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XPO - Q2 2016 XPO Logistics Inc Earnings Call

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PRESENTATION

Operator

Welcome to the XPO Logistics' second-quarter 2016 earnings conference call and webcast. My name is Christine, and I will be your operator for today's call.

(Operator Instructions)

Please note that this conference is being recorded.

Before the call begins, let me read a brief statement on behalf of the Company regarding forward-looking statements and the use of non-GAAP financial measures. During this call the Company will be making certain forward-looking statements within the meaning of applicable securities laws by which their nature involve a number of risks, uncertainties, and other factors that could cause actual results to differ materially from those projected in the forward-looking statements. A discussion of factors that could cause actual results to differ materially is contained in the Company's SEC filings. The forward looking statements in the Company's earning release or made on this call are made only as of today. And the Company has no obligation to update any of these forward-looking statements, including its outlook, except to the extent required by law.

During this call the Company also may refer to certain non-GAAP financial measures as defined under applicable SEC rules. Reconciliations of such non-GAAP financial measures to the most comparable GAAP measures are contained in the Company's earnings release and the related financial tables, or in the investors section of the Company's website at www.XPO.com. You can find a copy of the Company's earnings release which contains additional important information regarding forward-looking statements and non-GAAP financial measures in the Investor section on the Company's website.

I will now turn the call over to Brad Jacobs. Mr. Jacobs, you may begin.

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

Thank you, operator, and welcome to the call, everybody. With me today are John Hardig, our CFO; our Chief Strategy Officer, Scott Malat; and our Head of Investor Relations, Tavio Headley.

Last night we reported second-quarter results that confirmed that we're at a positive inflection point in the evolution of our business. We achieved record net income, record EBITDA, record cash flow from operations, and record free cash flow. Our adjusted EBITDA was $355 million. And we generated strong cash flow from operations of $261 million and free cash flow of $170 million. Our highest top-line growth came from our last mile and truck brokerage operations in North America, and our European contract logistics operations. E-commerce continues to be a major tailwind. It drove margin expansion last mile and gave our logistics operations some major wins on both sides of the Atlantic.

From a profitability standpoint our North American LTL business was the star of the quarter. We grew operating income in LTL by a whopping 66% over second quarter last year, which was pre-acquisition. Operating income for the quarter in LTL was $115.5 million, a record accomplishment for our LTL operations. The operating ratio was 86.7%, the best ratio in a decade. These are monumental improvements, and we achieved them in just seven months after buying the business.

Looking at the full year, we now expect to generate at least $1.265 billion of adjusted EBITDA, which is up from $1.25 billion. And we have raised our free cash flow target to at least $150 million from a range of $100 million to $150 million. We expect our free cash flow to accelerate significantly in 2017 and 2018. For 2018 we have a well-defined path to our target of $1.7 billion of EBITDA.

More than $300 million of our profit improvement opportunities are Company-specific and independent of macro conditions. This is only a little more than 2% of our $14 billion of addressable spend. The largest categories of savings will come from procurement, real estate, technology, shared services, and transferring best practices globally. Our Companywide focus continues to be on driving results, on accelerating EBITDA and free cash flow, while making the investments to grow our business long term.

With that, I will turn it over to John to review the quarter. John?

John Hardig - *XPO Logistics, Inc. - CFO*

Thanks, Brad.

We had an exceptionally strong quarter despite a sluggish market. Our EBITDA and free cash flow were well above our expectations. Adjusted EBITDA for the quarter was $355 million and net income was $50 million. We delivered these results despite a low growth market environment. On a pro forma basis, excluding fuel and FX, as if we had owned all of our acquired companies on April 1 last year, adjusted revenue increased 1.8% year over year in the quarter.

As Brad said, our strongest growth was in our last mile, truck brokerage, and European supply chain operations. This was offset by market softness, which impacted our domestic intermodal and expedite operations. Organic growth in the quarter also reflected our yield management and restructuring initiatives to improve the profitability of former Conway operations. Excluding Conway, our pro forma revenue growth for the quarter was 4.3%.

Revenue in our Transportation Segment was $2.4 billion during the quarter, up 181% over last year. And adjusted EBITDA was up 365% to $276 million. Operating income in Transportation was $153 million. Within our Transportation Segment, in freight brokerage, we increased revenue by 12% year over year. Net revenue margin declined to 17% from 20.1% last year due to decreases in expedite and intermodal margins, while truck brokerage margins were flat. In truck brokerage we increased share and grew volumes organically by over 20% year over year, while revenue per load decreased due to lower rates and lower fuel revenue.

In intermodal, the market remained weak from continued excess truckload capacity and low fuel prices. Expedite volumes declined in the quarter versus a year ago due to the ongoing slow industrial economy. In less than truckload we continued to improve service and profitability during the quarter. Compared to the prior year pre-acquisition, revenue per hundredweight excluding fuel surcharge increased 5.5% year over year. And daily LTL tonnage decreased 7.4%. Consistent with our strategy and the trend over the last few quarters, reductions in national account revenue were partially offset by increases in revenue from local accounts. Our LTL operating ratio was 86.7%. Adjusted operating ratio, excluding amortization of intangibles and integration costs, improved to 85.5% compared to 92.4% last year.

Tonnage trends did improve through the quarter, with June being the strongest month. In the third quarter we do expect tonnage declines to moderate. We expect yield improvements to continue, but at a more measured pace as we begin to lap last year's yield initiatives. Our last mile operation continues to experience strong growth. We grew revenue by 18% year over year. We continue to see a high volume of new business opportunities, especially in e-commerce. Last mile net revenue margin increased 80 basis points in the quarter from an increase in e-commerce business as well as improved carrier utilization and productivity as we leverage our growing network density.

In North American truckload, revenue in the quarter excluding the impact of fuel was 1.8% lower than the same period last year, which was pre-acquisition. Volumes were flat and rates excluding fuel declined 2.7% year over year. In the face of a challenging market we improved our truckload operating ratio over the prior year by reducing SG&A expense and improving empty mile percentage to 9.2% from 9.9% a year ago.

In our European Transportation operation we drove revenue growth through higher volumes while pricing was flat compared to the full quarter a year ago. Transportation management in France and our LTL operations had especially good revenue growth year over year. Strength in these areas was offset by lower fuel revenue and pricing pressure from more competitive market pricing in Spain and the Eastern European countries. We improved margin in our European Transportation operations through actions to reduce infrastructure costs.

Our Logistics Segment continued strong performance in the quarter. Revenue increased to $1.3 billion and adjusted EBITDA increased to $107 million due to our 2015 acquisitions, along with organic revenue growth and margin expansion. Operating income in Logistics was $51 million in the quarter. Performance in our European Logistics operation was particularly strong compared to the prior full-year quarter. Year-over-year revenue growth was driven largely by new contract starts, notably with e-commerce and food and beverage customers.

Supply chain margins in Europe increased year over year during the quarter mainly by improving warehouse utilization and turning around unprofitable sites. In our North American Logistics operation we significantly improved margins by exiting low-margin business, optimizing the cost structure of our combined platform, and driving higher productivity. New contract wins were more than offset by exiting low- or no-margin business. Areas of strength included the high tech and chemical verticals, while retail and transportation management were weaker.

Corporate SG&A expense decreased to $34 million in the quarter from $57 million a year ago. Included in corporate expense is approximately $4 million of integration costs. The reduction in corporate expense was primarily from higher transaction and integration costs in the second quarter of 2015. We expect corporate SG&A expense excluding nonrecurring integration costs to be in the range of approximately $25 million to $28 million per quarter.

Net capital expenditures for the quarter was $91 million. More of our CapEx will come in the second half of the year, which coincides with the timing of our revamped procurement processes. Our expectation for net CapEx in 2016 remains $475 million to $500 million. Depreciation and amortization for the first quarter was $162 million. D&A was lower than expected, reflecting a reduction in the estimate of Conway asset values and purchase accounting. Purchase accounting for the Conway acquisition is not finalized. However, based on current analysis we expect depreciation and amortization to be in a range of $168 million to $173 million per quarter for the rest of the year.

Free cash flow exceeded our expectations for the quarter due to higher EBITDA, the timing of CapEx, and working capital initiatives. As a result, we raised our guidance for free cash flow to at least $150 million for the full year. We ended the quarter with $378 million of cash and approximately $940 million of liquidity when taking into account the $100 million we had drawn on our $1 billion credit facility at quarter end.

Now I'm going to turn the call over to Scott. Scott?

Scott Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

Thanks, John.

First, on the macro. Both North America and Europe are in slow growth mode, but still growing. In North America, truckload capacity continues to be relatively loose, although we did see some seasonal tightening in June and into July. Customers are showing more interest in locking in longer-term capacity, which is usually a bullish sign. In Europe, Spain's economy has shown solid growth. It's been driven by consumer spending and industrial investment. The rest of the euro zone has generally been more sluggish. E-commerce continues to be a strong tailwind both in Europe and in North America. We benefit in our last mile and contract logistics operations when heavy goods are purchased online. Our e-fulfillment platform gets involved at two stages of the transaction: outbound goods and inbound returns.

Within XPO we have many Company-specific opportunities to improve our profitability, independent of the macro. We have identified over $300 million in profit improvement initiative so far. They include roughly $120 million from our original profit improvement plan for LTL in North America, and at least another $180 million of opportunities across our global platform. We are attacking our $14 billion of addressable spend. One big area of savings is procurement. We have global sourcing initiatives underway to lower the cost of temporary labor, tractors, fleet maintenance, fuel, and warehouse equipment. Another area is real estate. We're consolidating our footprint, renegotiating leases, and reducing real estate maintenance charges.

The cross-fertilization of best practices is a huge potential catalysts for profitable growth. We are sharing technology and engineered standards in areas such as route optimization, the optimal use of warehouse space, and insourcing and outsourcing decisions, to give you a few examples. Our North American and European supply-chain teams are working together to build out our global e-fulfillment platform by applying the best practices from each operation. Our less than truckload teams are taking a similar approach in the areas of customer service, pricing, cross-dock operations, maintenance, safety, training, and HR.

With technology we see the ongoing enhancement of our IT as being critical to our ability to continually improve customer service and leverage our scale. We built an integrated cloud-based technology platform that gives us the agility and facilitates enhancements. We have completed over 160 IT projects so far this year. And we are rolling out updates monthly to get the best new functionality in the hands of our employees and customers. Some of the big enhancements we are working on currently include automated load offers to our brokered carriers, LTL pricing and route monitoring tools, last mile innovations to tighten up home delivery windows, and labor productivity tools for our warehouses in Europe.

The final thing that I want to mention is sales. We are making big investments in our sales force. We have a large opportunity with our existing customers today to play a bigger role in supporting their supply chains. We have already hired 50 new local account executives. We're going to continue to grow that sales group. And we plan to double the number of our strategic account managers. We have established growth-based initiatives. And we have gained a more holistic understanding of customer needs through our new CRM system. We are also ramping up our cross-selling. 77 of our top 100 customers already use multiple XPO service lines. Approximately 21% of the sales generated from these customers come from secondary service lines. That is up from 19% in the first quarter.

Customers want to do business with XPO. Our global pipeline for new business and contract logistics alone is over $1 billion. Those are active bids. Our win rate has been improving, and it has been approaching 25%.

If you go to our new website at XPO.com, which we launched last week, you will see our strategy summed up in two words: results matter. They matter to customers, and they matter to investors. We will continue to push the pace on every initiative that can contribute to customer service excellence, end profitability and cash. This quarter we turned in very strong results that give you an insight into the future of XPO. It is the best indication yet of the dramatic opportunity on our doorstep.

With that, we will turn it over for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Chris Wetherbee, Citi.

Chris Wetherbee - *Citigroup - Analyst*

Hey, thanks. Good morning, guys. Wanted to ask about free cash flow. And obviously a strong second-quarter performance on the free cash side. When you guys have talked about free cash seasonality and the cadence we could expect over the course of this year and going forward, I think there's always been an expectation that the fourth quarter was the strongest free cash quarter for you. I know CapEx probably is a little bit more back-half weighted than we've seen in the first half of the year. But how do we think about that? It would suggest that there is, if it still is the biggest quarter for you guys, that there could be a decent bit of upside to what you are talking about? Can you walk us through some of the moving parts of how that plays out over the third and fourth quarter?

John Hardig - *XPO Logistics, Inc. - CFO*

Hey, Chris. It's John Harding. Thanks for the question. We did increase our guidance in terms of free cash flow for the year. So we said we'll do at least $150 million of free cash flow whereas before we had a range of $100 million to $150 million. We did have a very strong free cash flow quarter. There were a couple of reasons for that. One was the EBITDA performance. We definitely exceeded our expectations from an EBITDA perspective. And from CapEx perspective, as I said in my comments, we're being very flexible around our procurement processes and pushing some of our CapEx to the latter part of the year to take advantage of some of those initiatives, and really try to optimize our pricing on investment.

We also did a lot around our working capital processes, just trying to manage DSO, DPO, making sure we get our billing out quickly, making sure that we collect cash aggressively. And making sure that we pay our vendors only when they are required to be paid and not before. We have done a lot in the quarter that was not really related specifically just to the performance of the business. We are going to do at least $70 million of free cash flow in the second half. And that will be weighted more towards the fourth quarter than the third. We are really just giving guidance for the rest of the full year.

Chris Wetherbee - *Citigroup - Analyst*

So some of the working capital adjustments that happened in the second quarter, maybe that is done now and you do not necessarily get the incremental benefit going forward. And that maybe is part of the reason that in CapEx why fourth quarter may not be the strongest quarter for free cash this year?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

Working capital is a long-term opportunity, Chris. That is something that we have invested heavily in. We have a best-in-class back office. And we are absolutely investing in making sure that we bill quicker, that we collect as fast as we can, and that we pay on time but it does not need to be early.

Chris Wetherbee - *Citigroup - Analyst*

Okay, that makes sense. Then I wanted to follow up on a Con-way question, or an LTL question if I could. When you think about sort of where you are in the cost savings run rate, I might have missed that in the prepared remarks. But I think last time we got it, it was in sort of the $90-plus million range. I think maybe now in the low $100-plus million range or so. Is the roughly $200 million of cost savings target still the right number to be thinking about Con-way, given all the progress you've made so far? And if it, is this sort of a potentially low $80 millions OR business for you guys? I am just want to make sure I get a sense of where we are in that process and maybe what the opportunity is going forward.

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

We have progressed on our plans for a profit takeout. We are now up to $120 million -- $110 million of run rate profit improvement. That is up from $90 million last quarter. The difference is some procurement initiatives and then some back office consolidation. The $172 million to $210 million, we still have a bulk of the procurement opportunity ahead of us. There's additional technology savings and some other rationalization of duplicative costs as we integrate the systems. When you look at the $300 million that we laid out, that takes into account the fact that while we are on a $110 run rate, we will report in 2016 about $80 million of those savings.

So when you actually lay out the run rate which came later in the year, you will report about $80 million of savings. If you assume we get to the $200 million, that is another $120 million from LTL between 2016 to 2018 plus another $180 million of additional opportunity. Within that $180 million is upside from LTL as well.

Chris Wetherbee - *Citigroup - Analyst*

Okay, that is helpful. One follow-up question. In terms of the full-year guidance, you've raised it a little bit, I know on the back of a strong performance of the second quarter. Organic revenue growth, John, you give us some pro forma numbers there. How should we be thinking about what is included in the full-year target? Is it in that low single digits? Or I know maybe a little bit higher ex the LTL acquisition? How do we think about that going forward?

John Hardig - *XPO Logistics, Inc. - CFO*

Chris, I think we will see a consistent rate of growth for the rest of the year. So we will be in the mid-single digit range.

Chris Wetherbee - *Citigroup - Analyst*

Okay. That is helpful. Thanks very much for the time this morning, guys. Appreciate it.

Operator

Ravi Shanker, Morgan Stanley.

Ravi Shanker - *Morgan Stanley - Analyst*

Thanks. Good morning, everyone. So Brad, a couple of longer-term questions. I heard you guys use the phrase inflection point quite a bit in the last few weeks, which implies that you are kind of settled in, have digested Con-way and Norbert, and looking ahead to the future. What does the next phase of XPO look like from here? Is it something that's mostly organic, or do you think that you're settled down enough that you can go back to the M&A well?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

When I use the word or the phrase inflection point, Ravi, I am referring to a record amount of EBITDA, $355 million, much higher than consensus expectations, and after generating $249 million last quarter. An inflection point in cash flow from operations, also a record $261 million cash flow from ops. An inflection point in terms of turning free cash flow positive at a very healthy $170 million free cash flow positive. And an inflection point in terms of we expect to continue to generate increasingly more cash flow going forward.

So that it's an inflection point in the sense that we have done the heavy lifting over the last several years in terms of acquiring, financing, the tough part of the integrations, putting in place the infrastructure. And now we're benefiting from operating leverage and we are turning into a cash machine while still investing in growth. So, you asked, what does it look like. Visually it looks like we are wearing green visors with our head down and running the business very, very well.

And focusing on a very well-defined plan to take the $1.265 billion of EBITDA this year to our target of $1.7 billion of EBITDA in 2018, with the vast majority of that profit improvement coming from actions that are Company specific and are independent of the macro environment, especially global procurement. As Scott said, attacking all $14 billion of our global spend. So we are not looking at acquisitions now, we're not. We're looking at dozens and dozens of specific work streams to optimize the business that we have and to delight customers more.

Ravi Shanker - *Morgan Stanley - Analyst*

Got it. Very helpful. And just you personally, I mean, you've obviously been here for a while and have kind of steered this ship to get it to where it is right here. Kind of where do you see -- how do you see your involvement continuing over time? Do you feel like you have a lot more to do here? Or can you help us understand that?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

Seven days from when I wake up to when I go to sleep, I'm fully involved and plan to stay fully involved.

Ravi Shanker - *Morgan Stanley - Analyst*

Beautiful. I love it. Thanks so much.

Operator

Rob Salmon, Deutsche Bank.

Rob Salmon - *Deutsche Bank - Analyst*

Good morning, guys. Really nice quarter. It has been a long time since we have seen Con-way Freight operate in kind of the mid-80%s. And you did it in a tough backdrop. Can you give us a sense if your longer-term expectations have changed at all in terms of where that margin can go to, given the execution that you achieved in the second quarter? And if you could also give us an update in terms of the pricing and tonnage July month-to-date trends that you have experienced quarter to date?

Scott Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

On operating ratio we're working our way into the high 80%s. Now, just keep in mind there is seasonality with the business. You have your best operating ratio quarters in the second and third quarters. We do have upside opportunity as we execute on the $200 million or so of improvement, and then the upside that is included addition. It is too early to say that we can get past the mid-80%s in getting into the low 80%s. We are really working our way into the mid-80%s.

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

On the July numbers, it is the same trends as we have been seeing. Yield up about 4%, volume down about 6%. That is how the model has been trending. Now, as we work through the tonnage that was unprofitable or very low margin, we will over time see that volume trend improve a little bit. But we are going to hold firm on pricing. We think we have a very rare product in the market that wins awards for, number one in on-time pickup. Number one in on-time delivery. Very low damages. Excellent service. And we want to charge a fair price for that. We want to hold firm on price. And over time we will improve the volumes.

Rob Salmon - *Deutsche Bank - Analyst*

It makes a lot of sense. You guys highlighted about $180 million of run rate profit improvement across a broad spectrum. Can you give us a sense of some of the new cost opportunities that Ramon has identified since joining the Company that are included in that kind of longer-range target that you guys laid out?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

So procurement is a very, very big component of that because we're buying billions and billions of dollars of things now as a $15 billion Company that were previously purchased as a $3 billion or a $5 billion or $9 billion Company. Now we deserve the $15 billion price and vendors understand that. As we consolidate our vendor base and we become a more meaningful purchaser of trucks, of trailers, of tractors, of fuel, of tires, of temporary labor, of office supplies, of forklift equipment, of all the things that we are spending tens of millions or hundreds of millions of dollars a year on, we deserve a better price. We are very much focusing on global procurement.

We are also focusing on real estate. Ramon has been doing some wonderful work on real estate. And finding ways that we can get better rebates from the brokers that we use and other ways that we can optimize our real estate spend because we have $600 million of Companywide real estate spend. We're also looking at how to improve labor productivity. We have over $5 billion of labor costs, both salary and temporary labor. Direct and SG&A labor as well.

And we are rolling out engineered standards for everything that we do. We are starting with -- we have 750 logistic warehouse facilities around the world. And we are monitoring the ones that function at the most efficiency, the most productive, satisfying customers the most. Where we have customers delighted with our performance and the financial performance is great. Then benchmarking those to all of the rest of them. And then bringing up the lower performance to the higher performance.

We are doing the same thing with our 450 or so cross-dock facilities in LTL, both in Europe and the United States. We have had a lot of people flying back and forth from places like Michigan to France and vice-versa and comparing notes and comparing metrics and comparing KPIs. So transferring these best practices all around the world, training people on these new standard work instructions, benchmarking them, rewarding people for meeting them. Those are the kinds of things that we are very excited about in terms of increasing the profitability of the Company and also pleasing our customers more.

Rob Salmon - *Deutsche Bank - Analyst*

Makes a lot of sense. Keep it up. We are seeing it show up in the bottom line. I will turn it over to someone else. Thanks for the time.

Operator

Scott Schneeberger, Oppenheimer.

Scott Schneeberger - *Oppenheimer & Company - Analyst*

Thank you. Good morning. I want to start off within LTL, obviously you've been doing a lot of repricing. I am curious, could you just speak anecdotally to the behavior of the customers that are going through this with you? And just what you are seeing as an overall behavior?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

Generally speaking, customers get it. They understand that we have an excellent product and we have to charge a fair price for that. Not as many customers that -- we already have a fair price. We're not trying to renegotiate those prices. We have a fair price. It's operating profitably for us. Everyone is happy. There's still a fair amount of, particularly our national account customers, that we're operating at a loss on. We're operating on a very measly margin, that we are having a very respectful discussion with of saying how can we turn this money-losing business into a profitable business, or at least a breakeven business for us? And we want to keep the relationship. We have other ways that we can help those customers and their supply chain besides just their LTL business. But we do not want to lose money. It is as simple as that. People get that. And business people do not want to show a loss. They want to show a profit.

Scott Schneeberger - *Oppenheimer & Company - Analyst*

Thanks. Brad, just to specify the question a little bit more. I think you have been most aggressive with the large national accounts. Are you losing a lot of them in the process, or how does it go post discussions?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

Well, we have three categories of LTL customers. On the large national accounts we have stopped doing business for some of them. That's part of what you see in the tonnage going down. Those were primarily customers that we were just losing too much money on and couldn't find out a way to bridge that gap, at least get it to breakeven. So for the time being, at least, we have turned away that business. Or they have gone somewhere else where they could get a deal, at least for the time being, that satisfies them. On the 3PL and the local account business, that is a different story. That business is profitable. And that business has been flat to growing.

Scott Schneeberger - *Oppenheimer & Company - Analyst*

Great, thanks. One more to follow up. Going over to Europe. It sounds like the Transportation business is performing very well. Could you elaborate, I guess, on a regional basis on what you are seeing there? Thanks.

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

So in Europe, although this morning UK suddenly got better than it already was because of the actions of the government in lowering the rates more. UK has been strong. Spain has been strong. France has been not so great, not so bad, kind of flattish. They've had strikes, they've had terrorism. It has been a tough few months for the French. But the business is holding up. The business is resilient, even in face of this adversity. Those are the three biggest countries that we're in in Europe. And overall, as you saw from the numbers, our European business has performed well.

Scott Schneeberger - *Oppenheimer & Company - Analyst*

Great. Thanks. Nice job on the execution.

Operator

John Larkin, Stifel.

John Larkin - *Stifel - Analyst*

Good morning, everybody. Thank you for taking the questions. On the LTL business, Brad, initially you had talked about the notion that the high-service LTL product that you currently offer only addresses about one-third of the LTL market and the other two-thirds is more of a generic lower-priced, lower-service alternative. Have you changed your thinking about the timing on when you may begin to roll out a service offering to attack that two-thirds of the market that you're currently not serving?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

That is likely to roll out second half of next year. That is a big project that needs lots of engineering, lot of pre-programming and has to go flawlessly when we roll it out. That's something that cannot be done frivolously. But it is something that we want to do. There is no question about that. There is a large market for an economy product where customers are not very sensitive to whether it gets picked up on Thursday or Friday or Monday, and are much more focused on price. That is not our product. Our product is one that picks up exactly when we say it's going to and gets delivered exactly when we say it's going to. And the damages are very, very, very low. That is a different type of customer.

John Larkin - *Stifel - Analyst*

But the idea would be to use essentially the same infrastructure, the same pickup and delivery network, and then engineer the line haul to be more flexible, especially with respect to the lower-service alternative?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

That is correct. A lot of work has to be done at the cross-dock physically. And a lot of work has to be done with the technology. So when the freight comes in, you've got to be able to read that on the barcode immediately, saying is that economy or is that priority. And then you have to have the right locations mapped out on the cross-dock so it goes to the right location. And the communication with the trucks has to be very clear where it goes. It is still a complex process.

John Larkin - *Stifel - Analyst*

Got it. Thanks for the answer there. Also originally you endeavored to try to find a buyer for the asset-heavy truck load operation. And because the price you were looking for was not there, you decided to keep it. And talked about some of the synergies that existed between the asset-based truckload and the asset-light brokerage capability within your brokerage business. Have you seen that really play out where you've got your asset-based operation handling the base load volume for particular customers and then the brokerage business sort of providing the flex capacity at the end of the month, end of the quarter, end of the year, et cetera?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

We have definitely started to see some great synergies between truckload and LTL and between truckload and brokerage. Brokerage has visibility into the empty miles and is filling those trucks. One very interesting synergy that's come about is about 80 of our repair and maintenance facilities in LTL, which previously had never been available to truckload, we have opened those up to truckload. So we don't have to go to third parties. We do not have to travel long distances. And of course it's cousins, it's LTL and TL. It's taking care of well. That is something that we have been rolling out, too.

This has the benefit of keeping maintenance down, as well. We can extend the life of the trucks. Many best practices are being shared. A lot of the things that we had been previously doing in LTL very well, like rate pricing, like load optimization, like lane optimization. All those things now we're rolling out into truckload. That's a process that's going to take a few months to do. But I'm very optimistic in our ability to significantly improve the profitability of truckload. I think Tim Staroba is doing an excellent job down there.

John Larkin - *Stifel - Analyst*

Excellent. Then maybe one last one for Scott. To what extent do you think the surplus inventories out there, particularly in the retail supply chain, are causing the softness in freight demand, not only in the US, but perhaps even in Europe? And how long do you think it will be to sort of clear that up so that inventories get to normalized levels and we will see the pull-through to freight demand normalize? Is that a 2017 event, or when do you expect that to be happening?

Scott Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

It is always hard to tell. If you look at the macroeconomic indicators and the things we usually track, industrial production, we have not seen as much freight as those macro indicators would imply. And we do not see anything right now that looks like it is just tightening up the market in the back half of the year so much and a big swell of volume. But we will see.

John Larkin - *Stifel - Analyst*

Thanks very much.

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

Thank you. I see we only have about 20 minutes left until the market opens.

(Caller Instructions)

Operator

Allison Landry, Credit Suisse.

Allison Landry - *Credit Suisse - Analyst*

Thanks. Good morning. So you talked about UK exposure and contract logistics being relatively insulated from the macro. And putting the QE expansion this morning aside for a second, how do we handicap the risk to EBITDA if GDP does go negative in both the UK and broader Europe?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

If GDP goes negative in the UK and broader Europe, that's going to be negative for us. So our business is -- some of them are economic sensitive and some of them are less economic sensitive. So our e-commerce business, which is our strongest vertical in Europe, I would say that is not going to be too affected. But it might be affected because even though the trend of purchasing goods online is increasing, the total amount of goods purchased may go down enough that that positive trend may not overcome it.

Another big vertical for us in Europe is food and beverage. Food and beverage. I think people will still eat and drink a fair amount. And in some of those countries in Europe they actually might even drink a little more. I am not as concerned about the F&B over there. Anything that's auto related in a negative GDP environment would be negatively affected.

But I am not very pessimistic about recession happening in Europe. Europe is in a different part of the cycle than we are. Europe is not raising rates. They are not thinking about raising rates. The debate is on how much they are going to lower rates, as they did this morning. Unlike here in the States, in Europe they are still doing quantitative easing. They're putting liquidity into the system. I just do not feel the likelihood of a recession in Europe being very high because of that. Now, if there is a geopolitical event or some massive terrorism, that is a different story.

Allison Landry - *Credit Suisse - Analyst*

Right. Okay. That was helpful. And then my follow-up question. You mentioned pushing some of the CapEx to the latter part of the year, sort of to take advantage of some procurement initiatives. But I was wondering if you could elaborate on specifically what types of investment you are able to push and which segments that would relate to? And if any of the spend was pushed to 2017, or if it's just to the back half of this year? Thank you.

John Hardig - *XPO Logistics, Inc. - CFO*

Hi Allison. Thanks for the question. Yes, nothing has been pushed into 2017. So we still expect our CapEx to be $475 million to $500 million. And the biggest category of that deferral in terms of pushing back and taking advantage of procurement was around the rolling stock, tractors and trailers.

Allison Landry - *Credit Suisse - Analyst*

Got it. Thank you for the time.

Operator

Brian Ossenbeck, JPMorgan.

Brian Ossenbeck - *JPMorgan - Analyst*

Good morning. Thanks for taking my question. I had a question on European e-fulfillment. Back in April and May there was a few announcements about EU, single EU event and also more concerted effort to facilitate a more cross-border e-commerce in Europe. Obviously those are still early stages. But I did not know how you saw that playing out. If more facilitation will be beneficial for you to get more volume, or if that would somehow affect what you do on a day-to-day basis. I would be curious to hear your thoughts there. Thanks.

Scott Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

In general anything that opens up the borders, anything that makes it easier to trade around Europe, makes it easier to grow e-commerce. E-commerce for us has been very cross-border. It has been where we have more centralized auto -- e-fulfillment facilities and we can distribute that across pan-Europe. We think it is moving in that direction.

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

Everything related to e-commerce globally is doing very, very well at the moment. Either that's contract logistics, last mile, even the linehaul. Anything that touches our big e-tail customers is growing very rapidly. And that's not just for us for. That's for our competitors as well. We just happen to have a very significant portion of our business levered to that.

Brian Ossenbeck - *JPMorgan - Analyst*

One quick housekeeping. Can you give us the integration costs you expect for the second half of the year?

John Hardig - *XPO Logistics, Inc. - CFO*

Around $25 million in the third quarter and then it'll moderate in the fourth. We still expect integration costs to be in the $75 million to $100 million this year, as we have always forecast.

Brian Ossenbeck - *JPMorgan - Analyst*

Great. Thanks for your time.

Operator

Brandon Oglenski, Barclays.

Brandon Oglenski - *Barclays Capital - Analyst*

Good morning everyone, and thanks for taking my question. And also thank you for the improved financial disclosure on LTL. That is helpful this quarter.

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

That more disclosure was partly in response to your request for it on the last call, Brandon. Thank you for that request.

Brandon Oglenski - *Barclays Capital - Analyst*

I think it helps a lot of your investors in analyzing results here, too. So appreciate it. On that question of e-commerce, I think you mentioned about a few contracts that were helping in the quarter with both logistics and final mile. I was wondering if you could expand a little bit more on that and also provide a little bit of thoughts on organic growth within Logistics? I think you might have covered it, but I missed it. But just talk more broadly about how e-commerce is fitting into your various verticals and how that could be a future opportunity or even risk from some of the bigger players.

Scott Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

For e-commerce, it is really been a play on our e-fulfillment and contract logistics, and also in last mile, as you are saying. From organic perspective, Europe supply chain was a star in the quarter. It was very, very strong. And that is because of the e-commerce as well as some customer wins on the consumer side. Last mile was also a big grower. It grew 18%, and that is including fuel. So excluding fuel was higher than that. And that is very much the e-commerce.

We work with a lot of different brick-and-mortar retailers and e-commerce direct providers to provide e-fulfillment and last mile. And we do more things in the areas where we can add more value than anyone else. So in big and bulky, that is something that we do extremely well. It's something that we're the largest player. We have density. There is very specialized characteristics and what you need to handle that well. And in e-fulfillment, having the largest platform in Europe, we have very strong returns logistics, which is a very complicated part of the supply chain. So with e-commerce providers we're handling things that are very specific, very complex, and adding a lot of value.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay. Appreciate that, Scott. Then maybe one just very quickly on the balance sheet. So as you look forward to better free cash flow next year and into 2018, can you guys update us on where you are looking for target leverage and potentially any ability to refinance debt as you pay down some of that aggregate outstanding right now?

John Hardig - *XPO Logistics, Inc. - CFO*

Yes. Sure. We are about 4 times leveraged today based on the 2016 EBITDA. Obviously that has come down through the course of the year. We do expect leverage to come down again in 2017. And in terms of repaying debt, we have said before that we want to run with about $300 million of cash on the balance sheet. That is the amount of cash availability that we're comfortable with. And anything in excess of that, we would used to repay debt. We cannot repay any of the term loan yet because it is not callable without a premium. But we will be able to do that in a few months, if that is something we should choose to pursue.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay. Thank you.

Operator

Jason Seidl, Cowen.

Jason Seidl - *Cowen Securities LLC - Analyst*

Thank you, operator. Good morning, guys. Couple quick of questions. When we are looking at the contract logistics business, can you give us an idea about the pipeline sort of into the back half of the year and into 2017, and what we should expect?

Scott Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

That pipeline has grown to about $1 billion overall. So far in Europe we have closed -- just in Europe we have closed about EUR265 million of new business. So we're very much -- we are closing somewhere in the range of 25% of the business in that active bidding pipeline. And you are right to say that a lot of things in that $1 billion pipeline would start to impact us in 2017. So when we win our share of that, you'll see it ramp up maybe in the back -- at the end of this year, but more likely in 2017, and even the back half of 2017 for the contracts we're working on right now. These are a very complex long-term, 5- to 10-year contracts where the sales cycle is usually 18 months and the ramp-up time could be a year.

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

Jason, when you look at the EUR265 million new business won to date that Scott just mentioned, that contrasts with EUR175 this time last year. So EUR175 million won has now gone up to EUR265 million won year to date. So my hat's off to Jean-Luc Declas and his team who run the sales organization for supply chain in Europe, doing a great job.

Jason Seidl - *Cowen Securities LLC - Analyst*

Clearly they seem to be with those numbers. Also just want to piggyback on a previous question. Somebody mentioned that you guys at one point were looking to sell potentially Con-way Truckload. Now it looks like you are getting a bunch of synergies out of it. Is that completely off the table now? Are there so many synergies that you are finding that you would rather keep it in the long term? Or if the markets were to turn and you could get an adequate price for Truckload, that would be something you would potentially revisit?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

We're not trying to sell Truckload. We are trying to optimize Truckload. We see lots of ways to take that $110 million to $120 million EBITDA business to $130 million to $150 million in EBITDA, and even higher than that over a period of years. We are improving it. We are increasing it. And we're making it a better business.

Jason Seidl - *Cowen Securities LLC - Analyst*

Okay. Those are my two now, guys. Appreciate the time.

Operator

Todd Fowler, KeyBanc Capital Markets.

Todd Fowler - *KeyBanc Capital Markets - Analyst*

Great. Thanks. Good morning, Brad. Just on the guidance here. I think historically you've talked about the second quarter being about 26% of the total year EBITDA. If I take what you did here in the quarter it implies a run rate higher than what you've guided to. Can you help us think about maybe some of the strength here in the second quarter? And how do we think about the EBITDA sequentially as we move through the back part of the year?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

Thanks, Todd. We did have a very good EBITDA quarter in the second quarter. I think third quarter will likely be in line with second quarter with EBITDA. And then fourth quarter we have always said is a much lighter quarter. We would expect, given the strength especially so far this year, somewhere in the range of 24% to 25% of the EBITDA for the year to come in the fourth quarter.

Todd Fowler - *KeyBanc Capital Markets - Analyst*

Okay. So the thought process there is that the seasonality is offsetting some of the cost opportunity and some of the growth that you will see as you move through the rest of the year at this point?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

We will continue to grow on a year-over-year basis, but there is significant seasonality. Our second and third quarters are very close together. Usually in LTL, seasonally second quarter is the best quarter of the year. And in Europe Transportation second quarter is the strongest quarter in the year. In the rest of the business, third quarter is the strongest quarter in the quarter year. So they're very close, somewhere neck and neck. Then fourth quarter, as the seasonality at the end of the year, as shipments start to tail off, you will see a slowdown in mid-December. So that is a much smaller quarter than two and three.

Todd Fowler - *KeyBanc Capital Markets - Analyst*

Okay. That helps. Just for my follow-up. Can you remind us the difference between the depreciation that you report on the cash flow and then the other depreciation adjustments that you make? I have quarterly cash flow for the depreciation statement, that $160 million range. But the total depreciation, when you to the add-backs for the segments, it's closer to $225 million. What is that $70 million difference in the D&A in the cash flow and what you do on the segments?

John Hardig - *XPO Logistics, Inc. - CFO*

I am not sure I follow your question on that, Todd. Why don't I reach out to you afterwards and follow up? I am not following your math.

Todd Fowler - *KeyBanc Capital Markets - Analyst*

Okay, John. We can follow up offline. I'm trying to reconcile between when I do the segment EBITDA and I add up all the segments to get to what you reported and the difference between what you report for depreciation on the cash flow. I know there is some reclassification coming out of purchased transportation, some of the other costs. I just wasn't sure why they show up in the segment D&A -- or the segment EBITDA, I should say, versus the cash flow. But we can follow-up off-line if it is not clear the way I am asking it.

John Hardig - *XPO Logistics, Inc. - CFO*

We definitely will follow up and talk about it. Within the segments we usually include footnotes where there is D&A included within our net revenue line.

Todd Fowler - *KeyBanc Capital Markets - Analyst*

Yes. Okay, and that's the the piece I guess I'm trying to reconcile. But let's do it offline at this point.

John Hardig - *XPO Logistics, Inc. - CFO*

Sure.

Todd Fowler - *KeyBanc Capital Markets - Analyst*

Okay. Thanks, guys.

Operator

Nate Brochmann, William Blair.

Nate Brochmann - *William Blair & Company - Analyst*

Good morning, everyone. Wanted to talk a little bit in terms of when you originally set up these targets in terms of how much you can cut out of the business, as well as obviously the recent acquisitions. How you establish that threshold in terms of not cutting too deep where we would either destroy service levels or maybe a year from now we realize that we cut too much then have to add a bunch back. What is kind of the initial thought process with that?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

We never want to do anything that hurts customer service levels. First and foremost we have to delight our customers. We have to keep our customers happy. We have to be listening. We have to have lots of feedback loops to make sure that they are happy with our service. Because customers have choices. We're not the only transportation logistics provider.

In terms of headcount reduction, let's talk about the place where we've had the most headcount reduction, LTL. In LTL every single metric of our service has gone up. And we do weekly customer satisfaction studies. And in every single metric we have improved our customer satisfaction. I would say it is not despite the headcount reduction, it is in part because of the headcount reduction. When you run an organization more leanly with clear lines of authority, clear reporting structures with clear metrics and you roll out P&Ls to every single unit. And you hold people accountable and you have very clear objectives, you end up working more efficiently and more effectively for the customer. I think in large part the headcount reductions and our ability to compete more effectively with a better cost structure has been a plus.

So we have not seen any degradation in customer satisfaction in any of the businesses that we bought. Every single one of the businesses we have bought has been improved since we bought it. That is the thing that I am most proud of, what the team has accomplished over the last several years.

Nate Brochmann - *William Blair & Company - Analyst*

Okay. For a quick follow-up. Obviously you have been benefiting a ton from the cross-selling opportunity. I'm just wondering how much of that is coming from just customers who use that other service and that are using you for a portion of that spend versus kind of the ongoing sightly secular trend here of allowing some of the more third-party providers to get a little bit deeper into their supply chains and overall operations? And just how you see that trend progressing and how that has benefited you?

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

It is both. There is a little love. We inherited a customer with a certain acquisition and a year or two later we inherited the same customer with a different acquisition. So suddenly they are doing two services or three services instead of just one previously. But the majority of the cross-selling growth is the latter. It is proactive. It is going out and having a completely different level of discussion with customers.

So who we meet with at our customers is a higher level as a result of the broad service offering that we have. We're meeting with global chief supply chain officers. We're meeting in the C-level suite. And we are looking at not just a specific mode, but we are looking at their $500 million or $5 billion a year of total transportation logistics spend globally. And our role is, how can we take out tens of millions of dollars from that spend. That is what we are doing now.

That is a completely different business model than just trying to bid on a commoditized basis for a specific service line. This is really forming a partnership, a strategic partnership with our customers to understand their supply chain and how they can do what their bosses are putting pressure on them to do, which is to take out a couple points or more of costs every year, continuous improvement of their supply chain cost structure.

Nate Brochmann - *William Blair & Company - Analyst*

Great. Thanks for the additional color there.

Operator

Bascome Majors, Susquehanna.

Bascome Majors - *Susquehanna Financial Group - Analyst*

Thank you for squeezing me in. First off, congrats on the accelerated progress towards your multi-year targets on the EBITDA and cash flow. Clearly there's some external challenges out there. But you are doing well. I was hoping in light of the improving margin and cash flow profile here, can you give us a fresh walk-through of your sense of downside sensitivities to EBITDA and free cash in a recessionary scenario?

John Hardig - *XPO Logistics, Inc. - CFO*

Sure. The good thing about our model is that our CapEx is very flexible. We can take down CapEx in downturns and maintain or actual increase our free cash flow. So in a deep, deep downside scenario, we can still cut our CapEx more than EBITDA. And then you get the money back on free cash flow. Different businesses react differently to the cycle. That is the power of the model. Some of our businesses, like contract logistics, do very well through a cycle. In actuality, sometimes we do better in contract logistics in a downturn, as some of our customers look to outsource more of their supply chain to variabilize their own costs. So you will win -- you have a lot of opportunity to win new business.

Then in truck brokerage tends to do well through a cycle. Last mile with e-commerce trends is more secular. We'll do well through a cycle, and has done well through previous cycles. Things like LTL and truckload and other parts of transportation. Sure, that will be more hit on the EBITDA line than some of those other, more resistant levels. But again, CapEx, especially within LTL, is very flexible. The trucks on the local pickup and delivery can last 10, 11 years or more in some cases. And you can delay purchasing for a number of years until you need to revamp that purchasing.

Brad Jacobs - *XPO Logistics, Inc. - CEO & Chairman*

Bascome, if there is one single point that we would like to communicate to you on this call, it is that the majority of the several hundred million dollars of improvement that we are executing on in profit over the next few years are Company specific actions that are independent of the macro. Regardless of what happens with GDP, I can assure you we will be purchasing tractors and trailers at lower prices over the next few years than we are now. I can assure you regardless Brexit or recession or GDP, we will be purchasing tires at lower prices than we have been historically, and so forth and so on. So that is the main point we want to get across, that we have an amazing opportunity right in front of us to continue to execute on cost reduction and improvement and transferring best practices that are independent of the macro.

I see now it is past the market open at 9:30. Le me conclude with the following. We started the call with saying that we're at a positive inflection point in the evolution of our Company. And that we are reaping the rewards of the last five years. We have built a very well diversified, well functioning global business that provides significant value to our customers.

The proof is in the pudding. Look at the numbers this quarter. We had record EBITDA, way above expectations. We had record cash flow from ops, way above expectations. Record free cash flow. We have a clearly defined action plan to go from $1.265 billion of EBITDA this year to our $1.7 billion target in 2018. Thank you for participating in the call. And we look forward to speaking with you in three months.

Operator

Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation. And have a wonderful day.