Barclays 2021 Industrial Select Conference (Virtual)
Werner Enterprises (WERN), February 17, 2021, 10:50 EST
Barclays analyst: Brandon Oglenski
Werner Enterprises: Derek Leathers, Vice Chairman, President and CEO. John Steele, EVP and CFO.

Brandon Oglenski:

OK, good morning, everyone. And welcome back again to Barclay's 38th annual Industrial Select Conference. I'm Brandon Oglenski, airline and transport analyst. And next up on the transport track, we do have Werner Enterprises. And in fact, I think it's their first time attending this conference in 38 years.

Welcome, gentlemen, really appreciate having you. And for those that aren't as familiar with the company, Werner is a predominantly truckload, asset-based carrier based out of Omaha. 2020 had a revenue of about $2.4 billion and operating margin, I believe about 10% last year. I know we're going to talk more about that. But joining us from the company today is Derek Leathers, Vice Chairman and CEO. And I think soon to be Chairman as well. And John Steele, CFO. And both of them have been with the company for a number of decades. And I can say this from the heart, John might be the nicest CFO we cover as well.

Thank you, gentlemen, for both joining us. And as usual at this conference, we do have the audience response questions. If you're an investor listening to the webcast, we'd love if you fill out the survey questions here, asking about your ownership and sentiment on Werner. And if you have any questions during the live webcast, I believe there's a question link that will email me directly. We can read that out loud here.

Gentlemen, thank you for joining. And I'm just going to kick it off very short-term focus. But obviously talk more about the long-term as well. But I've heard it from every railroad, every transport, every airline. That 1Q weather is pretty challenging right now, I think half the continent is frozen. Can you talk to how those dynamics are impacting your business right now?

Derek Leathers:

Sure. Brandon. Well, first of all, thanks for having us. We're happy to be here and spend time with you today. The first Q1 weather has been a significant challenge to say the least, this is incrementally more difficult than regular weather. Obviously, weather is always a factor in the first quarter, as we've been working our way through this storm and will continue to dig ourselves out of it over the next, probably several weeks. There are a lot of known and more quantifiable impacts that we wanted to share everything from, you know, down drive time, to driver pay where we need to pay them, because it's certainly not their fault that they're not able to move all the way through tows and jumpstarts and everything else. The teams are managing it very well, but there is a clear-cut impact in the quarter. And I'll turn it over to John and let him talk through some of those numbers.

John Steele:

Yes, we've taken a very aggressive safety-first approach to what's happened with the weather here lately. Nothing we do is worth hurting ourselves or hurting others. And we're really focused on taking care of our drivers who are in remote locations at times. And it makes sense to park their trucks until the weather clears. From a cost standpoint, really it's drivers, it's operations, it's even our driver training schools. We've had several that are shut down due to the power grid impact in the markets in which they serve. As a result, we did our best estimate of what we thought the impact was, based on what we know at this time and anticipate for the rest of this week with the latest storm. And we expect that the negative earnings impact on first quarter will be in the three to four cent per share range based on what we know at this time.

Brandon Oglenski:

Ok. But I assume that a lot of this is just really mother nature related, right? Nothing from a commercial standpoint that has you guys a little bit worried here?

Derek Leathers:

No, not at all. Actually, it's exactly that. This is the incremental impact of above normal seasonality of mother nature, if you will. What we're going through right now, it's not throwing the kitchen sink at the issue. It's trying to gauge it versus what a normal winter would look like. It's certainly not systemic. And arguably, if anything, what it will do is extends the cycle as it relates to inventory restocking. It extends the cycle as it relates to overall demand. We came into the storm, very oversold. And so, before any of the weather impacts took hold, we were in an oversold environment with very strong demand. Right now, we're at an extreme oversold environment.

Obviously, that's weather related. We'll have to dig out of that over some period of time, but some of the direct costs to John's point about being safety-first at all times are, we've literally had to shut down. And at certain points we've had in the thousands of, out of a total of 8,000 trucks, roughly, we were north of a thousand trucks that were shut down at any given time over the last couple of days. And that can be painful on your ability to produce. But it's, short-term in nature and we'll get through it.

Brandon Oglenski:

Yes, that sounds pretty significant, Derek. I mean, what would it be in a quote unquote, normal winter environment for you? A couple of 100 trucks or-

Derek Leathers:

Well if that is that, in a normal winter environment influence that, it's usually for a couple of hours, a few hours. It's usually revolves around road closures and then waiting for something to

reopen and, or high winds. This is more widespread. In your 40 States in the United States right now that have some snow event or some sort of snow precipitation, that's way more widespread. You've got ice, which is more dangerous than snow. And especially you've got a bigger impact in the southern states where they're just ill-equipped to be able to handle what's going on at the roads. The power outages obviously put another wrinkle on it, because if you don't have power, if you don't stop, you don't have fuel. If you don't have power at our terminals, you're unable to really conduct business normally. Now we have backup generators in most of our sites, and many truck stops do as well. But that is a real issue and we've seen closures and other things that impact our ability to dispatch a truck on a particular route.

Brandon Oglenski:

Gotcha. Sounds like mother nature is pretty challenging right now. I guess if I could talk a little bit longer term then. If I look at your stock valuation or even some of your peers in the truckload business, we're trading near half the market valuation. And I know you guys aren't necessarily focused on day to day trading, but I think the perception from a lot of investors that we're near peak on demand versus supply in the market historically. And trucking rates go up a lot, which I think you guys are talking about this year as well. The industry will add a lot of capacity. I guess, do you want to refute that? Or is this cycle potentially going to play out a little bit longer than people anticipate right now?

Derek Leathers:

I'd love to talk about two things. Let's start with refuting the logic around this company and our secular story. I mean, the rap on Werner traditionally was that we didn't get our fair share during an upmarket or a strong market. We clearly demonstrated that wasn't true in '18. We re-demonstrated that in '20. And so that ability to perform in a strong market, like those two years were, and what '21 is setting up to be, has been, I think, demonstrated through a multi-year example. The other rap would be obviously that trucking is cyclical and Werner's in an up market, they always claim too defensive. But if you believe that and you buy into that, then great. Because nobody's going to have a more defensive portfolio set, than what we have right now, whenever this cycle may change.

I'd point further that in '18 and a strong market, how we performed and kept pace with the best-in-class carriers out there, as it relates to margin and achievement. But then '19, in a down cycle year, our earnings didn't go negative. We held the line and didn't back up. And that's what we've said, we'd be able to do. And so, we think '21 is a year to expand earnings over '20. And then the goal would be if, and when, that cycle changes to draw that same line, and not back up from there. We think the defensive nature of our portfolio sets up very well for that. And we don't run the business based on quarterly estimates or quarterly sentiment, per se. But yes, it is a little baffling to me because the very people that think of our portfolio as being too defensive, seem to not be, finding it desirable, for it's the very defensibility that they have concerns about in other times.

Brandon Oglenski:

Okay, Derek. I think that's a great point that in '19 you didn’t see the earnings challenges, and some of your other competitors did. Can you talk to how you instilled a more defensive mix in your words, inside the business relative to maybe what it was in the past?

Derek Leathers:

Yes. There's really several legs of the stool. It's at the highest-most level, it was reevaluating who could we do business with and why? And I have this philosophy around aligning our business with winners. And so that means winning companies with winning models that have winning management teams with strong leadership. And if you do that, they tend to be also more cycle proof. They tend to find a way to persevere during down cycles or tough times. They tend to view their supply chain as a competitive advantage. They tend to view their supply chain with a longer-term horizon, and they tend to view their supply chain strategically. It starts there. You go down one rung on that ladder, as you will. And you start talking about, okay, now, where do you place the trucks within that? And we wanted to have a shift from One-Way you-call we-haul kind of commoditized business to get closer and closer to that extreme service business that has high expectations. There's very few that can do and perform well in that space. And so, we don't just look for designated fleets, that are being bid or offered as a Dedicated opportunity. We want true, Dedicated, hard to do, 99 and a half percent on time or better, multi-stop, driver touch. A variety of characteristics that are hard to duplicate. And now we have 63% of our fleet in Dedicated. Within One-Way, that remaining portion of the fleet we want to focus on our franchise which is Mexico cross-border we’re very strong. Our Canadian cross border operation is a differentiator as well. Team expedited is a differentiator. And the last one is making sure we engineer as much in that One-Way network as we possibly can, to create repeatable, return to home type employment for drivers, so that their lifestyle is very similar to Dedicated. Although the freight, they all will vary from day to day.

You do all of that, and you come up with something that's extremely defensible. It was engineered One-Way. Low rate lanes can be done at a very high efficiency level. And it makes it hard to displace it, even as the market rates are going down, because we can perform with high margins at very competitive rate levels, because of the engineered nature of the business.

Brandon Oglenski:

I guess, can we talk about the shift in Dedicated and the customers that you're seeking? And I hate to reference one of your competitors, but we understand the Dedicated business at JB Hunt pretty well. They'll talk about private fleet conversions and not necessarily just going after the run of the mill opportunity in that segment. Is that sort of the direction you guys are taking as well?

Derek Leathers:

We certainly look at private fleet conversion as one of the opportunities. We certainly don't look at run of the mill Dedicated opportunities as something we're real interested in. I think there's a tremendous amount of Dedicated business out there today that is anything but run of the mill, but may not be a private fleet conversion. It's got to be hard to execute, true Dedicated, as I mentioned. We like the advent and growth of e-commerce, because Dedicated fleets built around that have extremely high service expectations. We like successful retailers. Retail has been under duress, but within that, there are retail stories that are doing phenomenally well.

We're big in the discount retail space in particular, because it's more cycle proof. We're big on home improvement, because it's more cycle proof. And then the last piece is making sure as you add those Dedicated fleets, it's always with an eye toward building kind of the pieces of the puzzle. We want countercyclical surge events. We want Dedicated that surges at different times during the year, so that we can actually cross pollinate and utilize fleets to maximize and sweat the assets. It's beneficial to our customer from their cost perspective. It's beneficial to us because we can better utilize those very expensive assets.

Brandon Oglenski:

And Derek, is there any way that, that is also working together with the more engineered nature of your One-Way network as well?

Derek Leathers:

Well, sure. I mean, there's cross-pollination between One-Way and Dedicated. One of the reasons we used to talk about having 60% being kind of the cap we thought the Dedicated fleet could be, was we relied a lot on the One-Way assets to provide that surge and provide that flexibility. As Dedicated got bigger and bigger, we started to learn and get better at relying within our own Dedicated fleets for that surge, and being able to utilize assets better to lower our customer's costs, but also increase our margin potential at the same time, which is great if you could do that.

And so that 60% barrier was removed and we talked about a 65% barrier. I actually think that's a soft barrier, if one at all. We've modeled recently and believe north of 65 is very possible. Maybe even approaching 70% someday. Right now, we're, as I said, we're at 63 on our way to 65 this year, probably. And we'll revisit throughout the year to make sure all of our assumptions are still correct. The specific engineered drivers inside of One-Way, they're on pretty regimented schedules. I mean, they're going to work at a specific time going home at a specific time. Those aren't the drivers that would then bleed over to Dedicated. It would be more than One-Way over the road folks. That the further we can be careful about how much exposure we have to that, commoditized end of trucking, the better I think we'll be over the long haul, over the full cycle.

Brandon Oglenski:

Gotcha. And I think as it relates to this year, you guys have guidance to fleet growth of one to three per cent, is that right? In aggregate?

Derek Leathers:

Yes, we've got it to one to three per cent and that is almost predominantly driven, not by opportunities, but by ongoing structural supply constraints. There's this fear about all this capacity coming. I don't think it's on its way. I don't think it will be here anytime soon. I think you start at the production level, or the manufacturing level, and you look at OEM comments and public statements, and it adds up to roughly replacement level builds, regardless of what the order board says. Even if you look at the order board and you factor in the six months preceding August and the six months subsequent to August, and you put them together. It's a replacement cycle level order board. They're not going to be able to produce 400,000 trucks this year.

They're not going to be able to produce, in my estimation and their own words, 300,000 trucks this year. You're looking at replacement level. In the event, vaccinations accelerated, in the event that somehow there's a breakthrough on some of the supply shortages of parts and other things, and they were able to ramp up later in the year, the driver shortage is still alive and well. And it's more significant this time and more structural. Schools produced nationwide last year, something in the neighborhood of 40% less graduates. The Drug and Alcohol clearinghouse took out 56,000 drivers out of the mix, with less than half of the fleets actually registered into the clearinghouse. And now that number up ticking to, it'll get near a 100%, I think throughout this year.

That number of 56 is likely to double if you look at the advent of the number of states that added more drug legalization across the country in November. That's only going to make that drug and alcohol clearinghouse be more of an issue. I don't believe the calvary is coming anytime soon, as it relates to capacity. But our job is to do the best we can to increase capacity with the trucks we have.

Brandon Oglenski:

Yes. I think you said, the up cycle, you want to be aggressive with your rate structure and said, I think contract rates of up high single digits or low double digits, is that still the view? Does the constraints in the first quarter in any way maybe boost that a little bit?

Derek Leathers:

I think that's the view, because it's too premature to do otherwise. I can tell you that in renewals we see those numbers or higher, but you've got to get those numbers or higher based on timing, to be able to move the needle on your overall rate structure. We're going to ask to be paid away, fairly for the amount of reinvestment this industry requires. It's a very capital-intensive industry. And we need to make sure that we ask to be paid with the services we're providing. High single

digits or low double digits on the One-Way side, three to five per cent on the Dedicated side. Those have opportunity potentially to be better than that. But we're not straying from our roots, we're pretty consistent and pretty conservative with our guidance. We'll do the best we can to make sure and maximize shareholder value throughout the cycle.

Brandon Oglenski:

I appreciate that. And on the Dedicated side or even more broadly, I guess when we see rate increases though, that usually means driver wage increases as well. Can you talk about inflation protection on your Dedicated contracts? Is that something that you have built in?

Derek Leathers:

Yes. Probably the best thing, the thing that allows me to sleep best at night, with all of these different obstacles, whether it's storms, COVID, social unrest, driver shortages, et cetera, is the fact that 63 on its way to 65% of our fleet is in Dedicated. And so, when we have wage pressure there, first off, those drivers are paid way more. That Dedicated average W-2 is going to be significantly higher than the average U.S. W-2 for an over-the-road driver. It's the starting point is better and more defensive to begin with. The quality of life is better and more defensive to begin with. And in the event in a particular hotspot that were to come under pressure, it's a dialogue with a specific customer.

It's not trying to go out and get some GRI to cover your need to raise wages. You're talking to the customer and talking about what the fleet-seated ratio is, what there needs to be, what the truck count is and where it needs to be. And you're making a joint decision on driver wages. So, I think it puts us in a much better position to manage through that as this year develops.

Brandon Oglenski:

Gotcha. And John, on the demand side, you often will provide some analysis of your top customers, their inventory situation. Is that still a pretty difficult situation for your customer base?

John Steele:

Yes. We'll be getting updates from the large retailers here in the next couple of weeks as they report their earnings for the year-end January. But the last update we got publicly through the end of October showed still really tight inventory conditions. And since that time, we had increases in COVID activity that slowed the ability of their suppliers to be able to deliver the merchandise they needed. The winning customers that Derek referred to are in our customer base. And the same store sales growth that they've had this year has been very, very strong. And so, even though they expected to make up ground on inventories, the fact that their e-commerce and overall sales have been so strong, has meant that there's still a big gap between their sales growth and their inventory growth that they've had. We see a market where the inventory levels

will be challenged for several quarters going forward, based on all the factors, COVID-included, that impact their ability to restock inventory.

Brandon Oglenski:

So, you're not too worried that as, hopefully we get vaccinated and start getting on planes again, that sort of behavior shifts. And you're out of demand later in the year on a relative basis.

John Steele:

As we get late in the year, I think that you'll see some catch-up effect occurring, but I think it's still multiple quarters before they get the inventory levels back to where they would like to be. Just think about the e-commerce business. E-commerce by its nature requires more forward-deployed inventory that's closer to the end consumer that's making the purchase. And so, the inventory level that's needed is actually higher with the e-commerce volumes being greater, than it would have been for normal pick it up and buy it in the store deliveries.

Derek Leathers:

Yes. I would just add that on this issue of wallet share shift, which I think there'll be some of that. But the bigger issue in my mind is that, as we sit here today, we're still well below pre-COVID levels in terms of total transportation employment for the industry, total truck count for the industry. Both large and small truckers shrank in 2020. Which is very uncommon. Usually one shrinks at the expense of the other, and both large and small showed shrinkage in 2020, and yet volumes are significantly higher. Even I think the more likely is you see a plateauing of this product-based focus and an increase in the service space, wallet share if you will, but, you're the starting point is still a driver-constrained, truck-manufacturing-constrained environment with higher net volumes than they had going into COVID. And so, best-case scenario, in the event you saw some major swing. I don't think you're out of the house and engaged and involved in going to ball games and big gatherings till pre-peak or peak season this year. And when you get to that time of year, people do one thing consistently, and that is they buy. They buy leading into the holidays. And they're not going to not buy this year and tell kids' nothing's under the tree, because we're going to go to four concerts instead. I like the set up for '21 quite a bit.

Brandon Oglenski:

Well, my, my kids might be suffering. Derek, can we talk longer term here? I think you guys have raised your long-term margin targets as you, I think, exceeded them in the last quarter or two. Can you talk to some of the changes there, and I want to come back to the idea that you're not going to give a lot of this back, when inevitably the cycle does turn a little bit more challenging?

Derek Leathers:

Yes. I mean, we updated our guidance. We spent a lot of time thinking about it, and trying to be again, consistent and conservative with our guidance, and make sure that we do what we say we can do, and feel comfortable through the cycle. How we got there is we've been aggressively pursuing excellence in every corner of this building. And one of the places that Werner wasn't traditionally excellent, was in the cost control side of the business. Our revenue per truck per week has been a leader for years, many, many years. And yet we've come out the other end with margins that were lesser than certain competitors. Still at the upper end of the range of the overall industry, but not at the best-in-class level.

So, we had to get equally serious about the cost side. That's more of a culture shift and one that early on, you have to will it to happen. But eventually it really takes root and kind of grows on its own. Right now, we have a culture built around cost containment and cost controls. I like the opportunity to just pick that whole range up and move it more aggressively toward best-in-class levels. And at times we will be at the high end of the range. There'll be times where opportunities present themselves to be out of the range, to the positive. We're going to defend the other end of that range, like the Alamo, and fight to the very end.

I don't see any reason with the mix of our portfolio, with the type of customers we're doing business with, and with the culture we built, that there's any risk of falling off the shorter end of that range, the less performing end, if you will. So '21 is shaping up. We've already talked about, we expect to be in the high end of the range, and we'll work our tails off to be outside if the market is there and it presents us the opportunity to do so.

Brandon Oglenski:

I appreciate that. And can you talk about your 5T strategy? And I think you've recently added sustainability to that as well. And how that's helping shape the culture of the company? Because personally, I think these are important things.

Derek Leathers:

Yes. I do two, obviously. Look, I'm a simple guy. I like simple messages and things that people can wrap their minds around. And when I became CEO in 2016, one of my concerns is we didn't have simplicity in what we were here to do. And that's safely service our customers every day and do it on time, every time, but safety at the forefront. How do you do that? You got to figure out where are you putting your money at and why? And the 5T's defined it and still defines it, and it will continue to define it. But if we're not spending money on the best possible talent out there, to make sure that's who we're bringing into the organization, both drivers or office. And then giving them the best equipment in the form of trucks and trailers for them to do their jobs, backing that up with the terminal infrastructure, so they can perform at a very high level, and then wrapping it in the best tech. Then we're not going to have this through cycle, sustainable, best in class results.

And so, we're not swaying from that strategy at all. The S is sort of the overarching umbrella over the whole thing. And it's probably the most important thing, as it relates to all of that can be done with an eye towards sustainability, with all of the principles of ESG wrapped up in it. And so, we do think we have a commitment and a responsibility to the environment. We've come out with some pretty lofty goals of a 55% reduction of our carbon footprint by 2035. That's both with known and in certain cases, still to be developed technologies. But we're at least in beta or knowledgeable of those technologies right now. We're going to continue to drive on the environmental side.

And on the social side, we think we have a responsibility, like all corporate America does, to lean into that, and do better, and listen more and maybe talk less, and improve our results in that area. And we're going to be focused on doing it.

And then governance, we've always been the gold standard of governance in my view. We're going to continue to do that, but we've still made moves to further improve. We recently made a change on our board to bring on somebody with an extensive experience in diversity and inclusion and who as well has a strong resume as a founder and CEO of a growing thriving business. And with the addition of Carmen Tapio, we think she's going to help us accelerate some of those learnings. I'm real excited about ESG. I think it can be done and done profitably. It's not something we're reluctantly showing up at the party. We're going to make it part of our fiber just like the other things that I've talked about are.

Brandon Oglenski:

Guys, I appreciate this chat. We could go on for over 20 minutes, I think. But we're running up against time. I want to get two more in here.

And you guys did talk about this conversion to Mastery or partnership there, moving to the cloud on your IT systems side. I'd love to hear more about that. And then Derek maybe longer term, I mean, I'm not a huge proponent of autonomous tomorrow, but it's coming. How does it reshape the truckload business where, at least in my view the drivers, the real value proposition that you guys bring. How does that change the outlook for you guys?

Derek Leathers:

Yes. I'll try to weave all that together if I can. First and foremost, I know one of the things people think about when they think about Werner is that we're not involved in M&A. And a part of that is because we had a line of sight to improve margins and best in class performance. And we went and invested in this business first to do that. And we've done it.

We are though open to investment and being on the leading edge as it relates to where technology is headed and what it can do for us. We think Mastery and our entire strategy around going cloud-first, cloud-now is something that accelerates our digital transformation. We think

Mastery allows us to have a better-connected ecosystem for the core operating units of this business.

We'll still maintain and build out a lot of the secret sauce that allows us to provide the number one revenue per truck per week in the entire industry in the fourth quarter. And we're going to continue to make sure that the optimization and things that we do that we think are special and different that we still do in house. But Mastery provides a platform, a cloud-based platform, for us to do all of that work more, and less of the blocking and tackling of load ingestion and EDI, and some of the basic, the back-office functionality and seamless visibility. And we think it's a great team. We're excited about that.

As it relates to autonomous, look, we believe it's real. We believe it's coming. We believe electric and/or hydrogen is real and coming. I think it is in the out years. It's not tomorrow. It's not around the corner, but this is the time for us to be more infused in the conversation. To be on the inside, looking out.

And so, the investment we made in TuSimple was an opportunity for us to do that. We already have those conversations with our OEM's. We continue to stay close to them and the developments they're doing. But kind of that startup entrepreneurial environment sometimes creates a little more openness and open-mindedness about what it might look like. I don't think it's displacing the driver anytime soon. We did some analysis from now to 2030. And if you were to assume that by 2030, every truck sold was an autonomous truck, which was way too aggressive in my view, but let's just make that assumption for a second. We think there's still a need for incrementally of a million new drivers to come into the industry over that decade. And that has a lot to do with still needing to do the dray on the front end and on the back end. Still needing to recognize the life cycle of a truck. And even with a thousand or 100% sales rate in 2030, you're still talking about a fairly limited overall penetration rate. There's a lot of need for professional truck drivers for as far as the eye can see. We got to take care of them. But we have to have an eye toward how autonomous will play a role in this industry longer term, and what niches and places and geographies will work and where do we think it won't.

Last thought on that. As our Dedicated portfolio in particular is, sort of uniquely positioned defensively once again. As we think about autonomous, there'll be opportunities for us to utilize it, but in Dedicated, these are high touch, high involvement, high engagement work activities, short length of haul things. There'll be the last frontier before autonomous ever gets there. That's yet another layer of defensiveness that we have built into what is still at this point, yet unknown.

Brandon Oglenski:

Well, Derek and John, I apologize because I think we're over time now, but really appreciate you guys coming to the conference and hopefully we can do this in person next year.

Derek Leathers:

Absolutely. Thank you for having us and look forward to Miami versus a virtual, someday soon.

Brandon Oglenski:

Thank you, guys.

John Steele:

Thank you, Brandon.

Derek Leathers:

Thanks, bye.