The Mullen Group Limited

First Quarter Earnings Conference Call Transcript

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Speakers:

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Corporate Secretary and Vice President of Corporate Services

OPERATOR:
Welcome to the Mullen Group Limited First Quarter Earnings Conference Call and Webcast.

As a reminder, the conference is being recorded. After the presentation, there will be an opportunity to ask questions.

I would now like to turn the conference over to Mr. Murray K. Mullen, Chairman, CEO, and President. Please go ahead.

MURRAY K. MULLEN:
Thank you. Welcome everyone to Mullen Group's quarterly conference call.

Once again, we'll provide shareholders and interested investors with an overview of our first quarter financial results, we'll discuss the main drivers impacting operating performance, our expectations for the year, and we will close with a Q&A session.

Before I commence today's review, I am always reminded but I need to remind you that the presentation contains forward-looking statements that are based upon current expectations and are subject to a number of risks and uncertainties and as such actual results may differ materially. Further information identifying the risks, uncertainties, and assumptions can be found in the disclosure documents which are filed on SEDAR and at www.mullen-group.com.

So, with me this morning, I have the majority of our executive team. I have Richard Maloney, he's the Senior VP; Joanna Scott, Corporate Secretary and VP of Corporate Services; and Carson Urlacher, who's our Senior Accounting Officer, who has been filling in for Stephen Clark as he recovers from the side effects of multiple surgeries on his ankle, son of a gun. So, Steph is taking some well needed time to try and get that looked after. Carson has been filling in for Stephen, as I said, and will until Steph comes back to fulfill his normal duties.

So, as I turn to the next section, I'm going to talk about the Q1 2022 financial and operating performance. I think the way to start this is the numbers really tell the story. We had record revenues, we had higher operating profitability, and if we can base the future on our March results, I will tell you we have a lot of room to improve. Oh yes, you will notice we have fewer shares outstanding. So to all of our loyal shareholders, we had a very good quarter, and if I'm right, then many more solid quarters are in our future, but more on this in our outlook commentary.

If you looked at our MD&A, you'll see it has a new look to it. It's crafted by Carson Urlacher and he'll provide the additional commentary in just a few moments, explaining in detail the reasons and events influencing our Q1 performance. In my opening comments, I'll summarize the important highlights and themes impacting the economy and our business in the quarter. Let's call this my Twitter version.

So what did we see in quarter one? Let me start with the obvious. Acquisitions that we completed in 2021 provided the growth. What the numbers do not tell you is the quality of these new acquisitions. They are all first-rate companies and I'm delighted that they are part of our organization. Truthfully, based upon what I see in this market, acquisitions are the clearest path to growth, especially in a market where there is near full employment.

New equipment is virtually impossible to obtain, and if you talk with any transportation service provider, they'll most likely tell you the warehouses and docks are running at full capacity. I know ours were. In other words, internal growth is difficult to achieve. Now this might just explain why inflation is running so hot. We'll talk more about this shortly.

So here's what we've witnessed in the first quarter from an overall economic and market perspective. When I analyze our results and the data, it's pretty evident the economy continued to show some pretty good resilience, with consumer spending still remaining strong, freight demand elevated and tight labor markets, but truthfully, we did not see any real growth.

There were also a few issues. For example, inflationary pressures started to really alter consumer behavior, high food prices, the rising cost of home ownership, and of course, fuel prices that have doubled year over year. So of course, consumers must alter their spend. I can also say that some of these inflationary pressures we didn't plan on, like the huge jump in oil prices, which only accelerated when Russia invaded its neighbor. This impacted costs but more importantly, the rate increases we implemented early in 2022 did not take into account the surge that occurred in the quarter. As a result, margins got squeezed by a couple of points.

Let me spend a few minutes on the fuel story. Year-over-year, fuel prices have doubled. We all know this because as individuals we go to the gas station every week or so, but to the trucking industry, we go to the fuel pumps every day. Fuel expense is now the number one issue for the trucking industry. Generally, we are indemnified from increases in fuel with fuel surcharges but this always lags the real time price that shows up at the pumps. So, we're behind in quarter one because fuel prices just kept rising. As they moderate, the surcharges will catch up to the cost.

There’s another issue related to the rise in fuel price and that is inefficient trucks. If you operate an older truck, and let me tell you there are lots of older trucks on the highway, your fuel mileage will not be where it needs to be. Even the fuel surcharges won't be enough to cover your increased costs. So I predict there will be a huge shakeout of the inefficient carrier, small and large, especially as freight demand slows and rates fall. So stay tuned to this. This could tighten trucking capacity even more.

Now, what about the supply chain? Obviously it starts with the demand. As I commented, overall freight shipments were generally quite strong in the quarter, but this may or may not be a negative, because consumer demand did not appear to grow. So if spending cools for a period, then the supply chain can regroup, productivity can improve, and costs can moderate, helping the inflation bite. In the quarter, there was lots of rates to haul. However, it appears some of this most certainly was tied to backlogs associated with the supply chain bottlenecks that continued deep into quarter one. This kept the trucks moving and warehouses full. It does appear that end demand was virtually pretty stagnant.

So, I suspect the supply chain will start to improve in quarter two with improved weather, fewer employee absences, and the expected change in consumer spending habits.

What about flat deck freight or more accurately, let's call that the demand for goods related to capital investment? I'll tell you, this part of the economy in our business was quite strong as evidenced by our logistics and warehousing segment. One area still struggling was service activity related to oil and gas investment, as the drilling rig count really never took off in the quarter. This part of our business changed little year-over-year and most likely because oil and gas companies simply bought back shares or paid higher dividends rather than go through the drill bit.

But this too may be changing, as the need for additional crude oil and natural gas continues to grow. At least, this is what the commodity prices are telling us. Now, if this has to occur, then our specialized industrial service segment will be a big beneficiary. I suspect we will know more in the next few quarters if a new cyclical uptrend emerges.

To our long-term investors, you all know we have had a successful history in the oilfield services business. As for last quarter, however, the industry was basically flat year over year. With all of this as a backdrop, I admit we did not improve our margins as expected, most of which I attribute to increased costs and lower productivity levels that were really tied to unplanned events, issues such as weather, blockades, COVID-related absenteeism, and vaccine mandates. These all cost money in margin. For example, we had 10% fewer drivers qualified to cross into and out of the US border.

All in all, however, I take the view that our business units did a pretty good job of managing the issues. Those that didn't, I will tell you this, they'll get it right this quarter. Our biggest issue today is inflation. As I look back to 2020, we had the COVID surge. In 2021, we had a freight surge, and this year we have a cost surge. So, we just adapt, we stick to our long-term strategy, we manage our business, and we capitalize on miscalculations by our competitors.

Carson, you are up. Take it away.

CARSON URLACHER:
All right. Thank you Murray and welcome everyone.

I'll provide a bit more of the detail. However, our first quarter interim report will fully explain our financial performance. So as such, I'll provide you with some of the financial highlights.

For the quarter, we generated record revenue as compared to any previous quarter, which was largely driven by acquisitions. Year-over-year revenue was up $166 million, or 57%, to roughly $457 million.

Our revenue growth can really be broken down into three factors, the first and most significant of which is the $135 million of incremental revenue we generated from acquisitions. Our growth from acquisitions really started to commence in the third quarter of 2021.

Secondly, we also experienced modest internal growth of approximately $17 million or 6.4%, that was mainly attributed to the strong results experienced within our L&W segment, while our internal growth from the LTL and S&I segments remained largely flat when compared to the prior year.

Lastly, our revenue from fuel surcharges, excluding acquisitions, rose by $14 million, due to the sharp increase in diesel fuel prices. In terms of total fuel surcharge revenue, which includes the amounts from acquisitions, this was $45 million, an increase of $25 million compared to the $20 million we recorded last year. Most of the increase in fuel surcharge revenue occurred in the LTL segment.

The average wholesale rack price for diesel fuel—this isn't the price that you see at the pump, but the average wholesale rack price in Canada—for the first quarter of 2022 was approximately $1.17 per litre, and ended the quarter at $1.36 per litre. Needless to say, the wholesale rack price for diesel has continued to climb in April. It's important to note that virtually no margin is made on fuel surcharge revenue, so this is actually detrimental to our overall margin, but more on this in a bit.

Now going a bit deeper into our segment revenue. First, starting with our largest segment, being the LTL segment, it grew by $55 million to $175 million compared to $120 million in 2021. Acquisitions accounted for $44 million, or approximately 80% of the rise in revenue. The remaining increase was mainly due to an $8.6 million increase in fuel surcharge revenue and a modest $2 million of internal growth as consumer spending remains strong but did not grow.

Revenue growth was challenged by unplanned events including severe weather conditions in northern Ontario and Manitoba, and freight bottlenecks in major distribution hubs of Vancouver and Toronto. Revenue in the L&W segment rose by $51 million to $142 million as compared to $91 million in 2021. This was due to $29 million of incremental revenue from acquisitions, as well as a $4 million increase in fuel surcharge revenue.

We also experienced almost $18 million of internal growth as demand related to capital investment and infrastructure projects was strong. This translated into an overall improvement in freight demand, and higher spot market prices in virtually all of our business units within this segment.

Moving over to the S&I segment, it increased by $4 million to $83 million as compared to $79 million in 2021, primarily due to $4.5 million of incremental revenue from the acquisition of Babine and a $1.1 million increase in fuel surcharge revenue. Revenue from our established business units declined by $1.6 million, mainly due to a $9.3 million decrease in Premay Pipeline Hauling, which came off a stellar performance in the first quarter of 2021.

This decrease was almost entirely offset by greater revenue being generated from our drilling related services and from those business units involved in the transportation of fluids and servicing of wells, as higher commodity prices lead to a slight improvement in activity this year compared to 2021. Drilling activity recovered a bit but not enough to really provide for any meaningful growth.

We also experienced greater demand for our dewatering and water management business at Canadian Dewatering, which had an excellent quarter in what is traditionally a slow period for that business unit.

Revenues generated by our US 3PL segment were strong coming in at $57 million for the quarter, as consumer spending remained robust and the supply chain was still recovering from bottlenecks that were noted in 2021. Our team at HAUListic continues to grow in the 3PL space by adding new additional station agents to our Silver Express technology platform.

Now moving over to profitability, our adjusted OIBDA was $60 million in the current quarter, an increase of $19 million as compared to $41 million in 2021. The $19 million increase was largely due to acquisitions which generated $13.4 million of this increase. We also generated $5.8 million from internal growth.

Now, internal growth was mainly experienced in the L&W segment and to a lesser extent in the S&I segment. So, let's take a look at adjusted OIBDA by segment for a minute.

In the LTL segment, adjusted OIBDA increased by almost $5 million to $23 million as compared to $18 million in 2021. This increase was due to $6.8 million of incremental adjusted OIBDA from acquisitions, which was somewhat offset by higher fuel and purchase transportation costs. An $8.6 million increase in fuel surcharge revenue in this segment had a detrimental impact on our margins.

As a percentage of revenue, adjusted operating margin decreased by 2% to 13.2% as compared to 15.2% in 2021. This margin erosion is due to higher operating costs and lower productivity levels that resulted from inclement weather, protests and blockades, freight bottlenecks that I spoke up to earlier, and surging costs, most notably being fuel. Overall, the segment did experience a stronger month of March as the weather improved, volumes recovered, and a number of price increases were implemented.

Adjusted OIBDA in the L&W segment increased by $10.8 million to $25 million as compared to $11.7 million in 2021; $5.1 million of this increase was due to incremental adjusted OIBDA from acquisitions, with the remaining increase largely attributed to internal growth of $5.7 million, and across virtually all of our business units within this segment.

Adjusted operating margin increased by 1.8% to 17.9%, compared to 16.1% in 2021, as our business units did an excellent job mitigating the cost surge with general rate increases and fuel surcharges. The cross-border freight market between Canada and the US saw the largest freight increase. This, coupled with government mandated vaccine requirements for drivers traveling to and from the US, reduced the capacity of qualified drivers, resulting in customers paying higher rates to get their freight moved.

Adjusted OIBDA in the S&I segment increased by $2 million to $13 million as compared to $11 million. The $2 million increase is attributable to improved results at Canadian Dewatering and from those business units involved in drilling-related services in the transportation of fluids and servicing of wells. These increases were somewhat offset by a $2 million decline in OIBDA and Premay Pipeline. Adjusted operating margin improved by 1.9% to 16% from 14.1% due to the strong performance at Canadian Dewatering.

Adjusted OIBDA in the US 3PL segment was $1.1 million or 1.9% of gross revenue. During the first quarter, the availability of contractors was extremely tight which led to higher spot market prices and which negatively impacted our margins. Operating margin as a percentage of net revenue was 23.4%. From strictly a cash perspective, adjusted OIBDA in this segment is virtually the same as earnings before tax.

So, as I summarize our margin on a consolidated basis, adjusted OIBDA as a percentage of revenue was down by 0.9% to 13.2% from 14.1%. This 0.9% reduction is explained by really two factors. First, accounting rules require us to report gross revenues on our US 3PL segment, which in the quarter generated $57 million of revenue and a margin of 1.9%. By excluding the financial results of this asset light segment, our overall margins would have actually improved by 0.7% to 14.8% compared to the 14.1%. So, excluding the US 3PL segment on a consolidated basis, our rate increases and change in business mix enabled us to more than offset the surge in inflationary costs in the quarter by a bit.

Secondly, including acquisitions, we generated $45 million of fuel surcharge, which was increased by $25 million compared to the $20 million last year. If we were to exclude that $45 million of fuel surcharge in the first quarter of 2022, our adjusted operating margins would have actually increased by almost 1.5% to 14.6%. Similarly, in 2021, if we excluded the $20 million of fuel surcharge revenue, our adjusted operating margins would have improved by just over 1% to 15.2%.

Looking at some other notable items, we continued to generate cash in excess of our operating needs as net cash from operating activities for the period was $18 million compared to $39 million in 2021. This decrease of $21 million is due to our revenue growth and business expansion as we are now a much larger organization. As a result, we need to finance our working capital requirements.

We have a total of $250 million of bank credit facilities available to us, and we had $111 million drawn at the end of the quarter, thus leaving us approximately $140 million worth of room. Our earnings per share was up to $0.17 cents as compared to $0.13 cents on a reduced share count as we bought back and cancelled roughly 926,000 common shares in the quarter at an average price of $12.01 per common share.

The main reason for the increase in earnings per share was due to the $13.2 million increase in OIBDA and the $1 million increase in earnings from equity investments. These were somewhat offset by a $3.4 million negative variance from our exchange due to our US debt swaps and a $3.3 million increase in income tax expense due to greater earnings.

With respect to ESG, I'd like to remind everyone that posted on our website is our 2021 ESG report that outlines our approach for ESG, along with some of the measurements that you can use to benchmark our performance. In the first quarter, we continued to make progress on some of our ESG initiatives by committing $9.5 million of CapEx towards our sustainability goals. The majority of these CapEx are expected to be received in 2022 and 2023, and consist of additional CNG-powered trucks, along with containers to support our investment in the intermodal space that will assist us in moving customer freight while reducing emissions.

So, Murray with that, I will pass the conference back to you.

MURRAY K. MULLEN:
Well done, Carson.

Now, if you read our new look MD&A, you're going to see that our outlook for each segment is well-explained so I don't need to reiterate it word for word. In the interest of your time, I want to make sure we leave the rest of today's discussion for the Q&A session.

Now, I'm sure everyone is wondering about the so-called freight recession that has been talked about in recent weeks. My personal view is yes, consumer spending on discretionary items will slow. By how much? No one really knows but I would be very, very surprised if it doesn't slow. Now, I do expect this is going to impact van carriers the most, which we are not highly leveraged to.

I do expect our LTL segment to slow somewhat, but we have a very good critical mass in most lanes so we will just simply adjust schedule, we'll focus on operating margin, and we're going to get productivity levels back which will help margin. I can also tell you, there's another round of rate increases that are absolutely required.

We know that the supply chain is quickly recovering. Now, this takes the pressure off of shippers and retailers, meaning they do not need to overbuy, which they have done for over a year now. All this did is really exacerbate an already overstretched supply chain. So, this is where I believe the trouble may occur. I think inventories are bloated. We know this because our warehouses are jammed. So, I wouldn't be surprised to see a few quarters of adjustments to clear out the backlog. If you're a buyer of discretionary consumer goods, I'm betting that there will be some good sales on soon.

If there's one lesson everyone should learn by now, it’s that anything can happen anywhere in the integrated supply chain ecosystem, so I wouldn't get too comfortable when things sort themselves out over the next month or so because trouble will just simply find another home. As such, I anticipate structural changes to the supply chain are still required.

How we're going to handle this, we're going to focus on building out our LTL network, we're going to expand our warehousing and intermodal service capabilities, and we're going to look at adding to our 3PL business, which really, this keeps us close to the customer without the CapEx burden.

Our shareholders also know we are a diversified logistics provider and we service multiple different verticals. Now, earlier I spoke about the other end of the economic spectrum which is let's call that capital investment. In terms of an economic outlook here, I'm actually quite optimistic because I believe that industry needs to retool and infrastructure needs to be built, two critical factors if productivity is to improve, a necessary ingredient for inflation to be tamed.

So, I'm in the camp that we're entering a strong capital investment cycle and that implies that our logistics and warehousing segment should be able to continue producing some pretty strong results. This stuff dovetails nicely into our specialized industrial services segment, which as you know, no one really liked for the last 10 years or so but evidence is mounting that oil and gas, mining, old economy needs to reinvest. When they do, we have a decent footprint from which to capitalize on the renewed demand.

So, I'm quite optimistic for our oil and natural gas business units, in particular. The service industry is really no different than the oil and gas companies. It has been starved of capital. So, any additional demand will be welcomed with open arms but it will be costly, as I say to our customers. Just saying, folks.

Now let's open up the phone lines for the Q&A session. So, Operator, I'll turn it over to you and to the Q&A. Thank you, folks.

OPERATOR:
We will now begin the question-and-answer session. The first question comes from Michael Robertson of National Bank Financial. Please go ahead.

MICHAEL ROBERTSON:
Hi. Good morning, all. Congrats on a solid quarter. Thanks for taking my questions. I was wondering maybe we could kick it off, I was just wondering if the M&A backdrop has shifted at all, given that spike on the cost side, maybe shifting to a more favorable buying environment, given some of those pressures. Murray, I know in recent calls, you weren't exactly thrilled with some of the asking prices out there. So, any colour on that would be great.

MURRAY K. MULLEN:

Thanks, Michael, for the question. That's one that I quite regularly get asked about is M&A and so let me just take a step back.

Last year, we were very, very active on M&A and have proved out to be, as you can see by our numbers, pretty good. What about today? I think part of the challenge you're having with M&A right now is forecasting what do we think is going to happen with the overall economy and then expectations? I suspect that M&A is going to be very, very active. It's what's the expectation of the sellers? That’s, I think, going to be the rub. We always take a long-term view.

I'll be honest with you, with everybody on the line. Look, we don't just buy companies to grow the revenue side. We buy it because it's strategic and it's in the areas where we see the future opportunities are going to be pretty good. So, we just don't buy to buy. Everybody knows we'll look at consolidating LTL because that just strengthens your critical mass in those networks.

We also know that the supply chain is changing dramatically because you can't just rely upon the supply chain on just-in-time today if you're in a global marketplace. As I said in my press release, I said, look, you can access the goods anywhere globally, but you've got to be able to deliver the goods locally, and that requires being close to the customer and that implies warehousing. We're seeing a boom in warehousing all over. That implies more inventory in the system so you can get it closer, you can get it to the customer.

So, we'll continue to look at warehousing and the long mile with intermodal as a service offering because we can tie it in with our LTL network. Very, very few companies can do that. I feel pretty good about that side. We get M&A every day, every week but we're pretty selective of which ones that we go after. They’ve got to be quality companies. There’s got to be some type of synergy that we can find so that that's how our investors win.

If all you do is just buy a company, you really don't get a good arbitrage for the shareholders. You’ve got to find some synergy. At least you’ve got to identify it so that you can say, look, one and one is more than two. So, that's just a long explanation for there's going to be lots of M&A activity over the next bit. That's nearly baked in the cake but we’ve got to be very, very sensitive to what's the price we pay on behalf of our shareholders.

MICHAEL ROBERTSON:
Got it. That’s helpful colour. Appreciate that.

One more from me. Just maybe a quick one for Carson. I think you touched on this at the end of your prepared remarks. I was just wondering if you could provide some additional colour on the spending surrounding the sustainability initiatives, particularly if one of those were hybrid or CNG or hydrogen fuel cell powered or maybe a combination thereof?

CARSON URLACHER:

Really, they're compressed natural gas trucks, Michael. I think we have six on order. We've had some good success with the ones that we've bought previously so we've added to that order. In terms of timing, not exactly sure if we'll get them all in 2022 versus 2023.

The other large order that we put in was for our intermodal containers and that's for growth to extend our intermodal footprint within our APPS group. Again, timing on that, it's going to be 2022, 2023. It's really difficult to say. Some of them will probably start trickling in throughout the remainder of the year but I suspect there'll be some coming in 2023 as well.

MICHAEL ROBERTSON:
Got it. Again, helpful colour. Appreciate...

MURRAY K. MULLEN:
I'm going to have Richard just step in here and talk a little bit about CNG, compressed natural gas, and why did we make that investment.

Rich, maybe you just want to talk a little bit about what the equivalent fuel mileage is to a diesel truck, but then the cost of CNG vis-à-vis. So, there's an ESG component to it, Michael, but there's also a business component that I want Richard to just define a little bit, to give some colour to all of our listeners on why we're really investing in CNG. We want to do the right thing for the environment but we also got to do the right thing for the bottom line.

Rich, can you just give some additional information to the listeners?

RICHARD MALONEY:
Absolutely. So, it was roughly about a year and a half ago, a year ago, when we first took the order with the CNG trucks through PACCAR Kenworth and we looked at it. With the compressed natural gas units, we put them into Mullen trucking. They're predominantly going back and forth into Edmonton. We've actually run trucks over the mountains into Vancouver. We've had very good success on the mileage on that. It's consistent with the newer trucks that we're seeing with the 680s with the PACCAR Kenworth trucks.

The difference in what Murray is alluding to is when we're seeing in the seven miles per gallon range for what we're able to do with these newer trucks, or as far as Carson pointed out, when you're seeing diesel prices approaching $1.40 a litre, the cost for us per liter for a CNG or the equivalent is $0.79. So, we are looking at continuing to invest in this. As we build out these units and as stations are built to help fueling and the partners we have with those groups, we suspect and we know that the cost of that CNG will be coming down as well.

So, it gives us, as Murray said, during his prepared remarks that fuel pricing right now is the single biggest cost that is impacting the transportation industry. CNG works predominantly when you're kind of between major centers and such as well, so that is something that we're looking at to continue to build out through our LTL type of network and parts of our logistics and warehousing network as well with Mullen Trucking.

MURRAY K. MULLEN:
So, real simple, these trucks CNG are used in local markets because the infrastructure is in there to do long haul, basically. Number two is they're basically getting about similar equivalent mileage as a diesel engine, but the price is down in half from diesel. What the guys were talking about is the rack price of diesel, but the pump price is actually higher. For example, in the Lower Mainland of BC, diesel is over $2 a litre, which equates out to nearly $10 a gallon.

MICHAEL ROBERTSON:
That’s super interesting colour. I appreciate the details. I’ll turn it back.

OPERATOR:
The next question comes from Walter Spracklin with RBC. Please go ahead.

WALTER SPRACKLIN:
Thanks very much. Hi everyone. Just a question on how you're looking at the quarter in terms of your plan and the guidance that you provided there back in December, and whether you add in any acquisition opportunity or acquisitions that have done perhaps a little bit better than expected.

MURRAY K. MULLEN:
So, Walter, based upon the first quarter, I would say we're more than on target for what we had originally opined to all of our shareholders at the first of the year. We’ll be on target. If I use March as the barometer, then I could make a pretty good case that we might be above what we originally came up with, but I think we need to see whether that's sustainable or not. The economy is pretty fluid right at the moment.

I'm optimistic but I'm reluctant to say this is exactly what's going to happen for the rest of the year. I think what we'll be able to do at the end of the next quarter is be able to say, okay, we'll give an update on what our overall plan was, whether we’re on target or above target—we will not be below target—whether we're on target or above target. We'll be able to give better colour on that after the second quarter.

The first quarter is typically not our best quarter anymore. Typically, the second and third quarters are our best quarters, so I'm expecting better but we'll give a full update at the end of next quarter. I think rather than me guessing, I'd rather say that. I know we're not going to be below target. We’ll give a better overview once we really see how’s inflation really impacting the consumer right now. Everybody's talking about it and everybody has a viewpoint. We'll be able to give you real time information in a couple of months.

WALTER SPRACKLIN:
Looking at March, what really stood out, would you say? Was it your operating performance? Was it your pricing that you were able to achieve? Was it the level of volume demand? Perhaps

some improvement in fluidity levels? What really stood out in March as being exceptional if you had to boil it down to one or two things?

MURRAY K. MULLEN:
Really, I think it was demand came back pretty strong. There was some real crappy stuff that none of us planned on. When I did our budget up and here's what we're going to do, or all of you did your analysis up, did you really count on blockades affecting the supply chain and all of the productivity and all the costs associated with that? We just couldn't move freight. Did anybody count on more absenteeism, 10% absenteeism because of COVID? I wasn't counting on that.

Then, boy, we had some real crappy weather in Northern Ontario and Manitoba. That really hurt our Gardewine group in January, February, particularly. They recovered nicely in March, but they got smacked around pretty good. I'll be honest with you, a lot of freight got stuck. It just wasn't moving with that crap weather. So, those impacted the margin. If I normalize those things, margins would have been up by about two points in the quarter. We'll see if we get that in this quarter. We'd better get it. I've told our business units, I expect it.

WALTER SPRACKLIN:
My last question is just on the M&A side. I know you touched on it but just with all the unprecedented and really structurally different ways things are happening here in the transportation logistics center that you had pointed to in your prepared remarks, are you revisiting what you're looking for anymore? Could you look at different operations than what you otherwise would have? Are you more emphasizing certain types of companies or in different geographies than you otherwise would have maybe a year or two ago?

MURRAY K. MULLEN:
No. We're not looking at anything different. We haven't changed our strategy. We know precisely what we're looking for but we don't chase them. We're very selective and we'll continue to be so. None of our numbers that we've given any guidance on or talked about have included if we do any M&A activity this year. We always have files under consideration. Every quarter, we have files under consideration, but we don't always move them along. Sometimes we don't like what we find but we've all got some files that are active.

WALTER SPRACKLIN:
Okay. That's all my questions. Thanks very much for the time.

MURRAY MULLEN:
Thanks, Walt.

OPERATOR:
The next question comes from Konark Gupta with Scotiabank. Please go ahead.

KONARK GUPTA:

Thanks, Operator. Good morning, everyone and congrats on a good quarter. Also, thanks for splitting out individual segmented outlook. That's really helpful.

So, maybe, Murray, my first question is on the broader market and spot rates especially, given the spot rates have been sparking a lot of fear among investors that there's going to be a freight recession. Obviously, a lot of trucking companies and your competitors have reported recently calling out that they are not seeing the weakness in the contract market.

I wanted to understand, in terms of your business, certainly the L&W segment seems to have a spot exposure. How would you characterize your spot business across your three trucking and logistics segments compared to what we are seeing out there in the spot markets broadly published by different platforms?

MURRAY K. MULLEN:
Boy, that’s a good observation, Konark.

Here's what we think. We know there was some surge pricing that happened in the first quarter, and it needed to. Now we use a lot of subcontractors and we got caught a little bit on that. You make a commitment to the customer, maybe in December, and then all of a sudden you have vaccine mandates that come in and 10% of drivers couldn't cross the border. Where you saw a lot of the surge pricing was crossing the border. Those prices have still remained elevated because the drivers still are not able to come back to work across the border.

So, we've really had about a 10% reduction in the amount of capacity going to and from the United States at the same time that demand has stayed relatively flat. That's where a lot of that surge pricing happened. We got caught a little bit, some of our business units in January, February but they recovered to what the market was in March. I think they're probably doing the same thing today.

When I talk to our business units, real time, it's softened a little bit, but we're not going back to where we were. That's absolutely a fact. So, I think generally, prices are going to be elevated from where they were over the last decade. I think some of the surge pricing might come out of it temporarily, perhaps, because the wildcard here, Konark, is what happens with fuel prices. If fuel prices double, I will predict right now that well over 10% of the trucks that are on the highway right now should be parked. They are not efficient and they are losing money going to work every day. That cannot last for very long.

You heard Carson talk about we cannot just go get additional capacity. The industry cannot add new trucks, fuel-efficient trucks today. Rich, what are we at—seven mile, eight mile per gallon is what a new unit will get you, and at least 10% of those trucks out there, there's a two to three mile per gallon arbitrage; those trucks at four are going broke. Either that, or prices have to go up to keep them in business because they're the marginal provider.

So, which way is it going to work out? Short term, I don't know. Long term, if fuel prices stay up and elevated, you've got to have new equipment and that fits pretty good with a professional company like ours. That's what I think is going to happen. I think we're going to lose a lot of independents. They just can't make it. Costs are too high and they can't retool.

KONARK GUPTA:
That's good colour, Murray. Thanks so much for that.

Then maybe switching gears to your S&I segment. If we go back historically, and not even very far back, just pre-pandemic, that segment has typically done north of $400 million in revenue. It's sitting somewhere near above $300 million plus right now.

You talked about drilling activity and the oil and gas market capital investment cycle could probably start rebounding in the second half while your pipeline business seems like it's still kind of softer than last year but kind of stabilizing perhaps. What's your operating leverage and what's your torque to the oil and gas commodity prices for that segment? Where can that go to if we see what's happening right now and drives capital spending?

MURRAY K. MULLEN:
Carson, what's our leverage to the drill bit? Maybe $150 million, somewhere around there above revenue right now?

CARSON URLACHER:
It'd be in that ballpark so you'd be looking at maybe 10%.

MURRAY K. MULLEN:
Yes, 10% of our revenues. I suspect that goes up. I think where you're really going to see the change, Konark, is this industry has been starved of capital for virtually a decade now, so if the oil and gas producers decide they are now going to go and increase production—and they can only increase production through the drill bit—if they decide to go and put more capital to work on the drill bit, then the assets in the business we have, this will be a pricing game, not a growth game.

I will remind our oil and gas customers is that just as you have seen a surge of your price of your commodity, I can tell you, you will see a surge in the price of our service. It takes a little bit of incremental demand, and it looks like the market needs increased supply of commodities. I'm not making that up. That's what the commodity prices are telling us. So, you either are going to have to have increase in the drill bit or consumers are going to have to quit consuming. I'll let you decide which one that is.

KONARK GUPTA:
That makes sense. Thanks for the answers.

MURRAY K. MULLEN:

Thank you.

OPERATOR:
The next question comes from Kevin Chiang with CIBC. Please go ahead.

KEVIN CHIANG:
Hi. Good morning everyone. Thanks for taking my question here. Two for me.

Just wondering, just with the spike in fuel pricing and that impacting the all-in freight rates that shippers have to pay, just what do you see from a modal shift perspective? Are you seeing more demand for intermodal versus over the road, just given the former should be cheaper? Are you seeing any changes in shipper behavior from that perspective?

MURRAY K. MULLEN:
We know that the long-term trend is towards intermodal. I don't think that is something that is revolutionary. It shouldn't be to anybody that's in the logistics and freight business. Freight has to move more efficiently. Particularly as the price of fuel goes up, it makes intermodal that much more competitive because trucking, the rates are going through the roof because drivers' costs, access to equipment, and fuel. So, intermodal becomes more competitive, and it just makes more sense.

So, we're going to continue to expand our footprint in that. Rather than buy trucks to go long haul, we'll invest in the container and we'll invest in warehouses and infrastructure so that we can provide that service to the customer. Intermodal has been one of the real beneficiaries of this freight demand surge. You've seen it in the United States, you've heard it from CNCP, intermodal is pretty strong.

Now, that might soften a little bit as the inventory management supply chain kind of rectifies a bit but I think the long-term trend is well-entrenched there. That's my thesis. Now, there's always ebbs and flows in the market, but the long-term trend is undeniable. I know it is with us and that's one of the reasons why we strategically invested in APPS. They are an exceptional intermodal provider with a good footprint, with good warehousing capabilities, and so that's a good long-term investment on behalf of our shareholders.

KEVIN CHIANG:
That makes sense. Then the second one for me, and it was really an observation from Knight-Swift last night. They were talking about the US brokerage market, and they made an observation that they saw, and I recognize that they're also talking to their own book here, is a shift away in the brokerage market away from asset-light brokers towards maybe asset-heavier brokers that offer a power only solution.

So, when I think about you growing your US 3PL, one, is that something that you're seeing? Or maybe because you're starting from a smaller position, this potential shift that might be happening in the market in some ways is irrelevant (phon 49:35) to you because you're building off a small base? I'm just wondering, I guess based on some of the comments some of your peers have said in the brokerage market in the US, maybe what you're seeing and what that means for your growth overall in US 3PL.

MURRAY K. MULLEN:
You know what, Kevin, I've seen some of those articles, the same ones that you're referring to. Honestly, I think it depends who the author of the article is. So, if you're a hard-asset business, you're going to take the view that, "No, we're going to win the game." If you're a non-asset one, you'll say, "Hey, we'll still find the arbitrage out there because you're always still got to find the best price in the market for the customer." I think there's room for both, to be honest with you.

We entered that market in the US just to give us another growth platform down the road, and we're just in the early innings of capitalizing on that strong book of business that we got. They've continued to grow their business and get access to customers. What we want to do is add more service offerings to it, which will be part of our longer-term game plan.

You're still going to have to find the best price and best arbitrage out there. Smaller shippers are going to have a very difficult time going to big companies, big carriers. Probably the big shippers will either do their own freight transportation. You saw what Walmart did, for example, to get drivers. They're paying drivers, what, up to $100,000 a year now, $120,000? So the big shippers are probably going to do their own supply chain. I know Amazon's doing more of their own. I think there's a place for both to be honest with you. We'll try and carve out our niche.

KEVIN CHIANG:
No, that makes a ton of sense. That's it for me. Congrats on a good start to the year.

MURRAY K. MULLEN:
Kevin, I know we were off on your expectations for the quarter, but I'm sure when you did your expectations, you didn't count on the blockades or some of the things either. I think we probably would have been a lot closer to your expectations in the absence of those one-time events that I didn't count on either.

KEVIN CHIANG:
No, that makes a ton of sense. That makes a ton of sense. Nonetheless, it was a good quarter.

MURRAY K. MULLEN:
Thank you.

OPERATOR:
The next question comes from Matthew Weekes with iA Capital Markets. Please go ahead.

MATTHEW WEEKES:
Good morning. Thanks for taking my question. I think I just have one that at this point. Most of mine have been answered.

Just thinking about acquisitions and the asset integration piece of the outlook here as you go forward, I was just wondering if you have a typical timeline that you look at in terms of integrating the assets and achieving the synergies that you would normally expect?

MURRAY K. MULLEN:
Yes, Matthew, good question.

Some of the business units we don't integrate. First of all, we don't integrate right off the bat. The first thing we do when we do an acquisition is we get it and then we learn. Is it best to integrate with another business unit, or is it best for us to integrate another business unit in with that one? It depends who's got the best footprint, best management teams, etc., etc. It takes about a year to learn that.

I can tell you, we've been very active over the last bit streamlining our businesses, and we did a bunch of it again this first quarter, which is aligning the business units where we think we can find those synergies. That's what we do. When we do an acquisition, it takes a little bit to learn. I don't slap them together and then hope it works.

We learn and then we put together the ones where it makes sense to do it, but we're always doing it to look for synergy. It’s not just we save a couple jobs. We're looking for real synergy, how we can provide a better long-term service offering to our customers because if we do that, then we win the long game. That's what we're really after.

MATTHEW WEEKES:
Okay, thanks. That makes a lot of sense.

I think I'll actually just ask one more, and you provided some good commentary on the market dynamics on the call, given some of the concerns that certain industry participants have been raising. You talked about if you see sort of a bit of a tempering of consumer demand, there'll be opportunities for productivity improvements, offsetting a bit of that as supply chain bottlenecks ease a bit. I was wondering if you could just comment specifically on what some of those productivity improvements might be.

MURRAY K. MULLEN:
Well, first of all, we’ve got to get people back to work because when you have 10% of your workforce off, all you do is you’ve got more costs related to sick days. Worse than that, you burden the other 90% that they’ve got to pick up the slack. Usually that means in our business with the hourly workers, you're paying overtime quite a bit, and then we just aren't as efficient. We're handling the freight twice. You can't get it in to get it offloaded. You're reloading it here.

We're handling freight too many times and too much overtime. That kind of explains what happened on that front. When you put that across the whole system, that ends up being a lot of cost. I suspect as it slows down a little bit, we'll be able to be able to get those productivity improvements back and get our costs back under control. They were a little bit squirrely in the first quarter to be blunt with you in a of number of our business units.

Yes, I think that demand is going to slow a little bit. As I said to you, the offset is what happened with supply. The offset is I think at least 10% of the trucks are going to be broke because they just can't be competitive. Even at elevated fuel price levels, they're still not making any money, so they're not going to last. Supply is going to shrink because we cannot add additional capacity. Right now, you just can't get it. I think, overall, if you've got a good fleet and you've got good capacity, I think you'll do just fine.

MATTHEW WEEKES:
Okay, thanks. I appreciate the answer on that. I think solid quarter overall despite some of those supply chain challenges. That's it for me. I'll turn the call back. Thanks.

MURRAY K. MULLEN:
Thank you.

OPERATOR:
The next question comes from Miguel Ladeira with Cormark. Please go ahead.

MIGUEL LADEIRA:
Hi, good morning. The first question I had I just wanted to talk about the margin delta between logistics and warehouse and LTL. Is this just a function of the markets being served or is there other dynamics involved here? Thanks.

MURRAY K. MULLEN:
First of all, we think logistics and warehouse, they had a fantastic quarter. They didn't get hit as hard as our LTL business did. When I talk about LTL, I'm really talking about our Gardewine group. They're such a big component of that, and they really got hit hard really with some bad weather and some productivity problems.

To be blunt, they were a little slow coming out of the gate on the pricing. They put pricing increases in but they got caught with the cost surge. So January, February were not kind to Gardewine and they were a big component there. I think if we normalize that, Carson, we would have been probably a lot closer to flat-on-flat in that section, if I'm not mistaken.

CARSON URLACHER:
Yes, for sure.

Miguel, if your question is more about why is the margin a little bit lower in the LTL segment versus the L&W segment, well, the LTL segment is predominantly assets that we own, so it's more Company equipment. So, you're seeing that the margin on that side is a little bit lower in the first quarter. A lot of that fuel surcharge flowed through into the LTL segment versus the L&W segment, which is detrimental to margins. As Murray mentioned, one of our largest business units within that segment, we lost several operating days within the first quarter just due to inclement weather in their main operating areas, which is going to impact your margins.

Coupled with that is the issue that we have with the drivers. You're going to see wages—it might look like in our chart that wages is down as a percentage of revenue, but you almost have to couple that with purchased transportation, given the fact that if we don't have a Company driver to put in a seat, now we're farming that out, so our purchase transportation increased in that segment as well, too.

MURRAY K. MULLEN:
Yes. Miguel, just to follow up on that, I don't think there was anything structured. We did get hit with some one-timers in that first quarter but really I think I outlined those pretty good as to the main issues of that. So, our longer-term objectives, we're still going to move our LTL margins up, they're not going down. I've told all our business units very firmly that I won't accept lower margins. I said this, I acknowledge we're behind the curve in the first quarter but I don't want to be talking about that every quarter. That's what I told our business units.

CARSON URLACHER:
Typically, LTL is weakest in the first quarter as well, just given consumer demand after the holiday season drops off, so it really is you've got the combined impact of lower demand, like the seasonality impact of it, and then this year we got the double whammy with the issues that Murray talked about.

MIGUEL LADEIRA:
That's great colour.

Then last one for me, just a housekeeping item. You mentioned some one-time costs in the US 3PL. Do you mind elaborating or just providing a number to stick into the model?

MURRAY K. MULLEN:
First of all, they use all subcontractors. So, when they bid to a customer, and then the spot market goes against you, you lose some margin there. They're behind the curve because there was some real surges in the first quarter. You've seen that in everybody's press releases is that the spot market was pretty high.

So, they got trapped a little bit there. Then we have some one-time healthcare expense costs that happened in regards to transitioning those medical expenses over to holistic from the previous owner, which was Quad/Graphics. So, there was some one-time catch-up costs there. They're just one-time costs. If you exclude those out, they were pretty much in line with where they have been since we acquired them.

Yes, there was a couple of one-time costs that they got hit with in that quarter as we true-up. We're ending our one-year transition agreement with Quad/Graphics. I think, Joanna, it expires at the end of June…

JOANNA SCOTT:
Yes.

MURRAY K. MULLEN:
…because we bought them a year ago. So, there's always a bit of true-up that happens and debates that you have so we just took the cautious approach and booked those for the interim (phon 1:02:05).

MIGUEL LADEIRA:
Perfect. That's all for me. Appreciate your time.

MURRAY K. MULLEN:
Thank you.

OPERATOR:
This concludes the question-and-answer session. I would like to turn the conference back over to Mr. Mullen for any closing remarks.

MURRAY K. MULLEN:
Thanks folks for joining us. We look forward to giving you a more fulsome update as to what the whole rest of the year will look like at the end of next quarter. Lots of moving targets right now. Some positives and I think the positives outweigh the negatives. Thanks for joining us. Really appreciate it. Take care.

OPERATOR:
This concludes today's conference call. You may disconnect your lines. Thank you for participating and have a pleasant day.