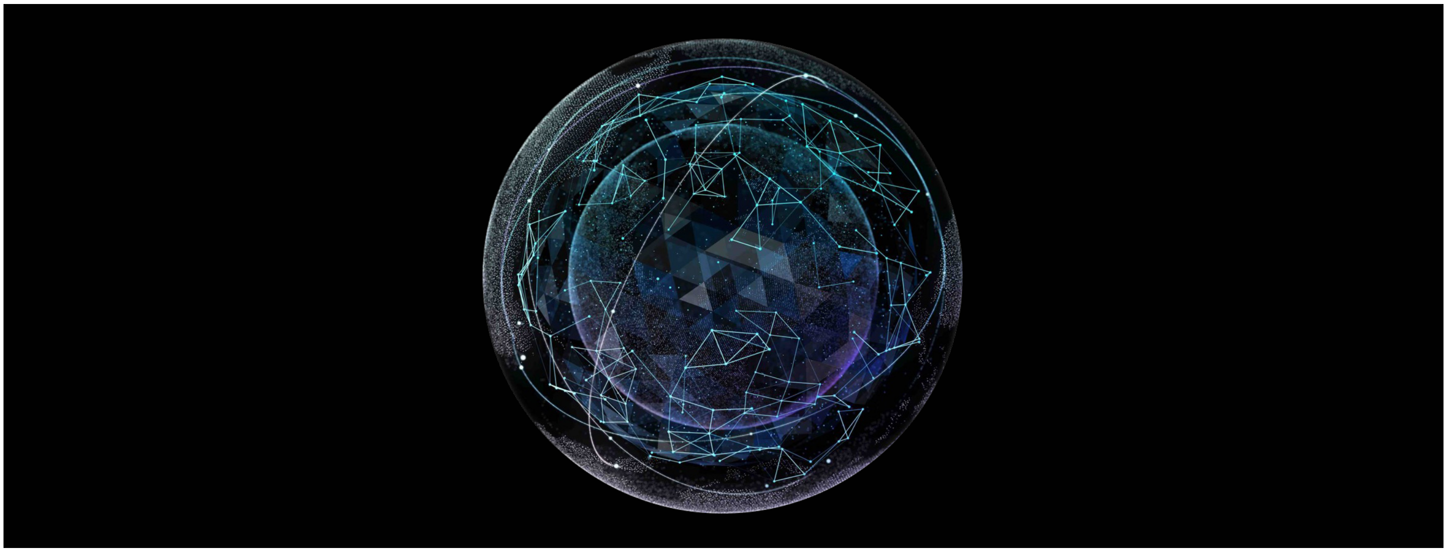


Finding opportunities in today's transportation sector

Leading by addressing the underlying certainties the industry has faced for years

The transportation[1] sector is the crucial element in the global movement of goods and people, and like most sectors, it's hurting right now. At the onset of the COVID-19–related downturn in mid-March, $160 billion of US-based transportation companies' market value had been destroyed. Yet the industry had trouble brewing before anyone heard of COVID-19. The pandemic has simply taken just a few weeks to expose underlying inefficiencies the sector has never fully addressed. There is an opportunity for many who choose to address these.

It is clear that transportation companies must navigate the COVID-19–related downturn. But the current crisis presents a dramatic opportunity—one that may allow companies to remake themselves and perhaps the sector as a whole by addressing the long-standing challenges of meeting ever-increasing customer expectations (such as faster and free delivery), inefficient networks and congestion, excess capacity, changes in workforce, shifts to trade patterns, and an underinvestment in technology. Indeed, almost 50 percent of responses from transportation companies surveyed larger than $1B indicated they have not invested sufficiently in the capabilities they need to respond to some of these issues.[2]

Yet even during today's COVID-19–related downturn, there are transportation companies that are thriving. So what is the course forward? Experiences will likely vary from place to place, because the nature of recovery will be hyper-local. It will also vary from company to company. Some may call it a win just to survive this downturn by addressing immediate liquidity challenges. But companies that have more financial and strategic freedom—and that have the ability and willingness to challenge sector issues that have existed for years—may find opportunity to thrive and perhaps even redefine the sector as a whole. In summary:

- Regardless of pandemic severity, there are **certainties** to address, many of which preceded COVID-19
- The current environment presents an opportunity for some companies to **leap ahead**
- On the next pages, we provide the outlines of an approach for any company to consider as you chart your path to both **recover** from the COVID-19 crisis and to **thrive** beyond.

New pressures, old opportunities

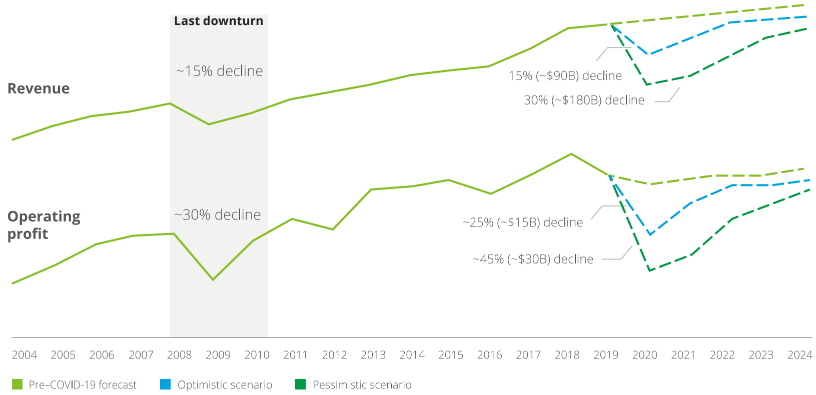
There is no question the COVID-19 crisis is a global tragedy. Setting aside the enormous human suffering, months of lockdown have destroyed value that may take some time for the sector to recover. Deloitte estimates that by the time 2020 ends, up to 45 percent ($30 billion) of the transportation sector's operating profits could be destroyed (figure 1). That's the equivalent of one-quarter of its companies' operating profits.

But the transportation sector was under pressure well before COVID-19. COVID-19 has simply exposed longstanding challenges, such as:

- **Customer expectations** for speed, service, and the implications for localized distribution
- **Inefficiencies and congestion** from inflexible networks and evolving trade patterns
- **Fragmentation of supply** in a sector that has rarely consolidated
- **Lack of investment in new technologies** to connect, learn, predict, and automate
- **Shifting talent models** from retiring workforce to the gig economy
- **Disruptive entrants** that are taking advantage of the inefficiencies to displace others

The combined impact of these problems is a five-year sector aggregate return of 19 percent, compared with 57 percent for the S&P 500, and a "revenue multiplier" (or enterprise value/revenue) lower than many other industries (figures 2 and 3, respectively)—meaning that investors are not willing to pay as much to invest in transportation as they are willing to pay for a stake in many other sectors.

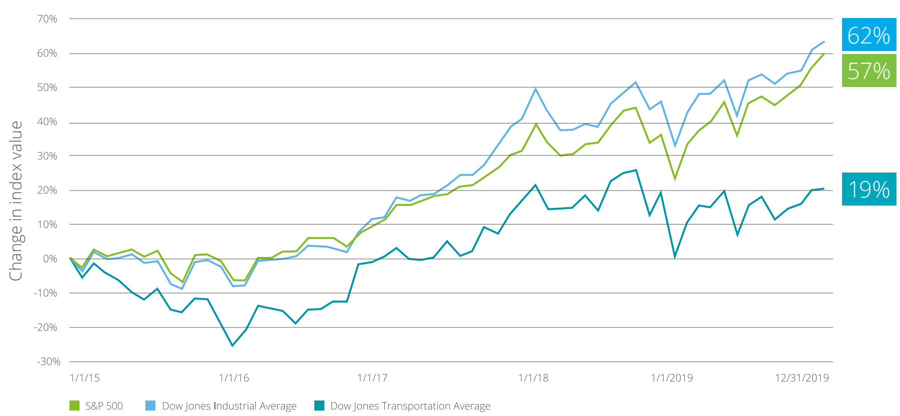
Figure 1. Up to 45 percent of the transportation sector's operating profits could erode in 2020



Note: Revenue and operating profit trends based on sample of 114 public transportation companies.[3] Total industry market size based on US Bureau of Transportation Statistics data for the same transportation subsectors.

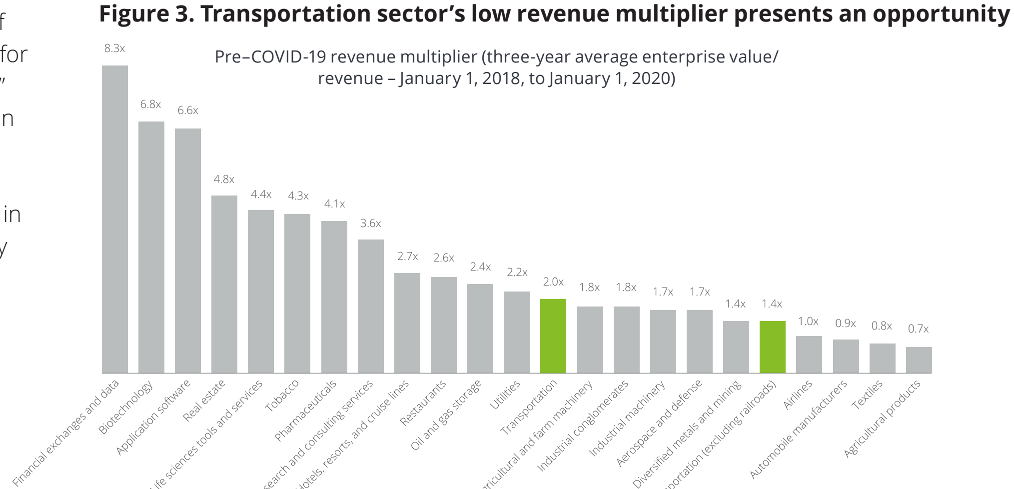
Source: S&P Capital IQ, US Bureau of Transportation Statistics, Deloitte analysis.

Figure 2. The transportation sector has underperformed the market in the past five years



Source: S&P Capital IQ

Figure 3. Transportation sector's low revenue multiplier presents an opportunity



Source: S&P Capital IQ, Deloitte analysis

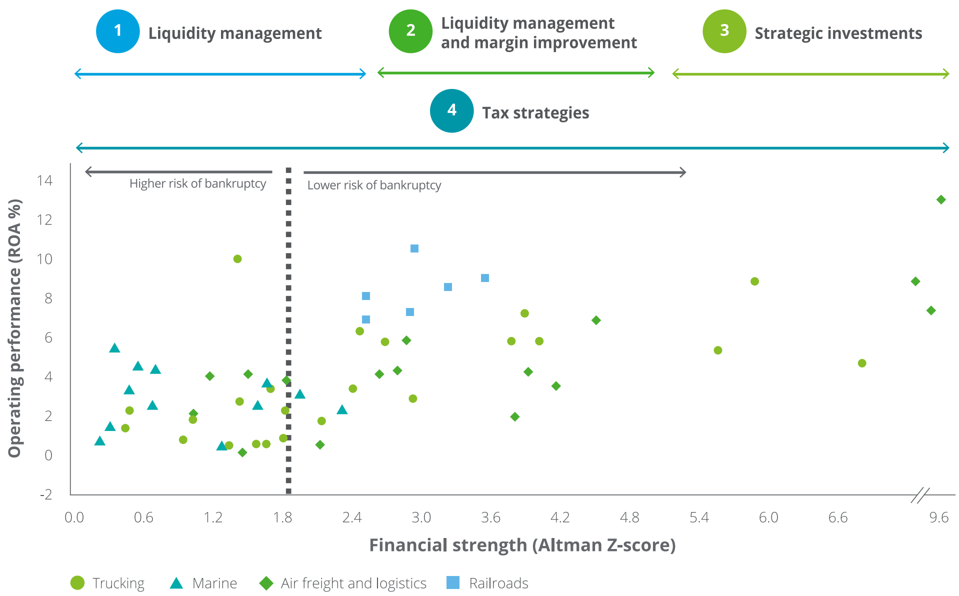
The COVID-19 crisis isn't the only thing, but it is the first thing

That's quite a barrage of discouraging numbers, and they make the point plainly. On the other hand, the transportation sector is essential to the global economy, and the performance of some companies has been superb despite the sector's underlying challenges (see figure 4).

So how can companies respond? Some strategies apply to all. Others depend on the strength of each company's current position—and may spell the difference between merely surviving the crisis and emerging from it stronger than before.

The first imperative is to weather the current storm. We can identify three different pandemic response levels based on financial strength (see figure 4). Close to one-quarter of transportation companies have likely found themselves in reasonably dire straits—urgently seeking to maintain liquidity. Other companies have greater degrees of freedom—enough not only to see them through the current crisis, but to invest to strengthen for the future.

Figure 4. Company operating performance and financial strength measures to frame a pandemic response



Note: Altman Z-score measures potential for bankruptcy, based on the following formula Z-Score = 1.2A + 1.4B + 3.3C + 0.6D + 1.0E, where A = working capital / assets; B = retained earnings / assets; C = EBIT / assets; D = market value of equity / liabilities; E = sales / assets; based on 60 public companies with operations in the United States; financials for last 12 months as of March 2019 (where available) or December 2019.

Source: S&P Capital IQ, Deloitte analysis

1. Liquidity management

For companies on the edge, survival moves may include actions such as:

- Accelerated invoicing
- Freight factoring
- Group orders
- Delayed supplier payments
- Assessing idle resources for possible sale
- Retiring obsolete or inefficient equipment
- Assessing liquidity headroom under refinancing options
- Drawing down revolvers or issuing more debt
- Reducing or furloughing workforce

2. Liquidity management and margin improvement

Companies with more financial and strategic degrees of freedom can add margin improvement actions, such as:

- Optimizing customer portfolio and terms
- Implementing strategic or dynamic pricing
- Optimizing network and route
- Changing the labor mix
- Reducing direct and indirect spend
- Mitigating time charging leakage
- Task automation
- Operating model transformation (such as insource versus outsource)

3. Strategic investments

At a certain threshold of financial strength are the companies who have the potential to emerge from the crisis stronger than before and who have the greatest potential to shape the future industry. Their strategies may include:

- Acquiring distressed assets
- Repositioning into adjacent portions of the value chain (such as transport roles from customers)
- Consolidating underutilized capacity
- Innovating service offerings (such as investments in autonomous, connectivity, or electrification)
- Expanding into attractive geographic markets

4. Tax stagegies

Tax strategies apply to all companies, no matter where they fall on this scale:

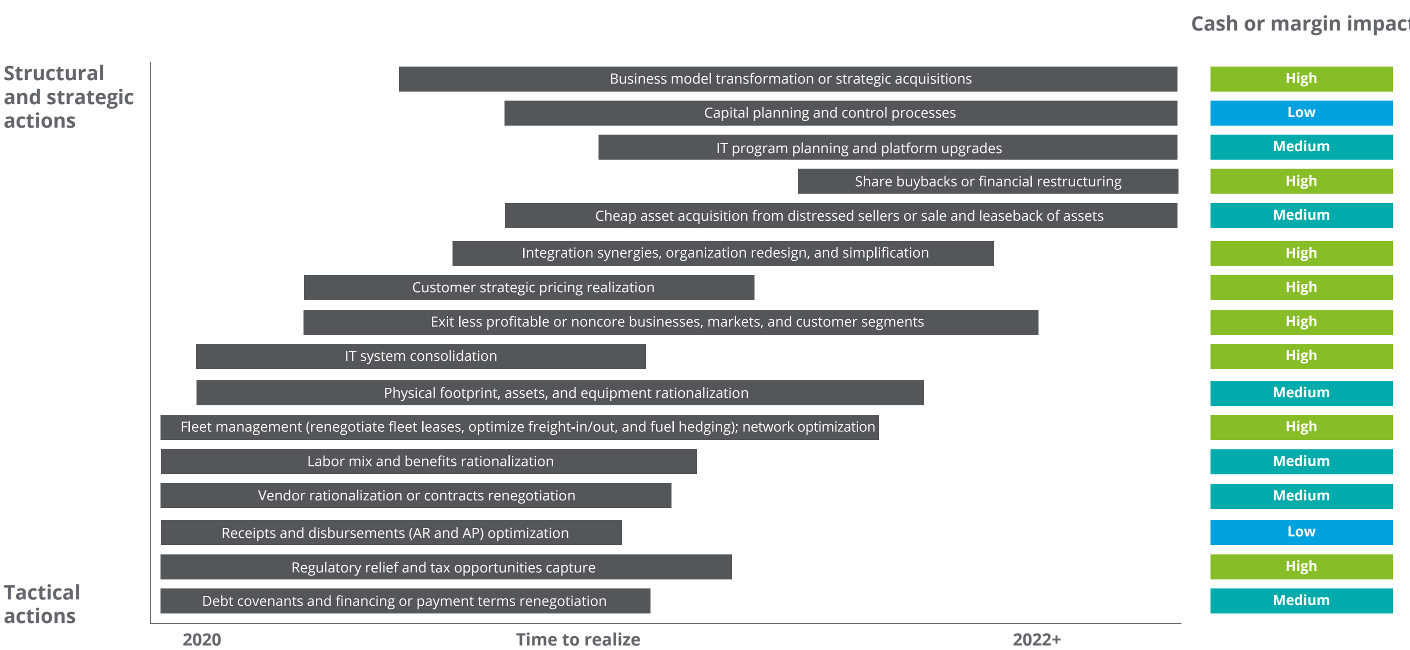
- Maximizing employee tax credits
- Five-year net operating loss carryback planning
- Capturing increased interest expense deductibility
- Assessing other opportunities under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act)

Any attempt to categorize transportation companies' financial strength or recovery options in just a few lines or with one chart will necessarily be a gross oversimplification. Figure 4 is an instructive simplification—it shows financial performance (using return on assets as a proxy) on the y-axis, as well as financial strength (using Altman Z-score as a proxy; see footnote in figure 4 for a description of Altman Z). Companies' financial strength increases as you move from left to right on the scale; companies to the left of the dashed line are typically viewed as being at a higher risk of financial failure.

There is a large and varied menu of specific liquidity and margin improvement actions open to transportation companies. Deloitte has identified more than 400 levers that can be tailored into a recovery strategy customized for each company's particular situation. Figure 5 illustrates a small number of these 400 potential actions.

Deloitte has identified more than 400 levers that can be tailored into a recovery strategy customized for each company's particular situation.

Figure 5. 400+ cost savings and transformation actions from Deloitte's repository (examples)



The "big rocks"—moves you should not ignore and likely will not regret

There is much debate regarding downturn scenarios and their implications. But regardless of how severe one believes the pandemic's impact will be, there are certainties any company should address—the only questions being how much and how fast. There are also known uncertainties—the questions being whether and how to address these. Figure 6 illustrates these certainties and uncertainties in summary form, and we highlight two examples below.

Figure 6. Regardless of the downturn scenario, there are certainties and uncertainties to address

Certainties and near-certainties
(How much and how fast to address)

Demand for last mile
Capacity, efficiency, visibility, products, services, modes

Need for more flexible or variable cost structures
Operating and service delivery models, automation, structural assets, supply chain, cloud

Customer expectations for the connected community
Integrated data platforms, minimal-touch operations, customer experience, digital freight

Need for more supply chain resiliency
Illumination and sensing, mitigation plans, safe operations

Evolving workforce and societal expectations
Stranded real estate, digital tools, security, privacy, performance management, talent and learning, safety, brand trust

Evolved importance of risk sensing and signal monitoring
AI-based sensing, enhanced analytics, risk management, role of strategy

Need for new tech and data for holistic decision-making
Operating model, application and data modernization, connected assets/IoT, D2D/V2V, cloud, AI, cyber, visual management

Guiding principles

- Isolate certainties and near-certainties and accelerate decision-making against them
- Create optionality in the face of uncertainty—bold bets and more tactical moves
- Be prepared to test external environment quickly; fail fast and fail small

Uncertainties
(Whether and how to address)

Attitudes toward social distancing
Last mile interfaces, sharing vs. ownership, hailing vs. ownership, worksite distancing

Degree of industry restructuring
Consolidation, vertical integration, bankruptcies or distressed sales, PE rollups, exits

Supply chain and trade
Regionalization vs. globalization, tariffs, fuel

Last mile models
EV vs. ICE, touchless, autonomous, connectivity platforms

Expectations for trust
Physical, emotional, financial, digital, brand

Subsidies, regulations, and financing
China vs. rest-of-the-world subsidies, environmental regulations, safety regulations, sources of financing

Winning business models
Asset-builder vs. other, direct-to-consumer, vertical or horizontal integration vs. specialization

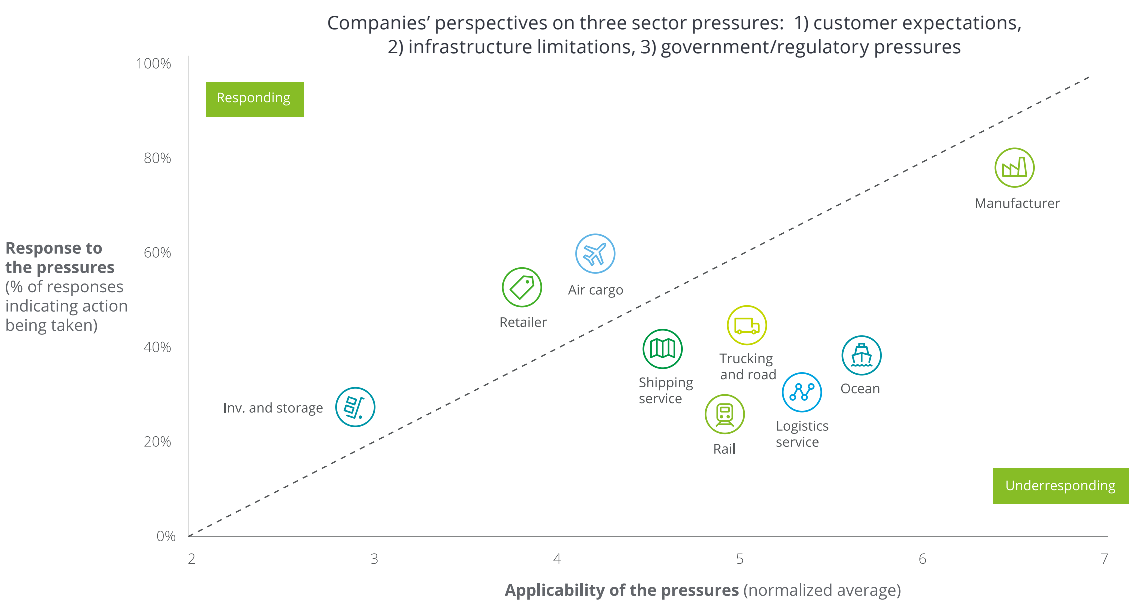
An example certainty: Need for new tech and data for holistic decision-making
In almost every sector, investments in technology are becoming more and more important to compete. Advances in cloud, AI-based sensing, analytics, and other technologies have created vast new opportunities to connect with customers, partners, and suppliers; to inform decision-making in rapid and insightful ways; and to automate larger portions of work. Yet in a recent Deloitte survey, almost 50 percent of responses from transportation companies larger than $1B indicated companies were not taking advantage of these technologies and data to address acknowledged pressures such as customer expectations, infrastructure limitations, and government or regulatory pressures (see figure 7).

This is a clear example of an issue the transportation sector would have to confront, with or without the pandemic. The question for leadership is not whether to invest, but how much and how quickly.

Beyond preservation: Winning business models
Some companies in the sector will have sufficient financial and strategic flexibility to "take advantage" of the COVID-19 crisis and leap ahead competitively. But how much inorganic movement will take place in the sector, and in what form? That's a question whose answer may depend on severity of the downturn. "Leaping ahead" can take many forms, but for those with the will and the way, there are multiple opportunities in distressed markets, such as:

- Consolidating underutilized capacity
- Repositioning into adjacent segments or value chain positions
- Diversifying into entirely new businesses
- Divesting or spinning out businesses
- Exiting
- Shifting business models into those with higher revenue multipliers

Figure 7. Recent Deloitte survey suggests an opportunity for many transportation companies to invest to address acknowledged pressures



Source: Deloitte's 2019–2020 Future of Movement of Goods Survey, a comprehensive study of 1,035 responses completed by 182 respondents.

Let's briefly discuss the last option in figure 6 above, as it is one of the few actions that can sustainably lift stock prices (and valuations) out of the constrained range many transportation companies have experienced over the past years.

One can argue that at a high level, there are only four business models: 1) asset-builders, who make and sell physical products (for example, trucking companies and automotive OEMs), 2) service providers, who charge for billable hours (such as financial services companies and consulting firms), 3) technology creators, who develop intellectual property and are able to sell it many times over (such as software, biotechnology, and pharmaceuticals), and 4) network orchestrators, who act as organizers as they sell goods, services, or information made by many to sell to many (for example, credit card companies, stock exchanges, or social networks).

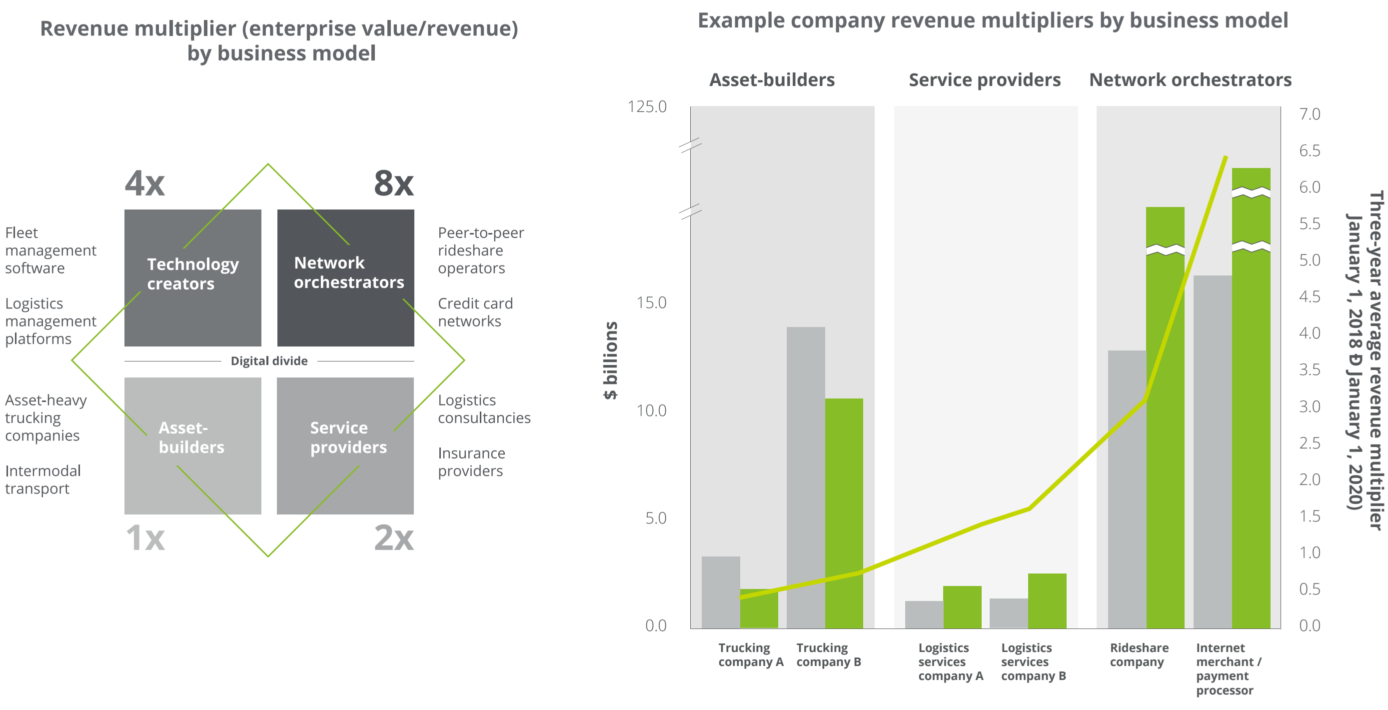
Our colleagues' research[4] has demonstrably shown that the capital markets value companies within each of these four models very differently. Figure 8 illustrates our colleagues' research applied to the transportation sector.

As we noted earlier, the transportation sector as a whole is characterized by lower revenue multipliers than many other industries (figure 3). Consider that some of the industry's most foundational "asset-builder" models—such as asset-heavy trucking companies or intermodal transport—have multipliers that hover around 1x. Doing more of what these companies are already doing (for example, cutting costs or growing revenue) has a limited upside for lifting enterprise value and stock price. Those moves are table stakes, but they won't sustainably move enterprise value.

However, adjacent models within the sector promise higher multipliers. A financial services or insurance unit would shift at least part of the company's valuation toward a service provider multiple. Crossing the "digital divide" into intellectual property–based businesses (such as fleet management software) could drive valuations higher.

Consider that companies with models different from the sector's standard asset-builder model are the ones that, in large part, are disrupting the sector. Transforming business models is not for the faint of heart, but is an option for those with the ambition and the wherewithal to fundamentally shift company performance.

Figure 8. Demonstrably shifting business models could help transportation companies break out of their trading range



Source: Based on the work of William Ribaudo, "Technology is Changing How We View Industry, Value Companies, and Develop Strategy," SNS Subscriber Edition, volume 21, Issue 16, week of May 2, 2016, S&P Capital IQ, Deloitte analysis

Conclusion

This is a challenging time for all. Some companies will fall back on the old ways of operating. Some will have the appetite and the means to incrementally improve their performance. Others will see this crisis as an opportunity to take head-on the long-standing inefficiencies in the sector. And perhaps a few will forge a fundamental rethinking of their companies or the sector overall. Regardless, we hope that this short paper provides an outline of an approach for any company to consider as you chart your path to both emerge from the COVID-19 crisis and to thrive beyond.

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Endnotes

1. Transportation sector in our analysis refers to US-based public companies in trucking (which includes car rentals), air freight and logistics, marine, and railroad as categorized by S&P Capital IQ; our analyses exclude rideshare providers.
2. Deloitte's 2019–2020 Future of Movement of Goods Survey, a comprehensive study of 1,035 responses completed by 182 respondents.
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