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XPO.N - Q3 2021 XPO Logistics Inc Earnings Call

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OVERVIEW:

Co. reported 3Q21 revenue of $3.27b and adjusted diluted EPS of $0.94. Expects 2021 pro-forma adjusted EPS to be $4.15-4.25.

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PRESENTATION

Operator

Hello, and welcome to the XPO Logistics Third Quarter 2021 Earnings Call and Webcast. (Operator Instructions) As a reminder, this conference is being recorded.

It's now my pleasure to turn the call over to Brad Jacobs. Please go ahead.

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

Good morning, everybody, and thanks for joining our call. With me today in Greenwich are Ravi Tulsyan, our CFO; Matt Fassler, our Chief Strategy Officer; and Mario Harik, our CIO and acting President of LTL. We also have Drew Wilkerson, who leads our North American transportation group, joining us for Q&A.

As you saw from our press release, the company overall had an excellent third quarter. We beat expectations for revenue, adjusted EBITDA, adjusted EPS and free cash flow, and raised our full year guidance by more than the beat.

We now have 2 reporting segments following the spin-off of GXO. The largest service offering in our Brokerage and Other Services segment is North American truck brokerage, which had another remarkable quarter. Our North American LTL segment had mixed results, and we're actively course-correcting.

Highlights of the quarter company-wide include a year-over-year increase in revenue of 22%. We also grew adjusted EBITDA, excluding real estate, by 25%. Our revenue was the highest of any quarter in our history, and our adjusted EBITDA was a third quarter record, marking the fifth consecutive quarter we've raised the bar on this metric.

In North American truck brokerage, we continue to significantly outperform the market in growth of gross revenue, net revenue and volume. Year-over-year, we grew volume with our top 20 customers in total by 45%.

We also significantly increased productivity, growing loads at nearly twice the rate of headcount. The largest driver of this productivity is our technology, specifically our XPO Connect digital brokerage platform, which continues to have very high levels of industry adoption. Matt will give you the growth numbers behind XPO Connect, including the number of carriers we have on the platform and the carrier usage, customer count and cumulative downloads.

In LTL, we delivered record third quarter revenue and adjusted EBITDA ex real estate gains and our strongest yield growth yet, up 6% ex fuel. But our adjusted operating ratio ex real estate eroded by 190 basis points year-over-year. Mario will cover this in detail later on the call.

Many of you know Mario from his 10 years with XPO. He's one of the most talented executives I've ever worked with, and one of the first leaders I hired at the company. Mario and I have worked shoulder to shoulder on every major project since.

Today, he'll talk about the 5-point action plan we've taken to return to our trajectory in LTL of significant multiyear operating ratio improvement. This includes how we're addressing shortages of equipment and labor using XPO-specific capabilities like trailer manufacturing and in-house driver schools.

We're also moving to the next phase of our strategy in LTL for shareholder value creation. Over the next 12 to 24 months, we plan to add approximately 900 doors to our LTL network, which equates to about 6% more doors than we have now. We believe these targeted investments will enhance network-wide operating efficiency and support future revenue growth.

And notably, our LTL segment has superlative return on invested capital, making it an ideal use of shareholder resources. We continue to target at least $1 billion of adjusted EBITDA in LTL in 2022.

In conclusion, we delivered a number of key financial achievements in the quarter company-wide and in each of our segments. And once again, we raised our guidance for full year 2021.

Finally, we were delighted to pay down $1.5 billion of debt in the quarter, moving us closer to our goal of an investment-grade rating.

I'll now hand over to Ravi to discuss our results and our balance sheet.

Ravi Tulsyan - *XPO Logistics, Inc. - Senior VP, CFO & Treasurer*

Thank you, Brad, and good morning, everyone. Today, I will discuss our third quarter results, our balance sheet and liquidity and our updated outlook for 2021.

In the third quarter, we delivered strong year-over-year growth in both revenue and adjusted EBITDA, with both results coming in higher than expectations. We generated revenue of $3.27 billion, which was a year-over-year increase of more than 22%. Fuel prices contributed 3 points to growth, resulting in organic growth of 19%. The impact of FX was not material in the quarter.

We grew adjusted EBITDA by almost 15% to $307 million. Pro forma for spin-off, this was a third quarter record for us, and it reflects strong growth and execution in our Brokerage and Other Services segment. Excluding real estate gains, our year-over-year adjusted EBITDA growth was 25%. For the quarter, our adjusted EBITDA margin, excluding gains from real estate sales, was 9.2%, an improvement of 20 basis points year-over-year.

Both of our segments, Brokerage and Other Services and North American LTL, contributed to our growth. In our brokerage segment, adjusted EBITDA increased by 46% in the third quarter. And in our LTL segment, adjusted EBITDA, excluding gains from real estate, was up year-over-year by 2%.

Operating conditions in the quarter were favorable, with robust consumer activity and an ongoing rebound in the industrial sector, as well as a firm pricing environment. This was partially offset by cost pressures, especially on the purchased transportation line and by the impact of labor and equipment shortages. Matt will provide additional color on our segment performance in a few minutes.

Our adjusted earnings were $0.94 per diluted share, which was up from $0.42 per diluted share from a year ago, an increase of 124%. This year-over-year increase was primarily driven by higher EBITDA, lower interest expense and lower tax rate.

We generated $250 million of cash flow from continuing operations, spent $77 million on gross CapEx and received $12 million of proceeds from asset sales. As a result, our free cash flow was a very robust $185 million. This exceeded our expectations for the quarter, driven by strong earnings as well as CapEx and working capital timing that worked in our favor.

We are executing our strategy of driving shareholder value as a pure-play transportation company. On a trailing 12-month basis, total company return on invested capital was 33%, with the North American LTL segment above that. Given this return profile, we are increasing our CapEx in LTL, primarily with plans to add additional doors and purchase equipment to support expanded door capacity.

Our cash balance at September 30 was $254 million after paying down $1.5 billion of debt in the quarter. This cash, combined with available debt capacity under committed borrowing facilities, gave us over $1.2 billion of liquidity at quarter end. We had no borrowing outstanding under our ABL facility. Maintaining strong liquidity will continue to be a top priority for us.

Our net leverage at September 30 was 2.8x adjusted EBITDA for the last 12 months. Following the spin-off of GXO, we used the $794 million dividend from GXO and $384 million in net proceeds from our equity offering, along with cash on hand, to repay all our outstanding senior notes due in 2023 and 2024, a total redemption of over $1.5 billion. For the full year, we have reduced our gross debt by approximately $3 billion.

We have begun to benefit from lower interest expense this year, and our interest expense will decline by another $60 million on a year-over-year basis for 2022. We now have no significant debt maturities until 2025.

We'll continue to delever our balance sheet through free cash flow generation and adjusted EBITDA growth. Our progress on deleveraging is important in the context of our target to achieve net leverage in the range of 1x to 2x adjusted EBITDA by the first half of 2023 and our commitment to achieve an investment-grade rating.

Turning to the outlook we issued yesterday after market close. We updated our full year guidance in light of our strong third quarter results and the favorable economic trends we see today. Our outlook assumes this trend will continue, and the market impacts of labor and equipment shortages don't get worse.

The raise in our full year adjusted EBITDA includes a fourth quarter adjusted EBITDA target of $300 million to $305 million. On the cash flow front, our new outlook is for full year free cash flow of $425 million to $475 million. We expect gross CapEx to be $375 million to $400 million and net CapEx to be $250 million to $275 million for the year.

The updated full year pro forma depreciation and amortization guidance is $390 million to $395 million, and there is no change to pro forma interest expense of approximately $200 million. We expect our reported interest expense for the year to be approximately $230 million.

Our full year tax rate is now expected to be 24% to 26%, which is an increase of 1% versus our previous guidance, driven by discrete items and nondeductible expenses.

Our average share count forecast for the year remains unchanged at approximately 114 million diluted common shares, and we expect to end the year at approximately 116 million diluted common shares.

The full year adjusted EPS guidance on a pro forma basis is now $4.15 to $4.25. The change in our adjusted EPS range reflects higher EBITDA and an increase in tax rate.

In conclusion, we had a transformative third quarter with the spin-off of our logistics segment, and we are enthusiastic about our prospects as a transportation leader in the markets we serve.

I will now turn things over to Matt.

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

Thanks, Ravi. I'll review our third quarter operating results, starting with North American LTL. We grew revenue by 15% year-over-year. Excluding fuel, we grew revenue by 10% year-over-year. We grew tonnage per day by 3% year-over-year. Our tonnage trends tracked typical seasonality in July and August, but trailed in September.

Our rate per shipment increased 4% year-over-year, with the increase broad-based across verticals. Shipments fell slightly by 0.6% year-over-year.

Our retail and e-commerce vertical was strong, reflecting a strong consumer economy and our expanding footprint in the consumer space. Our 1- to 2-day service offering is attractive to consumer-facing verticals. We see substantial room for further recovery in industrial and especially in automotive, though tonnage did rise nominally in both of these verticals.

The pricing environment remained firm. Yield, excluding fuel, rose 6% year-over-year. This is our biggest year-over-year yield improvement since we acquired Con-way in 2015. Price increases on contract renewals were 8%, consistent with Q2. Revenue per shipment, excluding fuel, grew 10%. This reflected the increases that we saw in both yield and weight per shipment.

Our LTL adjusted operating ratio was 83.9%. Excluding real estate gains, our adjusted OR was 84.4%, which was 190 basis points higher than the third quarter a year ago. The erosion in adjusted OR mirrored the impact of the higher cost of purchased transportation, which, when measured as a percent of revenue, increased about 200 basis points year-over-year. This increase was driven largely by higher truckload rates. In fact, we reduced our use of third-party transportation year-over-year, as we have for some time.

In-sourcing this volume in an environment constrained by shortages of labor and equipment impacted our efficiency. We've already taken steps to address this dynamic going forward. Also, through a number of pricing actions, our yield growth in October accelerated meaningfully. Mario will offer additional details on our strategic plans for LTL. We have enormous opportunity for outsized growth in the years ahead.

With the spin, we've allocated our lines of business other than North American LTL into a new segment, Brokerage and Other Services. North American truck brokerage is our largest revenue and profit driver among our lines of business in this segment.

Our third quarter truck brokerage results were outstanding as we gained share and delivered outsized profit improvement. Our loads per day increased by 37% versus a year ago, holding steady with our growth in the second quarter. And once again, we sharply outpaced the market. On a year-over-year basis, we generated a 62% increase in both revenue and net revenue. Net revenue per load increased 18% year-on-year. The truckload market remains exceptionally tight as shippers seek capacity and visibility to their freight movements.

Our digital brokerage platform, XPO Connect, is helping us drive tremendous volume at excellent margins. Carrier and customer adoption of XPO Connect continues to surge. We exceeded 550,000 cumulative downloads of our Drive XPO mobile app as of the third quarter, nearly tripling the cumulative number of downloads year-over-year.

We topped 90,000 registered carrier accounts on the platform, up 37% year-over-year. Average weekly usage by carriers more than doubled, and the number of customer accounts on the platform more than tripled.

Our North American truck brokerage profitability was very strong, and we leveraged our 62% net revenue growth into stronger adjusted EBITDA growth in brokerage.

Looking at overall segment results from brokerage and other services, revenue rose 27%, while adjusted EBITDA rose 46%. The adjusted EBITDA margin for this segment rose to 5.8% from 5.1% a year ago.

I want to mention a couple of recognitions that are particularly gratifying. We were recently named a top company for women to work for by the Women in Trucking Association, and we received both the Ford Excellence Award for treating customers like family and an award from Ulta Beauty for commitment to continuous improvement.

Now, I'll turn it over to Mario for a further discussion of North American LTL.

Mario A. Harik - *XPO Logistics, Inc. - CIO & Acting President of Less-Than-Truckload*

Thanks, Matt. I'm going to focus my comments on 2 areas of LTL, where we're bringing a lot of fresh initiatives to the table. One is the action plan we began executing in October and the other is our strategy to accelerate growth going forward by making targeted investments in the business.

As you know, we had some year-over-year erosion in our operating ratio, despite reporting our highest third quarter revenue and adjusted EBITDA ex real estate. I want to be clear that we know exactly why we fell short on our operating ratio, and we're taking a number of specific actions to get it back on track. I'll walk you through it.

As you know, we've had an ongoing strategy of in-sourcing third-party linehaul transportation to use our own capacity. This strategy has worked well for us for years, but the third quarter was a tough time to be in-sourcing, particularly given the ongoing labor and equipment shortages. This impacted our network efficiency and reduced the amount of available capacity. Short-term, we'll be taking a more balanced approach to our linehaul needs. We understand the problem, and we own the solution.

I took over as acting President in October, and we immediately began executing on a 5-point action plan. All of our initiatives are underway. First, we're improving network flow with selective embargoes, where we limit the freight we accept at certain terminals for short periods of time. We're working one-on-one with those terminal teams to clear the way for more volume. The short-term cost is embedded in our guidance.

Second, we're driving multiple pricing initiatives to improve yield, capitalizing on the firm industry pricing environment. For example, we pulled forward the general rate increase from January to November. That's a 5.9% increase that went into effect at the beginning of this week. And we're instituting accessorials to enforce appropriate charges for trailers that get detained at their drop-off points. The same holds true for loads that require special handling, like oversized freight or irregular dimensions. If the nature of the freight means we can't fully optimize our trailer, we'll get paid more for that. Our pricing actions are already paying dividends, and we saw strong yield performance in October.

Third, we're ramping up the attendance at our XPO driver training schools to help mitigate the driver shortage. This year, we'll have 800 graduates in the U.S., and we're targeting more than double that number next year.

And fourth, on the equipment side, we have an XPO-specific solution to our most immediate need, which is trailers. We have a major edge here and it's going to get bigger starting in 2022. We're investing to significantly increase our production capacity at our company-owned trailer manufacturing facility in Arkansas. We expect to nearly double the number of units produced in 2022.

And fifth, as Brad mentioned, while all these initiatives are underway, we're also embarking on a 2-year plan to expand our U.S. network by about 900 doors or approximately 6%. Over the next 12 to 24 months, we'll make strategic investments in the business and our top 10 metro markets. We'll add doors across the network where they can improve our operating efficiency and grow our revenue and yield while benefiting as many customers as possible.

We're in the middle of the planning process, so we'll have more color on this when we give you our outlook next quarter. We expect to add at least half of the 900 doors in 2022.

That covers the plan we launched in October and our strategic investments in the business, and we will continue to focus on rolling out new technology to drive value in LTL.

LTL pricing is front and center in our tech agenda. It's our biggest opportunity to accelerate yield in the long-term. We're building out our data-driven tools to optimize rates for small accounts, and we use elasticity models to identify the best pricing.

Another big opportunity is network optimization and linehaul, where our annual spend is about $1.1 billion ex fuel. Our goal is to reduce the number of miles required to process a given amount of volume in our network. And we're automating the load-building process to get higher trailer utilization.

The next area is pickup and delivery, where we launched new planning tools earlier this year and have upcoming launches of new dispatch tools and dynamic routing enhancements. Our goal is to increase the number of stops per route and the average volume per route.

Our other big focus is dock productivity. Our XPO Smart productivity tools are in place across our network, and they have had an immediate positive impact that should gain traction when the labor market settles down.

Another area where we can enhance dock productivity is through door planning, which is how we position trailers on the dock to minimize worker movements. We have additional developments underway for LTL on the technology front, including a new web portal a new API features for our customers.

And finally, you may have seen the recent press coverage of our new hub in Chicago Heights. This terminal has significantly increased our capacity in a key metro area, and it will drive efficiencies across our network. It's a state-of-the-art facility with 264 doors and 150,000 square feet, and it employs around 250 people. All of our drivers are held to strict safety standards, but I'll mentioned that 25 of the drivers based in Chicago Heights have an amazing safety track record of driving either 1 million or 2 million miles accident-free.

More doors mean more top-line growth, more efficiencies and more yields flowing to the bottom line for our shareholders. This is the same strategy that's driving our capital investment plan moving forward. Our North American LTL business delivers a high return on invested capital, and we're extremely bullish about this opportunity to unlock more potential.

I'll close with a personal comment. I've spent a lot of time in the field over the last month, and it's very exciting to work in the trenches with our first-class LTL organization. I'm impressed by how deeply this team cares about serving our customers and how quickly they've embraced our action plan. These are the folks with their ear to the ground, and there's a lot of positive energy driving the future of this business.

As we take actions to course correct our network, in the fourth quarter, we expect adjusted operating ratio to track typical seasonal trends. This implies year-over-year erosion, similar to or slightly greater than what we saw in the third quarter. We expect to inflect back toward year-over-year improvement in the first half of 2022.

We look forward to driving significant positive developments in LTL in the coming year. We're continuing to target at least $1 billion of adjusted EBITDA in 2022. And we have a strong conviction that we'll generate hundreds of additional basis points of improvement in our operating ratio in the long-term.

With that, we're going to take your questions. Operator, please open the line.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today is coming from Hamzah Mazari from Jefferies.

Hamzah Mazari - *Jefferies LLC, Research Division - Equity Analyst*

My first question, I'd just like to address some of these to Mario. I guess, what exactly went wrong in Q3 in LTL? I know it's OR related, and you gave some color. But just as part of that, do you think you underperformed your peers in the quarter? And then you mentioned some of the strategic plan going forward. Maybe just some more color on that in terms of the confidence level on that and the execution risk on that strategic plan going forward.

Mario A. Harik - *XPO Logistics, Inc. - CIO & Acting President of Less-Than-Truckload*

Yes. Thanks, Hamzah. So when we look at the third quarter, despite having a record EBITDA and revenue, we underperformed on OR, so we had erosion of 190 basis points versus a lot of our peers that had improvements in their OR.

Now I mentioned in the opening remarks that we, as a carrier, have a higher dependency on purchased transportation. So these are -- we call them internally highway subservice miles, where last year in Q3, we had roughly 26% of our miles were highway subservice.

And we continued a long-term strategy to in-source highway subservice, which has fared well for us in the past, but it was a tough time to do this in a quarter where you have obviously labor shortages and equipment shortages, which put pressure on our linehaul network, and that caused our network to become less efficient, and the network flow was not as efficient as we would have liked it to be, which effectively increases the cost of being able to fulfill the service we expect. And it also reduced the amount of capacity we have in the network. So, when you combine these things, we -- this is kind of where we saw that OR erosion.

Now, we have an action plan, as I mentioned in the opening remarks. It's a 5-point action plan to address this issue. Number one, it's around the strategic embargoes, where for a selective number of sites, we meter the amount of freight that we are getting from our customers in those sites to improve the network flow. And we've seen great results so far; great feedback from the field. I've been spending a lot of time in our terminals over the last month, and it's good to see the impact that this is having in our operation.

The second area is around yield. Although we had record yield in the quarter, which is a 6% year-over-year improvement, and it accelerated from 4.5% in Q2, it still needed to be higher. We didn't move as quickly as we should have on raising prices on our customers, and we are taking action on this.

So, we already are seeing a very nice improvement in October of our yield performance. And the actions we took there, one was on contract renewals. We've seen a higher percentage on yield improvement there. We are charging our customers accessorials when they detain our trailers, so we can get more of that equipment back into our fleet. We are also charging them whenever they are shipping something that is irregular or long or doesn't fit our network and doesn't allow us to optimize our trailers as well.

And then we pulled our general rate increase from early next year -- usually we do it in Q1 -- to this Monday to also capitalize on the local accounts, getting more yield improvement there.

Now, the third area has really 3 components to it, which is adding capacity to our network. So when we think about capacity, it's about drivers, it's about equipment and it's about physical terminals, so doors and actual -- the physical space where we move the goods.

On the driver side, we have a competitive edge with our driver school, and we're investing more into these driver schools where, this year, we're going to graduate roughly double the number of drivers we had done in 2019. And we are looking to further double that number going into 2022. So that's going to be a solution for us to add more drivers to our driver ranks and help counter some of the driver shortages we're seeing in the industry.

On the equipment side, our biggest need is around trailers. So when you have inefficiency in your network, effectively, you need more trailer space to be able to -- and when you in-source also purchased transportation, you need more trailers. And we -- I was in our Searcy, Arkansas facility last week, and we're investing more CapEx, adding more production lines to be able to double the production of trailers going into 2022, as well.

And the last aspect of the action plan, which is more of a medium- to long-term growth strategy, is focused on adding doors in the markets where we are seeing higher demand from our customers. These are typically the key metro markets, and then investing in the physical footprint of adding terminals and expanding terminals from a doors perspective, and we're adding roughly 6% more doors than what we have today in the network over the next 12 to 24 months, so we can handle more of our customers' freight and capitalize on the hot market we're seeing in LTL.

But that hopefully gives you a good color on what happened one in Q3, the action plans we're taking to course-correct that moving forward and pivoting toward the growth strategy, as well.

Operator

Our next question is coming from Amit Mehrotra from Deutsche Bank.

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

Brad, on the LTL business, I'm not so focused on where we've been. I think the results are pretty clear, but I'm really focused on where we're going. And so what I'm trying to understand is the level of urgency in the organization, the level of urgency in your mind to get the LTL business back on a better trajectory. And is it fair to say that 3Q results is a bit of a kind of watershed moment for the company to kind of change course on the LTL business? So that's kind of the first question.

And just separately, the M&A market is very, very hot right now, as you know better than anybody. There's obviously several deals in the space in the recent weeks and months and quarters. How do you, in your mind, balance kind of the benefit of retaining businesses outside of brokerage and LTL with the potential benefits to accelerate the deleveraging of the balance sheet, which is obviously one of the key strategic priorities?

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

On the second question, the M&A, while I don't want to get into specifics of what we may or may not be doing on non-core parts of the business, to answer your question, the obvious advantage, if we chose to go that path is it would accelerate our getting to our goal of becoming investment grade.

I was very happy that we paid down $1.5 billion of debt this quarter. That was a real good move toward getting investment grade, but we have more ways to go. So if we chose to go down that path, it would just accelerate it.

With respect to your first question, we listen to our shareholders, and we listen to them very closely. Sometimes, we hear most of what they say, not all of what they say. So, we heard 2 things that investors told us over the last year. One was reduce your debt. So, we're making huge progress on that. Second was simplify the business model. The spin accomplished that. So, I think we heard those 2 things, loud and clear, and we acted on them.

The third point, I don't know if we heard it so well, which was you need to grow your LTL business -- not just sweat the assets and grow the margin and get great returns on capital, but grow top line. So, we have heard that now, and that is something we are going to do.

Now, with respect to the third quarter, I would say this: Even great companies stumble now and then. And we certainly did not stumble company-wide. We beat and we raised. So, I rest my case there. We certainly did not stumble in Europe. The numbers were great. It would be very difficult to make an argument that we stumbled in truck brokerage, since we have industry-leading results there. We stumbled in LTL. We were focused on other things and didn't keep our eye on the ball there.

We do have our arms around the issues there. We have been intensely focusing on this in the last 3 or 4 weeks, and we will continue to intensely focus on this.

With respect to your question about what's the level of urgency, we love solving problems -- that's how we create alpha. We have a tremendous track record of creating significant shareholder value over the long-term for our investors. And we will course-correct this LTL with a great level of urgency, and I'm confident we will.

Operator

Your next question is coming from Todd Fowler from KeyBanc Capital Markets.

Todd Clark Fowler - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Brad, to the last point on looking for growth within the LTL business. How do we balance or how do we think about some of the near-term actions and the impact on tonnage and what that means for growth here in the near term? And then can you also speak to service metrics during this time period? Were you able to maintain service? Or did service suffer as you went through some of the actions to basically free up some of the network fluidity?

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

Well, Todd, I think service levels for the entire industry, not just the LTL industry, but globally, transportation, wasn't functioning at peak efficiency in recent months due to the significant upsurge in volume, yet the shortages of labor and equipment, and we were not immune to that either.

With respect to what the short-term impacts will be on tonnage, the embargoes that we do selectively, they slow down tonnage a little bit here and there. The raising yield, okay, there's some elasticity on that. But overall, you'll see in the coming quarters a shift to growing the revenue line -- not immediately, but you will see that shift slowly and steadily growing the revenue line. And you'll see us investing more in CapEx, and you'll see us be more aggressive on raising rates. You'll see us being more aggressive on enforcing accessorials. So, there's a whole slew of initiatives we've got in place, and Mario summarized the top ones, that will allow us to regain our position in LTL.

Todd Clark Fowler - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

So Brad, you're saying that any deterioration in the service metrics would be consistent maybe with the industry? Is this kind of the comment that you're making?

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

I don't see the service metrics for the competition, so it's hard to compare them. But I would say that the industry as a whole suffered as a result of the shortages of equipment, shortages of labor and the big influxes of volumes.

And in a network business, in that part of the transportation supply chain, that suffers a little bit more because it's a network -- you tickle it here and it laughs there; you pinch it here and it cries there. I will say that we've got 25,000 loyal customers in LTL, and customers choose carriers that meet their service expectations.

Operator

Our next question is coming from Chris Wetherbee from Citi.

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

I wanted to get a sense of what you think the capacity of the network is today. So I understand you're adding 900 doors, which is about 6% of the capacity. I look back a few years, you guys are down in terms of tonnage, about 6% from where you were in 2017.

So I just want to get a sense of maybe where you think the capacity is today. And then was this just simply the linehaul piece that was the constraint in the quarter, that you didn't see the sort of sequential uptick in September in terms of tonnage that your peers did? So I just want to make sure I understand sort of the dynamics around capacity. And what do you think this will actually drive in terms of the next 24 months as you roll out these new doors?

Mario A. Harik - *XPO Logistics, Inc. - CIO & Acting President of Less-Than-Truckload*

You got it, Chris. This is Mario. When we think about excess capacity, we roughly have about 15% excess capacity when it comes to the terminal footprint. However, it's not evenly distributed. And so there are pinch points in certain markets, and when we think about our plan going into next year, opening up the additional 6% of doors, we are looking at metro markets where we are seeing higher demand from our customers. And we already cover more than 99% of the zip codes in the country, so we have line of sight to the demand in the many of these markets. And in those markets where we do have pinch points is where we're going to either opening terminals or adding doors as we head into 2022.

Now the physical capacity is one aspect. However, obviously, the 2 other aspects of capacity are drivers and equipment. And as we all know, the driver shortage has been impacting our industry significantly, and this is where we are doubling down on both our recruiting efforts and our driver schools to graduate more drivers to fill the gap there on the short term.

Now the second part of your question on linehaul. So typically, the way linehaul works, when you in-source purchased transportation, you effectively break one longer haul that you're doing with a third-party carrier into smaller hops in the network. So when you have a driver shortage in some parts of these segments, effectively, you add to either linehaul miles, where you are diverting trailers to another facility, or you add cost on rehandling on the dock as well. So that's the dynamic when you have an imbalance in the driver -- when you have a driver shortage and you have an imbalance. And while we kept on in-sourcing purchased transportation, that impacted our capacity in certain markets where we didn't have enough capacity to meet our customer demand.

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

Okay. That's helpful. I appreciate that, Mario. And then in terms of some of the actions you're doing, you said that you're metering volume coming in. You said in October, there was, I think, a positive response, generally speaking, probably to network fluidity is the point that you were making.

Can you give us a sense if you can see tonnage growth in the short run as you're going through this process? I'm thinking specifically about 4Q. I don't know if you want to give us an update on where tonnage was in October. But I want to get a sense of do you think that you could still grow tonnage while you're going through the short-term fix to the network.

Mario A. Harik - *XPO Logistics, Inc. - CIO & Acting President of Less-Than-Truckload*

Yes. I'll give you color kind of what early in the quarter looks like. So one on the yield side, the pricing actions we have taken have shown a very nice acceleration of yield improvement year-over-year in October. However, tonnage with the embargo actions we've taken to meter some of the freight, and as we take this corrective action, we would expect tonnage to be soft in the fourth quarter as we are taking those corrective actions.

And when we look going into next year, as we clear the way for more volume and add more of that capacity on the driver side then on the trailer side, we expect to have an inflection point in the first half of the year on both OR improvement and volume improvement as well.

Operator

Your next question today is coming from Jordan Alliger from Goldman Sachs.

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

Just a couple of questions. One, can you talk about your strategy of using purchased transport going forward, since that seemed to be a bit of an issue in the quarter? Is that, at least in the near term, expected to increase? And then, in terms of the inflection on OR, to get to that $1 billion EBITDA number, what sort of improvement are you currently contemplating next year?

Mario A. Harik - *XPO Logistics, Inc. - CIO & Acting President of Less-Than-Truckload*

Yes. So let's start with the first part of the question on purchased transportation. So on the short-term, and this goes from this quarter -- Q4 and going into Q1 -- we are taking a more balanced approach on purchased transportation. So, we are analyzing on a lane-by-lane basis.

We all know what's happening in the truckload market rates. So, these rates have gone significantly up. So, we are going lane-by-lane and analyzing what could be the cost to outsource that to a third-party versus using our own drivers for it, and tying it back to the demand we're seeing from our customers in those markets.

So, on the short-term, we're going to take a more balanced approach on purchased transportation that leans towards adding more purchased transportation, if the rates are right and depending on which lanes we can get a good rate.

So as an example, if you look at outbound from Southern California today, the rates are just completely out of typical market norm, given the tightness we're seeing in that market. However, other parts of the country, like in the Midwest or the Northeast, you would have much more desirable rates on the truckload side.

On the long-term, our strategy to in-source purchased transportation will continue. So, as we clear the way to adding more drivers and more equipment, we do believe that we want to handle more of the linehaul network on our own equipment with our own drivers, but that's going to be back on the long-term strategy.

Now in the -- going back to our guidance --- or, our targets for next year, we are targeting at least $1 billion of EBITDA for the full year 2022. When it comes to OR, we will give more color on that going into the next --- so, on the next earnings call, we'll give a bit more color on what we expect on the OR improvement for the year to hit that number.

Operator

Our next question is coming from Brandon Oglenski from Barclays.

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

I know we've had a lot of focus on LTL, but can we talk about the brokerage business and some of the efficiencies that you guys are seeing there? I think a lot of it is being driven by your XPO Connect app. And can you talk about the sustainability of brokerage earnings going into next year, just given that we have such elevated rates on the trucking side, like can this earnings base be maintained? Or do we need to think that, that could reset?

Drew M. Wilkerson - *XPO Logistics, Inc. - President of Transportation -- North America*

Brandon, this is Drew. On XPO Connect, we started it over 10 years ago, and we had 3 things in mind. The first thing was our customers. And so, when we built this for our customers, we really wanted to be able to give them massive amounts of data to help them make the best transportation decisions possible.

When you look at the vendors, or the carriers, we want to be easy to do business with, and that's something that shows, because on a 30-day run, 77% of our carriers are likely to come back to us.

And the last piece was for the employees. We continue to see improvement with our employees and the productivity off of them. If you look at the volume over the last 5 years, it's increased 60%. And we have added less than half of that --- or, about half of that on headcount. So our volume continues to outpace headcount overall.

As far as the sustainability on the market, I don't think anybody has got a crystal ball for where the market is going. I can tell you right now, we are confident that we will continue to take share overall. We've proven that we can take share in a tight market or in a loose market, and we've got a great group of proven operators who, on average, our director level and above have with XPO for over 8 years. And so that team has had success in both a tight market and a loose market, and we're confident that we'll continue to do both.

We have very strong relationships with our customers. That's evidenced by growing volume 37% on a year-over-year basis. And with our top 20 customers, they depended on us in the tightest capacity we've seen and grew volume 45% on a year-over-year basis.

Operator

Your next question today is coming from Jason Seidl from Cowen.

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

I hate to go back to LTL here, but I'm going to give it a go. Just wanted to think about sort of 3Q to 4Q. You sort of laid out some of your OR targets. I'm surprised we're not going to see, I think, a little bit more sequential improvement, only because you are pulling up your GRI, which is 5.9%. And then you have pretty strong rate increases there that you had in the previous quarter of 8%. What should we think about the puts and takes for the OR for at least the near term? I understand the long-term plan.

Mario A. Harik - *XPO Logistics, Inc. - CIO & Acting President of Less-Than-Truckload*

Yes. So going -- when you look at OR going into Q4, so we expect the fourth quarter to have typical seasonal trends coming from Q3, which again will make the year-over-year erosion similar or slightly greater to what we saw in Q3.

Now the dynamics of the quarter, as you said, so we're seeing already a very nice improvement for yield in October based on the actions that we have taken so far, on all the things I mentioned earlier on with accessorials, with the higher contract renewals, with all the different pieces there.

However with the embargoes we implemented in October, that effectively created a drag for us in October when it comes to volume. So the dynamic of the quarter will be you would see higher yield, you would see softer volume, and that will contribute to what our OR target looks like for the quarter.

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

Okay. So it's going to be more on the embargo side. And on your GRI, you're really the first person I've seen to push the GRI into November. FedEx freight came out, but there's -- their GRI, not some of the surcharges, is not taking place until January. Do you think that you could suffer some on the tonnage area with that? Or do you think that the market is just so hot it's not going to matter?

Mario A. Harik - *XPO Logistics, Inc. - CIO & Acting President of Less-Than-Truckload*

Listen, when we look at the current market, it's a pretty firm pricing market. So there is more demand in the market than there is capacity in the market. And then we believe -- the way the GRI works for us, it impacts our local accounts. And we also have spent a lot of time with our sales team to get that feedback on where we need to be. And we felt that, that was the right action to take.

We haven't, so far, heard any pushback or negative feedback from customers. They understand that in this market, there's cost inflation in terms of driver wages and getting equipment and all the things that they see in their supply chains. So it's been pretty well received so far.

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

Mario, if I could sneak one more in here. Vaccine mandate, wanted to get your thoughts on that. I don't know if Brad wants to chime in as well. That's a pretty hot topic in the trucking market. Obviously, the ATA has pitched the administration that the industry should get an exemption. I, of course, agree wholeheartedly with them, but I would love to hear your thoughts on that.

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

My personal opinion is everyone should get vaccinated. I think the evidence is very clear that people who are vaccinated get infected less. And when they do get infected less, they get hospitalized less than nonvaccinated people. And for sure, the data shows that if you're vaccinated, you die less. So there's very compelling reasons to get vaccinated.

Having said that, there's a lot of resistance from a lot of people to get vaccinated. And one, the government needs to take into consideration the practical ramifications of policy. And in the trucking industry, in particular, there's probably a little bit higher percentage of people who are anti-vaxxers, so to speak. And if that policy went in right away, it probably would not, short-term at least, have a good effect. You'd see a lot of labor leave the market. So, that's my overall view.

Operator

Our next question today is coming from Ravi Shanker from Morgan Stanley.

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

Mario, maybe if I can start with you. A, congratulations on the new role. B, when you look at the old hat you were wearing, or maybe the current hat as a CIO, I think a lot of the opportunity on the tech side was in LTL. But now that you've actually got under the hood of the LTL business and got your hands dirty, if you will, are you seeing any incremental opportunities on the tech side that make you excited about what you can do with the LTL business?

Mario A. Harik - *XPO Logistics, Inc. - CIO & Acting President of Less-Than-Truckload*

Yes. First, thanks, Ravi. And as you said, I've been very involved in our LTL business in all the technology initiatives that we have been rolling out. And if you go back over the last 5 years, we've improved our operating ratio by 1,000 basis points and nearly tripled the profitability of this business, and tech had a big component to play in that.

Now going forward, I mean, obviously, in the role of running the business, I have much more impact in terms of accelerating some of these initiatives and getting them out in the field on the medium to long run. And if I break it down, the biggest opportunity continues to be in pricing, where pricing is all about using price elasticity to better understand where customers are willing to pay in a high elasticity model with a firm pricing environment.

And to give you an example, in our brokerage business where we've had 10 years of experience using machine learning to optimize pricing, you can see that evident in how well we price and the margins that we are getting on that business as well. So we continue to believe there's a lot of opportunity in pricing and improving technology there.

The second area is around linehaul. When we think about linehaul, there's roughly $1.1 billion worth of spend ex fuel, and it's an area that the more -- so 1% improvement, obviously, is $11 million of EBITDA. And we have improved, we already have good technology there, and we're going to continue to improve that. A lot of it is optimizing the load building process and where we put, for example, freight within a trailer to reduce the amount of rehandles we're seeing in the network as an example there.

The third area is around pick up in delivery. We launched new planning tools earlier this year. These were tools that allowed our planners -- it's all web-based, just beautiful-looking user interfaces, easy to use, and that helps our planners do a better job in their P&D routes. And we're in the process now of launching our new dispatch tools and then, going into next year, launching additional route enhancements that would allow us to increase the amount of weight we're putting in a certain trip or increase the number of stops on a certain trip as well.

And then the next area is around dock productivity. So as I mentioned in my opening remarks, Smart is already deployed in all of our terminals. And Smart allows us to make sure we have the right amount of dock workers for the amount of work that we need to do. And we're also now launching a new technology that allows us to better position trailers on the docks, so we can minimize worker movements between the doors, so we can improve efficiency by minimizing travel on the dock as well.

Then finally, with customers. I spend a lot of time with customers. A lot of their feedback is -- we are launching new API technology that is making our integration with customers go easier. A new web portal, we're currently in pilot. We're very excited about it, and we're getting great feedback from customers on it. So we're definitely accelerating the tech agenda. And similar to what we've done in brokerage of getting outsized results driven by technology. We believe that the LTL business will continue to use tech to better optimize the business.

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

Very helpful. And maybe a quick follow-up to Brad. Brad, increasing resource allocation to LTL makes a lot of sense given the fundamentals of that business. But what about the brokerage business? Obviously, you guys are firing on all cylinders there. What's your strategy to resource allocation there? Is it more of a milk the cycle for its worth? Or do you feel that there's real share gain and growth potential there in the long-term?

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

I think we will continue to take share. I think the investments we've made in XPO Connect over the last decade have been consistently paying off, and we've been outperforming the market and outperforming the market in brokerage by a significant amount.

If you look in this particular quarter, our loads are up 37%. And if you look at the volume from our top 20 customers, it's up 45% year-over-year. If you look at our net revenue, it was up 62%. And you look at XPO Connect specifically, year-over-year carrier is up 37%. Carrier usage has doubled. Customer count is up 3x year-over-year. You look at the API-driven transactions, they're up fivefold year-over-year.

So XPO Connect is working very, very well, and that's enabling us to meet customer demands, to meet them where they want to transact with us. So XPO Connect is very, very sticky. And 77% of the carriers who do business with us on Connect, come back within 30 days and do more business with us. So it's a virtuous cycle.

Now with respect to your question about allocating resources. In terms of CapEx, truck brokerage doesn't need much CapEx. It's really just the IT and some of the overhead, which is really not even CapEx, it's OpEx. So it just doesn't need a lot of CapEx. The real place we're going to put CapEx in is going to be on LTL, so that we can do what our shareholders have told us, which is to grow, grow in LTL. For that, we've got to invest in it. So that's what we'll do.

Operator

Our next question today is coming from Tom Wadewitz from UBS.

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

Wanted to ask, I guess, to start with on -- I know you've had a lot on LTL, but what do you think changed sequentially? Was it -- I want to understand it a little bit better. Was it the labor attrition picked up? I guess, in terms of the change on linehaul, I mean, were you at 26% outsourced linehaul in the second quarter and then you went to 24% kind of too quickly. I mean it seems like a number of things that are kind of intertwined.

And I think I'm just trying to understand partly what is just the macro is a lot tougher, which, obviously, you work harder to improve, but the macro -- the labor market may not improve. So I wanted to see if you could give some more perspective on really what changed sequentially second quarter versus third in LTL?

Mario A. Harik - *XPO Logistics, Inc. - CIO & Acting President of Less-Than-Truckload*

Yes. You got it. So as I mentioned earlier, as we had the long-term strategy to in-source our purchased transportation, but when we think through the summer, especially with the COVID variant picking up and the driver shortage, effectively, that wasn't the right time. It was a tough time to be in-sourcing purchased transportation.

So we -- when we in-source that, we effectively move drivers in our network between city and linehaul operations, but there wasn't enough drivers given the shortage. So it was too quick of a move in a market where you have a driver shortage.

So moving forward, as we pivot from that, so one, we're going to take a more balanced approach to look at -- depending on the rate for certain HSS lanes, or purchased transportation lanes, we're going to make the right decision for the business on the short term. And also we're accelerating our driver hiring.

Now I mentioned driver schools earlier on. If we look -- obviously, when we think about hiring drivers, that includes both hiring externally as well as internally. And this is where we're doubling down on both of these. I mentioned already doubling the number of drivers we're getting from our driver schools this year versus '19, obviously, and it was roughly 6x what it was versus last year and doubling that going to next year.

And we're also doubling down on our efforts where we're adding -- increasing the size of our recruiting team. We're using social media. We're adding benefits for -- between referrals or starting bonuses in some markets for drivers to capture that portion of it.

Now for us -- but going back to Q3, September really was the pivot point where we've seen the threshold of drivers versus how much we had in-sourced on purchased transportation hit a bottleneck that caused the network to become inefficient. And when that happened, we effectively didn't have enough capacity to pick up customers' freight and that created cost inefficiencies in the network as well.

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

What was -- how much did the linehaul outsource -- or excuse me, in-source increase 2Q to 3Q?

Mario A. Harik - *XPO Logistics, Inc. - CIO & Acting President of Less-Than-Truckload*

So on a Q3 basis, it was 26% to 24%, and it was roughly around the same in terms of year-over-year in Q2 as well.

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

Okay. That makes sense. Can you offer any quick thoughts on just what your macro assumptions are for the $1 billion EBITDA in LTL in 2022? Is it like, labor market wise, do you assume stability? Or do you assume some help that the labor market eases a bit to get to that significant improvement in 2022?

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

It's Matt. In the short run, we expect the macro conditions that we see today, including all of the realities that we see in terms of labor and capacity.

We do assume that, over the course of 2022, there's some normalization on both of those fronts. But to be clear, the key to us getting to those numbers, we understand, is achieving the goals that we've set in the 5-point action plan, particularly with relationship to network efficiency and network flow in the short run and achieving the results that we expect on head count and equipment from the initiatives that we outlined earlier.

Operator

We've reached the end of our question-and-answer session. I'd like to turn the floor back over to management for any further or closing comments.

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

Thank you. So I'll leave you with 4 points. In LTL in the third quarter, it obviously was not our finest hour. However, we have our arms around the issue, and we're dealing with it with great urgency, and I'm confident that we will achieve our goals there. In terms of truck brokerage, we're just continuing to kill it in truck brokerage. The tech investments over the last decade are clearly paying off.

The biggest -- the third point I'd point out is the pricing environment. Inflation is not a good thing for consumers, but it's not necessarily a bad thing for companies within the supply chain, assuming you can raise your pricing in excess of your price inflation, which we should be able to do. So we should be benefiting from the firm pricing environment, and we've seen ourselves be able to execute that in Europe. We've seen ourselves being able to execute that in brokerage and all the lines of business within brokerage. And we are now going to push the pedal to the metal on exerting pricing power in LTL.

And the fourth point I would end with is, I'm just very delighted that we paid off $1.5 billion of debt in the quarter, and we've made great progress towards our goal of becoming investment grade.

So with that, I thank everyone for participating in this call, and we'll be talking to you all in due course. Thank you.

Operator

Thank you. That does conclude today's teleconference and webcast. You may disconnect your line at this time, and have a wonderful day. We thank you for your participation today.