Deutsche Bank Annual Global Industrials & Materials Summit
Fireside Chat with Brad Jacobs and Matt Fassler of XPO Logistics
Conducted by Amit Mehrotra of Deutsche Bank
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1. **Amit Mehrotra, Deutsche Bank:** Good morning, everybody. My name is Amit Mehrotra and I'm the transportation and shipping analyst at Deutsche Bank. We have over 500 people participating in this conference, with 370 clients and investors and over 150 company representatives. Deutsche Bank appreciates your time and hopes the next two days prove to be insightful.

   I'm very happy to start the Summit with Brad Jacobs, the founder, chairman and CEO of XPO Logistics, as well as Matt Fassler, XPO's chief strategy officer. Brad has an incredible track record of building companies from the ground up and creating tremendous equity value in the process — companies like United Waste, United Rentals and now, of course, XPO Logistics.

   XPO is a $15 billion global transportation and logistics company. It's the No. 3 for-hire transportation company, just behind FedEx and UPS. XPO is also a top LTL company and the No. 1 provider of home delivery for big and bulky goods in North America, and is the second largest global contract logistics provider as well. I can't think of a better way to kick off our conference today.

   To get things started, I'll ask the obvious question first. Given the global reach of your business and the various end-markets XPO serves, please give us a sense of the current trends in the business related to COVID-19. Europe appears to have come off the bottom nicely. That's about 40% of your business. Has that trend continued? What are you seeing in the US with respect to the economy starting to open back up?

2. **Brad Jacobs, XPO:** Your description is accurate. Europe has rebounded nicely and the US is rebounding, but so far not as much as Europe. Let's look at it geographically and by business line. Geographically, France has come back very strongly, almost back to prior levels. Spain has recovered nicely, too. The UK has rebounded ahead of the US, but not as strongly as France and Spain. It's definitely headed in the right direction, though.

   If you look at Europe from the standpoint of business lines, contract logistics is doing better than transportation. That's not surprising because, as the name implies, contract logistics is contractual by nature. Also, we do a lot of fulfillment business in e-commerce and food and beverages in European contract logistics, both of which are holding up very well. In European transportation, the majority of our business is in three verticals: construction, industrial and automotive, all of which have just started opening up in the last couple of weeks, so that's behind contract logistics.

   Looking at North America, our business at the end of May trended up from the beginning of May. This continued in the first week of June, so that's encouraging. If you look at transportation by different lines of business, in the US, in brokerage, we haven't seen much change in volumes. But our brokerage margins expanded in May because the spot market was down. So far in June, the spot market has firmed up a bit so we don't expect to see that same margin expansion. On the LTL front, there's a nice rebound happening in both tonnage and price. We'll see how that develops over the next few weeks, but the trend with LTL is absolutely encouraging and it's the same kind of trend that some of our competitors reported last week. In last mile, we had an acceleration in May over April. June is too early to call. Contract logistics outperformed our North American operations overall, and that's not surprising, for the reasons I mentioned.

3. **Amit Mehrotra, Deutsche Bank:** That's very helpful. XPO acquired Con-way Freight back in 2015, when the company was operating at a 5% operating margin. Today, it's 1,500 basis points higher. It's been a pretty remarkable transformation in terms of what XPO has done to restructure the margin. Can you talk about some of the drivers behind that? Obviously, Old Dominion is the bellwether benchmark in the industry. Con-way Freight actually had higher margins than OD prior to the Great Recession. There doesn't seem to be anything structural holding XPO's LTL back. Can you talk about the structural outlook for LTL? How quickly do you think we can see the old Con-way Freight business reach parity once again or become even better than OD?

4. **Brad Jacobs, XPO:** When we bought Con-way, it had four parts. While LTL was the main part of the business, Con-way also had a solid truck brokerage business that we completely integrated with our truck brokerage business. It had a capable managed transportation business that we merged completely into our managed transportation business. And it had a blue-chip contract logistics subsidiary called Menlo that we merged into our logistics business. We've more than doubled the profit of the LTL business. We did it the good, old-fashioned way: we paid attention to detail, execution and operational excellence. And we tied the compensation program throughout the whole organization to profitability improvement.

   On top of that, we changed the culture to focus on performance on all levels and it worked. We have a strong focus on cost control, with a lot of transformational-type initiatives that you don't see outwardly. But inwardly, we got rid of a lot of freight that we shouldn't have had in the first place, and we onboarded freight that matched our network better. That's a big deal. You don't see that externally because a dollar is a dollar, so one dollar is gone and another dollar comes in. You don't see it in the revenue line, but you see it in the bottom line, because the freight matches our network better and is more desirable than the freight it replaced.

   We've been on a multiyear journey that's extremely exciting in LTL. We have technology applications that improve the way we pick up, handle, consolidate and deconsolidate freight, and the way we move it on linehaul, and the way we price it to begin with. We're applying technology to all aspects of a pallet's journey from cradle to grave, to make it more efficient. While we've made great progress, and it's been a big contributor to our profit improvement, I would say we're in the second or third inning of technology development in LTL. We have a lot of effort going into that. So, what we've done in LTL is really great, but what we can do over the next several years is even greater.

5. **Amit Mehrotra, Deutsche Bank:** What I'm really intrigued by in LTL — and we're seeing this in some other companies that are non-unionized and still making their way up the margin curve — is this totally transformational way to think about labor management. Obviously, labor is the biggest piece of the cost structure for most, if not all, transportation and logistics companies. You have this XPO Smart tool that you

can utilize in every LTL service center to dramatically change how you think about productivity and overtime. I don't think it's well-appreciated. I was in Boston at your Tech Day and saw this tool in action. I think it would be helpful if you can talk about how much you spend on labor, what this XPO Smart tool is all about, what the potential savings could be, and the payback timeline of that.

6. **Brad Jacobs, XPO:** Yes, management of the labor cost is critically important, because it's our biggest cost. We do that by applying our proprietary technology. XPO Smart gives us visibility into labor costs throughout the company — at the service center, district, regional and corporate levels. We're benchmarking and monitoring different ratios that are relevant to specific sites and the results are amazing.

   The XPO Smart labor tools actually started with our contract logistics business. It was one of the radical innovation projects that our tech team was working on. Once we trialed the tools in our warehouses, we saw over 5% labor productivity gains within a month. Then we made some adaptations that made XPO Smart more applicable to the cross-dock facilities in LTL, where we've been rolling it out and seeing roughly the same amount of labor productivity improvement.

   It works like this. The information comes in, and XPO Smart uses predictive analytics that tell us, "Hey, here's how much labor we had today and here's how many pallets we had today. Here's the kind of labor we need tomorrow, and for the rest of the week, and for next week." Then we plan accordingly, so we're not overstaffed or understaffed. The upshot is that our overtime is appropriate, our ratio between temporary workers and permanent workers is more optimal, the ratio between drivers and dock workers is more optimal and, very importantly, the tools tell us what the length of shift should be. Historically, the industry has had three eight-hour shifts per day, but freight doesn't come inbound in three eight-hour shifts. It comes in big spurts in certain parts of the day and then it's kind of quiet in other parts of the day. XPO Smart shows us when each shift should start, when it should end and how many people should be on the shift. All of that information is reduced to a dashboard that's very simple and easy to understand. It's an amazing productivity enhancement and just one example of the many tech innovations we're rolling out.

7. **Amit Mehrotra, Deutsche Bank:** I think you spend over $6 billion a year on labor across the entire business, and the XPO Smart tools are being overlaid across every site you have, not just in LTL. You mentioned it started in contract logistics. Just a 2% savings is over $100 million in EBITDA, and you're also improving linehaul and pickup-and-delivery productivity. Is it possible, given all this opportunity, that we may see margin expansion this year in the LTL business, despite the depression of the last few months?

8. **Brad Jacobs, XPO:** Well, we're still in the middle of 2020. We're certainly not going to see LTL margin expansion in the second quarter, not when you have tonnage and revenue down so much. It's just not possible. For the rest of the year, we don't know yet. We don't want to go out on a limb and give guidance on that, partly because we don't know how much expense could be created by the expected second wave of the coronavirus. If it's a modest wave, great, it'll be more like background noise. But it could come back in a major way. That's very hard to predict, so we need to be realistic about the fact that there's ambiguity in how the rest of the year will play out.

On the labor cost itself, yes, it's our biggest cost globally at over $6 billion, and yes, we’re applying XPO Smart labor tools step by step in a methodical way to the entire organization. There are other ways that we're approaching labor, as well. In our warehouses, for example, we’re one of the biggest logistics industry pioneers in terms of cobots and other technologies. That’s certainly the wave of the future.

There’s no doubt in my mind that, if you went into one of our warehouses five years from now, and flash back to what that warehouse looks like today, there would be no comparison. The biggest difference being that the number of people per warehouse will be dramatically lower. Employees will be safer, and the business will be more efficient. Data will be more transparent and inventory accuracy will be better. It's going to be better for the customer, our employees, and better for our shareholders, too. The distinction between the haves and have-nots with technology is going to be dramatic. The 15-year joint venture we have with Nestlé, for example — where we're creating the warehouse of the future — that's going to be the industry standard. We're not just designing one warehouse of the future with Nestlé, and that’s the end of it. We're taking all of that technology, know-how and expertise, and we're applying it to the rest of our organization.

That's the future of contract logistics: more and more automation utilized in a very engineered, consistent and standardized way. One of the advantages is that our labor costs will go down quite a bit. If you think about XPO over the next 10 years, with our margins and profits much higher, a huge driver of that will be a more optimal labor cost for the same footprint.

9. **Amit Mehrotra, Deutsche Bank:** The Nestlé facility in the UK is fascinating to me in terms of the size and automation of it. My understanding is that it’s the size of 10, 11, 12 football fields and only has 30 employees in it. A third of those employees are automation and engineering employees, which baffles my mind. How’s it going? Also, how should we think about the contract logistics business in terms of all the verticals you're exposed to in e-commerce?

10. **Brad Jacobs, XPO:** The Nestlé facility is about a dozen football fields in size. Yes, it does have just a few dozen employees in it, many of whom are in tech. We have virtually every vendor of warehouse automation pitching to us and it's an amazing learning experience. We're picking the best of the best, and we provide the integration with our software and the technical platform to make it one, harmonized solution. And yes, it's revenue and of course that's important for profit, but the bigger value to us is the R&D — to be able to replicate innovation throughout our nearly 800 warehouses around the globe.

    There are three whales that will drive our growth in contract logistics in Europe over the next couple years. One of them is Nestlé. The second is a contract that we won in February with one of the largest UK grocers, Waitrose. It’s a three-year contract that starts in July, for about $85 million a year in revenue. And, we purchased three verticals from Kuehne + Nagel in the UK: e-comm, food and beverage, and technology. That acquisition should close around October. It’s highly synergistic with the business we already have in the UK, and it’s very accretive, so we’re really excited about it. There's a fair amount of wind to our back on the contract logistics side from those three big whales.

11. **Amit Mehrotra, Deutsche Bank:** The acquisition in the UK has been an interesting one. It sounds like you guys, because of your scale in the UK, can dig out an enormous amount of synergy and have that payback be quite significant. Is that the right way to think about how that Kuehne + Nagel M&A can impact profitability in the back half of the year?

12. **Brad Jacobs, XPO:** Yes, some benefit in late 2020, with the bulk of it in 2021. Synergies are a beautiful thing. This transaction is something we studied in depth for a long period of time. It's very well mapped out — what we do with it after we buy it — and, like I said, it will be highly accretive. At the same time, it was a win-win deal. It was a good deal strategically for Kuehne + Nagel, who's refocusing on other priorities.

13. **Amit Mehrotra, Deutsche Bank:** If we wrap all this together and think about the logistics business, it's the biggest individual piece of your business, at least from a revenue perspective in North America and Europe. Is that poised to enter a stage of growth as some of these big projects come online? The R&D that you have can be leveraged in other areas of the business. Should we assume that the contract logistics business will enter this renewed phase of growth that can be sustained over the next several years?

14. **Matt Fassler, XPO:** If you think high-level about the macro factors driving contract logistics, there are three huge trends that were already evident as we approached this year, and I think will be even stronger tailwinds for us post-pandemic.

    The first broad trend is outsourcing. This is very relevant to the contract logistics arena. Our customers, having been through the pandemic, and having seen the potential fragility of supply chains, understand that they need well-capitalized partners to help them manage their supply chains.

    The second high-level trend is that, while e-commerce has obviously been growing for years, now it's accelerated dramatically. Most of us have experienced that firsthand during the pandemic. There's been a step-function change in the penetration of e-commerce. We don't expect that to revert back to a pre-pandemic norm. We think it's going to be sustained. Consumers' tastes have changed. Some brick-and-mortar capacity is coming out of the market, and even where brick-and-mortar capacity is maintained, lots of vendors have had their distribution disrupted and want to improve their direct-to-consumer capabilities. We're very well-positioned to help our customers in this regard.

    We have the leading third-party e-fulfillment platform in Europe. We're a major player in reverse logistics. We have a huge presence in omnichannel in North America and Europe. We can deploy advanced logistics solutions at scale across the world. We're one of the very few go-to partners that our customers have. We expect that, as companies emerge from the pandemic and look to future-proof their businesses, this will provide a nice backdrop for us for a number of years.

    The third driver is the supply chain automation that we've talked a lot about. Again, we can deploy advanced solutions at scale quickly. It's good for our customers and for our shareholders, and we expect that to be a big source of business for us going forward.

15. **Amit Mehrotra, Deutsche Bank:** When XPO Direct was announced a couple years ago, it was really interesting. It was almost like a supply chain subscription model, because you were utilizing your footprint, which is enormous— about 800 sites globally in contract logistics — as a way to marry e-commerce fulfillment capacity with those that need the capacity. What we've seen over the last couple quarters is that the margins in logistics have actually been rated a little bit higher, mostly because a lot of those internal startup costs associated with XPO Direct have now been realized or incurred. Can you talk about how the contribution margins associated with the revenue in that business should be higher because you're basically already leveraging your fixed cost base? Is the margin profile in logistics at a new normal, now that these costs are in the rear-view mirror?

16. **Matt Fassler, XPO:** I think you described the XPO Direct business well. It's a shared distribution network across our contract logistics facilities and our last mile hub network. XPO Direct was profitable in Q1, which was barely more than a year after our full national launch. We expect it to be profitable for this entire year. When the US retail world went on pause, there was a dramatic surge in opportunities for XPO Direct. Many retailers and brands — including digitally native brands that are direct-to-consumer — need help getting to their customers. They can leverage our footprint.

    Also, many of our customers don't have the technology they need for real-time visibility of volume flows and we can give that to them. Our sites position goods within one to two days' delivery to 95% of the US population. There are very few supply chain partners who can offer that — but these aren't the only factors that are going to enhance our profitability in logistics. We also have core business initiatives to improve profitability in European contract logistics. That's been a focus since last year, and over time, we expect automation to aid profitability as we take on larger, more complex, long-term contracts.

17. **Amit Mehrotra, Deutsche Bank:** Thank you, Matt, that's helpful. Brad, your strategy over the last 10 years has been, what does the company need to do to maximize equity value? That's what caused you to look at acquisitions back in 2016 and '17, and then divestitures more recently. Obviously, the world changed earlier this year and is slowly getting back to normal. The credit and equity markets are functioning and deals are getting done. You terminated the sale or spin process. You didn't just suspend it, and I think that language was very deliberate on the company's part. Can you talk about why it doesn't make sense now to revisit that? The market is opening back up. I know you probably are going to say you don't spend any time on it, but why doesn't it make sense to revisit that?

18. **Brad Jacobs, XPO:** It doesn't make sense to revisit it now. We want to be a buyer when the market is soft, not a seller. We get paid to allocate capital in a way that's going to generate the best return for our shareholders. When that means putting it into growth capex, then that's what we're going to do. When that means using our cash flow to pay down net debt, then that's what we'll do. When that means buying back stock, that's what we'll do. When that means M&A, whether it's buying or selling, that's what we'll do. That rational flexibility has always been our strategy, and it always will be. We have to keep an open mind and be very flexible, doing whatever best serves our core mission to create shareholder value.

19. **Amit Mehrotra, Deutsche Bank:** You've spoken recently about XPO's cost structure, and how much is fixed and how much is variable. I think that's helpful. And, when you put that on a schedule, it implies that anywhere in a 20% revenue-decline quarter, you're looking at decrementals of between 25% and 30%. On top of that, there are some unique circumstances around COVID-related costs. You've talked about $50 million in the second quarter. When you overlay all of that, consensus for the second quarter is $180 million of EBITDA. In the past, you've been willing to characterize whether expectations are in the realm of reasonable. I'm hoping you can do that now, and maybe talk about the $50 million in costs. I know that was an estimate. Are they less than or more than that? Can you provide any kind of update or color there?

20. **Brad Jacobs, XPO:** For the second quarter, when you do the math with the 77% variable costs and 23% fixed costs, and revenue down as we discussed on our call, it's actually lower than the number you said in terms of EBITDA for the second quarter. I'm not giving guidance. Let's be very clear about that. I'm just telling you the math. The COVID cost itself of $50 million or so in the second quarter is not far off. The rest of the year, we'll still have COVID costs. It won't be as much as it was in the second quarter. It'll taper down over the balance of the year.

In terms of the remainder of this year, and especially the next couple of years, as long as there's no big, second coronavirus wave, I think it's extremely positive. The reason for that, in my estimation, is that we're benefiting from a number of big tailwinds.

First, there's the outsourcing trend, which has driven the business over the last 10 years. We have more and more people wanting our services. That's a good thing. I believe that, as a result of the pandemic, outsourcing is going to increase, not decrease. We've seen it already. We see many of our customers much more willing to outsource and de-risk their supply chains, rather than do it themselves.

Another long-term driver of the business, in addition to outsourcing, is the explosion of e-commerce, which has been growing during the pandemic. We believe it's not a temporary growth spurt. It's going to continue on afterwards. Also, warehouse automation is a nice cost reducer and driver of margin improvement. Then there are the investments we've made in technology, with things like our XPO Connect digital freight marketplace and XPO Smart, which are taking off.

And then we've got our 10 levers of profit improvement, which collectively represent an opportunity of up to $1 billion of EBITDA improvement. We're making nice progress on those and we're going to continue with that. Those initiatives were crowdsourced from a large number of people inside our organization. They're the 10 best ideas that people had to significantly improve the profitability of the company. People's names and time are associated with each lever, compensation is tied to them and I'm optimistic about the execution of them.

21. **Amit Mehrotra, Deutsche Bank:** Okay, that's great. Thank you so much for kicking off our conference today. We really appreciate your time.