Morgan Stanley Laguna Conference (Virtual)

Werner Enterprises (WERN)

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Ravi Shanker: Good morning, everyone. Next up we have Werner Enterprises kicking off the TL portion of the day. Very happy to have with us Derek Leathers, President and CEO; as well as John Steele, EVP, Treasurer and CFO. Gentlemen, thanks so much for joining us.

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With that, Derek, John; welcome to the virtual Laguna conference, obviously a bit different versus where we were at the Laguna conference last year in terms of where we are in the cycle. Maybe you can kind of take us through what you're seeing out there. Clearly the market is super-hot, but there are some initial kind of just whispers, hints of maybe it's kind of cooling from being kind of as red-hot as it was over the summer.

Are you seeing that? Are things getting tighter? Kind of which areas are you seeing the tightness in particularly, maybe just the demand would be a great place to start.

Derek Leathers: Sure, Ravi. First off, thanks for having us. We appreciate being a part of this conference. And you're right, Laguna would be better than webcasting from Omaha. But on the demand front, it's been strong and consistently picking up, starting really in May. But when you get into June, that strength really started to build more noticeably. July was one of the strongest Julys we've seen on record. July is traditionally the second-worst month of the year, February being the worst month. And there was no indication of anything like that this July. You get into August, and we've seen building from there. And it still is very tight right now.

As for the whispers, I can't speak to what is causing some of those concerns. What I look at is what's the overall backdrop. And the overall backdrop right now is inventory levels are at historic lows. The amount of restocking that's still ahead of us that needs to be done is significant. Peak is still around the corner, with all the changes in 2020. Christmas is still on the 25th of December. People are still going to be shopping and buying and participating. Consumer is engaged. If you look out across same-store sales of successful retailers, they've done very well through COVID and very, very well since, as things have started to reopen.

So, our perspective on it is demand is strong. The setup is strong. It's wide-based. You mentioned geography. I think that's important to talk about. There's often times in trucking where a carrier might be way oversold. But if you look under the covers, what's really true is that maybe the West Coast is very strong, but there's pockets of weakness that balance it out. And so, you end up with this imbalanced strength. And that's not good for utilization. It's not good for optimization, production, and ultimately your financials, not as good anyway, as when you see it wide-based. And right now, it's wide-based geographically across the country. Certainly, the West is even stronger still. But the rest of the country is plenty strong to keep the networks flowing.

So, there's a lot of good news to tell right now. There's a lot of strength as we look into peak. Our conversations with shippers remain strong. Their conversations and projections around this peak season are strong. So, the setup is really good in my view.

Ravi Shanker: Got it. Derek, I think the important thing in what you said that really stood out was what you said, the inventory levels are extremely low, and restocking is largely ahead of us. But we're already at a truck spot rate that's almost at all-time high levels we last saw in 2018. That would imply that pretty much the entire runup in the rates we have seen so far has been driven by the supply side. Would you agree with that kind of, and what are you seeing on the supply side that's been driving that? And more importantly, is that over, or is there more to come in terms of supply tightening in the coming months and quarters?

Derek Leathers: Yes, it's a great question. I mean so a few things on the supply side. I mean first off, let's talk about some of the math behind it. There's 100,000 less CDLs that were issued in the first 6 months of the year, year-over-year, to new CDL holders. That's probably the best window into what does the COVID-reality look like, and what happens when SDLAs were shutdown around the country, when driving schools were forced to go to social distancing, and when frankly the appetite to enter an over-the-road, frontline worker-type environment for new entrants wasn't what it once was.

You couple that with retirements that are on the uptick. So, you've also got on the other end of the spectrum, this is an older demographic industry. Our driver demographic is about 10 years below the industry average. But there's a lot of drivers out there in that sort of at-risk category that have over the last few months, we've seen retirements accelerate. So that tightens the truck/driver supply even further.

Drug and alcohol clearinghouse was 30,000 new names in there with 90% of them -- 80% haven't even attempted to kind of come back. 90% are nowhere near any ability to come back and be reinstated, and 10% are in the process. But very few have actually been able to reenter, once they've entered into that clearinghouse. So, you think about that on an annual basis, and I think it's a very comfortable number to think about somewhere between 200,000 and 250,000 less drivers this year on the entrance side and/or elimination side. Then you layer retirements on the top of that. And retirements will continue to I think be accelerated.

So, supply is going to be constrained. It's been a big part of a story. But I think folks underestimated the consumer in all of this. PPP was pretty stabilizing in its effect. People have money, where there's tons of studies out there that talk about what's happened in people's individual bank accounts. They've learned and transitioned to an e-commerce world versus a brick-and-mortar world, maybe more rapidly than they would have without COVID. But they're still out participating.

And so, when we think about demand today, one of the interesting things that I think gets overlooked is we are vastly oversold as an industry right now. Capacity is very tight, and the economy is not fully opened. This is in a semi-opened economic state. So, as the economy opens up further, as people continue to participate and the consumer stays engaged and there's a lot of structural headwinds, not disciplinary actions being taken by carriers where they're being disciplined in their approach. It's just structural headwinds that make growth difficult. I think it stays this way longer than people realize.

The last piece I'll throw in there is just the simple reality around any manufacturing environment today, and that includes OEM's. They've been up and then they were down. They were closed and then they were up, but with reduced production. I don't think a really reasonable person believes that we're going to see OEM production at full scale for an extended period of time without interruptions as we go forward. So yes, people are going to have some urgency around their orders. They're going to think about making sure their truck orders are in, because nobody knows exactly when these interruptions and the truck supply chain will happen. And at least at Werner, we don't want our fleet to age. So, we're going to make sure we've got our place in line, so to speak. But our guidance is a range of negative 1 to negative 3 fleet growth in the back half for an annualized guidance, and we think that's where we'll be, and certainly very little risk to being on the high side of that, because that's just how tight it is and how difficult growth is today. And that's for a well-capitalized carrier with very low turnover, with a strong morale right now within our fleet. Many fleets are not in that position, and that growth will be even more difficult for them.

Ravi Shanker: Got it. So maybe piggybacking off that comment on the supply side, I think historically investors have gotten a little bit nervous whenever rates have hit an all-time high, because while obviously currently the market is really tight and you guys are doing really well, that's also typically a sign of supply coming in to normalize those rates, and that typically marks the end of the cycle. But it looks like this time may be different, given some of the demand-supply dynamics.

So again, you've touched on a few of these points. But do you have confidence that these rates are sustainable and can push to new all-time highs, given that big demand wave that's ahead of us and some of these supply constraints? I mean do you feel like the new supply coming in this time is going to be more restrictive than it typically is?

Derek Leathers: Yes. I think it will be. I mean I think the reasons I outlined are bigger than maybe are fully understood on the driver side. On the equipment side, there is uncertainty there. On the recent order level, you're talking about replacement or even slightly below replacement levels, when you factor in fleet aging due to OEM shutdowns, meaning people's fleets have aged by 2/10, 3/10 of a year. We don't like that. We pick our ages based on our models and based on how we feel is our best operating ability. And so we're going to, at Werner, work to make sure our fleet age freshens slightly over the coming few quarters. And that takes truck orders to do that. We're not looking to grow our one-way product. Dedicated will grow over time.

I think there are structural headwinds. I mean one of the things that I think is interesting is there's a belief out there that there's 15% capacity still sitting on the sideline that's going to come back at some point in the future. Well going back to your opening question, you know if spot rates are at all-time highs and if the market is as hot as all of the spot indicators would portray, there are truckers that sit those out. I mean they're not just sitting on the sideline in this market. They're back in. Or if they're not back in, it's because they're struggling to come back in, because of these very structural impediments that I'm talking about. So, the calvary is not coming. There's not some big wave of people on the sideline that are going to suddenly enter in our view.

There's an appetite across carriers to grow longer-term structural business units like dedicated. But there's very little appetite for anyone -- nobody's talking about trying to grow their one-way business, because of some of the volatility that we're speaking of right now. Our one-way business is more than booked, and our biggest concern right now is, I've never spent as much time as we've spent this year conversing on how are we going to cover or be effective during peak. Because we're at peak levels today, and peak hasn't started. That's new. That's a new phenomenon. And so, I think the -- and I'm talking about peak as it relates to freight volumes during the peak season. And so, there's more volume coming, and we know that from committed conversations with customers, and we're going to work our tails off to make sure to fulfill their expectations. But it's going to be tough.

Ravi Shanker: Great. Derek, on the fleet comment, it's kind of very encouraging to hear kind of all the large carriers basically saying what you're saying, which is they're not looking to grow the one-way fleet. And if anything, if there is going to be any growth, it's going to be on the dedicated side of things. Is that -- are you having similar conversations in the marketing and sales side with your customers, where if customers are kind of coming to you for more capacity and more growth; are you actively trying to push them to the dedicated side of the business, given the stability and kind of visibility in that business?

Derek Leathers: Yes, under normal circumstances, that's exactly kind of the activity that would be going on, meaning we would be talking to them about dedicated, and we still are today. Make no mistake about it. But dedicated, our pipeline there is as robust as it's been in a long time. We started commenting on that in the fourth quarter of last year, and we've reiterated those comments each quarter on each call. So, my point being there's not a lot of selling needed right now to garner interest in dedicated. The real work to be done there is sifting through the opportunities to make sure they're truly structurally dedicated in nature, meaning we want to participate in businesses that are hard to serve, high driver input and activity, service levels at 99.5% or better, with expectations that can't be displaced someday by a one-way product.

So, if somebody wants to hide out from the one-way pressures that will certainly exist over the next several quarters, by creating a designated fleet, that's not the kind of dedicated that we're looking to do. Because we know those things will go the other direction someday. The business we have in our pipeline is this vetted, high-service, high-activity dedicated with winning customers that we believe have a model that succeeds in good markets and bad. So that gives us a lot more confidence, as we think about our future and our future mix.

Ravi Shanker: Got it. So, given that demand and supply construct, what does the pricing environment look like for the back half of this year and into '21? Obviously in 2018 when we had similar conditions, I think contract rates were up double-digits for the large TL carriers, including yourselves. Is that -- are we looking at something similar for 2021 and kind of what are some of the early bid conversations you're having right now?

Derek Leathers: Yes, so I think a couple of things there, commenting on relative to that. First off, so 2018 rates came off of a very low base, as you think about '16 and '17 building into '18. We at Werner, I'm not going to speak for the industry. But here at Werner, even in '19, we did very good job of holding onto those gains we made in '18 through '19, and then into '20. And so that baseline has been -- or that bar is starting at a higher point in a more elevated position, if you will. With that said, the setup is better today than it was going into '18 in terms of supply and demand. The constraints and tightness is tighter than it was going into '18. And some of the pressures will be real, not yet, and we're not experiencing them today, but that we are having to start thinking about this new normal with driver supply. And so, we've got to make sure that we price appropriately to be able to take care of our drivers and attract new entrants into the market, as well as continue the progress we've been making on pulling away experienced drivers from other fleets that have found the Werner culture to be a better fit for them.

Ravi Shanker: Got it. Maybe shifting gears again, Derek, or maybe John; how do you think about the cost side of things? Can you remind us again, obviously 2Q you and the rest of the industry did a really good job of -- and are downsizing your discretionary cost base to adapt to what was going on. Can you remind us, how much of that maybe comes back as the volumes return in 3Q and beyond? How much of that can be permanent and kind of with this new environment, how do we think about driver wages over the next 6 to 12 months?

John Steele: Yes, Ravi. We already had several cost initiatives in progress before the pandemic hit in March, and clearly, we doubled down on the cost initiatives when the pandemic started to address the uncertainty of how long would COVID last and how difficult would the environment be. We have something on the order of 170 items with $20 million of cost savings in 2020 that are already in place, and that's growing. That's procurement. That's productivity. That's efficiency. Our non-driver side of our business is improving significantly due to productivity and efficiency enhancements. And we expect that to continue.

There will be some things that will come back, like medical expenses and travel. I don't think they'll come back all the way to where they were pre-COVID. But they'll come back some, as people start going to the doctor more, and as the economy starts traveling a little bit more to hotels and commercial airlines to conduct business. But I think some of that will be a permanent reduction. So overall, we think the cost savings that we've achieved, most of it will be sustained. The only couple of things I'd point out that are sequential cost headwinds, they're more minor, are we renewed our liability insurance August 1st. That's on a quarterly basis, that's about $1.8 million per quarter, and that went into effect August 1st. So, it's $1.2 million in the current quarter.

Also, the driving schools are operating at 70% of capacity, so it's hard to be as effective on the revenue side, the cost side, in an environment where you're 30% less productive than normal. So those are a couple of challenges that we're dealing with. But overall, we feel really good about the cost improvements we've made, and keeping most of those as we move forward.

Ravi Shanker: Got it. And how would you describe the driver environment right now? How hard is it to find drivers and kind of what are we looking at in terms of wage inflation through the next 12 months?

Derek Leathers: Yes, so it's a tough driver market. We've talked a little bit about that, all of the different social distancing constraints of the school networks, people not really being as open to wanting to switch jobs or companies, or go through the "welcome experience," as we refer to it, or orientation, if you will. It makes it tougher. The good news for us is, look, we've leaned into our culture during COVID. We came out early with our COVID relief plans. We came out early with our COVID taskforce. Our drivers have seen our values in action. Turnover is down. We've really kind of, I think, been able to increase morale during the difficult period with some of what -- the kind of Werner belief system that I care about deeply. That's enabled us to now become an even more attractive destination in the marketplace, because drivers talk.

So, we've been able to position ourselves very, very well. So, whenever we think about a tight driver market, it's sort of a net positive for us in our view. The tighter that market gets, the better winning formulas will do. And so, we have a vertically integrated school network. We have a strong culture and we have low turnover. You put those together, and I think we weather that better on a net basis than the aggregate of the industry. So, we're fine with it. I'd like to see obviously people be comfortable coming into the industry. But social distancing is here to stay for at least a few more quarters. And so those schools are not going to get to 100% production, neither ours nor anyone else's. And so, it's going to be constrained.

The one nice thing in our business is over 60%, or just slightly over 60% of our fleet is in dedicated. Those are one-on-one conversations. When we need to raise wages in dedicated, it's literally we, us, the customer together need to have that conversation, and we need to decide what we need to do to make sure that that fleet is fully seated. So that insulates us from some of the impacts of driver wage inflation, because we're going to work with them. We're only going to do it if it's the right thing to do and we both agree on it.

On the one-way side, the capacity is tight. They know that. In order to add capacity, rates are going to have to go up. And we're going to have to get more creative. And we're going to have to push rates where they belong. And in that, there's going to be a share of that that's going to need to go to the driver. Right now, we don't have widespread driver wage pressure. There are certain spots or certain fleets where we're doing work even today, as appropriate, but with our customers' support.

Ravi Shanker: Got it. So maybe kind of switch gears and kind of move away from the trucking business and talk about logistics for a few minutes. So maybe two questions there, one, in the near term, kind of what are 3Q trends like in the logistics business? Obviously, the market is super tight, so that should be good for revenues. But maybe the margin is under pressure.

So maybe you can give us some color there. And second, what's the long-term future of that business? Obviously, the pressures kind of that the digital entrants have brought on, on pricings and margins, have been kind of well-telegraphed. How does Werner play in that space over time?

Derek Leathers: Yes, so I mean in the short term, the pressures are there for sure. I mean there's margin pressure in logistics. We know how tight the capacity market is. We're going to be suffering from those margin pressures, just as other shippers and/or 3PLs, are. We are working with our mix all of the time. We believe that 50/50 contractual/transactional mix is where we want to be. We're approximately there today. We are able to move the transactional business from a revenue perspective through rate fairly quickly, and we're doing so as we speak. We're also having contractual conversations with customers about just how tight it is, and looking for relief there. So, in the short term, margins will be pressured in logistics. And we will do and weather that storm, as well as other best-in-class companies do. But it's going to be tough.

As we think longer term, our logistics business is relevant. The brokerage business is relevant. It can participate head-to-head with the biggest brokers. Our tech and tech stack continues to be flushed out, and we're finding the same levels of efficiencies that others are talking about, and the ability to ingest loads and dispatch loads more and more in a frictionless environment. I like where we're headed on the tech side.

Our intermodal product is doing very well. We've seen a lot of gains in the market that hasn't actually had a lot of share growth this year. We have, on a more secular basis through some of the work our team has done. And so, as I think forward, I think we get back on a revenue growth path. I think some of the irrational behavior that was taking place by some of the digital competitors has calmed some, and they've learned the lessons of what happens when this market turns. And we'll see how long those lessons stick. But we're going to try to price rationally, and always have an eye toward the bottom line. So short term margin pressures, long term the outlook is good, and we feel good about where we're seated in that logistics space.

Ravi Shanker: Got it. That's helpful. We have a few minutes left, so again, a reminder to the audience, please send me any questions you have for the management team via webcast. Derek, maybe we kind of pivot away from short term, to kind of looking at more strategic things. Obviously, there was almost a beginning of a new era, if you will, for Werner a few months ago when CL retired and you joined the board. What can we expect from Werner for the next decade? I mean would you expect to see a different strategy, a different approach? Obviously your 5T plan is kind of well-known. What are some of the new things you're looking to implement kind of as you really put your mark on this company?

Derek Leathers: Yes. I mean so I think I'd start with this. In order to look forward, you almost have to look backwards first. And over the last three years, I think the evolution that's been taking place here really starting in '16 with both CL's leadership, and then my assumption of the CEO role, serves as a pretty good guide as to where we're headed and how we think about the business. The market is going to be more complex. It's going to be more aggressive. And as a result, Werner's going to be those things too. I mean we're going to lean into technology probably at a greater pace and invest further and more aggressively.

There's going to be certain times and places where our risk profile is going to need to be maybe more aggressive than what you've traditionally seen. But make no mistake. We're not going to abandon the roots that got us here either. CL and I still talk all the time. He's in a great place and I'm so happy for him to be able to enjoy this point in his life. But we got here through executing very well. We've always been a revenue-yield focused company, but we are increasingly succeeding on better cost management, cost controls, expectations of excellence of our people, the willingness to do what it takes to compete to become best-in-class in each of our products.

If you look at how we've performed, traditionally there was always these raps around Werner doing as well in a strong market. I think we put those to bed in '18. Then the thoughts turned immediately to Werner doesn't perform well in a down market. And I would argue that '19, and then more importantly through COVID in the second quarter with an 86 and change OR net of fuel, proved that to be untrue. That's who we are, and we're going to continue to evolve that story through the same things that got us here, which is a relentless focus on execution, a relentless focus as you said on our 5Ts in the base. I know it sounds very basic. But that is what trucking is about. I mean you've got to take the money you earn and put it back into things that matter. You've got to execute at the top of your game. And you've got to expect everybody in your business to expect excellence of their self. I do have those expectations. They know that. It's clear. But I also think we've got a team that's performing well, and I'm damn proud of all of them. So, the future is going to be more progress on what's been playing out over the last 3 to 4 years.

Ravi Shanker: Got it. And maybe on the balance sheet side of things, you kind of surprised everyone with the special dividend last year, kind of even when things were pretty tough, which kind of showed us the confidence you had in the balance sheet and the strength of operations. Obviously as we push to what looks like they're going to be new highs of the cycle, potentially going to have record margins next year, with kind of wage inflation being under control, when pricing is higher; how do you think about capital allocation and return of cash to shareholders over the next couple years?

Derek Leathers: Yes, so a few thoughts there, I mean the first one is we've come out and talked about a guidance range of 0.5 to 1 turn of EBITDA as it relates to our debt tolerance. We're well below that today. We're at 0.2 today. And we know that. But during COVID, we found that to be a prudent approach, to conserve cash, think about the balance sheet a little differently during this short-term, maybe next couple of quarters timeframe. But we stand by our original guidance, which is we think a balance sheet with some debt on it makes sense for us.

That means that there's going to be some choices to make around capital allocation. I think investing in a business that's performing and whose performance is expected to improve will always be our first choice to invest back into this business. Clearly regular dividends, not special, but regular dividends are always on the table. Share repurchase opportunistically, and M&A is something that we're open to. I mean we're looking at things differently, as I've already spoken about. But we're not going to suddenly wake up tomorrow and be a fundamentally different Werner. But it's going to be a Werner 2.0, if you will.

I mean just basically evolving for the marketplace we're in, looking at things a little bit differently, thinking about all opportunities, which include where appropriate, select M&A examples. But during COVID, when we're still in the throes of the uncertainty and the election, and future tax policies, that's not the time you're going to see some major move necessarily. Especially because we've got several quarters ahead of us, if not all of '21, to really make some hay while the sun shines by investing back in this business, and making sure it's operating at the highest possible efficiency.

Ravi Shanker: Got it. We have a couple of minutes left. So maybe we can kind of end by you mentioned Werner 2.0. I'd be surprised if Werner 2.0 didn't have a big truck technology component to it. So obviously we've been talking about this for years. But I'd say the headlines for the last few months have really brought this to the front burner. We had Nikola present yesterday at the conference. We had Daimler Truck, kind of a big focus on hydrogen and electrification, even autonomous. Can you kind of remind us again kind of of how close you are to this, and kind of keeping an eye on things, what early work you're doing here, and kind of what's the path to maybe testing and rolling out some of these trucks to your fleet?

Derek Leathers: Yes. So, we're going to stay really close to it, both as a company and me personally. I mean I think this is one of those things as a CEO in this industry, you have to be personally knowledgeable of, and that includes site visits, ride-alongs, and actual interaction with this equipment. And I'm doing all of those things.

We're bullish longer term on the reality that there will be an evolution and transition over time to alternative fuels, whether that's electrification, hydrogen or a combination of both. But we're practical about the reality that right now there is major obstacles still across the board. Infrastructure is still lacking. Weight still needs to come down. Range still needs to be improved, and overall cost needs to be contained on the initial up-front cost. With all of that said, it's going to happen. Like, we believe that, and we know we need to be prepared for it. So, we're testing a prototype electric vehicle today. We're going to continue to lean into and try to understand the future of driver-assist. And autonomous technologies lead to more and more driver assist.

Will there be a day someday where select routes and some share is actually handled fully level 4? Yes, I think so. But that's further off I think than people realize. And even when it happens, it's going to need to be selective and it's an implementation. If you think about GDP growth leading to tonnage growth, which leads to truck need growth, over the course of the next several years, in all likelihood, there's still more driver jobs needed and available, as autonomous starts to fold into the mix, than there are today.

Just because we have more tonnage to move. E-commerce only exacerbates that with more and more forward deployment, shorter and shorter length of haul, and more lanes that need to go truck, because of the makeup and distance of the lane than maybe traditionally have even existed with longer length-of-haul intermodal lines finding themselves more in a truck environment, as people forward deploy more inventory.

So, we'll stay close to this. It is not a time to be a denier. It's a time to embrace it and understand it's coming. But we've still got to move freight in the short term. And to do that, clean diesel with a professional driver behind the wheel is still the best possible application in the over-the-road environment in my view.

Ravi Shanker: Got it. Sounds like an exciting 12 months ahead of us, and maybe an even more exciting 3 years ahead of us. Derek, John, thank you so much for your time today, and we'll speak soon on the call.

Derek Leathers: Yes, thank you, Ravi.

John Steele: Thank you, Ravi.