Morgan Stanley Virtual Laguna Conference
Fireside Chat with Brad Jacobs and Matt Fassler of XPO Logistics
Conducted by Ravi Shanker of Morgan Stanley
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1. **Ravi Shanker, Morgan Stanley:** Hello, and welcome back everyone. For our next session, we have a fireside chat with XPO Logistics. We're very excited to have XPO chairman and CEO Brad Jacobs with us today, as well as Matt Fassler, chief strategy officer. Thanks so much for joining us virtually.

   If you have any questions for Brad or Matt, please send them to me via the webcast browser and I can pass them on.

   Brad, it's certainly been a very interesting year so far, to put it mildly. I think very few people out there have the insight that you do into global supply chains and the multitude of industries. So, maybe a good place to start is, what are you seeing out there? What kinds of conversations are you having with your customers? Are you seeing "open for business" signs or are people still kind of in their shells?

2. **Brad Jacobs, XPO:** First of all, thank you for the invitation and the opportunity to meet today, Ravi. I appreciate it. In terms of the macro and what's going on in different parts of the business, overall it's come back a lot from even a month ago — and it's come back a huge amount from where it was three months ago. Contract logistics is doing better than transportation, in part because logistics didn't dip down as much to begin with.

   Geographically, in transportation, Europe started recovering first, but the US is coming back, as you're seeing in the truck brokerage market. Brokerage is a really tight market right now. It takes more effort to find the trucks. I think it's going to stay that way for a while. A lot of capacity came out during the throes of the pandemic and that doesn't just come back right away. Demand, on the other hand, is coming back. In the LTL business, the industrial economy is starting to come back and shipments and tonnage are generally better in the industry. Business conditions are not as good as they were before the pandemic, but they are noticeably better than a few months ago.

3. **Ravi Shanker, Morgan Stanley:** That's a great overview. Can you delve into a little more detail? Are things coming back pretty much the same way as before? Is it the same kind of business as it was prior to the pandemic, or do you think anything is permanently changing with the way your customers are doing business? Are they outsourcing more or less? Any other permanent changes as a result of COVID that you see out there?

4. **Brad Jacobs, XPO:** To state the obvious, e-commerce is booming and everything e-related is going gangbusters. Our contract logistics business in Europe, for example, where 55% of our business is retail or e-tail, is doing super well. Our last mile business here in North America is also doing very well, partly because of the e-commerce trends, and partly because people are indoors much more. So, they're ordering more exercise equipment and home entertainment equipment and do-it-yourself improvements in and around the house.

You mentioned outsourcing. No doubt about it — there's more of that. Many customer conversations are about planning to shift more supply chain operations externally to 3PLs rather than doing these things themselves, simply because they got beat up during the pandemic and their supply chains fell apart. It makes a lot of sense to outsource. It always has, because 3PLs like XPO have the people who have the expertise. We have logisticians. We have technology. We have our finger on the pulse of what's going on.

We have a big managed transportation business, so we're seeing the changes minute-by-minute. There are a ton of reasons why outsourcing has been driving the growth of the 3PL industry over the last couple of decades, and now that growth is definitely accelerating.

5. **Ravi Shanker, Morgan Stanley:** Got it. Obviously, XPO has been known to really hit that organic growth algorithm, driven by new business wins over time. You guys don't disclose your pipeline of new opportunities anymore, but can you talk about the conversations you're having with your customers? Are they willing, at this point, to look out three to five years? Are they willing to come out with new bids and new initiatives, like you have with Nestlé, with your Warehouse of the Future? Or are they more like, let's dig ourselves out of this hole and then see what happens later on?

6. **Brad Jacobs, XPO:** It's both. People are dealing with the near-term first, making sure their goods are getting to their customers in a timely and cost-effective way. But there's probably an all-time-high amount of strategic thinking happening within customer organizations. Do we really want to be doing all this ourselves? Do we want to outsource all of it? Do we want to outsource two thirds of it? One third? There are a lot of internal discussions about that going on.

   Technology is the big element here, because most customers don't have the necessary tech. A few do. But, for the most part, they're not spending half a billion dollars a year on technology and innovation for transportation and logistics. They're not up-to-date on the systems and the apps and the capabilities. There are other drivers, too, like stability and reliability.

   Before the pandemic, when all the tariffs were happening, we saw customers increasingly moving their supply chains out of China, going to places like Vietnam and Malaysia and India. Some came back to Mexico. Now we hear a lot of conversations about nearshoring with the OEMs. Customers want supply chain reliability first — but secondly, they're concerned about political risk. Whichever party ends up winning in November, both have an America-first strategy that's going to reward US-based jobs and penalize foreign jobs.

   So, there are some changes taking place, for sure. I think we're well-positioned to benefit from all of these trends. I think we've got the right locations around the world, the right business lines, the right tech focus, the right customer sensitivities, and the right types of customers. I think the future is bright for this industry and for XPO over the next few years.

7. **Ravi Shanker, Morgan Stanley:** Can I just follow up on your comments on nearshoring? I think that's a pretty important topic. It sounds like these are initial conversations at this point. Do you think this is going to be as big a trend as we saw with outsourcing from the US to Asia three or four decades ago? Is this a complete reversal of that trend or something that happens

opportunistically on the fringes or on the margins, but the current supply chains stay as they are?

8. **Brad Jacobs, XPO:** The current supply chain is not going to stay as it's been. It's changed even in the last few months and there will be radical changes coming. Supply chain distances are going to become shorter. That's a major change that's going to happen. Certain parts of our business are going to be big beneficiaries of that, particularly LTL. I don't think it's going to go back to what it was. I don't see that at all.

9. **Ravi Shanker, Morgan Stanley:** Let's talk about LTL. I'd say you had a pretty good second quarter under the macro circumstances, but I think LTL understandably had a bit of a tougher quarter, given how tough the industrial environment was. Can you give us a recap of what happened in LTL in the second quarter and how you see that changing in the second half of the year?

10. **Brad Jacobs, XPO:** In the second quarter, we got significantly penalized for prioritizing the lives and health of our employees over profit. I don't regret that for a second. It's too bad we took heat for it, but c'est la vie. We did the right thing.

    We've never prioritized market share growth or tonnage growth in LTL. That's just not our strategy. We go for profitability growth and for margin growth. That's worked really well. I find it very ironic that we were being criticized for our operating ratio in LTL in the second quarter, because — when you just rationally and unemotionally look at the numbers — if you take the period from 2015, when we got into the LTL business, to 2019, we improved our operating ratio by over a thousand basis points! The next company that improved its operating ratio the most after us improved it by about 400 basis points. We improved our operating ratio two-and-a-half times the industry stalwart. So, no apologies about operating ratio improvement.

    We've improved our year-over-year LTL operating ratio in 16 of the last 18 quarters, and one of the two outliers was during the pandemic. That was a one-time blip because we were prioritizing our employees' health over making money. In that same four-year period, we nearly <u>tripled</u> the EBIT from when we bought Con-way. We're doing very well in the LTL business, and we expect that's going to continue.

    We've got a nice path forward over the next few years — not with exactly the same playbook, but a similar playbook focused more on the technology side. It's not just taking costs out to get the organization lean and right, it's also from automating pickup and delivery more so we can pick up more loads with the same number of trucks and people at the same cost. It's optimizing the labor cost on the cross-docks using our proprietary XPO Smart labor management tools. We've already seen percent improvements in the mid-single-digits in labor productivity in LTL from XPO Smart, just like we're seeing in our contract logistics business, where the tools were first developed.

    In the linehaul part of the business, we're making really good progress taking miles out, while still getting the freight from here to where it's got to go — directing more pures, more directs, with less zigzagging around the country. We're driving 2.5 to 2.6 million miles per day in linehaul, and we think we can bring that down by several hundred thousand miles. I think we've got a really good plan to take more cost out of the business through operational excellence, through improving the way we run linehaul, and primarily by using technology to do that.

I'm very bullish about our ability to take our LTL OR from the 80s, where it is now, into the 70s in the future. And I'm very optimistic about our LTL business overall, even without significant revenue growth. We're not trying to move up the league tables and pat ourselves on the back for revenue growth. Our shareholders don't benefit from that, except to the extent that it increases profit growth. We've got a fantastic four years behind us and we've got a fantastic four years ahead of us of improving the profit and profit margin in LTL.

11. **Ravi Shanker, Morgan Stanley:** That's a great summary of where you guys are. It's not often that people will make that connection with LTL and technology. It's kind of viewed as an old-school business, but clearly, you're doing very different things with it. Would you say that you're significantly different than your peers in the way you operate that business and the way you're deploying technology? You don't always hear, "We're not chasing revenue growth" — because that's essentially how a lot of your peers drive growth. You're clearly focused on the cost side.

    Also, you went through some of the technology initiatives you've put in place in LTL. Can you expand a little bit more? I was lucky enough to be at your Technology Day in Boston last year, when your tech team showed us some of the initiatives you're working on. What are some of the most exciting things you have going at XPO? Is it the GreyOrange robots? Is it the automation on the LTL side? Can you give us an overview of what's happening with technology right now?

12. **Brad Jacobs, XPO:** Two things. First, I'm not putting down our competitors. We've got some great competitors and that's a fantastic thing. They're pursuing slightly different strategies in terms of the topline growth, and that can work. We've already got a network that covers 99% of zip codes, so that wouldn't work as effectively for us. We wouldn't have tripled the EBIT over the last four years if our primary focus was chasing revenue. What we try to do is continue to shed revenue that has lousy margins and doesn't fit our network very well, and replace that with revenue that's got more profitability and fits our network much better. But different companies have different strategies working for them.

    In terms of your question about tech, I could spend the rest of our time together talking about our tech initiatives, but I'll try to be succinct. You asked me to highlight some of the more exciting things going on in tech. I would pick XPO Smart, XPO Connect and automation in our warehouses. There are lots of other things too, but I'll spend time talking about those three.

    With XPO Smart, you've got to remember that the biggest line item we've got in cost, by a long shot, is labor. It's $6 billion or so of cost. We're using our proprietary analytic tools to optimize labor so that we're not understaffed. Some companies get too lean, they cut staff and then have massive overtime. So, what have they accomplished? But we don't want to be overstaffed either, where we have excess cost and less productivity. We want to find that Goldilocks number of not being overstaffed and not being understaffed.

    XPO Smart has been a real winner for us. We started it in our contract logistics business, because customers were telling us what they thought their labor demand was — and a lot of times they were unintentionally wrong. We found that, by applying our algorithms to what they predicted, we got a really good sense of who was a sandbagger, so to speak, and who was the opposite. Also, we were able to benchmark against similar types of SKUs across different geographies.

All that information gave us a much better handle on predicting customers' demand for labor, better than what came from the customers themselves. This enabled us to right-size the staffing levels to match the demand that actually happened. It also enabled us to charge the customer less and make a higher margin on that lower price point, so it's a beautiful thing all the way around. We ended up passing this technology along to our LTL cross-docks, and it's coming along very well there. So, that's XPO Smart.

With XPO Connect, our digital freight marketplace, that's where the world is going — technology to do more loads with fewer people. You've been seeing the results in our numbers for quite a few quarters now. In the second quarter, we booked roughly the same number of brokerage loads with 14% fewer people than a year earlier. So, the productivity is really enhanced, and that's not a blip. That trend of handling more with less labor cost is where transportation is going. And we're able to pass that along to our customers in part, and keep some of that for ourselves. That's another example of technology being a win-win for us and our customers, and most importantly, for our shareholders.

Then, with warehouse technology, in the contract logistics part of our business, there's the way we use robots, co-bots, drones, robotic arms and all kinds of software to manage these operations in a way that requires fewer people. The labor cost comes down, but the quality of the work goes up. There are fewer injuries and accidents and fewer disruptions. It's a much more efficient way to operate and, again, it's where the world is going.

13. **Ravi Shanker, Morgan Stanley:** Moving to the cost side of things, one of the big announcements on the Q2 call was your hiring of Eduardo Pelleissone and Alex Santoro to run the cost side of things and focus on the $700 million to $1 billion of profit improvement levers. Can you give us an update on that? What are you focusing on? When will we start seeing traction on that, and how much of that overall bucket of $1 billion do you expect to realize?

14. **Brad Jacobs, XPO:** Well, Eduardo and Alex have humbled me. I thought we were really good at cost control. We've taken a lot of cost out of the business all around the globe. We've got a very good focus on that. But I'm radically impressed with their ability to turn sofas over and find nickels and dimes and quarters that add up to huge amounts of money. They're looking at our business now with a completely different perspective. They're using zero-based budgeting, and it's the first time we're going to use ZBB. I've been doing budgets for decades and I've never done ZBB. It's a new experience for me, and I like new experiences. I'm encouraged and optimistic. I know Eduardo and Alex are also optimistic about taking out significant costs while improving service levels. The best of both worlds.

With respect to the 10 profit improvement levers, they're still the primary focus of our operating cadence. When we do our operating reviews, every day and every month is about progress we're making on those 10 levers. You'll recall how we found those levers — by crowdsourcing our entire organization and asking for ideas to improve the profitability of the company. From this, we got thousands of ideas. We then quantified those ideas to see what the actual profit improvement would be, and on a risk-adjusted basis, what the likelihood would be of achieving that improvement.

We then narrowed down the ideas from thousands to just 10 big ones. These are the ones that can really make a difference in improving margins and improving return on capital. We're making good progress on all the levers across the board, and we're going to continue doing that. Eduardo and Alex are spending time on this, but also our team was already focused on the levers, and they're front and center as well. I'm highly encouraged by these levers. Most of them are technology-based improvements, but some of them are pure, basic procurement practices.

15. **Ravi Shanker, Morgan Stanley:** Got it. So, when you look at the $700 million to $1 billion cost opportunity, how much of that do you think is realistically accessible in the coming years?

16. **Brad Jacobs, XPO:** It's not all cost, by the way. The majority is cost, maybe 60% or 70% of it, but the rest is revenue-based. To answer your question, I think all of it is realistically accessible. We're not going to get the whole billion dollars because life doesn't work that way, but we should get the majority of it. We pushed it back almost a year, only because we had a slowdown with some of the initiatives from the pandemic. Our procurement organization, for example, was focused on things like PPE and protecting our employees, not chipping away at vendor costs. All our levers are actionable and are well thought out, well-conceived and highly vetted.

We have nearly 100,000 people in our organization, and the top 35 people really run the global company. This senior team has looked at the profit improvement opportunity from many different angles and we spend a lot of time going through each of the 10 levers, seeing what progress we're making and whether we're allocating too many or too few resources to each lever. Are we going too fast or too slow? What are the near-term objectives? What are the medium-term and long-term objectives? This is the cadence and rhythm that we're in. We keep chipping away at those 10 levers.

17. **Ravi Shanker, Morgan Stanley:** XPO has done an incredible job at creating organic growth and improving margins in the last five years. But, to be honest, when someone says "Brad Jacobs" or "XPO" the first thing that pops into someone's mind is M&A, because you have a long track record of M&A over the years. Do you see that becoming part of the equation again at some point? Is that a near-term thing? Is it a medium-term thing?

18. **Brad Jacobs, XPO:** First of all, I'm sad that people pigeonhole me as just an M&A guy. It's one tool in the toolkit. I think I've got a lot more things going on than just M&A. In fact, we've grown the business a half a billion of EBITDA and $2 billion of revenue, doing no acquisitions, since 2015. I think our operating ability is even more important than M&A because you can buy stuff, but if you don't improve it, then you're not creating much value other than that first accretion on the differential between your multiple and their multiple. M&A is something we look at as a tool.

We've done one recent deal that's going through regulatory approval now and should close in a few months. That's for some of the UK contract logistics assets of our great competitor, Kuehne + Nagel. They wanted to get out of parts of the UK market. We wanted to get more deeply into those parts. So, it was a nice win-win deal. We like that they're in tech, e-comm and food and beverage. These are some of our bread-and-butter verticals and they're key to our strategic emphasis going forward. Kuehne + Nagel was happy with our price and it made sense from an accretion point of view. We'll get tons of synergies between our UK footprint and theirs, so I'm super excited about this deal.

That's an example of the kind of M&A we want to do. We don't want to do M&A just for the sake of doing M&A — to get some headlines and check the box of having done a deal. That's temporary stuff. From a long-term value creation point of view, anything we do, including M&A, has to have a lot of juice in it. When we see M&A that has tons of juice, where we have a clear plan for how we can grow what we acquire, and grow it dramatically from where it was under previous ownership, then yes, we'll do M&A. But we'll continue to be very disciplined on price, on how compelling it is strategically, and on what our customers will think if we do that acquisition. Are they going to say it's a great idea or are they going to scratch their heads and say that that doesn't help them? That's part of our discipline on M&A.

19. **Ravi Shanker, Morgan Stanley:** Here's a question from the audience about customer conversations around outsourcing and converting those to sales. What is the typical lead time from conversations to contracts?

20. **Brad Jacobs, XPO:** It depends. On the transportation side, it's pretty quick. You can turn it on like a light switch. On the contract logistics side, it's a more complex situation, because you may have a five or 10-year contract that's very dense and full of legal documents and covers every possible scenario that could go wrong or might change. You have to figure out ahead of time, before you sign the contract, what you'll do if something happens. Who's going to bear the cost? What you don't want to do is get into a multi-year contract and run into something that hasn't been pre-agreed, something that significantly changes your profitability. That's how you get into conflict. You want to have a win-win relationship with your customer.

    We think about these things very carefully, and the contract logistics we offer is bespoke. You can't just hit F8 and spit out a contract, like you can in transportation. We don't do one-size-fits-all. It's very customized. That can take a while, even many months, to negotiate. But, in the grand scheme of things, many months isn't a very long time to get five-year or 10-year contracts. We won some big logistics contracts earlier this year, and we're negotiating some even bigger ones now because of what I was talking about before, where customers are outsourcing more. In some cases, customers are doubling the amount they're outsourcing.

    We have one customer, for example, that's a very big retailer. They have around 5,000 brick-and-mortar stores around the world and they're talking about taking out over 1,000 of them over the next three years because they're seeing their customers move towards e-comm. That's a wonderful thing for us because we have the largest outsourced e-fulfillment platform in Europe. We get a look at pretty much every e-fulfillment contract that comes up there, so I'm very bullish about the future of that growth trajectory.

21. **Ravi Shanker, Morgan Stanley:** One topic we haven't touched upon is the tightness in the trucking market and how that spills over into the LTL business. And there are a couple of LTLs, so far, that have come up with different strategies: going after growth versus protecting yield and not taking on that freight. How do you see that playing out right now? What's your approach to this super-tight truck market?

22. **Brad Jacobs, XPO:** We've always gone for yield over tonnage in LTL because when you do the math, you need somewhere between 3x and 5x tonnage to make up for 1 point on yield. It's just really straightforward, compelling math. You always want to go for yield, keeping the elasticity in mind. You can't get greedy and be way off the market. Our strategy is that we always want to be fighting for a fair price, and optimizing that price, and getting yield for the premium services that we're providing. That works for us.

That's why we've nearly tripled the EBIT in LTL over the four-year period from when we bought it. It's because we didn't go for tonnage — we actually shed a lot of tonnage. We went for yield and we went for process improvement. That strategy has worked super well for us and we're going to continue with it. We're not going for "lower your price and go for market share and beat your chest." That's just not how we roll.

With respect to the truckload spillover, we don't get much of that. We have different voices within our company saying maybe we should or shouldn't get more of that business. There are pros and cons to it, but presently and historically, we haven't played much in that, because it's cyclical. It happens and then it doesn't happen. We're trying to make a nice, stable network flow, but we're also continuously reevaluating our strategy, including our LTL strategy to generally avoid full truckload.

23. **Ravi Shanker, Morgan Stanley:** We have just about a minute left. I'll end with this very interesting question that came from the audience: What will XPO be in five years? Will you look like much the same company, with much the same businesses in the same geographies, or are you going to look different?

24. **Brad Jacobs, XPO:** We'll be whatever company it takes to have a much higher stock price. We're a shareholder value-driven company. And from our board to our senior management, we're always thinking: What is this going to do for shareholder value? What is this going to do to honor our most important commitment — to the shareholders who have given us their money to create the value for a great return? How much money are we going to put into something, and how much money are we going to get back, and when are we going to get it back, and how long is that stream going to continue?

It's a very basic, fundamental mindset that's made us successful. It's why we grew our EBITDA from $1.1 billion to $1.6 billion in four years. We keep coming back to that basic construct. If that means doing M&A, then we're going to do M&A. If that means doing some dispositions, we'll do dispositions. If that means doing neither and instead building up the business through capex, that's what we're going to do. We're going to be flexible, and we're going to be nimble, always keeping shareholder value foremost in our decision-making.

25. **Ravi Shanker, Morgan Stanley:** Very interesting times, and I think you're very well-positioned, from both a cyclical and a secular perspective. Brad, thanks so much for your time and we'll connect soon.

Edited for clarity.