Q2 2020 XPO Logistics Inc Earnings Call

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PRESENTATION

Operator

Welcome to the XPO Logistics Second Quarter 2020 Earnings Conference Call and Webcast. My name is Rob, and I'll be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded.

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

During this call, the company 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. You can find a copy of the company's earnings release, which contains additional important information regarding forward-looking statements and non-GAAP financial measures, in the Investors section on the company's website.

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

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

Thank you, operator. Good morning, everybody. In addition to my remarks today, you'll hear from David Wyshner, our Chief Financial Officer; Matt Fassler, our Chief Strategy Officer. And also, for the Q&A portion of the call, we have Tavio Headley, our Senior Director of Investor Relations; Meghan Henson, our Chief Human Resources Officer; Ravi Tulsyan, our Treasurer; and Kyle Wismans, Senior Vice President of FP&A.

The second quarter was dominated by the severe challenges of COVID-19. Nevertheless, we did deliver better-than-expected revenue, adjusted EPS, adjusted EBITDA and, notably, free cash flow. For us, the trough was in April in both North America and Europe. Since then, we've seen a recovery in Europe with a more recent rebound in North America, and all of our sites are open. Each month in the quarter showed sequential improvement across our operating regions.

Organic revenue for the company as a whole has gone from being down 21% in April year-over-year to down just 10% in June, and we've continued to gain ground in July. The improvement has been broad-based in both transportation and logistics. In North American LTL, for example, our tonnage per day was down 24% in April year-over-year, but down only 13% in June. We continue to regain tonnage in July.

In Europe, our LTL pallet count per day at the end of June was up from the trough in France by 49% and in Iberia by 44%. The U.K. was up 25% from the trough. And our European logistics business came back strong in the quarter with a 7% increase in year-over-year revenue per day in the month of June. These are all positive trends going into the back half of the year.

I also want to mention the 3 executive appointments we made this week. Eduardo Pelleissone is our new Chief Transformation Officer and Alex Santoro is Executive Vice President of Operations. These are 2 rare, talented operators who will work with our business leaders to turbocharge our profit improvement initiatives. We're excited to have them both on board. I'm also extremely pleased that we have our first Chief Diversity Officer in LaQuenta Jacobs. LaQuenta has an impressive record as a champion of diversity at blue chip companies. She'll be leading initiatives that are high priorities for us, reporting directly to me.

So to wrap it up, I'm proud of the extraordinary focus our organization has placed on keeping our employees safe throughout the pandemic while keeping supply chains moving for our customers. There are still a lot of unknowns with COVID, but our positioning is strong. For years, we've been investing in our vision for the future of supply chains, including our e-commerce capabilities, intelligent automation in our warehouses and customer solutions that are in high demand for outsourcing. These industry trends have been accelerated by the pandemic.

Finally, I want to say again how grateful I am to our employees for their intense dedication in such unusual times. It's a privilege to lead Team XPO.

And with that, I'll turn the presentation over to David. David?

David B. Wyshner, XPO Logistics, Inc. - CFO

Thanks, Brad, and good morning, everyone. Today, I'd like to discuss our second quarter results, our balance sheet and liquidity and our outlook.

In the second quarter, we generated revenue of $3.5 billion, adjusted EBITDA of $172 million and an adjusted loss per share of $0.63. All 3 figures reflect year-over-year declines due to COVID, but they are all better than we expected at the beginning of the quarter. Matt will review the segment detail in a few minutes.

We generated $214 million of cash flow from operations in Q2, spent $116 million on CapEx and received $23 million of proceeds from asset sales. As a result, we generated positive free cash flow of $121 million in the quarter. This brings our year-to-date free cash flow to $216 million, which represents a year-over-year increase of $66 million despite our having $75 million of cash outflows this year related to our exploration of strategic alternatives.

We've been able to generate positive free cash flow during the pandemic by managing working capital aggressively, turning our receivables into cash. We became even more disciplined about collections in the COVID environment, working with our customers to reduce our receivables and staying disciplined with respect to payment terms. We continue to use trade receivables programs, including our European securitization, to manage our working capital.

We didn't repurchase any shares in the second quarter, so we continue to have $500 million of authorized share buyback capacity. We throttled back our planned capital expenditures dramatically at the start of the quarter, but have begun to reopen the spigot a bit as demand and new business opportunities have rebounded.

We currently estimate that our gross CapEx will be $450 million to $475 million this year, which is up from our May estimate of around $400 million, but down about 26% from our pre-pandemic plan. And we estimate that as a result of our regular-course asset sales, our net capital expenditures will be $250 million to $300 million this year.

Even though financial markets have normalized significantly over the last 4 months, maintaining strong liquidity continues to be a top priority for us as an organization. We issued $1.15 billion of 6.25% 5-year senior notes in April and May. The proceeds are part of our $2.3 billion cash balance at June 30. This cash, combined with available debt capacity under committed borrowing facilities, gives us total liquidity of $2.8 billion at quarter end.

Our net leverage at June 30 was 3.5x adjusted EBITDA, which is in the middle of our targeted range of 3.0 to 4.0x. We have no significant debt maturities until mid-2022. Our liquidity position is strong.

In the second quarter, our adjusted EBITDA was right in line with what you would expect based on the combination of our second quarter 2019 results, a 17% year-over-year reduction in revenue due to the pandemic, the 77% variable, 23% fixed breakdown of our expenses, and the nearly $50 million of COVID-related costs we incurred. We've been seeing sequential improvement from month-to-month since April with that favorable trend continuing in July. Revenues in the first half of the month were down high single digits year-over-year. And we estimate that our COVID-related costs will be $10 million to $25 million in Q3.

Based on these conditions, we expect to generate at least $350 million of adjusted EBITDA, including COVID-related costs, in the third quarter. This means we're positioned to outperform the results that would be implied by a high single-digit year-over-year revenue decline and our mix of variable and fixed costs. This is because of benefits that we expect to realize in Q3 from operating initiatives, restructuring programs and other cost-saving actions that we've implemented.

On the cash flow front, with us having generated more than $200 million of free cash flow in the first half, we continue to be confident in our ability to deliver hundreds of millions of dollars of free cash flow this year.

Lastly, COVID-19 clearly dominated the second quarter of 2020. Revenues bottomed in April and have been recovering ever since. Throughout the quarter, we protected our employees, kept serving our customers and adjusted our variable costs to align with dramatic declines in demand. We also solidified our liquidity, continued to generate significant positive free cash flow, implemented cost-saving actions that will benefit future quarters and invested in technology. As a result, we expect the third and fourth quarters to be much stronger than Q2, and we are enthusiastic about our longer-term prospects as a leader in the markets we serve.

With that, I'll turn things over to Matt.

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

Thanks, David. I'll review the second quarter income statement and shed some more light on the trends we've seen in July.

Starting with our transportation segment. Segment revenue was down 22.6% in the quarter year-over-year, and organic revenue was down 19.3%. Adjusted EBITDA declined by 60%. This included $27 million of costs related to COVID, primarily in our North American LTL unit.

LTL tonnage per day declined by 19% in Q2 versus the prior year, primarily due to weak activity levels in industrial, manufacturing and automotive. April was the trough, and the business gained momentum as we moved through the quarter. While we did well in consumer staples, this vertical was not enough to offset the shutdown in the industrial economy.

As industrial sectors reopened, our trends improved. LTL tonnage was down year-over-year by 23.5% in April, 20.8% in May and 12.8% in June. Improvement continued in July. Yield, excluding the impact of fuel, improved 1.9% year-over-year. Yield growth in July is in line with Q2.

Our LTL price increases on contract renewals remained solid, up 3.7%, which kept us on pace with the Q1 increase. Our adjusted operating ratio in LTL was 90.1% for the quarter compared with 80.3% a year ago. The biggest driver of the change was lower tonnage, and we also had a negative impact of about 250 basis points from $20 million of COVID costs. These drags were offset in part by the improvement in yield.

We were also effective at controlling key variable costs, including P&D, dock operations and line haul. Our XPO Smart productivity tools are proving valuable in this environment. Bear in mind that this was just the second full quarter since XPO Smart was rolled out nationally in our LTL network. The analytics are driving up dock productivity by 6.5% on average year-over-year. We're encouraged by the early results, and we expect the improvements to compound going forward.

We also grew load factor by 3.9% and improved empty miles by 24%, better than the 15% decline in shipments. We expect the combination of a better revenue outlook and strong expense management in LTL to produce a significant sequential improvement in adjusted operating ratio in Q3 with much more modest year-over-year erosion.

Within our freight brokerage business, truck brokerage delivered a strong performance in a volatile market. Revenue fell 8%, but net revenue rose 3%. Brokerage volumes troughed in May and rebounded strongly in June. And we posted solid year-over-year increases in net revenue margin each month in the quarter. We procured capacity exceptionally well, buying at a 7.5% discount to the market, aided by the pricing tools within our XPO Connect platform.

XPO Connect continues to drive significant efficiencies in our truck brokerage service. In the second quarter, the load count was essentially flat with Q2 last year, and we handled it with 14% less headcount. Intermodal revenue was down sharply, reflecting the shutdown in automotive production. Intermodal revenue trends began to recover in June and have improved significantly in July as truckload capacity tightened.

Last mile was a real highlight for us in the quarter. Revenue increased 3% year-over-year, while net revenue dollars rose 11%. Net revenue margin rate in last mile increased by 270 basis points to a record 37%. And here again, revenue trends accelerated as the quarter progressed. Our last mile specialization in heavy goods continues to benefit from the growth of e-commerce, and we saw strong demand for home improvement goods and exercise equipment. This was partially offset by slower appliance installations due to COVID restrictions.

Turning to Europe. In our transportation business, Q2 revenue declined by 29% versus the prior year. Organic revenue, which excludes the impacts of FX and fuel, was down 23% for the quarter as a whole. Importantly, the year-over-year trend in organic revenue growth became more positive throughout the quarter. We were down 37% in April when the government lockdowns in Europe sharply curtailed our automotive, industrial and chemical customers. We rebounded to a 20% decline in May and a 14% decline in June.

The theme for the quarter in European transportation was "first in, first out". Among our larger countries, France and Spain locked down first and recovered first. The U.K. locked down several weeks later. The timing of the U.K. trough recovery is tracking later as well, and the curve of the recovery there has been more subdued. Overall, July market conditions have continued to improve for European transportation.

Moving on to our logistics segment. The contractual nature of this business mitigated the impact of COVID, as did our vertical mix and the embedded relationships we have with key customers. Logistics segment revenue was down 8% year-over-year for the quarter, and organic revenue declined 6.5% - again, improving each month. Adjusted EBITDA declined 39%, including the impact of $19 million of COVID costs.

In North American logistics, revenue declined 11% versus Q2 last year. We had solid growth in e-commerce and omnichannel retail, along with good results in consumer packaged goods and consumer technology. This was offset by the elimination of lower-margin business and by temporary shutdown requests from a number of our customers. At the peak of the pandemic, 8% of our sites were impacted by closures. And now all of our sites are up and running.

In logistics, as in LTL, our proprietary XPO Smart tools are driving productivity and cost efficiency. Nearly 2/3 of our warehouses utilize XPO Smart, and we're seeing an average labor productivity improvement of 5%. Some individual sites are much higher. This tech is still in the early innings of the value it can bring to the business.

Also, I'm pleased to report that XPO Direct, our shared-space distribution network, operated solidly in the black for the second consecutive quarter. The secular growth of e-commerce is driving more opportunities with omnichannel retailers.

In Europe, logistics revenue declined by 6% year-over-year. FX had a negative impact of about 2.6 percentage points on revenue. Importantly, organic revenue for European logistics turned positive in the month of June. Consumer verticals represent about 85% of our European contract logistics revenue, with the vast majority related to either e-commerce or food and beverage. Consumers leaned into these verticals during the pandemic, and we were happy to keep those goods flowing. We're encouraged by how well this business is performing, and we see additional opportunities to grow the top and bottom lines.

We're rolling out XPO Smart across Europe to drive labor productivity in our logistics warehouses. We had a soft opening for our warehouse of the future in the U.K. last month, which kicked off a 15-year contract with Nestlé. And the trend toward near-shoring creates additional potential business for us. Our acquisition of logistics operations from Kuehne+Nagel in the U.K. is on track to close this fall. That's an overview of the operating trends that underlie our Q2 results.

Moving down the income statement. Interest expense was $82 million in the quarter versus $72 million a year ago. Our GAAP effective tax rate rose to 35% from 24% a year ago. Our weighted average diluted share count was 91 million.

In a loss-making quarter, diluted shares outstanding don't include common stock equivalents. Our basic share count was down slightly from Q1 and from the year-ago number, reflecting the impact of our first quarter share repurchase activity. Our diluted loss per share was $1.45 for Q2 versus earnings per share of $1.19 a year ago. And our adjusted diluted loss per share was $0.63 versus EPS of $1.28 a year ago.

I want to note 2 items in our reconciliation of GAAP to non-GAAP metrics. We incurred $50 million in pretax restructuring cost in the quarter, primarily for severance. The pandemic led us to take a deeper dive into our cost structure and significantly reduced our overhead costs, particularly in Europe. This will drive approximately $100 million of annualized cost improvement. We expect to achieve this run rate by the middle of 2021.

The other item is the $46 million we booked in transaction and integration expenses in the quarter, primarily associated with our exploration of strategic alternatives. The largest piece of this relates to employee retention.

To summarize the second quarter, we responded to the pandemic by taking care of our employees, looking after our customers, protecting our liquidity and cash flow and rightsizing our variable costs to market conditions. As David mentioned, the adjusted EBITDA we delivered was in line with our mix of fixed and variable costs. In Q3, we remain focused on all of these critical efforts. At the same time, our operating environment is becoming increasingly stable. And we're directing more of our attention to our strategic profit initiatives, particularly XPO Connect and other technologies that can leverage the return of demand.

We now have more than 62,000 truckload carriers registered on XPO Connect globally. Downloads of our Drive XPO app grew 87% in the 3 months of Q2 versus Q1 and now exceed 150,000 downloads in total. And we've more than doubled the number of customers on the platform in the same period.

In LTL, we continue to make headway with our pricing initiatives, particularly as we gauge price elasticity, digging deeper into the full cost profile of each RFP. And we're expanding the data we use to optimize the line haul portion of LTL in terms of visibility, compliance and routing.

The opportunities within contract logistics are also compelling. Our capabilities with advanced automation are both a driver of new business and a competitive advantage. Customers who explore in-house robotics options often come to the conclusion that the cost of entry is high and the solutions can be tough to implement. Our first-mover advantage with goods-to-person systems and collaborative robots is leading companies to outsource these projects to us.

Another tailwind in contract logistics is that retailers are coming to us for more e-commerce capacity. In the short run, customers need interim capacity to manage peaks in demand, especially since the pandemic has made buying patterns less predictable. For the midterm, they're interested in arranging additional distribution centers for supplemental capacity on a regional basis. And longer term, retailers and brands are assessing transformational changes that de-risk their logistics networks. We can meet all of these needs.

I'll close by mentioning a few other highlights of the quarter. XPO was once again recognized by Gartner, which named us a worldwide leader in their Magic Quadrant of 3PL providers. This was the third straight year that we were designated a leader by Gartner. Also in the quarter, we were proud to provide critical support to the City of New York's Office of Emergency Services during the peak of the pandemic.

And the Tour de France race is scheduled to start on August 29 in Europe. 2020 marks the 40th anniversary of our partnership with this celebrated event. We're proud to help bring some much-needed sport to the world stage. Not only will our trucks and drivers cover every kilometer of the course - for the first time, 2 of our eco-friendly, natural gas-powered trucks will be at the finish line when the competitors arrive in Paris.

With that, I'll turn the call back over to the operator, and we look forward to your questions.

QUESTIONS AND ANSWERS

Answer – Operator: (Operator Instructions) And our first question is coming from the line of Ravi Shanker with Morgan Stanley.

Answer – Ravi Shanker: Brad, I think you probably have more insight into global supply chains than just about anybody else out there. So would love your thoughts on how you see the world changing as we emerge from the pandemic, especially with respect to near-shoring and running supply chains as tight and quickly as we have the last couple of years.

Answer – Bradley S. Jacobs: Ravi, the economy, obviously, is way better than it was a few months ago and better than we thought it would be, but it is certainly not back to where it was pre-pandemic. The good news is that every month has been better than the previous month and, little by little, business is trending back towards normal.

If you look at it geographically, Europe is ahead of the United States. That's not surprising. COVID started there earlier, and the governments mandated complete nationwide lockdowns right away. We're seeing parts of our business in France almost back to pre-COVID levels. In Spain, despite recent surges in the infections, transportation revenue is actually up year-over-year in July. In our U.K. transportation business, it's recovering, but a little more subdued than the continent.

If you look at the organic revenue growth in European supply chain, it was positive in June. It was plus 7%. So there are some encouraging signs, but we're certainly not out of the woods yet. If you look over here in North America, I think the rebound is real, but it's in an earlier stage and not as uniform as Europe. In the U.S., our business improved in July versus June even though COVID cases were going up, and I guess the best example of that would be LTL shipments. LTL shipments grew meaningfully from April, where they were down 22%, to July, where they're down single digits. So it's a big contrast between April down 22% and July down single digits.

I think also, to answer your question, you have to look at the different verticals, because there are definitely different industry trends by vertical. Trends in e-comm have not only been great, but they've accelerated, and we believe that's permanent. And because we're the largest last mile logistics for heavy goods provider in the United States, we have good insight into what's going on there, and there are big upticks in the e-comm activity in big and bulky, primarily in home improvement - because people are at home - and exercise equipment - because we're at home.

So people are going out less, but they're still shopping for goods, increasingly online. We move goods! So, if consumers are not going to theaters, to sports and to restaurants, that's not great for society and for the overall economy, but it's more germane to us, what's going on with the purchasing of goods. And that's positive. I mean, it's negative to what it was pre-pandemic, but it's getting more positive each month.

So, to sum it up, I would say, short term, we're encouraged but realistic. And the full recovery is in sight, but not in short sight. So COVID recovery is going to take a little time. Longer term, I'm still a mega bull because the recovery path is very clear. You've got the therapeutics coming on. People who get the disease don't die as much, which is fantastic. Vaccines seem to be around the corner. And most of the factors that were driving the worldwide synchronized growth just a few months ago, pre-pandemic, for the most part, they're going to still be present post-pandemic.

And with technology now so advanced and advancing faster and faster, global information is so much more voluminous and it's shared near instantaneously. That's got to be a good thing for the economy. So technology, automation and outsourcing are the 3 things that I'm seeing that are the big trends. And fortunately, we're well positioned to capitalize on all 3 of them.

Answer – Ravi Shanker: I think that was excellent color on the demand side and the pattern of recovery. I'd love some color on the supply side as well. Do you hear corporations talking about changing their global supply chains? And there's a lot of talk about near-shoring and bringing more manufacturing back to the U.S. or to North America even. Are you hearing that? Do you think that happens anytime soon? Or do you think that's a thematic discussion and takes a long time to play out?

Answer – Matthew Jeremy Fassler: Ravi, it's Matt. I'll take that one. Two points to make there. We're seeing this really play out in 2 different ways. First of all, you mentioned near-shoring. There was obviously a great deal of talk about this early in the pandemic. Interestingly, we're now hearing about it a bit from our sales force as they engage with some of our customers who are considering, over the long run, moving their means of production closer to their end consumers. This is not just a North American phenomenon, but also a European phenomenon. So we expect to see business opportunities emanate from that.

Secondly, as I discussed in our prepared remarks a couple of moments ago, the surge in e-commerce has really pulled forward demand that we expected to move online by a number of years. We're helping our customers really in 2 ways. Number one, we're helping them manage that today because they're coping with unanticipated changes in flows of demand, and we're helping them get those goods to consumers. And secondly, they're considering more structural transformational changes to their supply chains - larger distribution centers, more e-commerce distribution centers. And they're working with us to build those out. We're going to benefit from both of these trends as a consultant to these companies and as a deliverer of commercial solutions as they implement these changes to their supply chains.

Answer – Ravi Shanker: Great. If I can just sneak one more in. I think the appointments of Eduardo and Alex are really interesting. Brad, can you give us a little more color on what their mandate is, what they're going to work on and how we judge their results?

Answer – Bradley S. Jacobs: What was the last part, you said, Ravi, how they what?

Answer – Ravi Shanker: Well, how -- what they're going to work on, what their mandate is and how do we judge their results?

Answer – Bradley S. Jacobs: Oh, okay. So first of all, they're both rock stars. These are hard-to-find talent-like-that people. These are dyed-in-the-wool operating people with long records of year after year after year of doing profit improvement. They're like Swiss Army knives. They have commercial backgrounds. I mean very, very, very talented operators.

If you look at Eduardo, when he was COO of Kraft Heinz, he took out $3 billion of cost. I mean we've been pretty good at cost-cutting, but $3 billion of cost is a standout accomplishment. If you look at Alex, when he was [President] (corrected by company after the call) of Popeyes, doubled EBITDA in 3 years. And he was an architect of the famous Popeyes chicken sandwich. I mean these are very creative, sharp, highly experienced guys, and they both have a lot of experience in transportation and logistics. So it's really a perfect fit, and they blend in with our corporate culture just perfectly.

Now, in terms of what they're going to do, they're going to help execute the same strategy that's been working for us, which is to grow the business top line and, more importantly, bottom line and, along the way, generate gobbles and gobbles of free cash flow. So in particular, they're going to help work on the 10 levers, the profit pool opportunity of $700 million to $1 billion of profit improvement possibility over the next few years. And that's just right up their alley. They've done very similar things at multiple companies with 3G over the years. And there's no shortage of opportunities to find ways to improve productivity and efficiencies and, ultimately, profit of the company. And they're going to play a big role in that.

Answer – Operator: The next question comes from the line of Allison Landry with Crédit Suisse.

Answer – Allison M. Landry: In terms of the LTL yields ex fuel, it looks like it decelerated a little bit from Q1 even though, I think, the weight per shipment was lower. Is there some other mix impact to be aware of?

And then just in terms of the renewal rate, I think you said 3.7%, which I believe is in line with Q1. So just moving forward, should we expect the growth in yields to start to converge with the renewal rate? If you could walk through that.

Answer – Bradley S. Jacobs: Allison, I wouldn't guide to 3.7% yield because that contract renewal rate is part of our business, not all of our business. But we are seeing positive yield. So 1.9% positive yield in the quarter was helpful. And the yield trends were positive every month. It wasn't enough, though, even with a couple of points of yield to overcome a tonnage decline of 19%. When you have tonnage decline of 19%, you can do all kinds of great stuff, but you're not going to be able to overcome that given the fixed cost nature of the LTL business and the operating leverage.

But Q2 tonnage also showed an improving trend. Tonnage was down in April 24% year-over-year. It was down 21% year-over-year in May. It was down only 13% in June. And here in July, it's down single digits. So there's a decent trend there. And there were some bright spots in LTL, despite the poor OR. Load factor was up 3.9%. It was the highest load factor we had in 8 years. Empty miles improved 24% year-over-year versus shipments being down 15%. Dock productivity was up 6.5%.

And I would point you to our guidance for Q3. And one of the reasons why we're going to generate at least $350 million of EBITDA in the third quarter is that we fully expect our OR in Q3 in LTL to be substantially better than it was in Q2. So I feel that we're fully on track to achieve at least $1 billion of EBITDA. We have pushed that out from 2021 to 2022. And you'll see steady progress between now and there, getting to that level.

Answer – Allison M. Landry: Okay. That's helpful. And I think you guys won a few new contracts during the quarter. So hoping you can maybe walk us through sort of the nature of those, the size and duration and when we should think about the revenue starting to matriculate.

Answer – Bradley S. Jacobs: Okay. So there was one whale in Europe, and there were 2 whales here in the United States. In the U.K., we signed a $250 million contract that starts October 1. It's a 5-year contract. It's transportation. It's delivery of chilled dairy products to stores, and it's with Arla Foods. In the United States, we had 2 big e-comm wins, and these will be some of the most automated warehouses in the world.

So we have one new e-comm fulfillment center on the West Coast for a global branded apparel company. It is our largest site in the United States. It's 1.2 million square feet. It's a 5-year contract. It started this month, and it's on its way to ramp up to 400 robots. And then we also have another large e-comm fulfillment center on the West Coast for a global fast-fashion retailer, and that starts in September. It's also over 1 million square feet, also highly automated, and that will be ramping up to 500 robots. So we have some good momentum in the backlog on commercial wins.

Answer – Operator: Our next question is from the line of Chris Wetherbee with Citi.

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

Question – Christian F. Wetherbee: So we've seen how the business has performed on the downside in terms of decremental margins. As you look out, and hopefully this is a 2021 story where we see potential for revenue opportunities and growth coming back to the business, is there a new way to think about sort of the incremental margins on the upside? I know, traditionally, I think EBITDA margins have probably been in the sort of mid-teens-ish or so incremental margins.

As you think about LTL and the potential lapse on the [whole fleet] or some of the weaker performance this year and maybe some of the operating leverage as you move towards $1 billion in profit there and some of the cost-cutting taking out, is there a new paradigm to think about from an incremental margin perspective in a growth market?

Answer – Matthew Jeremy Fassler: Chris, it's Matt. A couple of points on that. First of all, as you start off by looking at third quarter and you look at the EBITDA guidance and you think about the kind of revenue trend that we generated in July, you'll see that the decremental margins that are embedded in that are better than the decremental margins that we generated in Q2 and better than the decremental margins implied by the 77/23 math that we spoke about last call and that David mentioned earlier today.

Secondly, as you emerge from a downturn, obviously, we have flexed our variable costs, we are starting to make more headway with fixed costs. Fixed is probably a slightly higher percent of your cost structure after a down year than it would have been going into a down year. So that implies the potential for more operating leverage to the upside, particularly, obviously, when you cycle a very unusual quarter like the one that we had in Q2, which obviously will be a big part of the '21 story. We're not going to talk much about '21 yet, but obviously, that's the way the arithmetic works.

So to reiterate, the third quarter will be a substantially better performance on that front than the second quarter. And then emerging from a down revenue year, you have the opportunity to generate better incrementals than you'd have in an average year. Plus we have the 10 levers and the progress that those are likely to bring us above and beyond that.

Question – Christian F. Wetherbee: Okay. Okay. I appreciate it. That's helpful. And then, thinking about the cost take-out, the $700 million to $1 billion, when can we start to see some incremental progress and maybe more meaningful progress along those lines? I know it's very difficult to do it in a disruptive market like we've had over the course of the last several months. Do we need to wait to next year to start to see some meaningful impact of that? Or does Eduardo and Alex really kind of get to dig in and find opportunities? Or is it something that maybe you can start to show up in a more stable market in later 3Q or 4Q?

Answer – Bradley S. Jacobs: We are hugely excited about the 10 levers. This is a massive potential to literally transform the business. And you will see -- you're already seeing some benefits, but you'll see continuous quarter-after-quarter, year-after-year benefits from the 10 levers. And in 2023, we will have achieved the substantial part of that profit pool. We had a quarterly operating review a couple of weeks ago for 3 days, and a good part of that was going over the 10 levers and crowd-sourcing everyone on each lever. What do you think? What do you think is the highest? What do you think is the lowest? What do you think is the likely?

And collectively, we're feeling very good about each one of those levers. If you look at Smart, this has already helped us variabilize and manage labor costs nimbly. The dock labor productivity that improved 6.5% year-over-year in the second quarter, we would not have been able to do that without Smart. Smart improved the labor productivity in our contract logistics facilities by about 5% already, and we're looking to improve on that going forward. So I think the benefits will just keep compounding going forward.

On Connect, in truck brokerage, Connect helped us handle the same number of loads this quarter year-over-year, but with 14% lower headcount. So that's an important lever. When you can get that kind of productivity from a sales force, that's really, really helpful. Look at procurement. In procurement we've got about $8 billion or so of nonlabor expenses. And adding Eduardo and Alex is going to be a big help with that. They've got a lot of experience with that.

On pricing, we're at the early innings of what we can deliver. We used pricing within Connect this quarter to buy 7.5% better than DAT. So we bought 7.5% better than the market due to the technology we're using on Connect. There's a big opportunity on pricing in LTL, as well, for pricing elasticity and more automation on that. And in LTL, there are other process improvements in terms of optimizing the line haul and P&D spend. So we're very excited about the levers.

At the core of our strategy is to deliver substantial long-term shareholder value, as we have. And our focus is on allocating capital in ways that achieve the best risk-adjusted returns. These 10 levers are a very, very, very important part of that strategy.

(Operator Instructions)

Answer – Operator: The next question is from Brandon Oglenski with Barclays.

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

Question – Brandon Robert Oglenski: I think you talked about how the pandemic is accelerating this outsourcing trend, especially in logistics and e-commerce. I mean, can you talk about your longer-term pipeline and some of the opportunities that you'd see coming there and maybe changing the direction of the organization or shifting direction? And how are you going to capture those opportunities?

Answer – Bradley S. Jacobs: I didn't quite catch the last part about shifting direction to something, Brandon?

Question – Brandon Robert Oglenski: Yes. It's like, are you making any changes on the capital side or personnel side that would help you capture the shift in direction in the market?

Answer – Bradley S. Jacobs: Oh, in the market, got it. We're always adding talent. When we find great talent, if we can find a place for them and if we think they can achieve for us a great ROI on their compensation, we hire them. We find a place to put them to work, and you've seen that done this quarter 2 in more than one instance.

The main ways that we're positioning for future growth is the big exposure we've got on e-comm throughout the company, particularly in supply chain; the advanced, sophisticated technology that we've got as a result of the $0.5 billion plus per year investment we've been making in technology; and the outsourcing trend. That's the main driver of growth in the whole industry, is more and more companies, and particularly during the pandemic, are putting their hands up and saying, you know what, let's outsource more or even all of our supply chain needs to people who do this for a living full time, and who have technology that is more sophisticated than their technology. And who have information and data and real-time info on what's going on in the market, have their finger on the pulse of what's going on in the market and know what's going on in the volatile supply chain situation for other companies in their same vertical, in their same industry. So I think we're well positioned to benefit from all that.

Answer – Operator: Our next question is from the line of Amit Mehrotra with Deutsche Bank.

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

Question – Amit Singh Mehrotra: Brad, the performance in the LTL business, which was over 70% of the profits of the total company in the quarter, was very weak relative to competitors. Tonnage was down way more than peers. Decremental margins were more than double that of peers, even when you add back the $20 million of COVID costs, which, arguably, other people had COVID costs as well. Can you explain that? I would have expected the opposite given the cost opportunity.

And could one explanation be that it's hard to focus the business when you're so diversified. You and the management team are sitting in Greenwich. The LTL business is in Michigan. The supply chain business is in Charlotte. The European business is in Paris. Isn't there tremendous value to focus? And you guys just aren't able to do that, so naturally -- it would absolutely make the breakup story that you guys outlined in January even that more valuable from an equity value maximization perspective. If you can just address those 2 points, I'd appreciate it.

Answer – Bradley S. Jacobs: Well, first of all, I compliment you on getting 4 questions in one sentence. That's fantastic. On LTL, for sure, the OR deteriorated significantly during the quarter. There were 2 big factors: tonnage being down so much and an intense focus on employee safety. So the tonnage being down 19% was due to our long-term business strategy, which has worked very well for us over the years. For this particular quarter, it didn't. We've been very highly selective on the freight we take on. We've had a strong bias towards yield over market share. And with the tonnage going down so much with the operating leverage and the fixed cost, it translates into the OR.

Now, employee safety has always been our #1 priority, but this greatly intensified during the pandemic. And some of those COVID costs are visible in the numbers. $20 million or 250 basis points of OR deterioration from PPE, from appreciation pay, from site cleanings. But the larger, harder-to-quantify impacts are from the network inefficiencies during the shutdowns. This was offset a little bit by about 2% yield improvement, but clearly not enough to offset the 19% decrease in tonnage.

The good news is that each month in the quarter was better than the previous month in LTL, and that improvement continued in July. As I said before, tonnage was down 24% in April. It was down only single digits in July. So nice trajectory there. And Q3 OR will improve sharply from the Q2 levels and much closer to where it was about a year ago.

I can't answer your question about comparing ourselves to competitors for a particular quarter because I'm not fully knowledgeable about what's going on with competitors. We're fully knowledgeable what's going on in our company, and it's what I just explained to you.

Now with respect to your other question about, was our LTL performance in the second quarter a result of being a large diversified company? The answer is no. We've got tremendous operating talent running our LTL business. They've doubled EBITDA over the last 4 years. So looking at them on a longer trajectory, they're doing a fantastic job. This was a very unusual quarter. Our goal wasn't to make a whole bunch of money in this quarter. When the quarter started and the pandemic was there, we didn't know what was going to happen here. Our goal was to make sure our people didn't get sick and didn't die. And that was really where we put our effort in, and we succeeded there. So from that point of view, it was a good quarter. From a financial perspective, it was not a good quarter for LTL.

Answer – Operator: Our next question is from the line of Scott Schneeberger with Oppenheimer.

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

Question – Scott Andrew Schneeberger: There's a good mine of cash on the balance sheet. Now I'm just curious where your focus is with regard to allocating capital. Has M&A reentered the picture? If so, how are valuations looking versus recent years past? And then just an update, kind of playing off Amit's question, of thoughts on reinitiating strategic review.

Answer – Bradley S. Jacobs: So nothing new to talk about there. We've done no acquisitions. The strategic review process was terminated months ago, and we're just not focusing on that. And our strategy of allocating capital where we can get the greatest returns on that capital is still the same as it's always been. So nothing new on that front.

Answer – Operator: Our next question is from the line of Brian Ossenbeck with JPMorgan.

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

Question – Brian Patrick Ossenbeck: One area I just want to talk about in logistics, related to e-comm, is reverse logistics. How do you feel about the opportunities and capabilities specific in that space? I think you had -- a little while ago, one of the largest contracts ever booked was in that. How is that ramping up? Do you feel like you have the capacity and capabilities to keep growing there, especially if we think that B2C takes a step change up and most likely drives a lot more returns with it?

Answer – Bradley S. Jacobs: Reverse logistics is very active and very dynamic. E-comm was our fastest-growing part of the business. And within e-comm, reverse logistics was at the top of the list. So, we had about 75% year-over-year growth in volumes for reverse. So it's very, very, very active. But returns from bricks-and-mortar stores are down because bricks-and-mortar stores are down. So that countervailed that a little bit.

We have what I would describe as unmatched automation and process controls in for our reverse logistics. We handle returns very, very well because of, in part, the historical data that we've got on the sales and our ability to very accurately predict the returns, and customers very much appreciate that. And we do more than just the traditional reverse. We do reprocessing. We do the repricing. We do the warranty management program. We do the quality control inspections. We do a lot of things for our customers in reverse, and that is a highly valued and growing part -- the fastest-growing part of our business.

Answer – Operator: Our next question comes from the line of Ari Rosa with Bank of America.

Answer – Ariel Luis Rosa: So Brad, the EBITDA margins in contract logistics, I think they were at the lowest level that we've seen since you guys essentially entered that business. I was hoping you could talk about, in terms of the outlook, what costs go away in third quarter or even into 2021. And what can give us confidence that those margins can kind of get back to where they have been historically, particularly in the context of e-comm -- or I'm sorry, contract logistics traditionally being seen as kind of the more resilient piece of the business?

Answer – Matthew Jeremy Fassler: Ari, there are 2 elements to think about here. First of all, there were significant direct COVID-related costs that impacted the business in the second quarter. There will still be some COVID costs we expect in Q3. But as David indicated in his prepared remarks, those are likely to be in the $10 million to $25 million range for the company overall, which is much lower than the $48 million we had last quarter. And that contributed, obviously, to the margin degradation in contract logistics.

Secondly, Q2 marked a series of shutdowns, much more so than slowdowns, and that's particularly true in contract logistics. We have customers in very resilient verticals that are typically recession-proof, but they are not shutdown-proof. And that was a set of circumstances that I think none of us would have contemplated prior to the advent of the pandemic. They are circumstances that we don't expect to repeat themselves. When we commented on the tone of business improving in July from where we were in the second quarter, that's true for contract logistics as well. So again, we view the second quarter as an aberrational performance in that business, too, for all the reasons I just stated.

Answer – Bradley S. Jacobs: And with respect to your question, Ari, about the growth drivers for the second half, it's 3 things: the Nestlé warehouse of the future partnership is starting to open now, and it will ramp up to full strength over the next 2, 3 months, and that's a 15-year contract; the Kuehne+Nagel purchase in the U.K., the regulatory approvals on that are progressing well, and we anticipate closing in October or November, and their business has been performing well because of the verticals that they're in - tech, food and beverage and e-comm - and the significant synergies with our existing U.K. biz; and Waitrose, that was a 3-year contract that we signed up earlier and started this month, and that's an $85 million revenue per year contract.

Answer – Operator: The next question is coming from the line of Jordan Alliger with Goldman Sachs.

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

Question – Jordan Robert Alliger: I just wanted to follow up on the LTL side a second, again, going back to sort of the tonnage. I'm just curious, given the differences across the LTL guys, are your LTL operations guys saying that perhaps competitively, from a price standpoint, maybe things got a little bit more challenging? I mean, could that explain some of the tonnage difference? Is there more going after share, would you say, in the LTL market?

Answer – Bradley S. Jacobs: We don't see aggressive pricing, by and large, in the competition. We see a rational pricing environment in LTL. That's not surprising, since there's just a handful of LTL carriers that represent the majority of the capacity. So we see a favorable yield environment right now. Each company has got its own strategy that they've selected and works for them. We have a strategy that's worked very well for us long term. It didn't work well for us this quarter, but it's worked very, very well for us long term. It will start kicking in and working well for us in the third quarter again. And that's to highly favor yield over tonnage. We're not looking for market share in and of itself. We're looking for profit share improvement.

Answer – Operator: Our next question is from the line of Jason Seidl with Cowen.

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

Question – Jason H. Seidl: I'll keep it to just one here. Looking at XPO Direct, it sounds like you guys had a pretty good quarter. You mentioned that the margins were profitable. I was wondering if you can give us a little more color on that. And also, as you look sort of to that long-term margin target that you gave us a short while back, has any of that changed either for the better or for the worse?

Answer – Bradley S. Jacobs: XPO Direct continues to be on track. The shutdown for the vast majority of the U.S. bricks-and-mortar retail network caused a surge in XPO Direct e-comm opportunities. XPO Direct is clearly beyond the proof-of-concept stage. It's been profitable now for the second quarter in a row, and we expect it to be profitable for the entire year. So that turned out to work out quite well.

I see it's 9:30. We apologize to those who didn't get a chance to ask a question, but we look forward to speaking to you off-line later today. Thank you very much. Talk again in 3 months. Have a great day.

Answer – Operator: Thank you, everyone. This concludes today's conference. You may disconnect your lines at this time, and we thank you for your participation.