

## Truckload 2011 Preview: A Whole Lot Like 2010 Only Better

Industry analysts remain bullish on truck transportation stocks going into 2011! In the trucking industry, it is always good news when investment analysts put their money (and stock purchase recommendations) where their mouths are. And that certainly is the case these days. After several dismal years, transportation stock outlook is very bright. If analysts are correct in their analysis and forecasts then the stage is set for a dynamic three year run. To highlight this outlook, I've summarized excerpts from latest (1/20/11) **Stephens Inc. Transportation: Trucking Industry Update**. Note the key drivers to economic recovery in the truckload transportation sector that will affect you as a shipper. As always, if you have questions or need additional information, don't hesitate to contact me.

**INVESTMENT CONCLUSION:** The year 2010 will most likely be remembered as a better-than-expected year for the truckload (TL) industry, and one where TL pricing finally hit an inflection point after three years in the doldrums. ...the primary driver was supply contraction... Looking into 2011, we envision a similar scenario where less supply, coupled with modest economic growth, leads to material improvements in TL rates and profitability.

### KEY POINTS:

#### Entering the Next Up-Cycle With Fewer Trucks on the Road.

- At end of 2010, rolling 10-yr avg U.S. Class 8 Truck sales was ~13.5% below 2008 levels, and ~9% below 2003 levels.
- ...we are entering the next cyclical upturn with roughly 9% fewer trucks on the road than the last cyclical upturn...

*Melton Truck Lines, like most carriers contracted our truck/trailer capacity during the recession by about 25%. However, unlike most of our competitors we are adding an incremental 100 trucks and 180 trailers to our fleet over the course of this year. This additional capacity will better position us to reward our year-round and loyal customers with more capacity and also allow us to take more advantage of the spot market pricing - which is estimated to be as much as 20% higher than contracted rates.*

#### Inflationary Cost Pressures Squeeze Marginal Capacity.

- ...expect TL supply to further contract in 2011, potentially to a greater degree than the ~10% consolidation in 2010.
- ...we expect cost pressures like rising fuel prices and driver wages and historically high maintenance expense to lead to material TL consolidation,

*Like all carriers, Melton has certainly felt the impact of the rising fuel prices, driver wages, and ongoing maintenance expense. Over the past two years, we have worked very hard to gain productivity, cut costs, and improve operating performance to meet Shipper demands for lower rates. However, we have maximized our productivity opportunities and incorporated these efficiencies into our standard operating procedures - - and it still is not enough to offset the high Inflationary Cost Pressures. We, like ALL carriers are now forced to adjust our rates & services in order to remain in business.*

#### Regulatory Changes Should have a Meaningful Impact on Industry Dynamics.

- ...TL industry faces new regulations (CSA and potential changes in Hours of Service) that have the potential to create the biggest regulatory impact on the TL space since deregulation.
- ...recent estimates of 5% - 10% contraction

*Everyone has heard this song and dance - - but what you may not have heard about is the X-factor that will have just as big an impact on driver capacity as these regulatory issues. The X-factor is the construction industry. Historically, when construction activity is stable to strong, many drivers exit their trucks to work construction (and manufacturing) jobs at higher wages and no time away from*

**home. Consider that unemployment is over 9.5% AND construction activity is the lowest in years. When, not if, but When construction again begins to pick up, many more drivers will exit the transportation market - further compounding the driver shortage. This, of course, will push driver wages even higher, capacity even lower, and carriers will have to recover these additional costs from somewhere / someone to keep their trucks seated.**

### Summary.

- ...stage is set for a strong FY11 both in terms of TL earnings and stock price performance.
- We are in the early innings of a cyclical recovery that could be steeper and longer in duration than any previous cycle.

### The Trucking Downturn Could Not Last Forever.

- ...trucking recession began in 2006.
- What came as a surprise was how little contraction of supply occurred in a largely commodity-based industry.
- Without the normal course of failures, the trucking industry struggled as the average carrier was losing money yet continued truck along. There were many factors propping up these marginal carriers:
  - Augmented balance sheets due to strong returns generated in 2003 - 2006;
  - Deferred fleet replacement cycles; avg. tractor age is now at an all-time high, 6.7 years.
  - Reduced maintenance expense as "parked tractors" were cannibalized for parts.
  - Cost-cut initiatives like headcount reductions, declining driver pay, and reducing idle time.
  - Lower fuel prices (down 42% from July 2008 to December 2009).
  - Banks' hesitancy to foreclose on carriers due to public scrutiny and a decline in equipment values.

**Melton Truck Lines' truck fleet is still very young. As of today, our overall truck fleet average age is approximately 38 months. Also, we are purchasing almost 300 new trucks. 200 trucks will be allocated to replace older equipment and 100 trucks for incremental growth (assuming the market & rate structure is as projected).**

## FOUR PRIMARY FACTORS THAT SUPPORT OUR BULLISH STANCE ON TRUCKING

1. State of the US Class 8 tractor fleet
2. Inflationary cost pressures
3. New government regulations
4. Economic conditions

### Entering This Cyclical Upturn With Fewer For-Hire Trucks on the Road.

- The rolling 10-year average U.S. Class-8 Tractor Sales is 9% below 2003 and at its lowest level since 1998 and 17% below the peak level of 205,000 in 2006.
- ....roughly 9% fewer for-hire trucks than at the beginning of the last cyclical upturn.
- Given rising tractor prices, more stringent lending standards, and the deterioration of truckers' balance sheets over the last five years, we think meeting these replacement requirements is highly unlikely.

### Inflationary Cost Pressures: Rising Maintenance Expense.

- Specifically, at the end of 2010, the average age of the U.S. Class-8 tractor was 6.7 years, the oldest on record and 11 months older than the long-term average. **Melton average tractor age is only 38 months!**
- ...at the end of 3Q10, industry-wide maintenance expense was at its highest in history and had increased by over 15% since the beginning of 2010.
- Furthermore, we would point out that maintenance expense per total mile was at an all-time high for public carriers.....
- .....it is a different story for the average carrier who is likely operating a tractor twice the age of its public counterparts and does not have the balance sheet to purchase the necessary new equipment.

### Inflationary Cost Pressures: Rising Fuel Prices.

- .... historically there has been a high correlation with trucking failures and higher fuel prices, particularly during recessions.
- ...and we expect the relationship between diesel prices and trucking failures to revert to historical norms.
- ...fuel prices have consistently risen since 9/30/10 and now stand 16% above the average diesel price in 3Q10 and 18.7% above year-ago levels.
- ...rapidly rising fuel prices create additional working capital constraints that are increasingly burdensome for marginal carriers.
- When rising fuel prices are combined with rising maintenance expense and a rather lackluster peak shipping season, we think the average TL carrier's cash flow is being pressured to a much greater degree than over the past year, creating the likelihood of further trucking failures in 2011.

#### **Inflationary Cost Pressures: Driver Wages.**

- ...expect increased business activity to create upward pressure on driver wages.
- ...new CSA driver safety regulations that we expect to reduce the driver pool by 5% - 7%, thus putting further pressure on driver wages.
- ...we expect inflationary driver-related cost pressures to begin impacting the TL space in 2011.
- In summary, we view inflationary driver wages as another potential pin to the bankruptcy bubble and think it could serve as the "straw that breaks the camel's back" in terms of survival for many smaller, marginal carriers.

#### **Key Regulation Changes on the Horizon.**

- ...the most significant changes in trucking regulations since deregulation.
- **CSA 2010:** The biggest change is in the enforcement and compliance model
  - FMCSA will be more effective in identifying those carriers that will require some form of intervention.....early contact, investigation, and follow-on.Industry experts estimate that the implementation of CSA 2010 could remove anywhere from 5% - 15% of drivers from the industry as carriers will be less willing to hire drivers with marginal ratings.
- **Hours of Service:** If new HOS legislation is passed, industry experts expect the number of allowable driving hours to be reduced by at least an hour, which by itself would instantly reduce driver productivity by 9%.
  - New HOS regulations, coupled with CSA and an already tightening driver market, are likely to materially limit truck capacity in the near/mid-term and could dramatically affect the long-term supply/demand balance.
  - ....we think the industry is setting itself up for one of the longest and steepest rate recoveries in recent memory.

#### **Initial Signs of Improving Demand.**

- **Inventory / Sales Ratio Remains Near Historical Lows.** ...it appears we are now at point where excess inventory levels have been worked through and we are seeing more normal restocking patterns. ...the inventory to sales ratio suggests shippers are being more cautious.
- **ISM Data Has Been Better Than Originally Expected.**...strengthening in the domestic manufacturing segment has helped improve trucking trends
- Specifically, the ISM has measured over 50 for 17 consecutive months and outpaced original expectations in most months in 2010, reflecting the continued rebound of the domestic manufacturing industry.

#### **Conclusion.**

- Looking ahead into 2011, we think inflationary cost pressures coupled with new government regulations will make it even more challenging for marginal carriers to stay in business and, therefore, we are expecting TL capacity to contract at a potentially greater rate in 2011 than we saw in 2010 (est. 10%).
- Given Class-8 tractor patterns, we think we are entering the next cyclical upturn with roughly 9% fewer for-hire tractors on the road than the start of the last cyclical upturn (2003).

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After a strong December 2010 and a solid January (excluding bad weather impact!), all the key indicators are positive for the truckload sector. It is anticipated that the factors above will benefit the larger, well-run carriers to the detriment of smaller, over-leveraged carriers. Often I am asked by Shippers what they can do to get capacity and be prepared for the busy summer months. Here's what I tell them...

- 1) Rates are going up - significantly - accept it as fact because if they do not, there WON'T be any carriers left in business to haul your freight.
- 2) Shippers & Consignees that load / unload fast will receive preferred treatment as will those shippers with few stops. With CSA & HOS implications, productivity will be reduced no matter what so Carriers will give priority to Shippers / Consignees who can get them in and out the fastest with few stops along the way.
- 3) Accessorials & Fuel Scales are at the top of every carriers review list. If a Shipper does not pay a fair fuel surcharge, that Shipper will be last call for Carriers.
- 4) Consistent freight / load allocations. Shippers who are inconsistent, want to bid every load, and change course often will be served only at a very high premium.

If you have any questions or need additional information, please don't hesitate to contact me or your Melton Regional Sales Representative

Best Regards,



Dan Taylor  
Senior Vice President - Sales & Marketing  
Melton Truck Lines, Inc.  
918-234-8000 x600  
[taylor@meltontruck.com](mailto:taylor@meltontruck.com)



**Melton**  
Truck Lines, Inc.

[www.meltontruck.com](http://www.meltontruck.com)