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XPO.N - Q3 2023 XPO Inc Earnings Call

EVENT DATE/TIME: OCTOBER 30, 2023 / 12:30PM GMT

OVERVIEW:

Company Summary

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PRESENTATION

Operator

Welcome to the XPO Third Quarter 2023 Earnings Conference Call and Webcast. My name is Rob, 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 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 in its earnings release. 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 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 Kyle Wismans, our Chief Financial Officer; and Ali Faghri, our Chief Strategy Officer. This morning, we reported financial results that were well above expectations for growth and profitability despite a soft market for freight transportation.

It was a strong third quarter for us company-wide. We grew revenue year-over-year to $2 billion and improved our adjusted EBITDA to $278 million, an increase of 6% year-over-year. Both segments of the business grew adjusted EBITDA in the quarter. Adjusted diluted EPS for the company was $0.88, which was also higher than expected.

I want to use my comments this morning to give you a progress report on the 4 pillars of our plan for LTL 2.0, starting with customer service, but we've made great progress this quarter.

Our claims ratio for damages was 0.4%, an improvement from 0.7% in the prior quarter. To put that in context, when we launched LTL 2.0 nearly 2 years ago, our claims ratio was 1.2%. So we've been steadily making good on our promise to elevate service.

Our third quarter claims ratio is our best result ever. And in the month of September, we exited the quarter with the best damage frequency level in our history. Another key service metric is on-time performance. This was 8 percentage points better in the quarter compared with last year.

We're very focused on ensuring that our service standards remain high as we grow. In the third quarter, our shipment count was significantly higher as we took more volume into our network, while at the same time, we delivered meaningful service improvements. And we're already taking the next steps forward with our investments in service. This includes enhancing our training programs and loading procedures and equipping our field operations with new service tools.

The high-caliber straps and airbag systems we're rolling out, are generating positive returns in a short period of time. For example, in the service centers with the new airbag systems, we're already seeing a 20% improvement in damage frequency. Our strong commitment to service is critical for our customers, and while we've made significant progress, we can clearly see the runway we have for further improvement. Our top priority is to be the best-in-class LTL service provider in the coming years.

The second pillar of LTL 2.0 is to invest in our network. Our business has historically generated a high return on invested capital. Since the launch of LTL 2.0, we've added 10,000 trailers, 2,000 tractors and over 500 net new doors. This has allowed us to take on more freight for our customers while maintaining strong network fluidity. More than 2/3 of our 2023 CapEx is being deployed to increase the capacity of our fleet.

Year-to-date, we've added more than 1,000 tractors which brought down the average tractor age to 5.2 years from 5.9 years at the end of 2022. And we're on track to exceed our production target of 6,000 new trailers this year. Year-to-date, we've manufactured over 4,900 trailers at our in-house facility in Arkansas.

In addition, we expanded our service center doors in the Atlanta and Dallas metro areas in July, and we broke ground on a new facility in Central Florida, which is a key growth market for us. This is consistent with the plan we outlined that we're adding new doors in markets where our investments in capacity can sustain more growth over time.

To date, we've added 531 net new doors against a target of 900, and we expect to open the remainder by early 2024, primarily at existing terminals. These targeted expansions are performing well and exceeding our return hurdles.

I want to touch on one of the long-term targets we introduced with LTL 2.0, which was for CapEx allocation of 8% to 12% of revenue on average through 2027. Given the recent market dynamics and the opportunity at hand, we're accelerating the pace of that spend. As a result, our CapEx this year will be 12% to 13% of revenue and will likely continue to exceed our target range in the near term.

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The third pillar of our plan is to accelerate yield growth. In the third quarter, we focused on strengthening our underlying pricing trends such as contract renewal pricing and executed a number of other initiatives to align the price we receive with the value we deliver. Yield is our single biggest opportunity for margin improvement, and you saw this impact in our earnings release this morning.

We grew yield, excluding fuel by 6.4% year-over-year, representing a significant acceleration from the first half of the year. We see a double-digit pricing opportunity that we expect to capture over the coming years through 3 primary levers: First, as we continue to improve our service, customers are willing to pay a premium price for the value we deliver. We're seeing this with both contract renewals and new business.

We also see a significant opportunity to grow our accessorial revenue, including a range of value-added services such as retail store rollouts and grocery consolidations. These are services that our customers are asking for.

And lastly, we're focused on growing our local customer base, which is a higher-margin business for us. In the third quarter, we achieved double-digit shipment growth in our local sales channel, and we're expanding our local sales force to reflect the scale of this opportunity. So while we had strong yield growth in the quarter, the key point is the momentum it indicates going forward. We're confident that we'll continue to improve our yield in the coming years.

The final pillar of LTL 2.0 is cost efficiency, specifically with purchased transportation, variable costs and overhead. In the third quarter, we reduced our purchased transportation cost by 21% year-over-year by covering more linehaul miles in-house while also paying lower contract rates for the miles we outsource. We ended the quarter with 21.5% of line haul miles outsourced to third parties, which was a 200 basis points reduction year-over-year, even though we purchased more transportation on a short-term basis to cover the recent inflection in volume.

Our plan is to accelerate bringing more miles in-house with initiatives tailored to our linehaul network. For example, we're in the process of adding more driver teams and sleeper trucks for long-distance hauls. We're targeting a few hundred of these teams to be in operation by the end of 2024, which will increase the efficiency and flexibility of our service. We're targeting at least a 50% reduction in third-party linehaul miles as a percent of total by 2027 compared with 2021.

Another margin opportunity we have with variable costs is labor. We managed this effectively in the third quarter. Our headcount and labor hours per day were roughly flat year-over-year while our shipment count was up by high single digits.

Our ability to realize these productivity gains, while also improving our service metrics, reflects the strong execution of our operational teams and the strength of our proprietary technology. That touches on the key points of our plan and the progress we made in the third quarter, with more to follow. We're generating record service levels, gaining profitable market share and driving yield higher. These are the critical levers of margin expansion in our LTL business.

We're continuing to make strategic investments in our network and we have the agility to capitalize on changes in market conditions. At the same time, we're becoming more cost efficient with our operations, so we can translate revenue growth into earnings at a higher rate. We remain solidly on track to deliver on our outlook of at least 600 basis points of adjusted operating ratio improvement through 2027.

Before I close, I want to mention that this week marks our 1-year anniversary as a stand-alone LTL provider in North America. I couldn't be more proud of the progress we've made and will continue to make as we work to realize the full potential of XPO. We're well underway in executing on the strategy we initiated at the end of 2021.

We're a focused, high-energy, customer-loving organization and we'll continue to build on our momentum.

I want to take this opportunity to thank our thousands of dedicated employees for their world-class support of XPO. We have a phenomenal team driving our strategy to be the best in the industry.

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

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Kyle Wismans - *XPO, Inc. - CFO*

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

Revenue for the total company was $2 billion, up 2% year-over-year and up 3% sequentially from the second quarter. In our LTL segment, revenue was up 2% year-over-year and up 8% sequentially. Excluding fuel, LTL revenue was up 8% year-over-year and up 7% sequentially.

Salaries, wages and benefits for LTL were 10% higher in the quarter than a year ago. The increase was primarily related to higher incentive compensation to account for the team's strong third quarter performance as well as the impact of wage inflation. Our improvements in productivity partially offset these costs. We handled more shipments with lower headcount and fewer labor hours than in the third quarter a year ago.

Importantly, it was the third consecutive quarter that shipment count grew at a faster pace than labor hours, and the spread has widened sequentially with each period. In the third quarter, our shipment count per day grew by 8% year-over-year, while labor hours increased by less than 1%.

We were also more cost efficient with purchased transportation through a combination of in-sourcing and rate negotiation. Our expense for third-party carriers was $97 million in the quarter, which was down year-over-year by 21%. Depreciation expense in the quarter increased by 29% or $15 million, reflecting our commitment to reinvesting in the business. This remains our top priority for capital allocation.

In the third quarter, our CapEx was primarily allocated to purchasing new tractors from the OEMs and manufacturing more trailers in-house.

Next, I'll add some details to adjusted EBITDA, starting with the company as a whole. We generated Adjusted EBITDA of $278 million in the quarter, which was up 6% from a year ago, reflecting a year-over-year increase in both North American LTL and the European business.

Our adjusted EBITDA margin was 14%, representing a year-over-year improvement of 50 basis points company-wide. And we reduced third quarter corporate expense to $7 million, as we continue to rationalize our corporate cost structure for the stand-alone business. This was a year-over-year savings of 67% or $14 million.

Looking at just the LTL segment, we grew Adjusted EBITDA year-over-year to $241 million. Our revenue growth and cost efficiencies more than offset non-operational headwinds from lower fuel surcharge revenue and pension income.

In our European Transportation segment, Adjusted EBITDA increased to $44 million for the quarter. Company-wide, we reported operating income of $154 million for the quarter, up 11% year-over-year. Our net income from continuing operations was $86 million in the quarter, representing diluted earnings per share of $0.72. This compares to income of $92 million and diluted EPS of $0.79 a year ago.

The year-over-year decline in third quarter net income was primarily due to an $11 million decrease in pension income and a $6 million increase in interest expense this year. We also had $8 million of transaction and integration costs related to the RXO spin-off and another $1 million of restructuring charges across our segments. These costs stepped down materially from the first half of the year.

On an adjusted basis, our EPS for the quarter was $0.88, which is down 7% from a year ago, also reflecting the impact of lower pension income and higher interest expense. And lastly, we generated $236 million of cash flow from continuing operations in the quarter and deployed $133 million of net CapEx.

Moving to the balance sheet, we ended the quarter with $355 million of cash on hand. Combined with available capacity under committed borrowing facilities, this gave us $944 million of liquidity. We had no borrowings outstanding under our ABL facility at quarter end, and our net debt leverage was 2.2x trailing 12 months adjusted EBITDA. Our capital structure gives us the financial flexibility to execute on the significant growth opportunities we have at XPO.

Before I wrap up, I want to highlight some updates to our full year 2023 planning assumptions. We now expect that gross CapEx will be in the range of $675 million to $725 million this year given the opportunities we have to invest in network capacity to drive long-term growth. We're also

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projecting interest expense of $170 million to $175 million, pension income of $15 million to $20 million and an effective tax rate of 23% to 24%. Our assumption for diluted share count remains unchanged at 118 million shares for the full year.

Now I'll turn it over to Ali, who will cover our operating results.

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

Thank you, Kyle. I'll start with the operating results for our LTL segment. In the third quarter, we had a year-over-year increase in shipment count of 7.8% led by 13% growth in our local sales channel. As a result, our tonnage per day increased by 3.1%. This more than offset the impact of macro conditions, which continue to put pressure on our industry.

Our weight per shipment declined 4.3% in the quarter compared with a year ago, which was slightly better than in the second quarter. There are 2 key drivers behind the solid growth we reported. First, we're continuing to gain market share because of the significant service improvements we're making in the network. And second, when Yellow exited the LTL market, we were well positioned to onboard incremental freight given that we've been investing in expanding our network since 2021.

We also demonstrated that we have the operational discipline to take on more volume while at the same time, continuing to improve our service levels. On a monthly basis, our July tonnage per day was up 4.2% year-over-year, August was up 3.3% and September was up 2.2%. Looking just at shipments per day. July was up 8.8% year-over-year, August was up 8.3% and September was up 6.6%.

Our shipment count increased sequentially by more than 1,000 shipments per day every month of the quarter from July to September. On a 2-year stack basis, monthly tonnage and shipment count also improved each month throughout the third quarter. With October almost complete, our preliminary tonnage per day is up approximately 2.5% year-over-year and shipment count is up 6%. On a sequential basis from September, October tonnage and shipment count are down 2.5% with both outperforming seasonality.

Looking at yield in the third quarter, we grew yield, excluding fuel by 6.4% year-over-year, which is an acceleration from the second quarter. On a sequential basis, we increased yield ex fuel quarter-over-quarter, outperforming typical seasonality by 290 basis points. And importantly, we accelerated yield growth as the quarter progressed, supported by our strong customer relationships and pricing initiatives.

Our underlying pricing trends also strengthened with contract renewal pricing up 9% in the quarter compared with a year ago. We expect year-over-year yield growth ex fuel to further accelerate in the fourth quarter and we're excited about the long-term impact that our yield initiatives will have on profitability.

Turning to margin performance, our third quarter adjusted operating ratio was 86.2%, which was 60 basis points higher than a year ago. On a sequential basis, we improved adjusted OR by 140 basis points compared with the second quarter. This outperformed seasonality by 370 basis points.

Moving to our European business. We delivered another solid financial quarter with adjusted EBITDA growth of 2% compared with a year ago. This was supported by strong pricing, which outpaced inflation, as well as cost discipline. While macro conditions in Europe remain soft overall, our sales pipeline is robust and the team continues to execute well especially in the U.K., where we drove positive organic growth in the quarter.

I'll close with the drivers behind our momentum, including the strong outperformance of our third quarter operating ratio. First, we continue to make significant improvements in service across the board and delivered record results. We also accelerated yield growth in the quarter and will accelerate it again in the current quarter. We expect our robust yield performance to continue into 2024. And we operated far more productively by leveraging our technology and effectively managing our labor costs.

In summary, our strategy is working. XPO in North America is stronger as a stand-alone LTL company with focused execution and our results will continue to reflect that. Now we'll take your questions. Operator, please open the line for Q&A.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question today is from the line of Chris Wetherbee with Citigroup.

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

Maybe first, if we can start on operating ratio and how you might think about the opportunity as you move through the fourth quarter and then maybe bigger picture for next year. So I guess, can you help us a little bit with what you view as normal seasonality and sort of what you think maybe you could do relative to normal seasonality in 4Q?

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

Chris, this is Mario. Starting with first -- with the fourth quarter, we can give you some color like we usually do on tonnage, yield and ultimately, what OR would do and then give an outlook for 2024. On the tonnage side, following our market share gains in the third quarter, we expect to be in line with seasonality in the fourth quarter, which implies Q4 tonnage being up low single digits on a year-on-year basis.

Now for us, on the tonnage side, normal seasonality Q3 to Q4 is a 4% sequential decline. October was better than seasonality, but this was also driven by a small increase in volume earlier in the month, given the cyber-attack at another LTL carrier, and we'll give another update on November tonnage in early December.

On the yield front, as we gain traction in our initiatives, yield growth improved through the third quarter, and we do expect Q4 yield ex fuel to accelerate versus Q3 and on a year-on-year basis to be in the high single-digit range improvement. And ultimately, for OR in the fourth quarter, we typically see -- seasonally, we see a deterioration of OR of 310 basis points from Q3 to Q4 and we expect to outperform that seasonality by somewhere in the 100 basis point range.

So on a year-on-year basis, this implies an improvement of roughly around 200 basis points in OR and the magnitude of the outperformance will depend on what the tonnage environment does in the back half of the quarter. As you know, Q4 is usually a tough quarter to predict with the holidays.

Now for 2024, we do expect a strong year. The biggest swing factor will be the macro and what the macro does through the course of 2024. But as said, we have a lot of company-specific initiatives, as we have mentioned in our opening remarks, our service product continues to improve, hitting company records, our yield is accelerating here in the fourth quarter, and we expect a strong year for yield in 2024.

And we expect to continue to make great progress driving cost efficiencies including linehaul in-sourcing and accelerating that and productivity improvements in labor as well. So from an OR perspective for 2024, we do expect a strong year, but we'll see what the macro takes us here over the quarters to come.

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

That's very helpful. I appreciate all that color. And just one follow-up on 2024. As you think about sort of the longer-term operating ratio targets that you guys laid out through 2027. Given what you've seen with the post-Yellow world, the pricing opportunity and some of the significant improvements you're making around the service side, is it reasonable to assume or can you give us a sense of what the cadence of that overall OR improvement might look like? Is it front-end loaded? Is it back-end loaded? Any kind of thoughts about how that cadence should present itself, particularly given what we're seeing in the market currently?

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

Yes. So first, on the number itself, we've always said it's at least 600 basis points by 2027. But we're not stopping at 600, and we're not stopping in 2027. And I think there's a cadence of improvement based on what we're seeing short term, it's fair to assume that we can get there faster. But as we execute, we're going to keep on posting these numbers and going from there. And it will depend a bit, short term, on what the macro does in 2024. But we expect a strong outlook going from here.

Operator

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

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

I want to dig into the pricing opportunity a little bit. So I think you said contract renewal is up 9%. Is that a number that you view as sustainable over the next few quarters? Help us think about -- I don't know if you guys announced a GRI or what you're planning on the GRI. And then maybe touch on the accessorial value-added opportunity. Are we seeing any of that benefit yet? Or is that still all incremental?

Kyle Wismans - *XPO, Inc. - CFO*

Scott, it's Kyle. So thinking about the contract renewal rates that you said, 9% is what we're seeing in Q3. And relative to GRI, just one clarification, too, is that the contract renewals will impact most of the business. So we'll go through an annual cycle increase.

So we expect those to be in the high single-digit range. And then when you think about the GRI for us, we're going to go through our annual process and we'll follow our normal timeline. So we communicate to customers here in the fourth quarter and then go live with increases in Q1.

And then I think your second question was on accessorials, Scott. accessorials are one of many yield initiatives we're excited about. Currently, accessorials are about 10% of our revenue. We're targeting to get closer to 15%. That's a combination of offerings we have today as well as some new service offerings. And then in Q2, we did begin rolling out new tools. That helped us really capture more location-based and time-based accessorials. We started seeing impact from that in Q3. We also have a team that's working on growing our premium service offering. So those should help us really drive that high single-digit impact in Q4 as well as positive yield in 2024.

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

Okay. And then you guys are talking a lot about the claims, seeing some nice improvement. Is there any way to help us think about what does lower claims actually mean for the model? Does it mean lower cost and better price? And how quickly do we see any sort of benefit of lower claims showing up in the model?

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

This is Mario. When you look at claims, one of our core areas of focus as a company is improving service for the customers. And in our industry, whenever we provide better service and we keep on that trajectory, and eventually, our goal is to be the best in class and to get to a 0.1% claims ratio. Customers are willing to pay a higher premium for the value that we would offer there. So what you would see is an impact on pricing. And we already are seeing that here in the third quarter.

As Kyle just mentioned, our contract renewals are up to 9%, and most of that was driven by these improvements in service. And to keep in mind, Scott, also when we started LTL 2.0, our damage claims were at 1.2%. And we've been able to take this here in the third quarter to a company best

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through a multitude of initiatives all the way from incentive comp to local incentive comp programs for, we call the Gladiator to incentivize our supervisors to load with quality to rolling out new technology and how we rate our trailers and moving forward, the combination of airbags as we're launching in all service centers, higher-quality straps and improvements across the board, all of these would lead to an even higher premium on price over time.

So that's how -- what we see the impact on the medium to long term of that continued improvement in service. There is a benefit on the P&L. Obviously, our claims dollars amount would go down, but that's small in comparison when you look at it versus the improvements in pricing we can pick up over the quarters and years to come.

Operator

Our next question is 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*

Just talk about the accelerating yield yet you only target about 100 basis points to outperform seasonality when you just did 370 basis points. Maybe you can kind of delve into the why we should or what the opportunity is to see better versus why you think it maybe takes a step back from outperforming seasonality versus what you just posted?

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

Sure, Ken. This is Ali. So we do expect to outperform seasonality by 100 basis points. That's going to be primarily driven by our stronger yield growth. Just keep in mind, we are coming off nearly 400 basis points of outperformance versus seasonality in the third quarter. So we're delivering 100 basis points on top of that 400 that we delivered in the third quarter.

I'd also point out that on a year-over-year basis, that 100 basis points of outperformance versus seasonality would imply 200 basis points of year-over-year OR improvement and about 20% EBITDA growth in our LTL segment ex real estate. There are also a few short-term impacts to consider from the investments we're making. As we continue to invest in incremental capacity that comes with higher depreciation. That was about 120 basis points year-over-year headwind to OR in the third quarter. We would expect a similar impact in Q4. We're also investing in growing our local sales force. And overall, we do expect these investments to generate strong returns for us over the medium to long term, but they will have a modest cost impact over the next few quarters.

So we feel comfortable with the roughly 100 basis points of outperformance versus seasonality for OR. It is still very early in a dynamic environment. And ultimately, that magnitude of outperformance is going to depend on how tonnage progresses through the rest of this quarter.

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

Great. That's great stuff. And great detail on the progress so far. So congratulations on a great quarter. Can you talk a bit about your thoughts on, I guess, two things. One, on Yellow, I guess you have 294 service centers. So how are you thinking about positioning into this? Are there different locations you may want to expand on? How do you think that process goes? Do you think it brings more than needed capacity into the sector? And does that impact the ability to get pricing? And then on that pricing, can you talk about how much of -- have you already renewed versus what is still to come?

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

Yes. Sure, Ken. This is Mario. On the Yellow service centers, it is an opportunity for us to potentially accelerate our capacity growth. We are participating in the process, and we'll see how things play out over the next few months.

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Now our focus from a physical network capacity perspective has been to grow the network in markets where we see higher demand from our customers over time. And we don't look at these things for the next couple of years, but we look at it over the next 10-plus years in terms of where the freight markets will be -- will have more demand in them over time as well.

So as I mentioned earlier, we've opened up so far more than 500 net new doors. Here in the quarter, we expanded 2 service centers into Atlanta and Dallas Metro areas, and we just broke ground on a service center in Central Florida and we're going to continue executing on that plan. But I think these Yellow service centers, we'll see where the process rolls out, and it will help us accelerate that plan over the years to come.

Now in terms of capacity coming back into the network, it's tough to estimate what percent of these service centers would be back in the hands of LTL carriers. We estimate it to be roughly around 50%, but it will depend on other uses for the land or these locations for other industrial-type applications.

Now for the service centers that will come back into LTL, it will take time. Keep in mind that a lot of these service centers to go back -- of course, the process has to play out, and then a lot of these service centers to get back into operations, they take time to get up to the standards of the different carriers. That could be -- we estimate it to be in the year plus range for them to get back into the industry. And they will get back into the hands of more premium priced operators. So you'd have a rising tide for pricing across the entire industry.

And the last thing I'll say also, Ken, is that capacity went out at a time where shipment count in our industry is down -- the underlying demand is down 10% across all the different carriers. So whenever the macro tightens again, you won't have enough capacity in LTL to handle all of that freight. I'll turn it over to Kyle to discuss yield.

Kyle Wismans - *XPO, Inc. - CFO*

Yes. From a renewal standpoint, Ken, the cadence for contract renewals is pretty level across the year. We have a disproportionately slightly higher amount in Q4 that will cycle through here in the quarter, but it's fairly even across the year.

Operator

Our next question is from the line of Fadi Chamoun with BMO Capital Markets.

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

Just a question on yield. You mentioned double-digit pricing opportunity in coming years from service, accessorial and local customer base. When you look at this kind of past quarter, third quarter, where are you having more success? It sounds like you're getting some decent penetration on the local customer base side? And what's the kind of areas where you're seeing greater contribution to the year? Is it accessorials, local customer base or is fairly spread across the 3 kind of levers of pricing?

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

So Fadi, when you look at the 3 of them, the biggest impact in the third quarter was the improvement of service because when you look at our claims ratio, 0.4%, customers seeing the trend of improvement and those relationships with our customers to keep on improving over time as well. This is where we're seeing the most amount of success that these contract renewals are coming in, and customers understand that we are investing in the network, we're investing in people and to be able to support and service them the right way, and that's leading to higher yield and price gains.

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On the accessorial side, we're still early innings, and we believe these over the quarters to come as we launch the premium services we mentioned and as we sell them to existing customers and new customers, we see that's going to happen again over the quarters and years to come to bridge that accessorial gap.

On the local side, we're making a lot of progress. I mean, here in the third quarter, we increased our shipment count in the local channel by 13% on a year-on-year basis. However, this channel is more impacted by the softer macro. So the weight per shipment is still significantly down in the local channel, so although we're making progress on it, we're still not seeing the impact on yield, but as we start seeing tonnage in that channel improved because we're gaining market share, you would see that becoming a tailwind for yield over the quarters and years to come as well.

Operator

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

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

Congratulations on the strong progress on the OR and service and pricing, all those things that I think are really positive. Wanted to see, Mario, if you could comment a little bit on the kind of underlying trend in freight and how you kind of weave that in? It seems like the, I guess, the monthly tonnage numbers are I don't know if it's kind of stabilizing or how you want to view it, but they're a little bit lighter maybe at the end of the quarter. So I don't know if you think underlying freight market is stable or if you could offer some trends, some thoughts on that.

And also, how do you think about that change in weight per shipment looking forward? Does that become more neutral? Or should we think about that even into '24 that that's maybe a bit of a continuing reduction in weight per shipment?

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

Thanks, Tom. I'll start by first covering the demand side, and Ali can walk through the cadence in the quarter as well because our comps are not similar to the other carriers in the back half of this year compared to last year. So there are a few things we can drill into it with more details. But if you take a step back on the customer demand side, it is a fluid environment, and it's hard to call what the macro will do when we look at the demand environment.

More recently, the underlying environment has been bouncing along the bottom since the month of April of this year. So it's been softer demand overall for LTLs. Now in terms of outlook, we do survey our customers on a quarterly basis, our top customers. And even the last survey last week, for the fourth quarter, our customers were more balanced. So some customers were seeing some strength in demand, while others were seeing softer in demand. But generally, it was balanced in terms of where we were earlier in the year.

Heading into 2024, we are hearing more optimism from customers about demand picking up. But again, it's not a big number, but it's still -- that is more customers that expect a demand pickup versus customers that expect more softness or flat.

Now when you look at some of the indices we look at, well, 2/3 of our customers are industrial companies and the ISM manufacturing index is a good proxy that pick up a bit to 49% last month. It's still under 50, but it did pick up a bit. And same thing on the retail side, we saw retail sales accelerate to 0.7% month-over-month in September. And that was also slightly better than expected.

So we're seeing things remain soft, slightly improving with a bit more optimism going to the first half of next year, but it's still very tough to call the macro at this point. There's a lot of cross signals here.

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

Tom, this is Ali. In terms of the cadence through the quarter, as Mario mentioned, we did have tougher compares in the second half of the year last year as our market share gains were accelerating. So if you look at it on a 2-year stack basis, our shipment counts and tonnage both accelerated throughout the third quarter and that 2-year acceleration continued into the month of October.

Also, if you look at it just on a shipment count basis, we saw our shipment counts improve by more than 1,000 shipments each month of the third quarter from July to September. And then as we moved into October, as we noted, October outperformed seasonality relative to the month of September.

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

One quick follow-up. Do you have any thoughts you can offer on linehaul miles and kind of where you're going in terms of making further gains? You've improved that quite a bit with the in-sourcing. Just wondering how you think about the opportunity is going forward. Do you improve a lot from that? I think you said like 21.5% outsourced.

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

Yes. So for the third quarter, we were outsourced 21.5%, where we in-sourced roughly 200 basis points on a year-on-year basis. Now keep in mind, Tom, it's something we did invest in on a sequential basis, Q2 to Q3. We did get a bit more third-party line haul miles given the inflection in volume. But moving forward, we expect to move quickly on in-sourcing. As I mentioned earlier, we are excited about the program we're launching called the Road Flex operation. It's a program where we have teams of drivers in sleeper cab trucks that move freight across longer hauls.

And this will enable us to move faster on the in-sourcing process. We do expect to be -- to in-source at least 50% of the miles by 2027. But given this new program, we're launching, we expect to accelerate that over the quarters and years to come here.

Operator

Next question comes from the line of Ravi Shanker with Morgan Stanley.

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

So good traction with the service improvements. I'm just trying to get an understanding of what percentage of the fruit on this tree are low-hanging versus higher up? I'm just trying to get a sense of whether we can expect this traction of improvement to continue in the coming quarters? Or does it get incrementally a little bit harder from here?

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

Yes. So Ravi, from our perspective, our top priority, one of the top priorities is to improve service and continue to improve service for our customers. And our goal is to be best in class and get to a 0.1% claims ratio over time. Now we've made tremendous progress. You look from end of 2021 through Q3 of this year, we went from 1.2% damage claims ratio down to 0.4%. However, the improvement from here won't be linear, and it will take time. It's not something that every quarter, we're going to post a 0.3% improvement from 0.7% to a 0.4%.

Now we have rolled out multiple new initiatives heading into 2024, with Dave coming on board, and the operating team are implementing a number of initiatives, including higher-quality straps, new airbag systems that we are launching across all of our service centers, and Ravi, I'll tell you here from the first couple of service centers we've launched, we've seen an incremental reduction of more than 20% of damages just with

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these new tools and programs that we launched that we're very excited about. And we're also enhancing our training programs and how we load trailers taking it to the next level as well.

And I mentioned earlier line haul in-sourcing. That's another measure of service improvement because today, when we use a third-party carrier, they typically have 53 feet trailers that don't have the bars in them. We call it the SafeStack system to separate freight from effectively having 2 decks of freight when we have that in our equipment.

So as we make progress on in-sourcing third-party linehaul, we will continue to see these improvements in service as well as we roll these things out. But again, the progress is fantastic. September was a company record in damage frequency. So how many damages do we cause versus the shipments that we move. And October got even better than the month of September. So great trajectory ahead. But again, it won't be linear over the quarters and years to come.

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

Got it. Very helpful, Mario. Maybe just a follow-up on the same topic. And as you had said earlier that better service begets better pricing and better share. What does that conversion process look like? How does that take? Is that kind of immediate? Is that 1 contract cycle? Does that take a couple of years? Again, just trying to figure out kind of what the longer-term trajectory of this improvement looks like.

Kyle Wismans - *XPO, Inc. - CFO*

Ravi, it's Kyle. So when you think about it, we're going to go through all of our -- again, about 20% of our customers are using a standard tariff that will get impacted by the GRI. The other 80% will go through contract renegotiations. That cycle is fairly consistent, meaning we cover the same number of contracts almost every quarter. The fourth quarter is slightly higher. But we'll see that improvement basically progress for the next several quarters to capture a lot of the service improvements that we're seeing right now in the network.

Operator

Our next question is from the line of Jason Seidl with TD Cowen.

Jason H. Seidl - *TD Cowen, Research Division - MD & Senior Research Analyst*

Congrats on the progress in the LTL 2.0. I wanted to focus a little bit on your cost per shipment. How should we think about the increases in the cost per shipment or the decreases as we roll into 2024, especially around you rolling out that airbag system throughout the rest of the network.

Kyle Wismans - *XPO, Inc. - CFO*

It's Kyle. So when you think about cost per shipment, let me start a little bit with Q3 and then some of the costs that we saw were slightly higher in the quarter. So from a cost per shipment standpoint, overall, we're down about 2%. There's progress made in a lot of areas. Mario talked about the insurance and claims. That was down almost 35% in the quarter.

We also saw a drop in fuel. There's a couple of areas where we saw kind of higher transitory costs in the third quarter. That's going to include some of the purchased transportation expense. So we were about $10 million sequentially, and that's reflecting the effort needed really to make sure we can service the additional shipments in the network. We'd expect as we continue to ramp up the linehaul and sourcing for that to come down both in Q4 and into '24.

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Jason H. Seidl - *TD Cowen, Research Division - MD & Senior Research Analyst*

So overall, you would expect cost per shipment to trend down into '24. Just wanted to clarify that.

Kyle Wismans - *XPO, Inc. - CFO*

No, I think we're expecting more cost productivity into Q4 and into '24.

Jason H. Seidl - *TD Cowen, Research Division - MD & Senior Research Analyst*

Okay. Fair enough. And then as a follow-up, I know we haven't really brought it up because it hasn't been a focus, but maybe a little bit of an update on Europe. And then as we roll into the new year, do you think the M&A market might be favorable enough to bring that back up again?

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

Well, our long-term plan remains to be a pure-play North American LTL carrier. But in the meantime, our European business continues to perform really well. When you look at the European economy, it's been softer here over the last couple of quarters, but the team was able to deliver great results, growing EBITDA on a year-on-year basis, is just firing on all cylinders. We're onboarding more customers, we are getting more cost efficient in our European business, and the team is performing well. But long term, our goal continues to be a pure play North American LTL company.

Operator

The next question is from the line of Brian Ossenbeck with JPMorgan.

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

Just wanted to see if you could comment, Mario, on capacity available in the network and what's actually the limitation or the bottleneck now. I know last quarter, you talked about needing to add some more. You talked about the doors you're adding, the new service center you broke ground on. Where does that stand? And how do you see the limitations at this point you're running up into any conditions that need a little bit more capital expenditure, especially when you're boosting that up here in the fourth quarter looks like a pretty big increase to get to that midyear target -- midpoint of the target rather you just raised?

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

In the third quarter, we had high-teens excess capacity in our network from a physical perspective, so in terms of how many doors we have. But as you know, this is not evenly distributed across our network. In some markets, we are bumping against capacity limits, but in many, many markets, we have available capacity from a doors perspective. And our service center expansion plan does contemplate those markets where we see that higher demand from customers, where we're going to expand physical capacity. But we were run rating in the high teens. Our goal is to be in the 20% to 25% range is where we would like to be on a longer-term basis.

Now in terms of rolling stock capacity, we have had tremendous progress since the beginning of LTL 2.0.

We've added more than 10,000 new trailers over the last 1.5 years, 2 years. We've added 2,000 tractors to our fleet, and this is enabling us to be able to take on more customers, but also run more efficiently. You see it here in the third quarter, we were able to handle 8% more shipments, while gaining productivity, I mean, our headcount was down on a year-on-year basis, and our labor hours were up slightly versus an 8% increase in shipments and equipment help us manage that.

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And on the people side, we're staffed for current volumes, but we do have headroom as well. And if the demand continues to increase, we can step up for that. The current state of markets are much easier to hire into. We have our driver schools as well. So we feel good from a people perspective. But generally, if you take a step back, we feel great from a capacity perspective, and we continue to invest in the network, and we're well positioned to capitalize on any upswings in freight.

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

Okay. Great. So as a quick follow-up. Maybe you can -- looking longer term, you've been able to sort of bridge the different buckets performance and productivity of pricing yield accessorials all things we're talking about here in terms of starting to narrow the gap with some of your peers. I just wondered if you could lay out some of the thoughts in terms of where those pieces are going to come from and if you're able to quantify them in some of those buckets like accessorials, yields, productivity, et cetera?

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

The biggest component is going to come from yield. As I mentioned in my prepared remarks, we see a double-digit incremental yield opportunity over the coming years through the 3 main levers I mentioned, which is one is around service and continuing to get this higher price from customers who understand we're investing in the network and investing in the business, that's roughly half the yield opportunity to bridge the gap. And the other half is we expect for the accessorials to go from roughly 10% of revenue to the 15-plus percent of revenue range based on the premium services we are implementing.

What I like about this program, these are services that our customers are asking for. So we're taking care of the customer, and we're making a higher yield and a higher margin. And then finally, on the local channel side, by growing our local sales force. And here so far this year, we've increased our sales team account by 10% to 15% so far. And our goal is to get to more than 30% increase in overall sales headcount by end of next year, and that's enabling us to gain market share in that local channel that would also help bridge the gap. But the lion's share of the opportunity does come from price.

The second category is around in-sourcing third-party linehaul, and we are accelerating that with our Road Flex team and our new program for team drivers, and we will get higher service and lower cost, which is also really good. And we're going to continue to improve efficiency as well. So when you combine all of these things, again, yield is #1 by a long shot, and then all the other areas will help make sure that we are running more efficiently as well.

Operator

Our next question is from the line of Stephanie Moore with Jefferies.

Stephanie Lynn Benjamin Moore - *Jefferies LLC, Research Division - Equity Analyst*

I guess you touched on a little bit of this and just in the previous question, but maybe just to double-click on it a little bit more. Can you talk a little bit about kind of the labor additions that you've had to make, just given the disruption from the post-Yellow bankruptcy, where you think you kind of are positioned today, adequately staffed? What are areas where you have added? Maybe you noted a little bit on the sales force and then kind of your view as we go through 2024 kind of incremental hiring needs.

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

Sure, Stephanie. This is Ali. So if you look at the third quarter, our headcount was down slightly on a year-over-year basis, and that's relative to shipment counts up high single digits. So we did a great job managing headcount relative to the volumes in the network. Also, if you look at it at a labor-hours perspective, labor hours were up less than 1% year-over-year, again, versus shipment counts up 8% year-over-year. And more

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importantly, that spread between labor hours and shipment counts accelerated through the year from low single digits in the first quarter to high single digits in the third quarter.

Now as we think about the fourth quarter, we would expect total headcount and labor hours for 4Q to be roughly the same as the third quarter on both a quarter-over-quarter and year-over-year basis. We've done a really good job again in managing productivity in the third quarter. We expect that to continue into 4Q and then into 2024 as well.

So we are staffed for current volumes, and we have some headroom. If demand does increase, we want to make sure we're staffed for that as well. I think the positive side is the labor market is looser than it has been in recent years. So we're confident in our ability to flex up labor as needed. And we're going to continue to manage headcount effectively relative to the volumes we're moving through the network.

Stephanie Lynn Benjamin Moore - *Jefferies LLC, Research Division - Equity Analyst*

Got it. And then just a follow-up. Can you talk a little bit about as you think about kind of going into 2024, your thoughts in terms of incentive compensation, if maybe you're looking to align metrics both from the top and then all the way down to the terminal level with new targets? Any changes in philosophy there as you kind of prepare for 2024?

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

This is Mario. So this last year and the one prior in 2022 as well, we did change our incentive comp structure. It used to be only based on EBITDA growth on a year-on-year basis, but we had a good portion of the incentive comp plan switch to also focus on quality and on-time service. And that was part of the reason why we were able to drive meaningful improvement in both of these categories through the course of the year since we started LTL 2.0.

Now if you look moving forward, we are contemplating a change to switch from having EBITDA as being the compensation driver. And this is for field operations at the service center level and at the regional level to using OR expansion as being the key metric for profit improvement for the compensation program. We're still in the early innings here. There's still a few months here before we saw 2024, but that's one change we are contemplating for next year.

Operator

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

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

Mario, I was hoping you could touch on CapEx. You mentioned it's going to be above your long-term guidance range here in the end of the year. And it sounds -- I heard that it was going to be elevated again next year in the way you positioned it. Just kind of curious if that's your anticipation? And is it predominantly tractor shares or new doors. Just if you could kind of hone in a little bit on where the excess spending will be? And curious if you're spending anything in Europe because that is picking up. I know that, that's an asset that may not be with you forever, but it's -- just curious if that's an area where you're having to increase CapEx as well.

Kyle Wismans - *XPO, Inc. - CFO*

Scott, it's Kyle. So as we mentioned earlier, this year, we think we're going to be in that 12% to 13% range. And if you think about the investments we made in the last 18 months, that includes over 2,000 tractors and 10,000 trailers, that's really helped enable the share gains in recent disruption. So if you think about more specifically what's -- what we're investing in right now to put us above that 12% range, really two things I can point to.

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One, we're going to produce more trailers at our Searcy facility. Initially in the year, we're thinking 6,000. We're now going to produce more about 7,000 trailers, and the second thing is something we mentioned earlier on the call, our sleeper cab initiative.

So we're going to bring about 100 tractors in the network to do that. For us, it's going to do a couple of things. It will help us accelerate linehaul in-sourcing, there's obviously a service benefit and a cost benefit there. But both of these efforts are really pull-forwards of capacity investments for us. And if you think about the investments we make in total, in general, we expect very high returns from our LTL investments in upwards of 30%. So we think this is the right place for us to be investing in the company...

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

Great. Thanks -- well go ahead.

Kyle Wismans - *XPO, Inc. - CFO*

Yes, I was going to say, the only thing to touch on from your question was Europe. So Europe is about 10% of our gross CapEx in general. That's been pretty consistent for the business and will remain there.

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

All right. Appreciate that. For my follow-up real quick. Just you mentioned at the top of the call, the 8 percentage points of on-time improvement year-over-year. That sounds impressive. I'm sure that goes into helping you interact in for your sales folks on new business wins. Just curious if you could put that a little bit more into perspective, is that trending? Is that something that's now that you've seen the first month of the fourth quarter? Is that something that you're going to continue to see trending very well here through the end of the year?

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

Absolutely. When you look at all of our service metrics here in the month of October, we've seen a step-up from where we were in the third quarter as well. I mentioned earlier, for example, I mean, on time continues to do really well and our network fluidity is the best it's been in a long, long while, which is great to see. And our customers appreciate that. And similarly on the damages side in terms of damage frequency, we've seen a further improvement -- September was a company record, dating back to 1996, and October was even better than September.

Operator

We've reached the end of the question-and-answer session. I'll now turn the call over to Mario Harik for closing remarks.

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

Thank you, operator, and thank you all for joining us today. As you saw from what we reported this morning, we're in a strong position as we begin our second year as a stand-alone LTL business in North America. Our solid momentum is driven by continued execution of our LTL 2.0 plan and it spans our entire business from revenue, earnings and yield growth to significant service improvements, operating efficiencies and market share gains. We're still in the early innings here, and there's a lot more we'll achieve. We look forward to speaking with you all on our next call. Thank you.

Operator

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

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