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XPO.N - Q1 2023 XPO Inc Earnings Call

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PRESENTATION

Operator

Welcome to the XPO Q1 2023 Earnings Conference Call and Webcast. My name is John, 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, which, by their nature, involve a certain 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 as well as its earnings release. The forward-looking statements in the company's earnings release 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 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 on its website. 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 of the company's website.

I will now turn the call over to XPO's Chief Executive Officer, Mario Harik. Mr. Harik, you may begin.

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Mario A. Harik - *XPO, Inc. - CEO & Director*

Good morning, everyone. Thanks for joining our call. I'm here in Greenwich with Carl Anderson, our CFO; and Ali Faghri, our Chief Strategy Officer.

This morning, you saw us report a solid quarter despite a challenging macro environment. Company-wide, we generated revenue of $1.9 billion, reflecting year-over-year growth in a soft market. And we grew adjusted EPS by 22%. We also delivered adjusted EBITDA growth of 14%, which was better than our outlook for low double-digit growth.

In our North American LTL segment, adjusted EBITDA was down 2%, within our guided range. This was primarily driven by weaker tonnage trends in the industry in March.

I want to focus my comments this morning on the progress we're making with the 4 pillars of our plan for LTL 2.0. The first pillar is to provide industry-leading service. In early 2022, we changed the incentive plan for thousands of LTL employees to tie their compensation to service quality in addition to profits. This was one of multiple initiatives we implemented to elevate our customer service levels.

Our focus on service excellence is having a tangible impact on the metrics our customers track. In the first quarter, our claims ratio for damages was 0.7%, which was an improvement from 1.1% last year. This is one of our best claims ratios in more than a decade. And our on-time performance in the quarter was back to pre-COVID levels.

We've made considerable progress in a relatively short time, and there's a lot more we can do. Our entire organization is laser-focused on providing the industry's best service.

The second pillar of our plan is to invest in our network for the long term. Now that the spin-offs are complete, we have more opportunity to invest in driving long-term growth in LTL, a business that generates a high return on invested capital.

Our business model is more streamlined now with higher visibility into opportunities to optimize our network. We plan to continue to invest in all parts of the cycle. Our LTL CapEx as a percentage of revenue was typically in the mid-single digits each year. That changed in 2022 when we launched our plan for LTL 2.0. And going forward, we anticipate CapEx of 8% to 12% of revenue on average over the next several years.

The investments we're making are mostly tied to our fleet. In the first quarter, we added more than 700 tractors, which brought the average age of the fleet down to 5.2 years from 5.9 years at year-end. We also produced nearly 1,800 new trailers at our in-house manufacturing facility in Arkansas. And we're on track to meet our target for over 6,000 trailers produced this year. Our plan calls for adding new doors in a market that can use more capacity and sustain growth over time. These are targeted additions that help improve network density and fluidity over the long term.

In 2023, we expect to grow our total door count by a percentage in the low single digits. When industry volumes rebound, we'll capitalize on these high-return investments.

The third pillar of our plan is to accelerate yield growth. In the first quarter, we grew yield, excluding fuel, by 1.4% year-over-year. That was in line with our outlook. We still had a headwind from mix, as we described last quarter. However, our underlying pricing trends remained solid with contract renewal pricing up by mid-single digits.

Yield remains a key area of focus for us, and we have multiple new initiatives underway to leverage the gains we're making in service quality and operating excellence. This will lead to stronger yield growth over time.

The fourth and final pillar of LTL 2.0 is to continue to drive cost efficiencies. The main opportunities here are in purchased transportation, the cost structure in the field and overhead expense. In the first quarter, we reduced our purchased transportation costs by 27% versus last year by utilizing 2 levers. First, we proactively pulled forward the bid cycle with third-party carriers to capitalize on favorable market conditions. At the same time, we have reduced third-party linehaul miles in the quarter by nearly 3 percentage points versus last year. And we're accelerating this to capitalize on the weak macro when we have more capacity available.

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We're targeting a 50% reduction in purchased transportation as a percent of revenue by 2027. On the labor side, we're executing on a plan to align our field cost structure more closely with the current demand environment and reduce some of our salaried headcount. You'll see the full run rate benefit of these actions starting in the third quarter.

Turning to Europe, our business continued to perform ahead of expectations in the quarter, delivering mid-single-digit organic revenue growth. Despite the macro uncertainty in parts of Europe, we're seeing a strong pricing environment overall, and our sales pipeline continues to be robust.

I'll wrap up my remarks by summarizing the progress we've made to date on our LTL 2.0 plan. We're continuing to elevate service as a top priority, and it's generating some of our best service levels in years. Customers like what they're seeing, and it's allowing us to gain profitable market share and grow share of wallet.

This will translate to stronger yield growth over time. We're being proactive on this by executing multiple initiatives to accelerate yield over the long term. We're also continuing to make strategic investments in our network to capitalize when demand recovers. We have a long track record of delivering high returns on investments in this business.

And we're executing on cost efficiencies by reducing our use of purchase transportation and rationalizing our cost structure at the corporate level and in the field. While we expect the near-term operating conditions to be challenging for the industry, at XPO, we remain on track to deliver on our long-term outlook for at least 600 basis points of adjusted operating ratio improvement through 2027. We're confident in our ability to deliver superior shareholder value as we increasingly drive financial and operational excellence in the business.

Before I close, I want to thank our thousands of dedicated employees for helping XPO be world class in every aspect of our business. Our people at every level are our great differentiator, and we continue to attract the best talent. This includes 2 top talents who see the significant potential in XPO. Wes Frye is now a member of our Board, and Dave Bates is our new Chief Operating Officer. These LTL veterans will help accelerate the execution of our plan.

Now I'm going to hand the call over to Carl to discuss the first quarter results. Carl, over to you.

Carl D. Anderson - *XPO, Inc. - CFO*

Thank you, Mario, and good morning, everyone. I'll take you through our first quarter results, balance sheet and liquidity.

Revenue in the quarter for the total company was $1.9 billion, up 1% year-over-year and up 4% sequentially from the fourth quarter.

In our North American LTL business, revenue was up 1% year-over-year and 2% sequentially. Revenue per hundredweight, excluding fuel, was up 1.4%, while higher shipments per day were offset by lower tonnage.

LTL salaries, wages and employee benefits were 6.7% higher than a year ago, due primarily to wage increases granted to employees last year. We are taking action to reduce labor costs and drive productivity as we move through the year.

Purchased transportation expense was down 27% or $37 million in the quarter as we in-source more third-party linehaul. We ended the quarter at approximately 22% of linehaul miles outsourced, which was also a 270 basis point improvement from the same quarter last year.

We also benefited from implementing significantly lower contract rates with carriers in the quarter.

In addition, we brought down our costs for insurance and claims compared with the first quarter last year. We're continuing to make great progress in reducing damage claims expense as we elevate our service levels.

As part of our LTL 2.0 plan, we are continuing to reinvest back in the business as we bring on new tractors and trailers. The increased level of investment in 2022 and through the first quarter of this year resulted in a $12 million or 21% increase in depreciation expense this quarter.

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Now I'll turn to adjusted EBITDA, starting with the company as a whole. We grew adjusted EBITDA by 14% year-over-year to $210 million. This was primarily driven by a year-over-year reduction of $31 million in corporate expense as we rationalize our corporate cost structure following the RXO spin-off.

Our adjusted EBITDA margin was 11%, representing a year-over-year improvement of 130 basis points. For our LTL segment, adjusted EBITDA was $182 million, down 2% from a year ago, as our revenue growth and cost efficiencies were offset by the aggregate impact of lower tonnage, wage inflation and lower pension income.

LTL adjusted EBITDA excludes $6 million of restructuring costs relating to the downsizing of administrative office. Excluding the impact from pension income, LTL adjusted EBITDA would have been up 4% versus last year.

And finally, in our European Transportation segment, adjusted EBITDA was $37 million, roughly in line with last year. Company-wide, we reported net income from continuing operations of $17 million in the quarter, representing diluted earnings per share of $0.15. This compares to income of $32 million and earnings of $0.28 per share a year ago. The year-over-year decline in income from continuing operations is primarily attributable to higher restructuring and transaction and integration costs.

In the first quarter, we had $24 million of restructuring charges that impacted all of our segments. In addition, we had $22 million of transaction and integration costs related to the spin-off last year. We expect that these costs will materially step down as we move forward in the year.

Our adjusted tax rate was approximately 19% due to the benefit of some discrete tax items this quarter. And on an adjusted basis, our earnings per diluted share for the quarter was $0.56, which is up 22% from a year ago. And we generated $76 million of cash flow from continuing operations and deployed $224 million of CapEx.

Moving to the balance sheet, we ended the quarter with $309 million of cash on hand. This cash, combined with available capacity under committed borrowing facilities, gave us $811 million of liquidity at quarter end. We had no borrowings outstanding under our ABL facility, and our net debt leverage at the end of the quarter was 2.2x trailing 12-month adjusted EBITDA.

Earlier this week, we extended our EUR 200 million securitization facility in Europe to July of 2026. And we're currently evaluating opportunities to refinance our term loan maturing in 2025 with new secured and/or unsecured debt.

Now I'll turn it over to Ali, who will provide an overview of our operating results.

Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

Thank you, Carl. I'll start with a review of the first quarter operating results for our North American LTL segment. The impact of the economy was evident throughout the quarter as demand for LTL stayed below historical levels, driving a 3.3% decline in our weight per shipment. We partially offset this with a 1.5% increase in shipment count, led by 9% growth in our local channel. This is a direct reflection of service improvements in the network. As a result, we were able to limit the decline in tonnage per day to 1.8%.

On a monthly basis, compared with 2022, January tonnage was up 2.8%, February was down 2% and March was down 5.5%. Looking just at shipment count, January was up 5%, February was up 1.1% and March was down 0.5%. Yield ex fuel increased by 1.4%, in line with our outlook. The year-over-year improvement held relatively steady on a monthly basis throughout the quarter.

As Mario mentioned, mix has continued to be a headwind to yield, but our underlying trends remain solid, with contract renewal pricing up 4.5% in the quarter versus last year.

In April, tonnage was down 2% compared with last year, while shipment count was up 3%. On a sequential basis, our April tonnage was up 2% versus March and shipment count was up 3%, both outperforming typical seasonality.

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Regarding yield, we expect second quarter yield ex fuel to continue to be up year-over-year at approximately the same level as the first quarter improvement. We're very focused on driving yield growth by elevating service and being able to price based on the increasing value we're providing customers. This will naturally translate to more yield over time. And beyond that, there are a number of other levers we're pulling to accelerate growth.

For example, we're taking additional pricing on accounts that aren't meeting our expectations. We're also growing accessorials, ensuring we're getting compensated for the value-added services we're providing.

Turning to our margin performance, our first quarter adjusted operating ratio was 89.6%, which is unfavorable by 70 basis points compared to a year ago. We had a headwind of 110 basis points from depreciation expense, driven by a higher capital investment in the business. Excluding this headwind, adjusted OR would have improved versus last year.

On a sequential basis, we improved adjusted OR by 70 basis points compared to the fourth quarter, which is an outperformance of 120 basis points versus typical seasonality.

Moving to our European business, we delivered another solid quarterly performance with organic revenue growth of 5% despite a soft macro backdrop. This was propelled by a mix of new customer wins and contract renewals. Volume and pricing in Europe were both higher than the year-ago period by low single digits.

And 2 of our key markets, Spain and the U.K. generated constant currency revenue growth of 11% and 9%, respectively, outperforming the European business overall. On the same basis, France was slightly positive year-over-year.

Before I wrap up, I want to mention the 8-K we released last month, which outlined some updates to our financial reporting. It also includes our damage claims ratio data as a key measure of our service performance.

Starting with the current quarter, we'll be reporting monthly tonnage numbers as well. These changes improve disclosure and make our reporting more comparable with industry peers. The recasting and the new performance metrics should give you greater visibility into our business.

With that, we'll now take your questions. Operator, please open the line.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first question comes from the line of Fadi Chamoun with BMO.

Fadi Chamoun - *BMO Capital Markets Equity Research - MD & Transportation Analyst*

Mario, maybe not many companies form a Board Operating Excellence Committee. I just wanted to get your thoughts about, how should investors think about the role of this committee and the purpose of this committee kind of as we move forward in the next couple of years?

Mario A. Harik - *XPO, Inc. - CEO & Director*

Thanks for the question, Fadi. Well, first, we obviously recently added Wes Frye to our Board. And Wes is a fantastic LTL operator, he's an LTL legend. So what that committee would do is effectively both, Wes Frye and Allison Landry, sit on it as well as myself. And it's focused on the big needle-movers, it's focused on the big levers of how we're going to improve operationally over the years to come to expand our operating ratio meaningfully as we execute on our LTL 2.0 plan. So that's the purpose of the operational excellence goal of the committee on the Board.

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Operator

And the next question comes from the line of Scott Group with Wolfe Research.

Scott H. Group - *Wolfe Research, LLC - MD & Senior Analyst*

So maybe just a follow-up there. So how engaged is Wes? It's very recent with Dave, where has Dave been focused to start? Do you think these additions change either the timeline or the magnitude of margin improvement you've been talking about? And then more near term, just as you try and act and sound and talk more like the other LTLs, just we typically get some near-term operating ratio expectations from the others, so any thoughts there on Q2 operating ratio?

Mario A. Harik - *XPO, Inc. - CEO & Director*

You got it, Scott. So when the -- so Dave, obviously, has just joined our team, and he's been a fantastic addition to our team. He's one of the best operators in the industry, and he will help us accelerate the LTL 2.0 plan. He already has spent quite a bit of time in the field with our frontline employees. And both, Wes and Dave, see what we see, which is a massive opportunity to improve our operating ratio over the years to come.

Now early feedback from Dave, obviously, he's very impressed with the progress we've made in improving our service quality in a very short period of time. He's impressed by our people and the culture and the winning momentum that we have across the team and by our technology platform, which will enable us to unlock further opportunities in operations, sales and how we service our customers.

He has already identified many areas for improvement as well in terms of how we run the business. Just to give you a couple of examples, Scott, part of it is how we organize our field organizational structure, how we align sales and ops, as an example, or enhancing our compensation programs, including a greater emphasis on OR expansion and many other capabilities and items of how we operate the business.

Overall, both Wes and Dave, will have a great impact on improving our service quality, improving our operational efficiency and density in the network and finding the optimal freight to add to our network. We're incredibly excited to have both of them on board.

Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

And Scott, this is Ali. On your second question about the second quarter, so from a tonnage perspective, normal seasonality is about a 5% sequential improvement in the second quarter versus the first quarter. And based on what we're seeing currently, we'd expect that to be up about low single digits sequentially. And just keep in mind, we're going to be providing monthly tonnage data starting this quarter. So that should give you more visibility into inter-quarter trends.

And then from an OR perspective, typical seasonality is about a 400 basis point, a sequential improvement, second quarter versus the first quarter. we'd expect to be a little less than half of that typical seasonality. And again, that's driven by the softer tonnage environment.

Operator

The next question comes from the line of Jon Chappell with Evercore ISI.

Jonathan B. Chappell - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Ali, on the headcount side, I think you're saying you're trying to drive productivity there. I'm just trying to understand where the productivity savings are going to come from. You've already taken a fair amount of PT out which has really been helpful to the margin. But are you cutting heads while

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growing doors? Is this just a function of attrition? Is it something with negotiating contract terms? How do we think about labor cost being so important kind of trending down amid kind of the LTL 2.0 growth initiatives?

Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

Thanks for the question, Jon. So the current plan that we talked about today, that represents greater than $50 million of annualized headcount-related cost savings, and that's going to be spread across LTL, Europe and corporate. But more than 2/3 of those cost savings are going to benefit LTL specifically. And you'll start to see the full run rate benefit of those cost savings starting in the third quarter.

And look, even beyond that, we see further opportunities to reduce costs in LTL while continuing to invest in the network. If you look at our variable labor hours, we've done a great job there while holding on to drivers. So for example, if you look at the first quarter, labor hours were down 30 basis points year-over-year, while our shipment count was up 1.5%. And we'd expect to see a sequential improvement in those labor hours in the second quarter and then into the second half of the year.

Jonathan B. Chappell - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Okay. But just to be clear, is headcount coming down amid those, 2/3 of the savings coming within LTL? Or is it just kind of productivity through technology, attrition, cost per employee? I'm just trying to figure out how to model that important line item going forward.

Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

So Jon, it's actually both. So if you look at the first quarter, for example, headcount was down about 1% sequentially. And given the cost actions that we announced, you should see a bigger step down in the second quarter in headcount, and then we should see further reductions in headcount in the second half of the year.

Operator

And the next question comes from the line of Chris Wetherbee with Citigroup.

Christian F. Wetherbee - *Citigroup Inc., Research Division - MD & Lead Analyst*

Maybe we talk a little bit about pricing. So when we look at what you guys have been reporting ex fuel as revenue per hundredweight, we've seen growth there, but maybe sequential deceleration over the course of the last couple of quarters. And it sounds like the core contracted piece of the business is still trending up in the mid-single digits. I guess, as we look at forward guidance, it seems like maybe we'll see some acceleration on the absolute dollars of revenue per hundredweight into 2Q.

Just wanted to get maybe if you could help us break down what's going on from a mix perspective as well as how you're sort of looking at the contracted side plus what you're doing with dynamic pricing. Just want to get a sense of kind of where the pricing environment stands if we can see maybe more consistent sequential increases quarter-to-quarter as we move forward through the rest of this year.

Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

Thanks for the question, Chris. This is Ali. So the mix headwind related to the local channel that we described last quarter, that continued into the first quarter. So while we're growing shipment count in the local channel, weight per shipment remained under pressure due to the macro impact. And so that resulted in less tonnage in that higher-yielding local channel, and that was about a few hundred basis points headwind to our reported yield.

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And this headwind was actually greater in the first quarter relative to the fourth quarter.

Now if you take a step back, as you pointed out, underlying pricing trends remained strong. Contract renewal pricing was up mid-single digits. And we're implementing a number of initiatives on the yield side that we would expect to drive stronger yield growth over time.

Christian F. Wetherbee - *Citigroup Inc., Research Division - MD & Lead Analyst*

But just to be clear about the sequential, is that headwind from the mix you expect to continue into 2Q? Or does that begin to abate as we move through the rest of the year?

Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

So as we look forward, that mix headwind has continued into April, but has stabilized on a year-over-year basis. So we'd expect that to continue in the near term as the macro remains challenged. But again, we're excited about some of the levers we're pulling on the yield side. That should help us mitigate that mix impact and drive stronger growth over time.

Operator

And the next question comes from the line of Brian Ossenbeck with JPMorgan.

Brian Patrick Ossenbeck - *JPMorgan Chase & Co, Research Division - Senior Equity Analyst*

So maybe just stepping back and looking at the strategy, you've been working on in the last couple of quarters, leaning into some of these channels a bit differently than you have in the past. Do you think it's getting the impact you expected so far from a density and a shipment customer retention perspective? Is that really working out how you would have thought, or there's a bit more challenging on the macro and you might have to force a little bit go through the rest of this year?

Mario A. Harik - *XPO, Inc. - CEO & Director*

Well, our strategy is actually working. And we have a strong strategy with our LTL 2.0 plan. And the first part of it is focusing on providing best-in-class service. And when you see those service improvements, what we hear from our customers is excitement to give us a bigger share of wallet. And we have a bigger or a higher pick on the freight that we get into our network.

Just to give you an example here recently, I was meeting with some of our customers in the South, and you could hear the feedback where they see us improving our service product on their scorecards, and they are giving us the bigger access to the freight that they have.

The second piece is around investing in our network. And when you look on that portion of it, we've made tremendous progress. We've added more trucks to our fleet. Our fleet age is down to 5.2 years, which helps with efficiency, helps with lower maintenance cost, but it also helps with us insourcing our third-party linehaul. And then we can have capacity in the right places where we need it, where we see stronger demand from the customer.

And then on the yield side, the initiatives that Ali just mentioned that we're driving to improve our yield performance over time as well. So all of these things are leading to us having high-quality freight. We're growing our local account business as well. We've grown shipment count 9% in that channel here in the first quarter.

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Brian Patrick Ossenbeck - *JPMorgan Chase & Co, Research Division - Senior Equity Analyst*

And just to clarify on the yield, it sounds like accessorials are going to be a bigger part of that moving forward here. Can you just elaborate a little bit more on that? Is this something you're just kind of catching up to in the market? Or are these additional opportunities you're digging into as you step forward into this year?

Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

Brian, this is Ali. So it's a bit of both. So we want to make sure that we're getting paid consistently and fairly for the premium services we're providing. So a few examples are, if a customer wants to get a delivery during a certain time window, we charge them for an appointment-based delivery. Or if a customer wants a guaranteed delivery before noon, we would charge them for that.

Accessorials right now are roughly about low double digits of overall revenue. And so we see a great opportunity to improve that over time.

Operator

And the next question comes from the line of Brandon Oglenski with Barclays.

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

I guess, can you guys talk about what network changes you might be affecting both, in linehaul and local operations, to drive both, service improvement but also maybe better cost productivity?

Mario A. Harik - *XPO, Inc. - CEO & Director*

Yes. So first, starting on the network side, our investments in the network are about expanding capacity in those markets where we have a need for having more doors or more physical space. To give you an example here, just this last month, we just expanded our Salt Lake City terminal where we added another 16 net new doors, because we needed that additional space given the amount of freight we were handling there.

And we are in the process of expanding other markets, which include further expansion in Atlanta, Georgia, includes expansion in Texas and a few other areas like Phoenix, Arizona, Florida as well. So all of these are markets where we are seeing stronger demand from our customers and being able to have this additional space will have -- will give us long-term tailwinds in terms of increasing capacity.

In terms of linehaul, one of our big goals is to in-source third-party linehaul. So here on the short term, we're getting a benefit from the rates that we're seeing in the truckload markets. But over time, by 2027, we want to cut our linehaul as a percent of revenue in half by in-sourcing more of these miles and having our own drivers and our own assets moving that freight, which is good both, for service and for cost reasons as well, as well as additional improvements in how we optimize the movement of freight and our linehaul network there.

Operator

The next question comes from the line of Tom Wadewitz with UBS.

Thomas Richard Wadewitz - *UBS Investment Bank, Research Division - MD and Senior Analyst*

Wanted to ask you, Mario, a bit about -- you made some pretty interesting hires in addition, obviously, to the Board with Wes and then with Dave as well. How do you think about the change in what you're focused on and the split of responsibilities, kind of who's making the call on big pricing

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decisions or capacity operational decisions? Is that clearly handing that off to Dave? Or is that something you'll collaborate on? Or how should we think about that -- some of those changes as -- in particular, as Dave comes -- is on board?

Mario A. Harik - *XPO, Inc. - CEO & Director*

Well, Tom, Dave is our Chief Operating Officer, overseeing North American LTL. So our field operations, our pricing, our sales teams in LTL, report up to him. But Dave is obviously one of the top leaders in the organization, and he and I work very closely on all of these decisions.

Generally, when you look at our strategy, the LTL 2.0 plan, that was one of the main reasons why Dave joined our team. Again, it's a strategy focused on service and investing in the network, on driving yield growth and strengthening our cost discipline. And Dave is going to play a critical part in all of these areas on how we improve them. And obviously, him and I are working very closely together to deliver on these goals over the years to come.

And again, our goal is to accelerate our OR improvement, and this is where the massive opportunity for us exists. And there's no reason why there shouldn't be a 7-handle in front of our OR over the years to come.

Thomas Richard Wadewitz - *UBS Investment Bank, Research Division - MD and Senior Analyst*

I guess that makes sense, but like how much discretion should we think of that he has or control in terms of changing things within the broader plan? Or is that just the wrong way to look at it?

Mario A. Harik - *XPO, Inc. - CEO & Director*

I mean, as our Chief Operating Officer, Dave is fully empowered to do what he thinks is best for the business from an operational perspective. He has more than 30 years of LTL experience. But again, as a team, we're working very closely together to accelerate the plan and execute over the years to come.

Operator

And the next question comes from the line of Ken Hoexter with Bank of America.

Kenneth Scott Hoexter - *BofA Securities, Research Division - MD & Co-Head of Industrials and Basic Materials*

Mario, just trying to parse some of the commentary from you and Ali and just on your thoughts on April, are you seeing a change in the economic backdrop? Or if tonnage is up low single digits sequentially, then I guess we're seeing larger year-over-year declines to maybe almost mid-single digits. Should we read this, I don't know, as winning more share? Is there a way to parse kind of economic impacts versus the share?

And then, Ali, you mentioned half the 400 basis points operating ratio impact. So does that mean you're targeting kind of upper 80s OR for 2Q, so a 400 basis point deterioration year-over-year? I just want to understand kind of how we should parse those 2 comments.

Mario A. Harik - *XPO, Inc. - CEO & Director*

Yes, you got it, Ken. I'll get started and then I'll turn it over to Ali. When you look at April, our tonnage was down 2% year-on-year, but our shipment count was up 3% year-on-year. And when you compare these to March, they both outperformed typical seasonality sequentially from the month of March to the month of April.

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Now we said a lot of these things for us are with the improvements in service quality. We're seeing a very robust pipeline, and we're being able to onboard either more business from existing customers or growing new customers. As Ali mentioned earlier, our local accounts have grown by 9% shipment count in the first quarter.

Now when you look at that from a macro perspective, there's still a lot of uncertainty in the environment. We're seeing a bit more strength in the month of April. When you look at the ISM, which today, 2/3 of our customers are industrial customers, so that's an important index for us. It has picked up in April versus March by roughly a point. So we're seeing a bit stronger demand there.

On the retail side, we've seen that softer consumer in the month of March. The flip side though is that retailers have worked through the higher inventory levels they used to have. But again, a lot of these things are company-specific, but we're seeing a slightly better demand environment in April than we did see in March.

Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

And then, Ken, this is Ali, for the second part of your question on OR. So again, typical seasonality, about 400 basis points sequential improvement Q2 versus Q1. We would expect to be a little bit less than half of that on a sequential basis. So that would get you to somewhere in that 88% range from an adjusted OR perspective.

Operator

The next question comes from the line of Stephanie Moore with Jefferies.

Unidentified Analyst

This is Joe on for Stephanie Moore. I think a lot of my questions have been asked, but I wanted to maybe get your thoughts on the progress through the quarter heading into April. It looks like at least through the first quarter that the monthly tonnage was going down, but I'm not sure if there was something in the comps that we need to be aware of. And then I just wanted to maybe get your thoughts on how we should put the 9% growth in local accounts, but still a lot of pressure coming from the national accounts. It looks like there is outsized growth in those local accounts.

Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

So maybe starting with your second question first. We're seeing about 9% growth in the local channel on the shipment count basis, as you mentioned. On the national side, shipment counts have been relatively flat. So that mixed headwind that we're describing, that's more related to that local channel and more specifically the weight per shipment pressure due to the macro we're seeing in that local channel.

In terms of the intra-quarter tonnage trends, on a year-over-year basis, they did decelerate through the quarter. So tonnage in March was down about mid-single digits. However, as we said in April, we have seen a modest improvement. Its tonnage is down about low single digits in April. And as Mario mentioned, we've seen a bit of a tick up on the industrial side, but the majority of that improvement is being driven by our initiatives and more specifically the service improvements we've driven in the network.

Mario A. Harik - *XPO, Inc. - CEO & Director*

And also to add to Ali's comments, April did outpace seasonality from March. So when you look at both, tonnage and shipments, we have seen an outplacement there coming from March to April.

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Unidentified Analyst

And then a quick clarification. Earlier in your prepared remarks, you mentioned taking the PT cost as a percentage of sales as a percentage, down 50%. Just to clarify, is that a company-wide metric? Or are you talking specifically LTL? And if it's company-wide, just rough numbers, are we talking about the number coming from a 25% number to roughly a 13% number?

Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

We're referring to LTL specifically. And so it would apply to both linehaul miles, which we would take it from roughly around 24% to that 12% range by 2027. You could also look at it as a purchased transportation cost on our P&L as a percentage of revenue. We would also expect that to get cut in half by 2027.

Operator

And the next question comes from the line of James Monigan with Wells Fargo.

James F. Monigan - *Wells Fargo Securities, LLC, Research Division - Associate Equity Analyst*

I just wanted to touch on CapEx and the ongoing investments link. Essentially, what's the appetite or sort of ability to flex that down either in the back half of this year in 2024 and sort of slowness at a point where you might consider that. And also, just wanted to understand sort of the investment impact on OR. And if there was one, sort of the ability to sort of flex that down and at what point you might do that in terms of like what you need to see in the macro and the softness?

Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

So we really view these investments as long term. And the best-in-class LTL playbook historically has been really to invest through the cycle, and that's both, in good times and softer times. Historically, we've been at more maintenance CapEx levels, call it, mid-single digits CapEx as a percentage of revenue.

And going forward, we're targeting 8% to 12% in the years to come. And really, those investments in capacity are much more long term and are going to allow us to capitalize on the eventual freight recovery. Just keep in mind, James, that the majority of that CapEx spend is on equipment like tractors and trailers that not only allows us to reduce our fleet age and reduce maintenance costs but it also supports our linehaul in-sourcing initiative as well.

The door expansion part of our CapEx plan is a much smaller part of it. It's about 15% of our total CapEx spend, and that implies only about low single-digit door growth this year.

In terms of your second question about the depreciation headwind, it was about 110 basis point headwind to our OR for the quarter. So excluding that depreciation headwind, our OR would have improved on a year-over-year basis. As we look forward, that depreciation headwind will continue as we're making long-term investments in our network. But as we start to see stronger returns on these investments, we'll be able to offset that headwind. And that's ultimately what's going to drive meaningful OR improvement for us in the years to come.

James F. Monigan - *Wells Fargo Securities, LLC, Research Division - Associate Equity Analyst*

Got it. And just real quickly, though, is there any sort of productivity drag from the -- on expansions or investments that you have?

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Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

So in the near term, there are some, but over time, it's a pretty modest drag. But as we move forward --, and again, we start to see the returns on these investments we're making in both our network and service, that should become smaller. and over time flip to a positive for us.

Mario A. Harik - *XPO, Inc. - CEO & Director*

And James, for -- this is Mario. For this year, most of the real estate expansions we're doing are adding additional doors to existing terminals. I mentioned earlier on, for example, Salt Lake City, this is where we just have enough land where we can grade the yard and then add, in that case, 60 doors to that particular facility. And we have half a dozen to a dozen projects that follow that same goal of making some of these terminals larger to be able to handle the additional freight.

Operator

And the next question comes from the line of Scott Schneeberger with Oppenheimer.

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

Wanted to inquire about new business wins in the quarter. You had some large -- in 2022, some large national accounts. Just curious, contract -- mid-single-digit contract pricing still sounds solid. But Mario, could you address how business wins were in the quarter, maybe a mix of local versus new and how that will -- local versus national and how that should play out over the course of the year?

Mario A. Harik - *XPO, Inc. - CEO & Director*

Thank you. When we are taking profitable market share across all channels driven by our improved service. Now we are seeing more of that growth here in the first quarter come from our local accounts, where we grew shipment counts considerably. But as Ali said, the macro is having an impact there on the overall weight per shipment. So we're seeing some tonnage pressure. But overall, a lot of gains in shipment counts that are backed up by the good service quality.

Now from a mix perspective, the mix continues to be fairly flat, and we expect it to be the case. Typically, roughly national accounts are 80% of the business, local are 20% of the business, which is usually consistent across LTL providers. But when we onboard business, it's all based on how they performed from a margin perspective. And we're not afraid to walk away from business if it doesn't meet our OR expectations. So when you look at that growth, again, backed up by service and then we're growing across channels based on the service product we're offering our customers.

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

And it looks like you're continuing to take share. Is that -- are you seeing it more in national account, more on local? Do you know from whom you're taking the share?

Ali-Ahmad Faghri - *XPO, Inc. - Chief Strategy Officer*

So the share gains are being driven by the local channel. Local shipment count was up 9% on a year-over-year basis in the first quarter. That's relative to the national channel shipment count, which was relatively flattish in the quarter. So if you look at where we're seeing that, the most share gains driven by our service improvement, it really is that local channel.

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Mario A. Harik - *XPO, Inc. - CEO & Director*

In terms of who we're taking that share from, it's a combination of all carriers. There's no specific carrier. It's just across the footprint there.

Operator

And the next question comes from the line of Jordan Alliger with Goldman Sachs.

Jordan Robert Alliger - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Don't really hear as much about some of the tech initiatives as part of Network 2.0 this morning. I'm just curious how impactful has that been thus far on some of the improvements that you've been making and plan to make, for instance, going forward around service and yield, et cetera.

Mario A. Harik - *XPO, Inc. - CEO & Director*

Yes, absolutely. Overall, Jordan, our technology platform is enabling us to run more efficiently. And it's one of the big drivers for us to achieve our 2027 objectives. If you recall, when we spoke about our profit improvement plan with the 11% to 13% EBITDA CAGR, 3 to 4 points of that will come from efficiency, driven by our technology platform and other process changes we're doing in the field.

Now when you look at it, here in the first quarter, our labor hours were down roughly 30 basis points, while shipment count was up 1.5 points. And the way we identify where we flex those labor hours is driven by our technology platform and the efficiencies there. And our focus on technology continues to be on improving our linehaul performance and how we optimize what loads we move anywhere in our network. It also includes focusing on our pickup and delivery environment, how we optimize routes and add more density, more stops per hour per driver in terms of how we organize these pickup and delivery routes. And then optimizing our labor in the docks with our smart platform and how we manage that.

And of course, technology plays a big part in helping us with quality and helping us with pricing and helping us with how we integrate with our customers as well. That continues to be a big competitive advantage for us, and we'd expect that to be the case over the years to come.

Operator

And the next question comes from the line of Elliot Alper with Cowen and Company.

Elliot Andrew Alper - *TD Cowen, Research Division - Associate*

Maybe just following up on a previous question. Can you maybe talk about what customers are telling you right now? I mean are you still cautiously optimistic about the second half recovery? And maybe kind of does your commentary around maybe the stronger industrial and slightly weaker retail kind of changed that dynamic at all?

Mario A. Harik - *XPO, Inc. - CEO & Director*

Yes. So when we look at the macro generally, it's still -- there's still uncertainty in the environment. And obviously, it's a softer macro than what we've seen. Now we are hearing mixed things from customers where some customers in the industrial space are seeing a pickup, while others are seeing more softness and lower demand as well. So there is still softness in the environment as we see it.

Now again, the ISM did pick up in April. However, it's still below 50, which shows that softer demand in the industrial economy. On the retail side, it's also a mix. The retailers that have done a good job in how they operate their supply chain and depending on the type of product that they're

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selling, we're also seeing mixed feedback there. Some customers are seeing flat demand year-on-year or slightly up in some cases, while others are seeing softer demand than it depends on the type of product that they are selling.

But generally, you do see a shift from the consumer spending more on discretionary type items to focus more on services. And you can see that evident in the retail space where these customers, again, are seeing the softness. Again, for us, in April, we've seen the trends accelerate, and we outpaced typical seasonality from the month of March to the month of April. But that feedback again from the customer is mixed at this point.

Operator

And our next question comes from the line of Jeff Kauffman with Vertical Research Partners.

Jeffrey Asher Kauffman - *Vertical Research Partners, LLC - Principal*

I wanted to address the fleet age question and just get an idea as you continue to ramp up this capital spending and you ramp up the trailer output, where does that average age go by the end of 2023? Where is that average age, let's say, your target is 2024, 2025, where are we bringing that 5.2 years down to?

Mario A. Harik - *XPO, Inc. - CEO & Director*

Thanks, Jeff. Well, our long-term goal is to be below 5. To be somewhere between 4 and 5 years would be the ideal average fleet age. Obviously, for us in LTL, we usually get the younger trucks, the newer trucks on our linehaul runs to capitalize on fuel efficiency in those runs. And then obviously, the tractors in the city, we run these considerably longer.

Now we took this down from 5.9 years at the end of last year to 5.2 years at the end of the first quarter. But we did front-load a good amount of our CapEx here in the first quarter where we got 700 new trucks through the course of the first quarter.

Now when we think about the end of the year, it all depends on what the OEMs can do for us. We have seen it's still tight to get trucks, it's not that you can get all the units you want to get. But at the same time, it is getting better where they're giving us a higher allocation in the back half, but we'll see how that will play out in terms of fleet age. But we'd expect that to keep on coming down as we add more of these newer trucks to the fleet.

Jeffrey Asher Kauffman - *Vertical Research Partners, LLC - Principal*

And just to follow up on that point, we have new rules coming out of the California Resource Board last week. I know the EPA came out with their 27 mandate, nothing that needs to be done right away. But where are you in terms of switching to things like electric vehicles, fuel cell trucks, nat-gas trucks, looking at kind of the zero-emission rules that, for California at least, are going to start to kick in 2024?

Mario A. Harik - *XPO, Inc. - CEO & Director*

Yes. So when we look at that, we do have pilots going on, and a truck order for electric trucks here in 2023 for California. Now today, a lot of what we're seeing is some of these larger Class A trucks are -- it's so tough to get the amount of mileage. We need to get on them and have the charging infrastructure to be able to charge those trucks to use them both, in the P&D environment as well as the linehaul environment.

However, we do have a number of these trucks ordered here for the year. And a lot of these are straight trucks to operate in the city for steady deliveries. And we're obviously working locally on how we meet all of the mandates from the state of California, but also very close to the American Trucking Association, which is obviously helping drive a lot of these regulations as well in terms of how we obviously drive our fleet there to meet all of these.

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Operator

At this time, we have reached the end of the question-and-answer session. And I would now like to turn the floor back over to Mario Harik for any closing comments.

Mario A. Harik - *XPO, Inc. - CEO & Director*

Thank you for all your time today. And as you can see, we're moving forward with a realistic view of the macro. But it doesn't impact the execution of our plan, which is elevating customer service to new heights, investing in capacity for the long term, accelerating our yield growth over time, and driving further cost efficiencies. These 4 avenues are the key to unlocking the massive potential within XPO. We'll give you an update on our progress on our next earnings call.

Operator, you can now end the call. Thank you.

Operator

Thank you, sir. This does conclude today's teleconference, everyone. Thank you for your participation and have a great day.

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