year period, we've divested from a piece of our business on the global logistics side that was actually doing well; it was performing, it was profitable. But we took a conscious decision to focus on being a leading North American transportation and logistics company.

Over that five years, we've further diversified, or further emphasized, what we believe to be best-in-class Dedicated services that we offer. And if you look at our fleet now, it's 63% Dedicated with the balance being One-Way, and even in the One-Way or the van over the road fleet, we've now taken that business, and really there's kind of three legs to the stool.

It's supported again, with an eye towards durability and diversification, as well as defensiveness by our cross-border Mexico franchise. We're one of the largest players doing business to and from Mexico today, team expedited, and then the third piece is really engineered regional fleets. So better lifestyle for the driver, better consistent service for our customer. But frankly, it's just more defensible, because we're really getting away from that long-haul, you call, we haul, commoditized end of the spectrum.

And then the third piece is Logistics. It's been a fast-growing part of our business. It's one that's begun to stabilize in terms of its consistency over time. With a recent acquisition that we announced on Monday of ReedTMS based out of Tampa, Florida, that business is now a $1.1 billion business on a pro forma basis and one that we're excited about.

Reed allowed us to add to our capabilities, a strong leader in the refrigerated brokerage space, as well as a team of professionals and expertise that the cultures just align. They expect excellence in all that they do, just like we do at Werner. And it really makes us a much more relevant player in that logistics space going forward.

Garrett Holland

Maybe starting with the TTS business. You see a lot of different end-markets, and have a lot of conversations with their shipper base. What are you seeing through peak season today? I know its expectations for a muted peak. How has demand evolved in Q4? What are you expecting in 2023?

Derek Leathers

Yes, so peak is certainly muted right now compared to what we've seen in prior years. There's no debate about that really at this point. We have developed a model that is very effective at executing in Q4 under normal upticks that happen year-in and year-out leading into the holidays. The last couple of years have been very outsized in their nature just because of the reality of COVID. And that project and peak business has really become a pretty key component of our fourth quarter operating plan.

This year, it's muted. We talked in our Q3 call that it was, our expectation is it's off about 70% year-over-year in terms of the peak and project opportunity. But the core business, the contract business that we haul every day, is really holding up pretty well. Dedicated is very strong and performing very well. And on the One-Way side, really volumes have stayed relatively consistent from Q3 into Q4. What hasn't happened is that sudden and noticeable shift in terms of increased volume in Q4 that has been kind of the case for the last few years.

To put it a different way, I would say this peak season is soft even seasonally compared to the pre-COVID years a little bit, but it's closer to that sort of pre-COVID peak experience than certainly, what we've seen for a couple of years during COVID.

Garrett Holland

Have you seen any diverging trends by end-market? Obviously higher mortgage rates and auto loan payments are going to impact the consumer at some point? Are you starting to see that in the demand for the shipper base? Or are you seeing your retail customer's blow through some of this excess inventory?

Derek Leathers

So, a little bit of both, but I would say, the retail term is such a broad term, right? And so, we have to think about, I ask you to think about what our retail looks like. So, we are heavy in the discount retail space. So, whether Dollar Tree, Dollar General, Walmart, people like that, are all in our top five.

We're heavy in the home improvement space, which is still holding up pretty well as people continue to invest in improving the home they're in. And as interest rates rise, they tend to actually shift even more focus on just staying put, but fixing where they're at versus chasing the next mortgage. So, we think that bodes well for us as well.

And so there's no particular part of that, that's peaking or seeing that normal seasonal lift, but that stuff holds up much better that maybe the more discretionary type retail. We're not heavily involved in those types of businesses. The stuff we do, and its part of our philosophical shift in 16, is really built around what we call our alignment with winners. So, we look for winning companies with winning management teams that we think have a model that would be durable through the cycle. And that's who we've really kind of focused our efforts on and our growth on over the last several years

Garrett Holland

So as we think about puts and takes for next year, just at the demand level, does it get worse before better, or how do you think it shakes up?

Derek Leathers

Well, I think the toughest thing, we think based on the customers that, again, we're aligned with, that we do business with; we see a lot of people trading down into those type of retailers. So they actually have, and we've got a lot of data on this that shows they hold up very well in recessionary times. And in some cases, they actually prosper during recessionary times, because people make that trade down. They also tend to, once they trade down, stay sticky with those retailers. They don't then migrate back up and spend more money for no reason once they've become accustomed to the offerings of these discount retailers.

So, we think that bodes well. Now we've got a really tough comp in Q4 and a really tough comp in Q1. Everybody's thinking about the Q4 comp, but Q1 last year really was just the extension of the hottest peak season we'd ever seen. And so, it carried over and spilled over all through Q1.

I expect Q1 is going to be a more seasonally normal Q1. But again, our folks and the type of people we do business with, we fully expect will hold up well. The last piece you mentioned, inventories. And there's really no great way to answer, in general, because it's a customer-by-customer conversation.

What I can tell you that what we're most excited about is, some of the biggest of the big in our portfolio, are telling us indications that they're in the seventh, eighth, even early ninth inning of clearing the deck on some of that inventory. And so that's exciting, as we've been meeting with them lately and getting a more recent update. You'll see data on that forthcoming here shortly as they all officially release their numbers. But we obviously have a lot of conversations with them about where they're at and where they're headed. And so, they've decongested. Now, make no mistake, we absolutely have customers and shippers in our network that are still in the third and fourth inning, so they've got some work to do.

Garrett Holland

That's a great perspective though. Pulling up and thinking longer term, a question we're asking all the companies participating at the conference. How does your business benefit from the nearshoring dynamic? Clearly, you've got a nice cross-border business. Are you seeing more shippers bring business closer to home?

Derek Leathers

Yes. So, I mean obviously the nearshoring thing is very near and dear to my heart. That's, my background is heavy in Mexico. I worked in Mexico, ran a Mexican trucking company for several years, called it home for over five years. And it's a big part of our franchise. I mean, we believe today, it's hard to get exact numbers. We think we're either the largest or certainly one of the largest, if not the largest cross-border operator to and from Mexico. Our customer base is strong, it's diversified, it's growing.

But when it comes to nearshoring, it's a journey and it's a marathon, not a sprint, so to speak. So, we have lots of conversations going on about people that want to do more of it and bring more opportunities closer to home.

But it's going to take years for some of that to play out. In the short term, we're just picking up from good old fashioned share gain, and what they can do around the edges where they move certain percentages of sort of near sourcing, they can move quicker. Nearshoring takes a little longer to actually move their own manufacturing and other things. But all of that bodes well for us and that's why we continue to invest in our infrastructure across the southern border and within Mexico.

John Steele

Can I add to that real quick?

John Steele

It's not just the trucking side of the business, as well, it's the Logistics side. We have a large cross dock facility that's state-of-the art for both reefer and dry van in Laredo. And we've got growing opportunities and Logistics to help us there. So, we think opportunities for both third party capacity as well as our own, look good as we move forward.

Garrett Holland

That's very helpful. When you think about the inflationary pressure you see, help us understand where we are today. Obviously, that's manifested in, from supply chain congestion, some bottlenecks like driver availability. Are we past that? Help us understand the inflation pressure you're seeing?

Derek Leathers

Yes, I mean I think the best way right now to think about it is, it's moderating. The pressure's not gone, but it's certainly moderating. Equipment availability is starting to become more real with, as we start to be able to get a little more equipment and refresh the fleet a little bit, it impacts positively on the maintenance line, the up time. It has at least marginal impacts around driver satisfaction as you get them in newer equipment.

We talked about in Q3, just one example, trucks out of warranty. The cost of that in Q3 was, call it between $750,000 and $1 million. It depends on how a few things go as we go forward, but ballpark, that's about what that was.

We had some inflationary pressures that are sort of self-inflicted, but they're investments, not really expense in my mind, where we've expanded our school network to better position it for where we see the market headed, so that we have the right geographies in place. That's about another $1 million of inflationary startup cost, if you will, for those schools.

We had in the third quarter; I think this is important to point out, a line that's hurting really across the industry is that risk or insurance line. And yet in the third quarter we had the lowest accidents, DOT accidents per million miles in 18 years, despite the fact that that line doesn't look very pretty. And it's about prior development of prior claims, or development of prior claims. It's about the cost per claims going up and it's about our quest to continue to lower, because over time, if we continue to lower the accident per million miles, you'll see it come through. But it's again, that's a long-term battle that we got to continue to fight.

Garrett Holland

I know it's been a key part of the Werner strategy to operate with a lower age of equipment. Now what's the equipment reinvestment plan for 2023? It sure seems like the order books are wide open at the OEMs. Can they deliver the equipment? Do you feel, have more confidence in that ability?

Derek Leathers

Not really. In short, no. They're going to have some relief in 2023 and some ability to build more trucks than they probably have in 2022, but they're far from out of the woods. It's my expectation you still will see another year of sub replacement level builds in 2023, just based on the reality that we are not out of the woods yet on some of the supply chain issues they're faced with. I think the issues going on in Europe with energy, in particular, are a much bigger problem than people really understand, especially as it relates to OEM production long term.

So, we think there's going to be fits and starts through 2023. Our fleet aged, but not nearly as much as most. So, we feel like the good news is, we can get back to where we want to be fairly quickly. It will not happen in 2023, because we won't be able to get enough trucks to do it. So yes, you'll see some inflated orders at least as it relates to the prior two-year period, but it'll still be sub replacement level. That's one issue.

And the second is, it will be to replace and refresh, more than anything their fleet. So, if I can get more trucks next year, we will order them, but it's not with an eye towards growth, it's an eye towards freshening the fleet, lowering the maintenance line, increasing our progress on the accident line through better and better technologies and improving driver satisfaction.

John Steele

And we're going on almost three years of sub replacement levels, because of the impact of COVID on the ability to produce new trucks. So, it's been a big challenge. So, there's a catch-up desire, but computer chips, energy issues, tier three suppliers to build the new equipment, all those are still challenges that are ongoing that make it hard for the OEMs to build at the level they would like to.

Garrett Holland

Yes. I know you want to get some new equipment in the fleet. So, we talked about the inflationary pressure, on labor, equipment, insurance side. Obviously, your shippers are looking for relief to stretch these transportation budgets a little bit further. How does that net out in your contract pricing discussions? And what are you hearing as you start the bid season?

Derek Leathers

Yes, I mean, first off, it's important to reiterate, it's a tale of two cities, right? So, 63% of the fleet is in Dedicated. Those are three-to-five-year contracts. Those are negotiated increases through the process and or indexes that are already set in place. But we've seen tremendous brand loyalty on the Dedicated side, both in renewals, but also in the annual negotiations that happen as part of price relief when we need it.

Our service levels in that business, on 63% of the fleet, year-to-date, is 99.5 or better, on time. So, we hear about companies improving service levels by 400 basis points. We've got 50 basis points to work with because it's near perfect already. We've got to continue to give that kind of service. And if you do that, those renewals and those increases to offset costs are met, never with open arms, but with understanding.

The last piece is with on the Dedicated side is we get better with every year we have a fleet. So, people confuse the idea that yes, we can get an increase and still save them money and that is doable. We get more efficiency. We get better low – better utilization on that fleet, and we can actually save them money while asking, maybe more per mile, and everybody wins. And so that'll be a focus, real heavy focus is looking for efficiencies.

On the One-Way side, for the first time ever, we're going into a turn in this cycle with roughly, a little less, but roughly a third of our business in long term agreements. We've never went into any change in cycle with any of our business in the One-Way side captured inside of a LTA. Right now, almost a third of our business is, that bodes well.

About a third of our business is Mexico cross-border, and you don't have this fragmented competition with Mexico cross-border, at least not the scale that we provide. You can count on one hand the number of high-quality players that can do that business, which means you can count on one hand the number of people that can price it. And so, we're going to be able to keep more discipline there.

And that last third is looking for engineered solutions. And so that's an interesting one because there's all kinds of opportunity as we engineer patterns within our network, that we might be able to go-to-market at a lower price and still hold onto the yield because we're increasing the efficiency, eliminating deadhead, getting drivers home more often and therefore impacting retention. So, it's not going to be an easy year. There's a lot ahead of us, but we've got our eyes on the ball and we know what we've got to go do.

Garrett Holland

Clearly some challenges out there, but easier to navigate for a scale carrier. Help us understand what the small carrier's seeing? Is the exit of capacity from the market accelerating now? Help – give us some perspective on that?

Derek Leathers

Yes, from my perspective, it's a very painful time to be a small carrier. And we don't wish that on anyone. We have a lot of those small carriers that work with us. They find shelter obviously working within our Power Only business. And we think that that becomes more attractive than ever in a time like this. And so, we're seeing a lot of gains as it relates to recruitment of carriers into Power Only. We want to continue to do that in Brokerage. It's a marketplace, but we're still going to try to make sure we help and assist and package savings for our carriers, because the rate's going to be the rate, but we want to make sure and package with them as much other benefits as we can.

But the small carrier environment is one made up of people that over the last several years, have went out and paid too much for their equipment, at a time now when interest rates are rising, at a time when fuel is higher than it's been ever before, and their efficiency of their equipment, because of its age, is not really competitive with what late model equipment looks like.

The insurance line isn't getting any better. And they did all of that wrapped inside of a pursuit of the spot market, which we don't do. We really play virtually not at all in the spot market. And so, they've seen their rate structure drop by 35%, 37%, 38% at the very exact time their cost structure is getting more expensive.

Last five weeks alone, the net deactivations, if you look at the federal registry, is 10,000 trucks, in five weeks, have left. I think that pace is going to accelerate and you're going to continue to see that as we go deeper into this slowdown. And for folks like us, we're going to come out the other side stronger for it. Again, I don't wish anybody's demise on anyone, but I do think you're going to see a cleanse taking place.

John Steele

And one key difference between this cycle and the previous two downturns, if you think about 2015 to 2016, fuel was $2.30 a gallon back then. 2018 to 2019 when there was a truckload recession, fuel was $3 a gallon. Today it's $5.33. It's the number one expense on their P&L now, and it's at a much higher rate than it was the previous two downturns within the business. So, it's a much more difficult challenge, and if you're small, you have got to pay for fuel when you pump it, put it in the truck at that moment. So, it's a big cash challenge on their part too.

Garrett Holland

I know it's challenging but you think about sequencing this dynamic and when the purge of capacity, really takes place. Is it contained and peaking in the first half of next year? How do you expect this cycle and the balance restored to the market over the next few quarters?

Derek Leathers

Yes, it's our belief when we've looked at a lot of different prior cycles. We've looked at what we've seen and learned from other cycles. And we've looked at current trends like the 10,000 trucks I just mentioned that have exited over the last five weeks. We really feel with growing confidence that by middle of next year, this is either back in balance, if not tight, and it sets up for a very interesting peak season in 2023. So short-term painful, less so for large, scaled operators with newer equipment and better financing, but not long-term duration as it relates to how long this down cycle is or this equilibrium problem exists.

Garrett Holland

And I like the commentary on the call about discipline on the One-Way business, but you're continuing to grow and be opportunistic on Dedicated. Help us understand the growth pipeline, the visibility after that and the discipline and the flexibility you have to redeploy equipment if the demand is not there.

Derek Leathers

Yes, it's a big part of our 2023 strategy and we've got to be nimble. We got to try to execute it at the right time in the right way, with the professionalism that our customers expect. But the bottom line is, as we go into 2023, our pipeline right now in Dedicated is as robust as it's been in a while. I mean, it's strong, they're still coming, they're still interested in what we bring to the table. That gives us, affords us, so to speak, the opportunity to grow that fleet regardless of what's happening from an overall economic background or backdrop. Because if you need it there on time, every time, at a customer level, you've got to go Dedicated to do that.

And so, we have opportunity. It also affords us the opportunity to have another layer of discipline on that One-Way business. Because we can migrate trucks from One-Way to Dedicated, and that will be more of the plan in 2023, not looking for overall fleet growth, looking more for redeployment of assets out of One-Way, unless of course, those One-Way shippers that really have been with us for many years, want to stay with us for many years. And if so, we have to make sure we have an economic model that works.

And so, we'll have those conversations, and we'll go through those bids, and there'll be some that'll take that route and some that want to chase price, and if they want to chase price, the good news is, I've already got business coming through the pipe that those trucks can go support.

Garrett Holland

And as you think about maybe some changes over time, do you see the Dedicated, One-Way mix that significantly changing relative to where we are today?

Derek Leathers

I don't think it's going to go down; I'll say that much. And I think, in all likelihood, if you project out, so you think about this portfolio today, post the Reed acquisition, it's 30% Logistics with the balance being in TTS. Inside of TTS, call it 62%, 63% Dedicated, the remainder One-Way.

If you ask me what's it look like three years out, five years out, I think it's at least a third Logistics. So, Logistics growing at a slightly faster pace than the asset side. And I think you have Dedicated at 65% or greater, not lower than that. So more migration, more focus, more specialization with winning customers, doing more defensible type work that's sticky because of how hard it's to do. That's really our focus.

Garrett Holland

Now turning to the Logistics business, I know you've had a very busy week with the ReedTMS transaction. And your M&A process is very disciplined, so why was this the right asset, the right team, to bring on board? Obviously sizable deal and I know it's been vetted extensively, so help us understand the enthusiasm and the opportunity to see with ReedTMS.

Derek Leathers

Yes, I am very excited about ReedTMS and what it means to us. You're right, we have a very diligent process and we kind of start with the matrix of needs and what our focus is. It's led by culture, like meaning we really, really, I feel strongly, our culture's unique. We believe in it. We believe in one another. And I don't want to mix bad culture into ours. And so, we find these opportunities that make sense on some, on paper, but you really vet the people and Logistics, more than any other business, it's truly a people business.

I mean, so these are great folks. They're very nimble. They do great work, and they have a specific skill set in refrigerated brokerage that I think is second to none. That was a gap in our Logistics portfolio and our capability set. They fill that gap.

They also bring along with it a strong presence, overall, in the southeast, which is consistent with where so much of our focus is in Dedicated and other parts of our business and it makes us even stronger. It's more of a coincidental thing, but it's certainly something that we're excited about. The headquarters of our largest school network in America is also in Tampa. And so now, that's in St. Pete, but the point being, we have a large growing presence in that market.

The single largest employment base for all of Werner is already in Florida, pre-acquisition, outside of Nebraska. So, it's Nebraska one, Florida two. And so, we're starting to create a presence down there that we think have lots of synergies, broader than just the brokerage business, as a way for us to attract and retain talent throughout our building, or throughout our business, I should say, going forward.

Garrett Holland

And should investors start to think about the Logistics business as a sustained engine for growth at Werner. Help us understand the growth rate potentially you see through the cycle of the Logistics offering?

Derek Leathers

Yes. So, the one thing with Logistics, and I think it even came up in the panel right before mine as I was walking in, you see more volatility in the yield per load in Logistics because it's going to follow and track the market more closely. So, it's harder to talk about revenue because, but it's easier to talk about volumes.

And so if you look at Q3, in many ways there's things we want to execute on better than we did in Q3 in Logistics, but I'll tell you, we followed the trend of the market for the most part and outperformed the market on things like volume, our ability to continue to grow and sell deeper into more customers. And we think we can continue to do that going forward.

So, mid-single-digit type volume growth at a minimum, with a bend toward more than that. And that will yield dramatically different outcomes in revenue depending on where we're at in the cycle. So as price per shipment goes up, obviously we'll have much bigger years than that in terms of revenue. Next year as we're in a part of the cycle that's comping against very high rates from a year ago, the revenue line will be challenged, but it doesn't mean that the bottom line is because we'll be buying cheaper as well, as we work our way through it.

Garrett Holland

I know the Power Only offering has been a key source of that volume growth and opportunity to bring to ReedTMS. Help us understand the outlook, for Power Only and the stickiness that business will have through the cycle.

Derek Leathers

Yes, I'm a big believer that I think Power Only is stickier than any other type of our Brokerage business. There's a lot of concerns, and it's been kind of interesting to us, how skeptical the investor community is about Power Only, their belief that it only took off because of COVID and that really people won't hold onto it long-term.

And I think they're partly right. It took off because of COVID, because with the tight capacity market, customers ended up being willing to try it, because they would take capacity in almost any form. But once they try it, they like it and they want to keep it, and it's far superior, in their mind, to standard Brokerage, because they don't have a rainbow fleet sitting out in the lot. They don't have to live load trailers and live unload.

They get a seamless kind of Werner experience, but the trucks that actually pick that freight up might be eight or 10 or 15 different brands. They don't care about that as long as they get our systems, our track and trace, our communications, our platform, and our trailer, because for the person on the dock, it's just another Werner trailer and they can load them very efficiently.

To go backwards by contrast, it means increasing labor cost at their dock, increasing spotting cost on their yard, CapEx investment in more equipment to move a rainbow fleet around. And very few people want to raise their hand and spend that kind of money if there's a viable alternative that performs very well.

Garrett Holland

It's been a busy couple months for M&A and obviously you were active last year as well. It's good to hear, Baylor's outperforming initial expectations. Sounds like you're on pause, digestion mode for M&A pursuits, but what's the roadmap going forward? Where would you like to add?

Derek Leathers

Yes, I mean, never and always are always dangerous words, so we're not using either one of those. We'll be open minded, and we've got deal flow coming through all the time. But the reality is, we have integration work to do, and we're all about execution and operational excellence.

We want to focus on making sure all these synergies that are identified and all this cross-selling that's been identified, actually happens. And so, I think a better way of thinking about it is, we're going to be even more selective in 2023 than maybe we've been up until now. And it's going to take something really special to get across the finish line. But we're open for business.

In the meantime, ECM was larger than it was the day we bought it a year ago and growing still. That's very unusual in a truckload acquisition, doesn't happen very often. That gets back to that culture.

NEHDS Final Mile was growing both with their organic customers as well as our core customers, and especially some of our blue-chip customers. So, we're extremely excited about that. Again, we had about a million dollars' worth of burden of cost of startups in Final Mile in Q3. That's a really good problem to have, when you have that much startup costs all on a quarter, that's a good problem to have.

Baylor looks great. I mean, it is a high-quality company with a really strong leader. Cari Baylor is somebody that's just been a breath of fresh air in our building and she's a bit of a whirlwind, but in a great way, and she's going to make us better.

And then now most recently Reed. The people at Reed were excited. I spent all day there on Monday in Tampa, when the announcement was made. I was in their offices, not my own. And we had a great day that day together. And I think, as we look forward, that probably out of all of them, has the biggest cross-selling opportunity. But there's components in each and every one of them where we can do more of that.

Garrett Holland

That's great to hear. And then just to pull up, the range of outcomes seems wider for next year. I know you're focused on executing, you've got stated margin targets for TTS, but what are some of the other ways to frame up trough earnings power? A company that performed well in prior downturns, how should we think about downside potentially this cycle?

John Steele

Yes, so the last downturn, 2018 was the best year at that point, in 30 years with Werner, that was the best year of my career. 2019 was essentially a truckload recession. Rates in the industry were down 5% and we had earnings that slightly increased in 2019 compared to 2018. This may be a tougher adjustment from the even stronger 2021 and 2022 environment compared to what we might be dealing with in 2023 with the actions the Fed has taken.

But we feel very confident that our durable, resilient, Dedicated base, which proved itself in third quarter and will keep reproving itself through next year, positions us well to deal with any challenges in the economy. We're optimistic that the second half of next year will be better and it's the first half that'll be more challenging.

Garrett Holland

That's great. Well any questions from the audience? We're running up on time. Maybe we'll adjourn there. We really appreciate the time, perspective from Werner Management today. And thanks for everyone for being with us.