Holland Views: XPO Logistics – Price: $89; MCap: $8.2bn; EV: $12.9bn

Picks, shovels and roll-ups

In investing, as in life, pragmatists rule. Stocks that we might have dismissed a decade ago, we today find ourselves offering more benefit of the doubt to especially where an owner-manager is heavily involved. We dismissed many acquisition-orientated businesses earlier in our careers – some for good reason. But when they go right aka in the right hands, roll-ups can deliver huge investor IRRs (Liberty Group, AB Inbev, Teledyne et al).

Eyes wide open

So, with our eyes wide open, we offer a new roll-up to consider, US-based **XPO logistics**. XPO first came to our attention thanks to our work on United Rental (Ashtead's US competitor) – itself a very successful roll-up. XPO was founded by serial entrepreneur/career CEO Bradley Jacobs in 2012. Jacobs (an oil arbitrager early in life) has a phenomenal track record as Founder, CEO (and ultimately seller) of both United Waste and United Rentals. XPO Logistics has a short corporate track record but the brains of the operation, Jacobs, has an exceptional and long pedigree.

Fig.1: More than a one hit wonder

> Jacobs' track record in the business world is nothing short of amazing. He started 5 business from scratch and each one has generated at least a billion dollars in profit. Furthermore, he's personally led about 250 cold starts and 500 acquisitions over the course of his career and raised over $20 billion in capital.

Source: Money Inc

XPO is a global logistics and freight transport roll-up of considerable success (shares up 26% cagr since 2012). We elaborate on and outline the merits of XPO in this note. Crucially Jacobs was very deliberate in targeting a fragmented market with growth opportunities at the outset. He also picked a sector – logistics – that will definitely still exist in 10 years' time. Jeff Bezos would approve.

> *"I frequently get the question, 'What's going to change in the next 10 years?' And that is a very interesting question." "I almost never get the question: 'What's not going to change in the next 10 years? And I submit to you that this second question is the more important of the two, because you can build a business strategy around the things which are stable over time"* – **Jeff Bezos**

We have read interviews and presentations showing Jacobs was thoughtful in targeting the logistics industry, highlighting the potential for scale to sustain higher margins. More recently, Jacobs has also shown that he is that rare thing, an excellent operator and a good capital allocator – He has done no acquisitions since 2015 and bought back 27% of his stock in 2018 shows an attractive trait.

XPO has multiple logistics businesses but its core 'LTL' business is the jewel. LTL has a pure-play peer of similar scale (Old Dominion) whose EV is twice that of the entire XPO group. We smell value here, with XPO possibly trading on at little as 8x earnings a few years out.

Internal friction – grist to the mill

Longstanding clients might have heard anecdotes of the internal 'friction' that lies within the research process at Holland. One of us is a glass half empty guy, the other is glass half full. The evolution of our thinking on XPO is therefore instructive. We initially thought "*this guy Jacobs is right up our street, the stock could triple*" to becoming disappointed at the 'Stock Promoter' aspect of him along with what seemed a less than ideal quality of earnings. We now find ourselves meeting somewhere in between. We still really respect Jacobs' track record and his clarity of purpose. We also see the value in XPO's best business (LTL) and the rationale in his roll-up plan. On the assumption that he is a man of integrity, we find our early enthusiasm returning. In short, XPO could be a great investment, for those who invest with their eyes wide open. Let's also remember the purists who cautioned against Henry Singleton's unorthodox approach to capital allocation back in the 1970s and missed out on his phenomenal returns.

A pragmatic look at a fascinating business (and its owner)

We have read extensively on Bradley Jacobs and XPO and have run the numbers on the company's potential earnings power and it peer valuations. We have tried to keep this piece brief and offer this note as a gathering point on our readings/starting block for clients to dig deeper.

Bradley Jacobs, a roll-up maestro?

In [Appendix 1 (hyperlinked[1])], we offer some newspaper profiles and transcript excerpts that give excellent background into Jacobs'. His track record as an arbitrager and his many reincarnations as an Owner Manager are instructive.

Of note:

- The subtle but important similarities with all his previous forays from oil trading to building the United Waste and United Rentals businesses from scratch (as he says himself "*its all just moving stuff*")
- We are impressed with the clarity in terms of what he set out to do with XPO in 2011 vs. what he has achieved. Early on, Jacobs saw the need for consolidation and how as a capital provider he could create value by consolidating select parts of the logistics supply chain, by greasing it with capital and investing in technology
- Additionally whilst having to accept the need for some ownership of assets in this industry Jacobs' instinct is (pleasingly) capital light
- A dynamic, opportunistic operator and allocator.

  The evolution of XPO suggests Jacobs is a dynamic operator with many of the attributes of 'Outsider' CEOs (see Appendix 1). Whilst XPO started out seeking the capital light freight brokerage businesses, when the opportunity arose it quickly moved to buy more asset-based Con-Way (inside which the LTL business resided). Importantly the targeted margin expansions have been realised (LTL +$200m or +c.300pp of margin since purchase). The result is an XPO division with excellent operating metrics and the potential for further profit improvement
- Close observers will see that Jacobs is something of a stock promoter, not a trait we are normally attracted to. A pragmatist would counter that having the capital markets on your side is a required trait of a roll-up when it is in acquisition mode. We remind you he has

[1] Our Appendices in this note are long but we try to ease their navigation by including hyperlinks to jump forward and back from the main Exec Summary to the Appendices

ceased all acquisitions since 2015 and reduced the share count by 27%. At one stage when the shares were depressed even offering to put many divisions up for sale.

Yes, roll-ups can be dangerous in the wrong hands

We simply would not be writing this note and deeming the shares interesting to our clients if the CEO was not also the Founder and 17% owner (with the vast majority of his wealth in this stake). In all investments, but especially in roll-ups, Owner Managers matter – period. Even great investors can get sucked in by the growth on offer from roll-ups. In [Appendix 2], we offer some third party reflections on the disastrous roll-up that was Valeant and remind investors that the benchmark for success are Singleton and Malone. To state that XPO is different is of course dangerous. What is key we think is to look for why some roll-ups have strong business rationale and some do not. Malone's empires built scale in utility type income streams. Valeant was a price gouger. XPO consolidation logic we think is sound. The lasting strength of premium margins that his consolidation has helped establish in United Waste and Rental is notable.

XPO – What's to like in this disruptor in third party logistics, and LTL freight?

We mentioned stock promotion above and true to form; XPO likes to spoon feed investors as per the 108 page (!) Q2 2020 corporate presentation. Actually, the document is an excellent summary of the bull case on the company and is very informative (see excerpts and link to entire presentation in [Appendix 3]).

Of note:

- Global logistics is indeed an industry ripe for disruption and innovation. This is an industry whose costs are largely labour and fuel. XPO is a disruptor with a clean slate and like its highest return peers, is non-unionised. Less than full Load (LTL) freight, the core business, is an attractive business with c.25% returns on capital
- XPO is #1 or #2 in US LTL and European logistics. Importantly, XPO mainly avoids the FL (Full load) trucking business sticking with the more lucrative LTL (Less than full Load), logistics and freight brokerage businesses
- XPO is notably not in the parcel delivery business either. Again it has sought a niche in the last mile delivery of bulk items (it is US market leader)
- It may surprise readers that XPO spends a huge $550m (3.5% of sales) annually on technology. This is not a private equity levered roll up but we wonder if rather more analogous to our friends at Melrose (Buy, Improve, Keep)
- North American LTL is 55% of group profits and is the backbone of the business. Pure-play peer Old Dominion (with margins 26%, a 7pp premium over XPO) suggests that XPO margins are credible and thus allays some of our quality of earnings worries. Dominion and XPO's LTL divisions are of similar scale, yet Dominion's shares carry 3x the XPO multiple

Caveats/Glass half empty, or a worrier's list of concerns

XPO has not escaped the short sellers, and a significant 'sell' report published in late 2018 proved influential. Some of the points raised were pertinent but the report struck us as overly sensational. The shares collapsed and Jacobs reacted with a sizable share buyback + commencing a strategic review of its non-LTL business. We highlight some of our early thoughts on earnings quality and link to the sensational short-seller's report in [Appendix 4].

Of note:

- Jacobs is a stock promoter. But maybe that's a key requirement as you have to keep the capital markets 'on side' for a business of this nature that uses the capital markets during its expansion
- We have unearthed several quality of earnings red flags that cannot be ignored:
    i. Property sales are included and overstate last year's LTL divisional profit by c.$110m. Without those gains, LTL margins would have stayed flat YoY at 20%

    ii. XPO has very material Accounts Receivable factoring. In 2019 it sold $2.2bn in receivables as shown in Appendix 4. This would usually cause us much pause. But, if you have read Jacobs' original investor pitch transcript (Appendix 1), he stated he thought factoring safe in this sector when bad debts run at less than 1%. Indeed he saw finance provision as something needed to build scale when trucking sub-contractors need to be paid before client bills may be settled

    iii. Pension gains were also brought through the P&L as core profits!

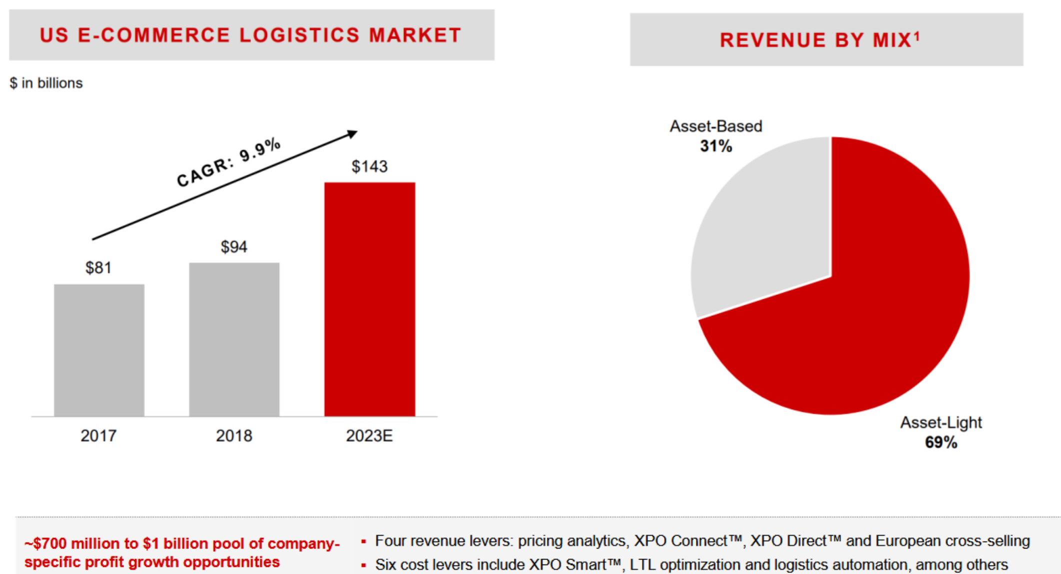
- Competition: Especially in asset-light areas has increased a lot – see Uber Freight. We include a useful trade article for context on this

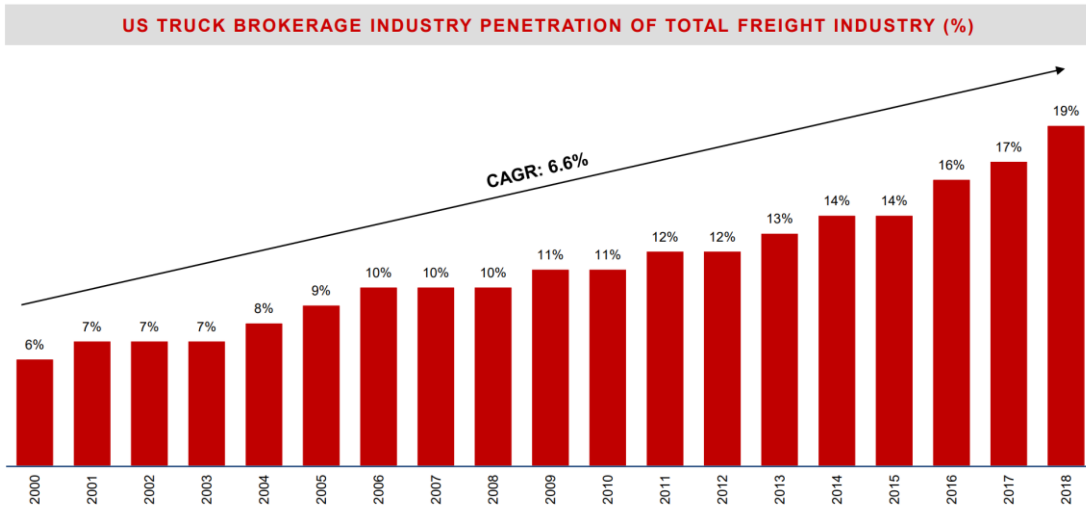
Pictures and words that help tell the story

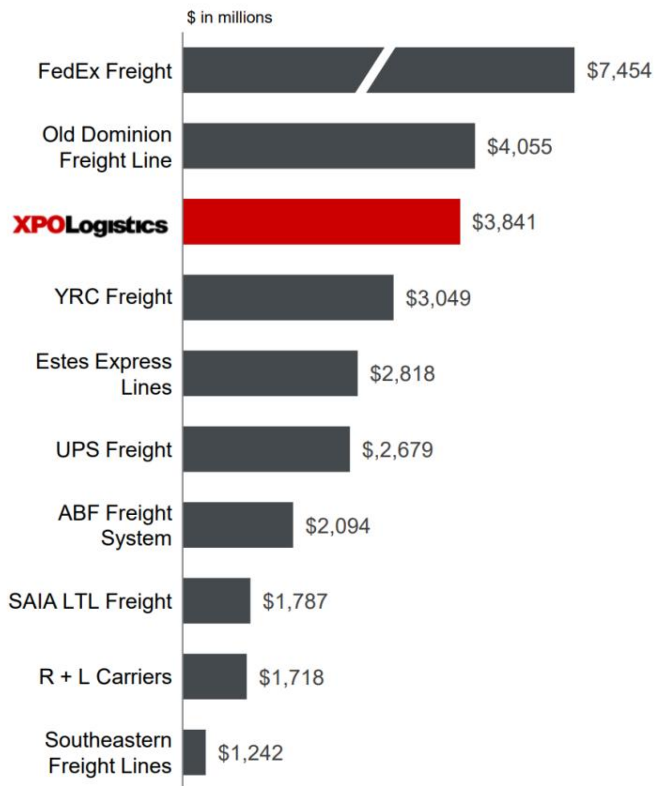
Before we delve into XPO's core division in the next section, we offer a little context on the markets in which the company operates and its culture. The following extract from the company presentation and quotes from its CEO, we think, are telling to those investors that know what they seek. In brief, in XPO we have:

- A resilient sector
- Organic profit growth potential
- An asset allocator who knows exactly what he is doing
- A stated desire to look for asset light and high return niches in a sector dominated by asset intensity and low returns

Fig.2: Pictures that tell a story







Source: XPO Q2 20 investor presentation

<u>Fig.3: Words that help tell the story</u>

> "*In my first 50 to 100 deals, I made a lot of mistakes.* ***Some of those mistakes were not attaching high enough priority to the quality of the people****. Because you can take a company that's sleepy and turn it isn't an energetic company by infusing energy and motivation and compensation plans and getting people pumped, understanding they're part of a bigger thing or a bigger mission. You can't buy a company that's got a dishonest culture and turn it into an honest culture.*
>
> *After I stepped down as chairman of United Rentals in 2007, I started looking for my next big thing. I studied a lot of different industries, and I ended up concentrating on transportation and logistics. It's larger and more fragmented than the industries I've*

been involved with in the past. It's more than $3 trillion worldwide. ***Once I settled on transportation, I first looked at an asset-heavy trucking company roll-up, but I couldn't figure out a way to create the kind of shareholder value I was looking for. I wanted a higher return on capital.*** *Then I discovered C.H. Robinson and Expeditors International of Washington. C.H. Robinson is the leader in truck brokerage, and Expeditors is the largest U.S.-based freight forwarder.* ***I love these two companies****. They're both non-asset based, which is a business model I understand because of my oil brokerage days"* **– Brad Jacobs, 2011**

"I actually like cold-starts better than acquisitions because the ***return on capital is generally higher.***

One ***big issue*** *is the time* ***lag between accounts receivable and accounts payable****. A trucker needs to get paid quickly. They'd like to get their money in a week, which is faster than the shipper will pay. The shipper might pay six to eight weeks down the road. That's not good enough for the trucker.* ***The key is to fund that gap. A lot of brokers hit a ceiling where they can't finance growth.***

We were highly leveraged in the last two companies I ran. This time it's a non-asset business, so I don't see the justification for the same level of leverage right now. ***I'm happy to borrow against the receivables, though, because the write-offs in this industry are typically less than 1%.***

Working capital and growth capital are pretty close to a magic bullet.

It was kind of shocking to me, when I started studying the industry, to see some companies turn ***down as many as one out of five customer calls****. If you can't fill a load you lose the sale, and you're not at the top of the customer's call list anymore. The turn-down rate should decrease as the universe of accessible carriers increases. With more volume, we should also be able to negotiate better discounts with the carriers, which should improve margin from another direction."* **– Source: XPO**

'Less Than Load' (LTL): The jewel

Our time spent understanding the LTL division inside this company was a key factor in helping us assess the potential undervaluation of XPO group. XPO's market position in LTL and the quality of its operating metrics we think more than underpins the valuation of the whole company.

Fig.4 shows a summary of how the company presents its profit by division. Later we show that these profit figures are flattered by one-offs and our more prudent 'owner earnings' makes relevant adjustments.

Also shown at the bottom of Fig.4 is XPO's closest pure-play peer, Old Dominion (with very similar revenue base to XPO's LTL business but with slightly higher margins). It enjoys an enterprise value double that of the entire XPO group.

Fig.4: A simplified P&L and valuation comparison with other LTL players

		2014	2015	2016	2017	2018	2019	...	2023e
Revenue	Transportation			9457	9820	11343	10687		
	of which North Am LTL			3445	3641	3830	3841	4%	
	Logistics			5323	5727	6065	6093		
	US						2500 #2		
							3600 #2		
adj EBITDA	Transportation			937	1028	1199	1265		
	margin			9.9%	10.5%	10.6%	11.8%		
	of which North American LTL		381	547	647	733	851	186	">1000"
	margin			15.9%	17.8%	19.1%	22%		
								0.545512821	
	clean					733	741		
	clean LTL margin					19.1%	19.3%		
	non-LTL margin					6.2%	6.0%		
	Logistics			401.8	460	501	554		
				7.5%	8.0%	8.3%	9.1%		
	Holland est corp overhead EBITDA losses						-151		
	stated GROUP (note P&L EBITDA mismatch below)			**1248**	**1367**	**1562**	**1668**		**2518**
	check						1668		
	GUIDED UPSIDE TO PROFITS								700-1000

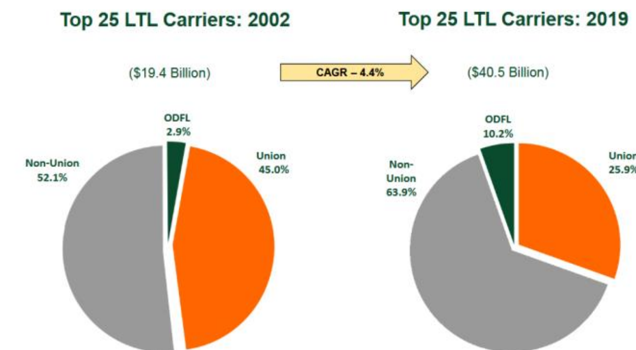
	Unionised	Pure-play	M Cap	EV	RoNTA	LTL revs	op profit	EBIT margin	EBITDA margin	EV/EBITDA
XPO Logistics	NO		9bn	12bn	c17%					7.7x
Less Than Load - LTL										
XPO - LTL division		no				**3.8bn**			19%	
Fedex Freight		no								
Old Dominion	no	yes	23bn	22bn	27%	4bn		20%	26%	22x
YRC	yes	yes	225m	1.2bn		4.5bn		2.8%		

Source: Holland Advisors

LTL EBIT margins vary hugely across the industry as shown above in Fig.4. With labour, c.40% of XPO's LTL cost base, it is thus notable that the lowest margin businesses such as YRC are unionised whilst the best in class (Old Dominion and XPO) are not. Keeping labour costs under control and building network scale is crucial to operating leverage. This was a theme in Jacobs' first listed roll-up Waste Management too. As a new entrant starting from scratch, there too, he was much better positioned to fend-off the 'Teamsters' attempts to organise collective bargaining for its drivers. The ability to further reduce labour costs (through technology efficiencies etc.) is central to the group's targeted margin expansion. Labour costs efficiencies could be up to $300m of the touted $700m-$1bn EBITDA growth XPO is targeting in coming years.

Fig.5: LTL labour costs are key

> *"in LTL, we have about $1.7 billion in labor costs. Really, we have a vision to be able to run the set of business we have right now at $100 million to $300 million less labor costs over time."* – **Bradley Jacobs Q1 2019 (emphasis ours)**



Source: Old Dominion investor presentation

Upside potential to profits

Swallowing company guidance for future profit targets is also something we do not do very often. We do however like to ask the question of '*what if?*' and '*why?*' i.e. what if such targets were achieved and why are such targets being given and by whom? Indeed it was this very thought process that lead us to our recent piece on Melrose (*Nanny McPhee*). The Melrose team have strong credibility on achieving turnaround targets that they have just chosen to reinstate. That fact, we saw as significant. That Mr Jacobs is a promoter we are happy to accept, but as 17% shareholder he need not target an increase in EBITDA from XPO's current operations of $700-$1bn (i.e. a 50-75% uplift). Our valuation work below merely observes *'what if'* i.e. what if such an uplift were achieved? The answer is that XPO would be valued at c.8x earnings. In fact, this estimate is too low as we have re-levered the group to the current 3.5x EBITDA level but not used that extra $3bn of debt for any purpose. Clearly these funds either used for buy backs or new roll-up deals would add further value.

Valuation

We have cited Will Thorndike, author of Outsiders, many times in prior work. Thorndike's work has helped us to frame the common characteristics of the great owner managers[2].

Thorndike astutely lists many common traits of Outsider CEOs such as **pragmatism, rationality, flexibility, frugality, patience and humility** (that narrows the field down just a bit). On the other side of the ledger, Thorndike also points that that his chosen Outsiders were generally not '**promotional'** in how they went about their business. Jacobs fails this latter criteria. However we might be willing to give him a pass on this as by design roll-ups require a level of capital market support – especially in the early years.

So, what's XPO equity worth?

XPO's share price is today -25% below its Q4 2018 peak when a short-seller report and worries about the US economy and competition gained prominence. A close look at Fig.4 earlier shows that the non-LTL divisions (i.e. logistics and brokerage) have seen some margin erosion last year and even in LTL, clean profit growth was actually quite minimal. That all said, the group's enterprise valuation divergence still looks significant. Additionally Jacobs' suggestion of $700-1bn profit upside is seemingly dismissed by markets.

We have taken two approaches to assessing XPO's intrinsic value. On an 'owner earnings' basis (the company helpfully discloses its maintenance capex) we think the stock is trading on perhaps c.14.6x clean 2019 owner earnings. That is after prudently adjusting headline profits downwards for 'sale and leaseback' and working capital outflows. But such a base case is on a 2019 run-rate of earnings, i.e. before the $700-$1bn EBITDA uplift that is outlined by company in coming years. By the way, only 20% or about $150m of that growth is suggested to come from the North American LTL division. Seeing greater profit margins in the logistics operations we think might get Mr Market's attention. For completeness, were that guided growth to materialise, the earnings multiple falls to an interesting 7.6x.

We start with our 'clean' EBITDA (i.e. without the flattering sales/leaseback and factoring of receivables) and layout a simplified summary of what a future earnings for XPO might look like. (NB: As stated above we have not utilised the extra $3bn of leveraged assumed).

[2] Though he is not infallible – he once touted Valeant's Mike Pearson as potential next generation Outsider. Perhaps this is another reminder of the caution needed when assessing roll-ups

Fig.6: Owner Earnings

	2019	2024?	profit uplift est
EBITDA	1560		
less s/leaseback gains	-110		
less working capital/factoring	-100		
Holland adjusted EBITDA	1350	2200	+850m
Maintenance Capex	-225	-250	
Interest	-233	-385	
Tax	-276	-391	
Owner Earnings	**617**	**1174**	
OE/share	6.05	11.51	
Net Debt	$ 4,654	7700	
Net Debt / EBITDA	3.4x	3.5x	
P/OE	14.6x	7.6x	

Source: Holland Advisors

The other simpler way to look at XPO is again in comparison to its peer Old Dominion (ODFL). ODFL is a pure play LTL trucking business that, based on our reading, looks to be a very high quality business indeed. ODFL enjoys best in class margins (26% vs. XPO at 19%) but even so, its EV is almost double that of the entire XPO group (which remember includes LTL plus logistics plus freight brokerage).

Conclusion

We try to have a decent investment process that helps up find businesses that excel in the operate, generate and allocate functions. Sometimes explaining the opportunity in front of us is easy, sometimes it is a little more messy – the latter often being the case when more maverick Owner Managers are being considered. Our attraction to XPO mostly comes from Jacobs' past success and the fact that Mr Market is less impressed with him today than once was the case. That the logistics industry is the pick and shovel of the digital world is not lost on us either. In 2025 an Amazon drone might deliver your paracetamol, but not your new fridge. Logistics is a resilient sector and we are interested in what an aligned Owner Manager can do cherry-picking assets within it.

Buy XPO

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The Directors and employees of Holland Advisors may have a beneficial interest in some of the companies mentioned in this report via holdings in a fund that they also act as advisors to.

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Appendix 1 – Understanding Bradley Jacobs

WSJ profile in full
https://www.wsj.com/articles/bradley-jacobs-has-acquired-more-than-500-companies-heres-what-he-has-learned-11572228061

Forbes profile
https://www.forbesindia.com/article/cross-border/bradley-jacobs-the-maestro-of-mergers/50127/1

Trade Press profile
https://www.dcvelocity.com/articles/29993-accomplishing-the-impossible-interview-with-brad-jacobs

What he set out to do – a fascinating transcript from the IPO roadshow in 2011
https://www.sec.gov/Archives/edgar/data/1166003/000095012311069724/k50546dadefa14a.htm

Appendix 2 – The dark side of Roll-ups

There is a dark side to roll-ups. In the wrong hands, serial acquisitions bring opportunities to mask underling company weakness and opaque acquisition accounting offer opportunities to under-state growth and profitability.

Warren Buffett's 2014 Annual Letter also touched on the subject.

> *"In the late 1960s, I attended a meeting at which an* ***acquisitive CEO*** *bragged of his "bold, imaginative accounting." Most of the analysts listening responded with approving nods, seeing themselves as having found a manager whose forecasts were certain to be met, whatever the business results might be.*
> *Eventually, however, the clock struck twelve, and everything turned to pumpkins and mice. Once again, it became evident that* ***business models based on the serial issuances of overpriced shares*** *– just like chain-letter models – most assuredly redistribute wealth, but in no way create it. Both phenomena, nevertheless, periodically blossom in our country – they are every promoter's dream – though often they appear in a carefully-crafted disguise. The ending is always the same: Money flows from the gullible to the fraudster. And with stocks, unlike chain letters, the sums hijacked can be staggering.*
> *At both BPL and Berkshire, we have never invested in companies that are hell-bent on issuing shares. That behaviour is one of the surest indicators of a promotion-minded management, weak accounting, a stock that is overpriced and – all too often – outright dishonesty."*

http://mastersinvest.com/newblog/2016/3/21/xtbc1eylyoj4gjik5hbuuv5minzq5z

The Economist from 2015 – Serial thrillers

December 19, 2015
https://www.economist.com/business/2015/12/19/serial-thrillers

Appendix 3 – An overview of the XPO business

XPO corporate presentation

https://investors.xpo.com/static-files/672f8b6d-382d-4e08-a43a-0298821fb1d8

Appendix 4 – What goes wrong?

Broker wars – Trade press article on increased competition in Freight Brokerage

https://www.freightwaves.com/news/the-broker-wars-big-bets-pit-new-entrants-against-incumbents

That short sellers report

https://www.sprucepointcap.com/xpo-logistics-inc/

2019 10k red footnotes

Direct operating expense in 2019 was $5,679 million, or 34.1% of revenue, compared with $5,725 million, or 33.1% of revenue, in 2018. The year-over-year increase as a percentage of revenue primarily was driven by higher personnel costs to support growth in our North American contract logistics, partially offset by lower temporary labor, and higher depreciation expense in our logistics segment. Additionally, 2019 and 2018 included $110 million and $6 million, respectively, from gains on the sale of property and equipment.

Under the new program, sales of receivables transfer control to the Purchaser and therefore are accounted for as a reduction in accounts receivable. We service the receivables we sell on behalf of the Purchasers, which gives us visibility into the timing of customer payments. The benefit to our cash flow includes the difference between the cash consideration in the table below and the amount we collected as a servicer on behalf of the Purchasers. In 2019 and 2018, we collected cash as servicer of $2.168 billion and $119 million, respectively.

Information related to the trade receivables sold was as follows:

	Years Ended December 31,		
(In millions)	2019	2018	2017
Securitization programs [1]			
Receivables sold in period	$ 2,231	$ 231	$ —
Cash consideration	2,095	179	—
Deferred purchase price	135	52	—
Factoring programs			
Receivables sold in period	858	663	119
Cash consideration	854	660	119

(1) Receivable transfers under the securitization programs are accounted for as either sales or secured borrowings. In the prior program, a portion of the transfers were accounted for as secured borrowings while under the new program, all transfers are accounted for as sales. This change had the effect of increasing the amount of trade receivables we reported as sold in 2019.

- Some of our customers may experience financial distress, file for bankruptcy protection, go out of business, or suffer disruptions in their business and may be unable to pay us. In addition, some customers may not pay us as quickly as they have in the past, causing our working capital needs to increase;

Source: XPO 2019 10-k

Disclaimer

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