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XPO - Q2 2019 XPO Logistics Inc Earnings Call

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OVERVIEW:

Co. reported 2Q19 GAAP diluted EPS of $1.19. Expects 2019 total revenue growth to be between minus 1% and plus 1% and organic revenue growth to be 2.5-4.5%.

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PRESENTATION

Operator

Welcome to the XPO Logistics Second Quarter 2019 Earnings Conference Call and Webcast. My name is Rob, and I'll 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, which by 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 earnings 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 except to the extent required by law.

During this call, the company may also 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 related financial tables.

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 Investors section on the company's website.

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

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Thanks, Rob, and good morning everybody. Thanks for joining our second-quarter earnings call. With me today in Greenwich are Matt Fassler, our Chief Strategy Officer; and Tavio Headley, our Senior Director of Investor Relations.

As you saw from the press release, we beat on our key financial metrics of EBITDA, EPS and free cash flow despite lower-than-expected revenue. We also achieved a record-high EBITDA margin of 10.7%. We delivered $455 million of adjusted EBITDA in the quarter, up from $437 million a year ago. We reported $1.19 of GAAP diluted EPS, up 16% year-over-year. On an adjusted basis, EPS was up 31% at $1.28. Free cash flow was stronger than expected at $246 million; that's 27% higher than a year ago.

Turning to some highlights by business unit. In LTL, our yield growth, excluding fuel, was 3.9%, an acceleration from 3.0% in the first quarter. And we continue to improve our LTL adjusted operating ratio, this time by 400 basis points to 80.3%.

In logistics, we generated organic revenue growth of 4.8%, which is about 3x the average GDP of the countries where we operate. And this is after the downsizing of our largest customer.

In North American freight brokerage, we improved net revenue margin by 360 basis points to 20.4%, up from 16.8% last year.

In managed transportation, revenue was up 24.6% in the quarter, as customers moved to the XPO Connect platform. While managed transportation is still a small component of our revenue, still, this is very positive trajectory.

In the U.K., we signed the largest contract in the history of our European transportation business. This is a multi-year dedicated transportation agreement with British Gypsum for GBP 55 million a year. We're partnering with British Gypsum to transform their U.K. supply chain into a single, digitally managed transportation network.

Yesterday, we updated our 2019 guidance. We now expect organic revenue growth for the year to be between 2.5% and 4.5%, and total revenue growth to be between minus 1% and plus 1%. The update primarily reflects the impact we expect from lower truckload rates and FX in the back half of the year. We also raised the lower end of our EBITDA range by $25 million. Our new target for adjusted EBITDA is $1.675 billion to $1.725 billion, up 7% to 10% year-over-year. In addition, we raised our target range for 2019 free cash flow by $50 million. Our new range is $575 million to $675 million. We expect to hold our net CapEx at around the low end of our range of $400 million to $450 million. And cash taxes are expected to be more favorable than we had previously anticipated.

Our tech initiatives had a hand in every significant gain we realized in the second quarter. This includes our record LTL operating ratio and our substantial improvement in both LTL yield and brokerage net revenue margin.

Matt will go into our growth initiatives in more detail, including our technology road map, but let me highlight 2 of them now. One is XPO's Smart workforce planning. We recently piloted this technology in 18 LTL sites with positive results in motor moves per dock hour, and we plan to roll it out to all of our 290 LTL service centers by the end of the year. We're also enhancing productivity by applying machine learning for dynamic pricing, route optimization of pickup and delivery, linehaul efficiency and yard management. These work streams are the next leg of significant profit improvement in our LTL operations.

In sum, we're pleased with the quarter. We're executing well on controlling cost and expanding margins. We're right on track to deliver full year adjusted EBITDA growth of 7% to 10%. And we're confident that our free cash flow will be in the higher range we guided to yesterday.

With that, I'll ask Matt to review the quarter in more detail.

Matthew Jeremy Fassler - *XPO Logistics, Inc. - Chief Strategy Officer*

Thanks, Brad. As we review the numbers, I want to highlight an important theme. We're managing costs and capital with discipline, while continuing to invest in strategic technology. This is improving margins, improving free cash flow and gaining us share in key lines of business. I'd like to walk you through the second quarter numbers and our strategic focus by business unit. I'll start with our Transportation segment.

Beginning with North American LTL, our primary focus in terms of maximizing profitability is yield. As Brad mentioned, yield growth accelerated from 3.0% in Q1 to 3.9% in Q2. Price increases on contract renewals accelerated sequentially to 5.2% from 3.7% in the previous quarter. Tonnage declined by 2% year-over-year. This was consistent with the prior quarter. Our operating ratio improvement in the second quarter reflected our improvement in yield, as well as tight cost control.

In freight brokerage, our top line declined by 14% as we lapped another tough comparison, a 27% revenue increase in Q2 of last year, and absorbed a reduction in spend by our largest customer. But our net revenue in freight brokerage held steady year-over-year, and our net revenue margin rose sharply for the second consecutive quarter.

In truck brokerage, we sourced capacity about 5% below market in the quarter, as compared to the DAT benchmark. This relates in part to the deployment of pricing tools in our XPO Connect digital freight marketplace. Also in truck brokerage, we had a year-on-year decline in load in the mid-single digits, which was an improvement from Q1. Excluding our largest customer, we generated truck brokerage load growth in the mid-teens in Q2, up from mid- to high single digits in Q1. We're taking share by deploying our brokerage technology suite to deliver high levels of service, while capitalizing on opportunities to drive margin.

Turning to our last mile operation. As we expected, revenue declined 21% year-over-year as we wound down our postal injection business in Q1. Last mile revenue excluding postal injection tracked flattish, mirroring trends in retail sales of big-ticket durables. Net revenue margin increased to the highest level we'd delivered since entering this business in 2013, largely due to mix. We achieved solid new business wins in last mile in Q2, second only to the record we set last quarter. Given our recent new business wins, we expect underlying last mile revenue growth in the second half of this year.

As we mentioned earlier, managed transportation posted strong sales growth in Q2. We're a top 5 global provider of managed transportation based on value of freight under management. Our global network uses a control tower approach through XPO Connect that provides customers with highly efficient, customized solutions for transportation procurement, asset utilization and freight management.

Our European transportation business had a revenue decline of 2.8% in the quarter. FX translation constrained this number by about 6 percentage points. We're continuing to grow and gain share in the U.K. and Spain. France remains our slowest-growth market in Europe. Our managed transportation business in Europe is putting up strong numbers, up mid-teens year-over-year.

Looking across our transportation segment overall, adjusted EBITDA rose 8% and adjusted EBITDA margin rose by 160 basis points, reflecting better profitability in freight brokerage and LTL. FX constrained this number by about $3 million or 1 percentage point.

Turning to the logistics segment, revenue rose 1% globally. We lost about 5 percentage points of revenue from the combined impact of FX and the decline in business from our largest customer.

In North America, our 6% revenue growth in logistics reflects ongoing strength in consumer packaged goods, food and beverage, aerospace and health care. In Europe, logistics revenue declined 2%. FX constrained this number by about 6 percentage points. We're continuing to build on our market-leading position as the largest outsourced provider of e-fulfillment logistics in Europe. And once again, e-commerce was our strongest vertical in European logistics.

Adjusted EBITDA for logistics rose 2% year-over-year in the quarter, and adjusted EBITDA margin tracked flat, improving from a small first quarter decline. The combined impact of FX translation and the downsizing of our largest customer cost us approximately $10 million of EBITDA. We believe that excluding these items more accurately frames the underlying growth in our core logistics business.

For the company overall, our global sales pipeline is now at a record level, up 31% year-over-year. It's progressively growing from $3.5 billion in December and now up to $4.4 billion in Q2. The dollar amount of our new business wins fell 5% year-over-year, but, at $1.04 billion, was still one of the highest quarterly sales totals in our history. Because new business won could be chunky, we look at it over a longer period of time. And for the first half overall, new business won rose 4%, with North America up in the high single digits and Europe down by about that same magnitude, consistent with the macro in that region.

Moving down the income statement, interest expense rose to $72 million from $55 million a year ago, reflecting our earlier debt issuance to fund our share buybacks. Our effective tax rate improved to 24.1% from 25.4% a year ago. Our weighted average diluted share count declined to 102 million from 134 million a year ago and 117 million last quarter. This primarily reflects our share buyback activity.

We purchased 2.1 million shares in the second quarter at an average price of $56.78 for total repurchase activity of $120 million. Since we launched our program in December, we've bought back 35.2 million shares at an average price of $53.42 for a total cost of $1.9 billion. Our buyback activity was $0.18 accretive to adjusted EPS for Q2 and should continue to prove nicely accretive for the year.

We've completed over $3 billion in debt financings since December to lower our interest rates and improve other terms, while extending the company's maturity profile. We amended our ABL facility in the quarter, extending its maturity date, increasing the size of the lender commitments and reducing the premium to our interest rate benchmarks and our commitment fees.

Cash flow from operations in the quarter was $260 million compared with $267 million a year ago. Gross capital expenditures decreased to $118 million from $126 million a year ago. Net capital expenditures were $80 million compared with $74 million a year ago. We booked a gain on sale of assets of $19 million, of which $17 million related to real estate, $11 million of this was in our LTL business, with the remaining $6 million sprinkled elsewhere in the business. Gross and net CapEx both tracked lower than expected, reflecting a combination of capital discipline and timing. All in, free cash flow of $246 million increased from $193 million a year ago.

I want to bring you up to speed on our strategic growth initiatives, especially as they relate to technology. As many of you know, we expect to invest about $550 million in technology this year. We have a rigorous process to determine how that investment can best deliver value for our shareholders. It's a thorough decision process that's guided by four principles.

First, we invest in technology to help make our customers' supply chains more efficient. We've seen this investment pay dividends in the form of market share and, increasingly, through productivity.

Second, we think the transportation world over time is going to be fully automated, and we're engaged in automating almost every touch point of the transaction, from the time a customer seeks capacity to the selection of that capacity and the various steps that take the freight from origin to destination. And we're doing it across multiple modes.

Third, we're using dynamic data science to operate our business more efficiently. The biggest opportunity is to increase the efficiency of our roughly $6.5 billion of annual labor spend, but there are applications in other areas as well.

And fourth, we're working to continuously improve customer visibility and customer service. We want to increase transparency for shippers and all of our transportation customers, for our contract logistics customers, for the customers who receive goods through our last mile contract carriers and for the suppliers and carriers who support these supply chains. This increases customer satisfaction by improving their ability to plan and allocate resources.

Looking forward, we're particularly excited about 10 key initiatives, all of which are underway, that represent potential profit growth opportunity of $700 million to $1 billion by 2022. We're highly focused on pricing analytics.

Our proprietary pricing algorithms leverage elasticity models to automate pricing and optimize mix. We're seeing the results play out in LTL and brokerage, and we've identified substantially more opportunities going forward.

Our XPO Smart workforce planning tools are driving productivity in our logistics network. We currently have this technology in about 100 of our warehouses in North America, with a larger rollout underway in both North America and Europe. We've typically achieved labor productivity improvements between 5% and 7%. At some sites, we've seen more than a 25% efficiency improvement. Based on the success we've achieved in our warehouses and in our 18 pilot sites, we are rolling it to our entire LTL network.

In LTL, in addition to workforce planning and pricing, we're leveraging the data that flows through our systems daily in areas like dynamic route optimization. This is where we can improve the efficiency of pickup and delivery, which reduces cost, but just as importantly, increases service levels. And we're optimizing our LTL linehaul routes to drive improvement in trailer utilization and miles driven.

We're generating rapid-fire growth from XPO Connect, with more than 28,000 carriers on the platform, and that number is climbing fast. We had more than 16,000 downloads of our Drive XPO app in Q2, which was more than double the number of downloads we saw in Q1. And with our Freight Optimizer engine behind XPO Connect, we're buying capacity better than the market and expect more sharp increases in productivity going forward.

The final tech-related initiative is XPO Direct. The distribution marketplace increasingly values speed and flexibility. XPO Direct, our shared distribution model, offers precisely that, along with real-time customer visibility and predictive analytics. The network includes warehouses and last mile hubs. We see it as a key component of our e-commerce and omnichannel strategy. We're investing in it, and we're getting traction with existing customers. We're on-boarding recent new business wins and engaging in active dialogue with prospective customers. We remain on track to reach a $1 billion revenue run rate by 2022.

In Europe, we have two notable opportunities for revenue and profit growth. One is cross-selling. Given the large addressable market in Europe and our relatively low share, we see vast potential to cross-sell our services in Europe, regardless of economic conditions. We're targeting about 250 pan-European customers and importing proven sales strategies and best practices from our U.S. strategic account managers.

Also, we have an opportunity to improve our logistics margins in Europe, getting closer to the levels we deliver in North America. We're installing managers at the pan-European level, setting up implementation teams to pilot new concepts and adding Six Sigma professionals to expand margins. We also see additional opportunity in back-office optimization. And we see further opportunities in procurement, for example, in temporary labor, purchased transportation and waste management.

In the second quarter, we continued to receive recognition for our service from a number of esteemed customers, including Ford, GM and Raytheon. And in May, XPO was named as a leader in the Gartner Magic Quadrant for the third consecutive year. Finally, over the past few weeks, we have been proud to have served as the official transport partner of the Tour de France. This is the 39th consecutive year that XPO has partnered to support all 21 stages of the race.

With that, I'll turn it back to the operator and we'll take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today comes from the line of Jason Seidl with Cowen and Company.

Jason H. Seidl - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Wanted to touch a little bit on the pricing in LTL. It's interesting that you guys have your core pricing going up while your tonnage declines really haven't moved in what many would characterize as a difficult marketplace. Is this basically attributed to the pricing analytics that you're doing? Or is there something else that we're missing here?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

I would like to take full credit for that, but I don't think we honestly can because you can see our competitors are also raising price, and in most cases, raising price more than we are. What I think the environment is, in LTL properly characterized, is you have sluggish volumes in general-negative tonnage pretty much across the board. And that's been that way for a while. It's not a new event. But you have a very concentrated carrier base, so there's pricing rationality. There's pricing discipline. So there's weak demand, but there's tight supply. And so that leads to pricing gains.

Now, the [deployment of the] (added by company after the call) pricing algorithms that we've been rolling out is fairly recent, so we're not seeing huge benefit from that yet. We're seeing beginnings of that. But over time, we will see a lot of benefit from that going forward.

Jason H. Seidl - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

And I'm assuming you guys remain confident in the direction of the LTL pricing marketplace.

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

We are. Pricing is definitely firm in LTL. It is across the board. We raised prices successfully in all three of our types of categories of customers: Large customers, small customers and 3PLs. You saw a progression in the raising of the rates this quarter versus last quarter. We also had contract rates on renewals, we're up 5.2%, which is something we were watching because in the first quarter it had decelerated, and we still increased. It was up 3.7% on contract renewals in the first quarter, but that had been down from the fourth quarter, and here we've seen it pop back up to 5.2%. So I think tonnage is going to stay soft, maybe even get a little softer depending on what's going on with the industrial economy, and I think price is going to stay firm.

Jason H. Seidl - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Okay. And Brad, as a quick follow-up, you guys obviously been very aggressive on your buyback as you sort of went to the sidelines on acquisition. But we've seen acquisition multiples come in, and several publicly traded companies have noted that they're sort of out there looking again. And have the multiples coming in changed your mind on how to deploy capital at all?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

We pay attention to that. But we also pay attention to the alternative of our multiple, which is also, as someone said, staggeringly inexpensive. So in the second quarter, we had about $246 million of free cash flow. We took about half of that and bought back stock, took half of that and reduced net debt. I say net debt because we didn't want to have prepayment penalties, so we basically just increased the cash. So that was our strategy in the second quarter, and the Board will look at the four alternatives we have to create shareholder value with all our excess cash regularly. And we may decide to err more on the side of reducing debt or more on buying back shares or returning to M&A or increasing in high-ROI CapEx. It just depends how the puts and takes of each one of those choices falls out.

Operator

Our next question is from the line of Chris Wetherbee with Citi.

Christian F. Wetherbee - *Citigroup Inc, Research Division - VP*

Wanted to stick on LTL here for a minute. And can you give us a sense of maybe how you're seeing trends kind of form here in the third quarter? I guess, can you give us an idea of maybe what July tonnage was like and how the sort of contract renewals were pacing through the beginning of the third quarter?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Yes. Contract renewals are going very well, very well. Pricing is strong. Pricing is strong in LTL, period. Tonnage is not so strong. It hasn't been strong for a long time and it's been a little less strong in the last couple of months. But that's not something new. That's still within the band of the softness that we've seen for a while.

Generally speaking in LTL, we feel very positive about what we're doing. We had a record OR, a record not just for this quarter but for any quarter ever in our company and the predecessor company we had bought. It was 400 basis points up year-over-year, so there was some real nice improvement. Even if you take out real estate, and we respect the opinions of people who want to give somewhere between 0% and 100% credit for real estate sales, it was about 110 basis points. So you would have been 290 basis points up on OR, even with giving zero credit to the cash we got from real estate. So we feel good about what the results are from all the activities we're taking. Load factor was up 1% year-over-year in the second quarter. This is great. It was down 2.7% in the first quarter. And as you know, every 1% of load factor is $10 million a year of EBITDA.

The workforce planning tools that we've rolled out in LTL are extremely exciting. You'll recall from last quarter, we had pioneered many of our tech initiatives, workforce planning tools. We thought, hey, we have about $6.5 billion of labor costs globally and we thought we did a real good job of managing it. That wasn't on the top of our list of things that we want to put effort in to improve. But we had a tech group who was applying algorithms to it. And we found out that we can do a lot better than we had been doing it in the past. And we rolled it out. Well, now it's at about 100 warehouses of our 801 warehouses. And we found productivity on labor there improved between 5% and 7%. We found in some outliers it was more than 25%, and that was just really eye-opening for us.

So we said let's change the GUIs a little bit and adapt it more for a crossdock and warehouse, which we did. We piloted it in 18 LTL sites; we've had very good preliminary results. And we're going to roll -- the plan is now to roll those smart labor tools out to all 290 of our LTL sites this year. I'm very optimistic about the improvements we're going to see there.

Now that we're halfway through the year, Chris, we have visibility into the year. You can expect more than 250 basis points of OR improvement in each of the third and fourth quarters. So that will come out to about over $200 million -- or 200 basis points of year-over-year improvement for the full year.

Christian F. Wetherbee - *Citigroup Inc, Research Division - VP*

Got it. Okay. That's helpful. And just when you think about some of the labor productivity tools and the initiatives you have going, obviously, they're giving you a benefit here in the back half. Should we change the way we think about sort of the longer-term opportunity in terms of OR within LTL? Is it still 100 to 200 basis points when we think about 2020? Is it more or less, given the progress that we've had so far this year?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Well, if you look at the ORs of the whole group of public LTLs, there's OD leading the pack and there's us catching up to them but haven't caught up to them yet. And they're a fantastic role model for us. And then there's a big gap and then there's the next group of operating ratios. So we're going to continue to improve our operating ratio. We haven't been able to crack 80% yet. And maybe we will, maybe we won't, but that's our goal. And our goal is to increase the actual amount of operating income and actual amount of EBITDA on a year-over-year basis and to pay attention to the amount of capital we're putting into the business and the return on capital we're getting for that. But as a result of all that, we believe our OR will still be among the two best operating ratios in the LTL group.

Christian F. Wetherbee - *Citigroup Inc, Research Division - VP*

Fair enough. It's tough competition, certainly. And then one last question, if you allow me. Just so we understand when we think about the rest of the year and what's embedded in the guidance. How should we think about gains, whether they be real estate or other gains, included in the EBITDA guidance for the back half of the year?

Matthew Jeremy Fassler - *XPO Logistics, Inc. - Chief Strategy Officer*

Sure, it's Matt. The first half of this year, we registered $36 million in gains from the sale of real estate. We would expect less than that for the third and fourth quarter combined. In addition to that, we have an underutilized office property which we're in the process of selling. And that has been embedded in our cash flow guidance and in our earnings guidance all year. That should generate cash flow in excess of $50 million and most likely a $5 million to $10 million gain on that sale at some point in the second half of the year.

Operator

Our next question us from the line of Ravi Shanker with Morgan Stanley.

Ravi Shanker - *Morgan Stanley, Research Division - Executive Director*

So just a follow-up on the pipeline of new business, Brad. A couple of quarters ago when you announced the departure of your biggest customer, you said that it will take some time to kind of recover or kind of rebuild post that, but you guys have done a really good job in a very tough environment of actually bumping up that pipeline. Can you just give us a little more detail as to kind of what drove that? I mean, are there any particular end markets? Have you changed your approach to recruiting new customers? And what's driving that incremental opportunity that you're targeting?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Well, there's a cliché that says there's nothing like a hanging to concentrate the mind. And when you lose $600 million of business like we did at the end of last year, you concentrate, you get focused, and that's what the organization did. When you look at the pipeline, it's at an all-time record high. As Matt mentioned in his prepared comments, it's up to $4.4 billion. So it's up 31% year-over-year. It's only the second time it's over $4 billion.

And I guess, apart from the actual number, the other thing that is impressive about it is the trend of it. You saw in Q4, the pipeline was up 9% year-over-year. And then in Q1, the pipeline was up 13%. And then in Q2, it zoomed up, it's up 31% on a year-over-year basis and accelerated in both places, here and in Europe. So I feel good about what the sales organization has done in order to get our services in front of customers and do a lot of cross-selling, and I feel very proud about the operations group to have a service that customers want to buy.

Ravi Shanker - *Morgan Stanley, Research Division - Executive Director*

Got it. And just kind of maybe related to that, you put out a slide that kind of -- you say that you're targeting an incremental profit opportunity of $700 million to $1 billion by 2022. Can you just give us a sense of how you're going to go about that? Kind of what percentage of that opportunity? I mean, you talked about a conversion rate of your new business pipeline. Kind of is there a targeted conversion rate of that profit opportunity as well?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Yes -- you're talking about the investor deck?

Ravi Shanker - *Morgan Stanley, Research Division - Executive Director*

Yes. I'm talking about the investor deck, yes.

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Yes. Okay, great. Yes. So yes, on Page 10 of that investor deck, there are 10 initiatives which is our to-do list, which are things we're working on. So we just shared that with the investment community. These are the 10 big levers that we're pushing and we're spending senior executive time on and we're holding people accountable. And we're stop-lighting them -- red, green, yellow every week and every month. And in aggregate, those 10 initiatives represent a pool of profit improvement opportunity of between $700 million and $1 billion.

Now we're not going to get $1 billion from that. Life doesn't work like that, but we're going to get hundreds of millions of dollars from those initiatives. And a little more than half of them are cost and a little less than half of them are revenue-driven. So the cost ones are things like the workforce productivity tool I was mentioning before. We're attacking that $6.5 billion labor spend we have around the world and just getting that up to world-class. And the revenue-driven ones are things like XPO Direct, things like the AI-based pricing. And a lot of thought and a lot of time and energy have gone into those work streams and we're pursuing them with great vigor.

Ravi Shanker - *Morgan Stanley, Research Division - Executive Director*

Got it. And just lastly, Matt or Brad here, you gave us some pretty good stats on the brokerage business in the quarter. I didn't hear anything on head count. Can you just clarify kind of what your headcount did in response to the higher loads?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

It was down 6% year-over-year. So as you know -- well, back to the days of where Bill was covering us, Bill Greene, we were the first ones to get out there and start spending tens of millions of dollars, which at the time was a lot, on updating the technology in freight brokerage. And we rolled out the Freight Optimizer in 2012. And as a result of that, we've been on a steady path, you can plot it year-by-year since then, of getting more loads done and more profit done per person. So there's a constant, continuous improvement of productivity in truck brokerage. So we're able to generate more business, more profitable business, service customers better with fewer heads and automate more and more of the process.

Ravi Shanker - *Morgan Stanley, Research Division - Executive Director*

I think Bill Greene will always be a honorary member of transportation conference calls.

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Absolutely.

Operator

The next question is from the line of Amit Mehrotra of Deutsche Bank.

Amit Singh Mehrotra - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Just a quick follow-up on the $700 million to $1 billion profit improvement in 2022. I just want to understand how fleshed out that is. Are you basically guiding to EBITDA of $2.5 billion -- a little over $2.5 billion in 2022 relative to the $1.7 billion, I guess, expected this year?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

No. I'm glad you asked that question because we're not trying to make the implication that we're guiding to $2.5 billion EBITDA in 2022. We have not put out guidance yet for 2022. What we are sharing with you is what we're working on. These are the levers of how we're going to take the company into the next level of profitability, of efficiency, of productivity. You asked how well they've been fleshed out. It's very, very well fleshed out. These are things we spend an enormous amount of time on strategically with the top level of the organization, with the operating people, saying what are the most important things we can use our collective time on to improve the profitability of the company?

Whether it's the XPO Smart workforce productivity tools, whether it's process improvement in LTL, whether it's more automation in contract logistics, whether it's more global procurement, whether there's more back office optimization we can do, whether it's more advanced pricing analytics, XPO Connect, XPO Direct. So these are the main lanes that we're swimming in, in order to grow profitability significantly over the next several years. Because that's our mission. Our mission is to create shareholder value by improving the efficiency of the company. And that Page 10 in that investor deck is how we're pursuing that. But we're not saying these are all in the bag. They're not all in the bag. That's just not the way it's going to work. But we'll get a substantial portion of them.

Amit Singh Mehrotra - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Okay, I appreciate the clarification. Just another follow-up if I could on just the framework for how we think about free cash flow in 2020. I know you're not guiding to it yet, which is a little bit of an anomaly because I think you guys are through your 5-year budgeting, and last year you did it 12 months before last year. So one, just talk about that; and two, free cash flow to EBITDA conversion this year is like 36%, 37%, embedding the new guidance. Is that how we should think about, like, the free cash conversion relative to the EBITDA growth next year? Or just any of the puts and takes there would be appreciated.

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

We don't want to, today, guide to next year's free cash flow. We want to spend another quarter or two getting through this year, and then we'll put out guidance, like most companies. We want to see how the macro develops. We want to see how a lot of these exciting projects that we're working on develop.

What we can talk about in the here and now is this quarter's $246 million of free cash flow, which is more than double what we were expecting. But the reasons for that were really simple. We were disciplined on CapEx, we had lower cash taxes and we had better cash interest than we expected. So those things all added up to about $50 million. So we raised the low end of the range from $525 million to $575 million and the high end of the range from $625 million to $675 million.

So that's how we're looking at the free cash flow now and that's how we're looking at free cash flow for this year. And when we do our budgeting for next year and we're ready with confidence to give you guidance, we'll give you guidance.

Amit Singh Mehrotra - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Okay. That's fair. Just one last quick one for me, just since you brought up the macro. Europe is 40% of the business. There's been some recent developments recently, Brexit, the macro indicators in Germany, particularly. I know you don't have a lot of business there, but generally, it's not great. Just talk about how the EBITDA and cash flow guidance is sensitized to the various scenarios around Europe for the back half of the year because there's just a lot of moving parts there.

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Well, you're right. Germany, sadly, we don't have a lot of business in Germany. We wish we did, but we don't.

Amit Singh Mehrotra - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

It's a good barometer through, for general European activity.

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

It is, but they have -- I was with a senior banker from Germany recently who had good insights on what's going on there, and he was explaining to me politically what's going on. There is a kind of -- they're stuck. So I don't know whether their specific circumstances are really applicable to the rest of the EU and what may end up being not part of the EU. But in any case, it's a little bit of a moot point for us because we don't have a lot of business in Germany.

We do have the preponderance of our business in the U.K., in France and, to a lesser extent, in Spain. And the GDP in those countries has been about flat in Q2 versus Q1. It hasn't gotten worse. It certainly hasn't gotten better. It's been weak and it continues to be weak, but about the same level of weakness. What's more weak is the FX. The euro has gotten weaker and the pound has gotten weaker as the dollar has gotten stronger. And that's sort of on the foreign exchange translation from euros and pounds to dollars.

But e-commerce is strong everywhere, including in Europe, including in all the countries we operate in Europe. And we're the largest e-fulfillment -- 3PL in Europe, and that business grew 20% in the second quarter on a year-over-year basis. I mean, not all of our parts of our business are growing anything close to that, but if you have a broad enough platform like we do, you can zig and zag and plot and put resources and capital and people and energy on the places that's working and downsize in the places that's not working. So I feel the team is doing a job there at dealing with a very soft environment.

Amit Singh Mehrotra - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Okay. Great. That sounds good. Congrats on the traction.

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Thank you, sir.

Operator

Our next question is from the line of Brandon Oglenski with Barclays.

Brandon Robert Oglenski - *Barclays Bank PLC, Research Division - VP & Senior Equity Analyst*

Brad, I don't think I heard it mentioned today, but could you just update us about where we are in the CFO search? And I find it a little odd because most public companies of this size I don't think would have a vacancy that long. So like, is this just not as important as we should be thinking about it? Or like, what is the delay?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Well, the finance accounting organization is working very well. And while we haven't hired a permanent CFO, we have hired new first-class heads of tax, of real estate and of corporate shared services, 3 excellent hires, and you actually saw the results from those hires here in the quarter. And the search is ongoing for a CFO. And when we find the right person, we'll hire them and we'll let you know right away. But as of now, the search continues.

Brandon Robert Oglenski - *Barclays Bank PLC, Research Division - VP & Senior Equity Analyst*

Okay, but we shouldn't be reading anything negative into this front, right?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Absolutely not. I'd read something positive into it, that the company is strong, it's well-organized and has mature, developed systems in finance accounting that are working very well, with a very large team of great finance accounting professionals globally. And Sarah's doing a great job at leading it on an interim basis. And we don't feel we have a gun to our head to hire the wrong CFO. We want to hire the right CFO. And when that CFO comes across us, we'll hire her or him.

Brandon Robert Oglenski - *Barclays Bank PLC, Research Division - VP & Senior Equity Analyst*

Okay, appreciate that. And on free cash flow, Matt, I think you mentioned that you're going to have $50 million cash flow from excess office space that you're selling this year. But I guess in a broader context, when we walk from EBITDA to free cash flow, how is working capital impacting that this year? Because with a lower revenue growth rate, we would expect working capital to become at least maybe neutral. Or am I thinking about this the wrong way.

Matthew Jeremy Fassler - *XPO Logistics, Inc. - Chief Strategy Officer*

Well, we do expect stronger organic revenue growth in the second half of the year than we registered in the first half of the year and stronger overall revenue growth in the second half of the year than in the first half of the year. So we have working capital in our model as a modest use of cash. Obviously, we'll strive to do better than that and we're very focused on that from an operational perspective every day.

Brandon Robert Oglenski - *Barclays Bank PLC, Research Division - VP & Senior Equity Analyst*

Okay. And then lastly, it does look like your North American logistics business took a step down, and I think that might have been associated with your large customer leaving. Can you talk about some of the initiatives you have there and the pipeline to potentially replace that size of business and how long that could take?

Matthew Jeremy Fassler - *XPO Logistics, Inc. - Chief Strategy Officer*

Sure. I'll start on that. We did register some deceleration in revenue growth in Q2 from Q1, most of that related to the downsizing of business from our largest customer. In terms of replenishing the pipeline, the pipeline in North American supply chain is very strong. New business wins in the North American supply chain are strong, and we remain very focused as we have been on closing new business in that segment.

Operator

Our next question is from the line of Kevin Sterling with Seaport Global.

Kevin Wallace Sterling - *Seaport Global Securities LLC, Research Division - MD & Senior Analyst*

You guys, I know you touched on the real estate gains, and Matt, you mentioned selling an office property. But Brad, maybe what we've seen so far to start the year, is that a function of you guys streamlining operations, selling off unprofitable terminals? Essentially, are you at a point where you can do more with less as a function of all of your technology initiatives?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Well, we're always trying to figure out ways to make money for our shareholders since that's our goal. And we have almost $1 billion of market value of real estate that we own. And we're looking at what's utilized, what's underutilized, what can be combined. Where we have two facilities that aren't fully utilized, we put them together. The office building that Matt mentioned is about half empty and we've got a real nice profit embedded in that if we sold it, so we're going to sell it. Maybe the Street will give us credit for it, maybe it won't, but we'll take the cash. It doesn't make sense to keep an underutilized building. And that's just part of our general program of continuously improving the company, to find waste, to find inefficiencies. And we've got a long way to go until we have no inefficiencies and no waste in the organization, including in our real estate portfolio.

Kevin Wallace Sterling - *Seaport Global Securities LLC, Research Division - MD & Senior Analyst*

Okay. Great. And Brad, you talked about getting to $1 billion in EBITDA in 2021 for LTL. Is that based upon current market conditions? If things were to deteriorate from here further, can you still get to that $1 billion number by pulling some of these levers you've talked about if market conditions deteriorate?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

If we went into a recession, particularly if it was a deep and long recession, no, we would not be able to get to $1 billion EBITDA by 2021. The math doesn't work. If between now and then on average we have this kind of sluggish environment like we've had for the last three or so quarters, yes, we can get there. We can absolutely get there.

We can get there through working on the technology projects, on the labor tools. We can get there on the P&D optimization and picking up more freight with fewer trucks and less labor. We can get there through the computer-based price discovery and understanding with greater detail elasticity of pricing and where is the exact Goldilocks amount of pricing versus the tonnage trade-off. We can get there through attacking the $1.3 billion a year we spend in linehaul and the use the new linehaul modeling technologies that we're building to build more pure runs and to increase load factors and to take out empty miles.

So those technologies, together with just running the business better and better every month and every quarter than the previous month and quarter, should get us to $1 billion of EBITDA in LTL by 2021. We feel very good about that projection.

Kevin Wallace Sterling - *Seaport Global Securities LLC, Research Division - MD & Senior Analyst*

Okay. Great. And then last question, and you've touched on this some, but if I could dig a little bit deeper into it if you don't mind. All your technology initiatives that you're implementing, obviously, you're working Mario pretty hard. You get some immediate cost benefits, it seemed like, but then down the road, is your objective to win new business? Is it to capitalize on organic growth? Obviously, you talked about your organic growth pipeline. How should we think about, after you realized these cost benefits, is it market share gains? Is it organic growth? Or maybe it's both?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

So what we're trying to accomplish in technology is to take out waste in the organization so that we can serve our customers. Our mission to our customers is to move their goods through their supply chain more efficiently, more cost-effectively. So how can we increase labor productivity? How can we use technology to shorten distribution cycles and increase fulfillment speeds? How can our tech increase order accuracy and inventory accuracy? How can we reduce stocking costs? How can we make return logistics more efficient, which is one of the fastest [growing] (added by company after the call) parts of the business that we have. How can we enhance safety so we have fewer injuries and fewer accidents and fewer fatalities?

So big picture, trying to use technology to run the business better and to wow the customer with tech, with capabilities that differentiate us from our competition. And if you look at it from what are the channels that we're doing, it goes in automation, in robotics. So all the cobots or robotic arms. It goes in big data, which are the AI-based pricing algorithms so we can forecast customer demand and predict labor better and improve network utilization. And it goes to enriching the customer experience for the whole digital freight marketplace, which we pioneered, and transacting automatically in real time and getting online scheduling and rescheduling of pickups and deliveries and having real-time, customized, automated track and trace. Those are the kinds of projects that we're working on, Mario and his now 1,800 tech professionals. And he's doing a great job.

Operator

Our next question is from the line of Allison Landry from Credit Suisse.

Allison M. Landry - *Crédit Suisse AG, Research Division - Director*

Brad, I think you mentioned earlier in the call something about prepayment penalties. So just curious, how much of your total debt does that apply to? And how should we think about your ability to reduce gross leverage over the next year or 2?

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Okay. On the leverage, we were at 3.2 net debt to adjusted EBITDA at quarter end. That improved slightly from 3.3x at March 31. We expect leverage in a base case scenario to move back to about 2.7x by year-end, as we generate more cash flow from operations, as we grow the EBITDA base.

The majority of our debt is fixed in nature. It's mostly high-yield and you can't prepay it just without tendering for that and paying something for it. We do have the ABL, which we can always move up and down. And we do have the term loan, which we always prepay without penalty. But the vast majority of our debt is high yield. I'm happy that our high yield is not so high as it was before. It's now yielding about 4.75%, partly due to the debt markets being great and partly because we're executing, we're performing. So that's the structure of our debt complex.

Allison M. Landry - *Crédit Suisse AG, Research Division - Director*

Okay. That's really helpful. And then just in light of the recent announcements that some companies are shutting down their last mile operations, is there an opportunity for you guys to pick up some share there? And maybe if you could just comment more broadly on the competitive landscape in last mile.

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

We're doing well in last mile, and we won $58 million of new business in the second quarter in last mile. That was the second-best quarter ever for new last mile wins, and that follows the first quarter, where we had record wins there, too. So this first half, building up the business, is looking good. The pipeline is up 150-some-odd percent year-over-year. It's almost $300 million. We still are though recuperating from the loss of our largest customer in postal injection business. We haven't made that up yet. We're making great, great progress replacing it.

We're also managing cost effectively in last mile. You see that the net revenue margin was a little over 34% in the quarter, and that was an improvement of 390 basis points, and that was an improvement of year-over-year. It's an improvement of about 30 basis points sequentially. It was our best net revenue margin of any quarter since we entered last mile six years ago. So I can't speak to how competitors are doing. I'm assuming some competitors are doing very well and some competitors aren't. We're doing very well, I'm happy to say.

Operator

The next question is from the line of Scott Schneeberger with Oppenheimer.

Scott Andrew Schneeberger - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

You guys addressed contract logistics and some top line thoughts on an earlier question. Just curious, Brad or Matt, if you could provide a little perspective on how you view margin trending in logistics segment over coming quarters.

Matthew Jeremy Fassler - *XPO Logistics, Inc. - Chief Strategy Officer*

Sure. As I said in our early remarks, contract logistics EBITDA margins would have been stronger if you added back the impact of our largest customer downsizing and the translation impact of FX. As you move through the rest of the year, keep in mind that we had House of Fraser last year in Q3 that impeded our Q3 EBITDA margin. But we would expect contract logistics margins in line with or better than year-ago numbers in the second half of the year embedded in our guidance.

Scott Andrew Schneeberger - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Great. A similar-type question with regard to the cadence of free cash flow in the back half, and particularly focused on CapEx: The mix of categories driving CapEx; how you feel you're pacing versus low end, the high end of the guidance range; and then just how that susses out 3Q versus 4Q.

Matthew Jeremy Fassler - *XPO Logistics, Inc. - Chief Strategy Officer*

Sure. So if you think about free cash flow through the rest of the year, we don't provide guidance by quarter per se. But the quarters won't be that different. Q4 likely stronger than Q3 or bigger than Q3, in terms of total free cash flow dollars. And then as we think about CapEx, as I said in my earlier remarks I believe, one of the reasons free cash flow was substantially higher in Q2 related to timing of CapEx. So you will see gross CapEx most likely higher in Q3 than in either Q1 or Q2 or than it was in Q3 a year ago. So that should help bridge you to the total gross CapEx number for the year.

Bradley S. Jacobs - *XPO Logistics, Inc. - Chairman & CEO*

Okay. So while we think we're more important than the stock market, we're not, and the stock market is opening now. So we'd like to thank everybody for the hour and look forward to talking to you again in three months. Have a great day.

Operator

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.
