THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

XPO - Q4 2017 XPO Logistics Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 08, 2018 / 1:30PM GMT

OVERVIEW:

Co. reported 4Q17 YoverY organic revenue growth of 10.4%.

CORPORATE PARTICIPANTS

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

John J. Hardig *XPO Logistics, Inc. - CFO*

Scott B. Malat *XPO Logistics, Inc. - Chief Strategy Officer*

CONFERENCE CALL PARTICIPANTS

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

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

Ariel Luis Rosa *BofA Merrill Lynch, Research Division - Associate*

Bascome Majors *Susquehanna Financial Group, LLLP, Research Division - Research Analyst*

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

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

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

Jack Lawrence Atkins *Stephens Inc., Research Division - MD and Airline, Airfreight and Logistics Analyst*

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

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

Matthew Edward Reustle *Goldman Sachs Group Inc., Research Division - Senior Equity Analyst*

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

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

PRESENTATION

Operator

Welcome to the XPO Logistics Fourth Quarter 2017 Earnings Conference Call and Webcast. My name is Rob, and I will be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded.

Before the call begins, let me read a brief statement on behalf of the company regarding forward looking statements and the use of non-GAAP financial measures. During this call, the company will make 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 or in the Investors section on the company's website at www.xpo.com. 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 and CEO*

Thank you, operator, and good morning, everybody. Thanks for joining our earnings call. With me in Greenwich are John Hardig, our CFO; Scott Malat, our Chief Strategy Officer; and Tavio Headley, our Head of Investor Relations.

As you saw from the press release, we had a very strong finish to 2017. We posted record fourth quarter results across the board, with beats on revenue, EPS, adjusted EBITDA and free cash flow.

Adjusted EBITDA for the quarter was $337 million. That brought us to $1.37 billion for the year, which was just above target. We generated $374 million of free cash flow in 2017 compared to our target of at least $350 million. Because of our momentum and the benefit of tax reform, we raised our two-year cumulative free cash flow target for 2017 and 2018 from $900 million to approximately $1 billion. We delivered robust organic growth in the quarter at 10.4%. In our transportation segment, we increased freight brokerage revenue by 33%, and in North America, we grew our last mile revenue by 21%.

In Europe, we continued to grow our contract logistics business above plan, and we saw an acceleration in demand for our transportation services.

In 2017, company-wide, we signed $2.8 billion of new business. That's a year-over-year increase of 55%. Our global sales pipeline stands at a healthy $3.2 billion, and our ongoing investments in technology and sales force effectiveness will pay long-term dividends.

More immediately, in 2018, we're off to an excellent start. We're confident in our ability to grow adjusted EBITDA by at least another 17% this year.

And on that note, I'll ask John to review the fourth quarter numbers in more detail. John?

John J. Hardig - *XPO Logistics, Inc. - CFO*

Thanks, Brad. Starting with our transportation segment, we increased revenue 14% to $2.7 billion. Operating income increased 58% to $133 million, and adjusted EBITDA grew by 22% to $258 million.

In North American less-than-truckload, our yield improvement accelerated to 2.6% in the quarter, and we improved adjusted operating ratio by 60 basis points year-over-year to 89.9%, the best fourth quarter OR in 12 years.

Contract renewal pricing accelerated sequentially to 5.3% versus 5.1% in the third quarter. Tonnage increased 2.9%, due primarily to heavier-weight shipments, partially offset by selectively targeting more profitable freight. We continue to better utilize and make investments in our fleet, as shown by our 4.5% improvement in load factor and the reduction of our fleet age from 5.2 years -- to 5.2 years from 5.6 last year. For the full year, we improved operating ratio by 130 basis points, and we expect to improve another 100 to 200 basis points in 2018.

In last mile, we had a strong quarter and delivered both solid revenue and earnings growth. The robust holiday season drove exceptional growth of 21% in our last mile e-commerce network. We launched eight additional North American sites in the fourth quarter to handle increased customer demand, and we expect to open another 30 locations this year.

In freight brokerage, we grew revenue by 33% year-over-year. The tight market that started in third quarter carried into the fourth, driving a significant amount of spot business. Our truck brokerage business increased volume 31%. We took care of our customers by using our technology to find capacity in a challenging market.

The trends we saw at the end of the year continue into January. Intermodal also posted solid revenue growth of almost 11% due to large customer wins during 2017.

We had good performance in our European transport operations. We grew revenue 16% with solid organic growth and an approximate 9% benefit from foreign exchange. Revenue growth was driven by increases in brokerage across Europe, dedicated transportation in the U.K. and France, and LTL in Spain and France. Organic revenue growth accelerated steadily through the year, peaked in the fourth quarter and carried into this year.

Our European last mile business is starting to take off. We are now actively facilitating heavy goods deliveries in the U.K, Ireland, Spain and the Netherlands, and we just completed our first last mile delivery in France last week.

Our logistics segment continues to perform well. Total logistics revenue increased 13% to $1.6 billion. Operating income increased 18% to $60 million, and adjusted EBITDA increased by 11% to $120 million. Our sales pipeline in Europe and North America logistics remains exceptionally strong at $1.8 billion compared to $1.3 billion last year. Globally, we're averaging two contract logistics implementations per week. The vast majority of these are front-loaded investments and long-term contracts.

In European logistics, we grew revenue 21% through solid organic growth and an approximate 9% benefit from foreign exchange. We grew revenue in our e-commerce business by over 20% in the quarter, and managed service and operations extremely well through peak season. During Black Friday and the holiday peak, we saw the strongest e-commerce growth in the Netherlands, U.K., Italy and Spain. We also drove double-digit revenue growth in our cold chain business.

In North American logistics, revenue increased 5% in the quarter. We accelerated revenue growth in our contract logistics business to approximately 9%, offset by revenue decline in managed transportation. The largest gains came from e-commerce, followed by industrial and consumer packaged goods. Given new sales wins last year, we have clear visibility of our sales growth in 2018. Our biggest win last year was a project that ramps up at the end of the first quarter this year.

Interest expense for the quarter decreased 23% to $62 million due to debt pay down, repricings of our term loan at lower rates, and the benefit of our cross-currency swaps. We expect interest expense in 2018 of $250 million to $265 million, of which $10 million to $15 million will be noncash.

Net CapEx was $94 million in the quarter and $425 million for the year. In 2018, we're planning net CapEx of $450 million to $475 million.

Our cash flow from operations was $274 million, and free cash flow was a healthy $180 million, due primarily to lower net CapEx, partially offset by higher working capital usage to support our strong fourth quarter growth. In 2018, we expect free cash flow of approximately $625 million.

Given our positive results in 2017, we're pleased to be paying performance bonuses of -- to roughly 20,000 employees. As a result of that, we expect to be free cash flow negative in the first quarter, same as in previous years.

For modeling purposes, we expect depreciation and amortization expense to be in a range of $685 million to $695 million in 2018. We are forecasting a book tax rate of 22% to 25% and cash taxes of approximately $125 million. Finally, we reaffirmed our full year adjusted EBITDA guidance of $1.6 billion, a year-over-year increase of 17%.

With that, I'll turn it over to Scott.

Scott B. Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

Thanks, John. Starting with the macro. Market conditions are positive in both North America and Europe. Our customers are feeling confident about their business outlook in 2018, which sets the stage for continued strong growth. We just -- we've just come off a holiday boom in e-commerce when a record number of consumers chose to make purchases online. There's a stickiness to e-commerce behavior. When a new wave of buyers moves to online shopping, it bodes well for our future growth in contract logistics and last mile.

In 2017, we grew our retail and e-commerce-related business by 20%, and it now makes up approximately 29% of our company-wide sales. We're doing a lot to capitalize on these positive market dynamics. We've amped up our sales efforts to get in front of high-potential customers that can increasingly benefit from our capabilities. Our emphasis continues to be on serving large customers with multiple lines of business. In Europe, we reorganized our entire sales structure to deepen our bench strength of senior-level sales talent in both logistics and transportation.

In North American LTL, we added 90 new people to our sales organization in December and January, and we're adding another 80 over the next 60 days. We want all of our sales people to focus 100% of their time on profitable growth. We've beefed up sales support, raised incentive compensation and invested in new training programs, and we built up our sales analytics capabilities. We have a global team dedicated to performing extensive analysis on new business wins, changes in the pipeline mix and cross-selling opportunities.

Another thing that's propelling our sales is our proprietary technology, which is a huge differentiator for us. Our technology is one of the main reasons customers choose XPO as a supply chain partner. For example, we've developed our own predictive analytics and machine learning models. We use these to help customers analyze their data and forecast future logistics demand. This is critical, for example, for our retail and e-commerce customers, who can use this information not only to plan inventory and bring down costs but also to generate additional sales, minimize returns and build customer loyalty.

In last mile, our web-based technology is a big reason retailers and e-tailers trust us to protect their brands. We provide a superior consumer experience with industry-leading satisfaction levels. If you buy something from one of our customers online, you can track your order in real time, set personalized alerts, and reschedule delivery times electronically using our software. We're able to offer tight delivery windows, which is especially important with heavy goods, and our technology is geared to facilitate the most complex home installations. Our system also gathers actionable real-time feedback after the delivery to help our customers build loyalty.

In our supply chain business, we're very bullish on our next-generation proprietary warehouse management platform that we plan to launch in March. It's going to dramatically reduce ramp-up time on new projects. It's completely mobile, and it integrates very quickly with other technologies. If a customer supply chain calls for robotics, for example, we'll be able to bring those robots online in a fraction of the time of a typical warehouse management system.

This gives you the flavor for the kinds of innovations we're deploying at a rapid pace. We've upped our technology budget this year to over $450 million to build on what is already an enormous competitive advantage. We'll be rolling out a host of new tools and apps throughout 2018.

One of the great strengths of our business model is that we can continue to meet these significant investments in long-term growth and still accelerate profitability faster than revenue. In the fourth quarter, we achieved double-digit organic growth, up 10.4% year-over-year, while growing our adjusted EBITDA by an even more robust 18% when you exclude the divested truckload business from a year ago.

So we're firing on all cylinders. We're growing fast and creating value even faster while accelerating free cash flow. We're doing this by executing on significant growth opportunities in every line of business and across our entire operating landscape. Given our powerful growth trajectory, we expect to generate significant long-term value through the investments we're making while delivering on our targets for 2018.

With that, let's open up for Q&A. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today is coming from the line of Ravi Shanker with Morgan Stanley.

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

On the 2018 guidance, your 2018 EBITDA and free cash flow guidance have remained, I think, largely unchanged in the past year despite conditions changing dramatically or the expectations changing dramatically for the truck market going into 2018. Is that because you are -- you still see uncertainty out there, and you want to see how this plays out before you kind of take numbers up? Or are there kind of puts and takes to the numbers that maybe offset some of the revenue strength? I mean, clearly, you highlighted a number of investment costs. If you can just kind of walk us through how that interacts with the top line that will be great.

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

Thanks for the question, Ravi. Good morning. So the way we get those numbers is we do it bottoms up. So we have every part of our organization, pressure test its best-case scenario, its worse-case scenario, its likely-case scenario, and we aggregate all that, and that comes to $1.6 billion or more of EBITDA in this year. So we're sharing with you the same internal numbers that we have, and those are the numbers. We feel very good about growing EBITDA another 17% in 2018 over 2016 (sic) [2017], and we feel very good about generating about $1 billion of free cash flow over 2017 and 2018, and those are the numbers that we internally have. If, for some reason, those change over the course of year, we'll let you know that when they change. But we're not going to change them just because people want us to change them. Those are the numbers, and they're really good ones.

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

Okay, understood. And again, just focusing on those investments you are making, what's -- what kind of payback do you expect on those investments? Is that going to be immediate? 6 months? 12 months? And is that going to translate into continued 5% to 8% or high single-digit growth rates into 2019 and beyond, given the pipeline that you have?

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

The short answer is yes. We did raise our organic growth targets up about a point or two, and one of the reasons we did that is because we're investing in future growth. So one of those things-- let's go through them one by one. We are experiencing a very favorable LTL market, so we've hired another 90 LTL sales and support people in the last 60 days; we're going to hire another 80 over the next 60 days. So we'll have hired another 170 LTL sales and support people by the end of the first quarter. So that's one investment. Second one is our last mile hub, which we've been talking about the last few quarters. As you know, our last mile business is growing 21%. It's really growing really, really fast. Big demand from customers for that business. We opened eight new last mile hubs in the fourth quarter. We'll open another 30 last mile hubs in 2018.

In contract logistics, we did 25 implementations for our customers in the fourth quarter. So we're averaging about two a week as we start 2018, and we're happy to invest in that for our customers.

And then the fourth area that we're investing for long-term growth, even though it may be a temporary drag on short-term earnings, is technology, which is our secret sauce, which is our competitive advantage. And we're now investing over $450 million a year in technology, and that's benefiting our customers across the board.

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

Very helpful. And if I can just squeeze one in lastly on the M&A process, can you just give us an update on where you stand there? Are you still vetting companies? Are you in final discussions or evolved discussions with a few of them? Where do we stand there?

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

Something in between those two characterizations. As you recall, when we returned to the M&A market in the middle of last year, we said the base-case scenario would be that we will complete 1-2 large acquisitions by the end of 2018. We're still very much on track to achieve that, and we're looking forward to that being the next turbocharge of our growth.

Operator

The next question comes from line of Brandon Oglenski with Barclays.

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

So I guess, I want to come back to Ravi's question, and Brad, we're not asking you to raise your numbers, but just understanding the philosophy behind them because it looks like core growth is going to be a lot better than maybe we thought a year ago, and EBITDA hasn't moved. So I guess, that's implicitly saying you don't expect as much margin expansion in 2018. So I just want to know if that's correct. And it sounds to me like, with the answers we just heard, that you guys are looking more towards growth opportunities and thinking, let's capture top line while we can and then leverage that in the future. Is that the way to think about it?

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

That's entirely right. We're not taking our eye off cost control. We'll always have that, that's an area of continuous improvement. It's part of our culture to always be looking for unnecessary cost and to take out waste, take out inefficiencies. But certainly, with the buoyant economy we're seeing, with the success we're seeing on the top line growth across the board in all business lines, in all geographies, we are absolutely capitalizing on this environment and focusing on top line growth. Now you said rightly that what you would see in the top line growth, we're not -- we have been seeing great bottom line growth, 16%, 17%, these are really, really high levels of growth. You're seeing cash flow growth of even higher than that. We -- they could be higher, but we are decidedly investing for the long term with short-term investments: the 170 LTL sales people, the 30 new last mile hubs this year, the ramp-ups in the contract logistics implementations and investing even more in technology. We're happy to make those investments, and we're happy to take that short-term drag on earnings because this is what gives us huge amounts of growth momentum for future years.

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

Okay, appreciate that. And then in the logistics segment, you guys, I think, you called out 23 new implementations, if that's how you phrased it, this quarter, and I think you also referenced that there's a lot of start-up costs in the quarter as well. Can you talk to what you would think the normalized margin is for logistics? And is that pace likely to continue with new implementations in 2018?

Scott B. Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

Sure. It's Scott. We do expect to improve margins in our contract logistics business in 2018. It's about operational efficiency and improvement. We do expect the implementations to continue at a very fast pace. So with that very fast pace, there will be some impact on margins that we will more than offset with our opportunities for improvement on the cost side, but we will see a continued drag on the percentage margin. Now when we look -- when we sign up a new contract, we are making money from the first day on a target. It's just not as a high of a margin until 6-9 months down the road.

Operator

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

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

So just wanted to ask a follow-up, maybe, a different way. If you could just help us think about how incremental margins are changing as a result of these investments. Scott, you've talked about 12% to 14% previously in terms of drop-through of incremental revenue to EBIT and EBITDA, is that still a good target? Or should we maybe moderate that a bit, given some of the investments that you're making for the growth?

Scott B. Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

That's still a good target. We actually have a little bit higher than that this year in 2018. If you notice, we're growing organic growth in 2018, let's say, 5% to 8%, and EBITDA growing at 17%.

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

Right. So all the prospective investments that you're putting into -- for the growth, at the end of the day, the incremental margin is still going to be well within the target that you previously laid out. So that's -- am I reading that correctly? Can you talk about maybe how that also flows through the cash flow because you've talked about incremental working capital investments? Just remind us there in terms of the drop-through to actually free cash flow as well.

Scott B. Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

You're thinking of it the right way. You're getting the best of both worlds because we're not only increasing the EBITDA 17%, we have very high incremental margins with our business, we're also dropping more and more to the free cash flow line. So we have free cash flow growth of around 2/3, 67%, expected from 2017 to 2018. That will likely be despite some more investments in working capital. We'll generally put in about 8%, 8% to -- around 8% of the growth in sales into working capital, the difference between accounts receivables and accounts payables.

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

Amit, our free cash flow in 2016 was $211 million. Last year, it was up 77% to $374 million. And this year, we're projecting another 67% increase in free cash flow to $624 million. So nice trajectory on the free cash flow.

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

Yes. No, I get that. But, I mean, a lot of that trajectory has to do with some removal of integration costs, some cash tax reform, things like that. And so the question is, really, as you look out prospectively from 2018 into 2019 and 2020, what's your ability to convert mid- to high-single digit revenue growth, if that's the case, into double-digit free cash flow growth beyond 2018?

Scott B. Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

Free cash flow growth will grow solidly in the double digits beyond 2018. You have to remember, cash taxes (sic) is a drag on us in 2018 versus 2017. We'll have -- we had about $75 million of cash taxes in 2017. 2018, we'll have about $125 million. It's less than it would have been had not been tax reform, but we're delivering 67% free cash flow growth despite cash taxes going up.

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

Yes. Can I ask one strategic one, if it's okay? On -- Brad, you did a, I guess, an interview this morning, and talking about the European last mile market, can you just expand on that in terms of is that heavy goods last mile? And then what's the opportunity in that market for kind of a 3PD-type acquisition to maybe give you a base to grow from? And are there any big start-up costs that we should expect in terms of you trying to organically grow that business? And that's it from me.

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

The European last mile business is taking off. We're now providing heavy goods last mile logistics in the U.K., in Ireland, in France, in Spain and the Netherlands. Demand is very high for this type of service. Customers are increasingly asking for it, and we're responding, as we always do, to what customers want. So that business is -- has high promise. To answer your question, there is no large last mile provider in Europe that has a very, very big market share that would replicate what we did here in the United States when we bought those 4 last mile companies and integrated them a few years ago. But organically, we can grow that business very well, and there's some small acquisitions we can do in addition to that.

Operator

The next question comes from the line of Chris Wetherbee with Citi.

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

I wanted to ask a question a little bit more specifically on the LTL outlook. So I think 100-200 basis points of operating ratio improvement is the target. Can you tell us a little bit about some of the assumptions embedded with that? What do you expect for tonnage? How does pricing look? Kind of, what can you do with load factors as you, sort of, move through 2018? Just wanted to get a sense of where we are, and maybe sort of a 1Q-to-date update would be helpful, too, on tonnage and price.

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

So yield was up 2.6% in the quarter, and that's accelerated. It was up 1.8% in the third quarter. It was negative in the first half of 2017, if you recall. Pricing on contract renewals has been up 5.3% in the quarter, and that's also up a little bit from 5.1% in the third quarter. Tonnage was up 2.9%. Those general trends on yield and contract renewals and tonnage are continuing into the first quarter. With respect to the OR, in the fourth quarter, our adjusted operating ratio improved 60 basis points to 89.9%, which was our best fourth quarter operating ratio in 12 years.

You asked about load factor. Load factor improved by 4.5 percentage points. That's accelerating. It was up 2.2 percentage points in the third quarter. We still can improve our load factor more and get better utilization on the line haul. In terms of our fleets in LTL, we improved the average tractor age to 5.2 years from 5.8 years (sic) [5.6 years] a year ago. And if you look at the operating income in LTL, just to put this all in perspective, in -- two years ago when we bought LTL, we had about $211 million of operating income. And last year, we had about 90% more than that, so it almost doubled. And we are solidly on track to generate over $1 billion of EBITDA in our LTL business within four years. So life is good.

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

Okay. And so, I guess, the first quarter trends that you're, sort of, talking about continuing from the fourth quarter, I mean, are those rough proxies of kind of how you think top line looks as you go through 2018?

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

Yes, that's correct.

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

And then just one more on LTL, and I'll turn it over. Just wanted to -- Scott, you mentioned sort of the sales force initiative that you kind of have rolling out here. We've always thought about this LTL business as sort of a mix of the local and the national business. It sounds like you're focused a bit more on the local side with some of these -- some of the sales heads that you're adding here. Can you talk a little bit about what maybe you can kind of get with sort of the structure here, and what's the focus of this sort of incremental addition? What can you get out of these adds, maybe, this year and 2019?

Scott B. Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

Sure. On LTL, both our national accounts and local accounts are very important to us. We have very good relationships with large accounts, but we need to cover the local market door-to-door even better. And we need to increase the number of account executives. We gave them increased tools; we gave them increased training. We are very selective on the type of freight were taking on. So we expect that to continue where we are taking out some freight in the network that's less attractive and replacing it with more attractive freight, and that's very much the focus of increasing the sales organization in LTL.

Operator

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

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

Just looking at your, sort of, e-commerce and retail-related business, I think you said it was up to about 29%. Obviously, you're going to have a healthy growth rate. How should we look at that going forward? Obviously, it's probably going to outpace the growth of your existing business, so we're going to push forward beyond that 29% mark. But is there an internal goal to get it at a certain percent of -- percentage of the business? Or are you just generally going to follow the demands of your customers?

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

It's not a goal, a proactive goal, per se, Jason. It's responding to demand, and the business is just growing quite a bit. If you look at e-commerce as a whole throughout the organization, without doubt, that's our fastest-growing type of customer. Those customers, company-wide, grew over 20% with us last year versus the previous year. So there's a lot of rising demand there. That's not due to anything great we're doing--a bit more in terms of, it's more just e-commerce is growing very good, and we're well positioned to take advantage of that. It is about 29% of our company-wide sales, both retail and e-tail. We would expect that to go over 1/3 over the next couple of years just in the natural course of things.

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

Is there any area in that subsector that you'd like to beef up? Something that maybe you think you're lacking to support your customers' needs going forward?

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

Well, there are four main areas where we are exposed to e-commerce, and we're continuing to invest in all of those. So those 4 things are e-fulfillment in Europe, where we have the largest e-fulfillment platform in Europe. And we grew revenues there 24% in the fourth quarter, and it's the primary reason why our logistics sales pipeline is at an all-time high. And then in last mile logistics, here in the United States and now increasingly in Europe, we -- more people are increasingly buying those types of heavy goods that we specialize in online. So we're going to continue to invest in that. We spoke earlier on the call about the 30 extra hubs that we're rolling out this year. And omnichannel distribution and reverse logistics in our supply

THOMSON REUTERS

chain business, our contract logistics business, that's also been growing very, very fast. We have the infrastructure in place. We're just growing with our customers there.

Operator

Our next question comes from the line of Scott Schneeberger with Oppenheimer & Co.

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

On free cash flow, that was helpful earlier, talking about '18 to '19 and beyond. Just kind of a more near-term, John, you mentioned that CapEx was a little lighter than expected in the fourth quarter, and you did allude to, as every year, first quarter is a little soft. But should we be expecting something a little bit softer than normal? Elevated CapEx, perhaps, driven in the first quarter? Sounds like you have a lot coming on in the spring.

John J. Hardig - *XPO Logistics, Inc. - CFO*

Well, our CapEx in 2018 will be more weighted towards the front end of the year. So we -- we did $425 million in 2017, that's going up to $450 million to $475 million this year. Most of that is IT spend, about 40% of our total CapEx is IT. As you know, that's our secret sauce. So about 35% goes into contract logistics, all the start-ups that we've been talking about, the two-per-week run rate that we're at. And then we're being much more disciplined on the fleet, 25% of CapEx will go there, mainly because we're able to drive much higher utilization of the fleet. But it will be more front-end loaded this year as opposed to what we saw last year.

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

Okay, great. And can we just get a broad overview, delving into a few of the categories of profit improvement initiatives? Clearly, you're still working on those, but just a little bit more deeper sense on what's going to be occurring in '18.

Scott B. Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

Sure. We are getting a lot of benefit from procurement. We already generated $120 million of run rate savings in centralized procurement. We're working our way towards about $160 million of run rate savings by the end of this year. We're making a lot of progress on utilization of our fleet. Brad talked a little bit about our load factor, that's a good way to look at it: 4.5% improvement in the quarter. We're doing a much better job of planning our network and improving that utilization so that the trucks are more full moving down the road, and every percentage point of price is around $10 million of improvement. So we expect continued improvement there.

Also, in LTL, we have a lot of initiatives around number of stops per hour on the pickup and delivery. That's both from our sales side of the equation, where we're making sure we're taking on freight that's in dense areas of our existing network, as well as better routing technology. And then we have dock operations improvement from planning for temporary labor for overtime. Across the business, our technology, robotics and automation are making us much more efficient, especially on the supply chain side where we are dropping a lot more to the bottom line.

Operator

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

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

So Brad, as we kind of think about the tight driver market and your growth in last mile and all the opportunity there, could the tight driver market constrain your growth some? Because I know, at least for those drivers, I mean, you're not just going to hire anyone off the streets since you're going to someone's home. So I'm just curious as to your thoughts on the driver market maybe impacting your growth opportunity in last mile.

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

In last mile, specifically, because of our large position in last mile, we're able to give steady miles to independent operators, so they gravitate towards us. We have a reputation for real high levels of service, so people want to be associated with us. So while I wouldn't make light of the capacity issues in -- out there because it does flow over into last mile, that's not a constraining factor to us. We have adequate capacity to serve our customers, and we just don't take on business unless we've got it lined up and feel confident about that.

Now in terms of driver situation in LTL. In LTL, we have very low driver turnover. It's like 8%, like eight, like single digits. So that's because they get home every night, and we don't see the same kind of pressures that you see in long-haul trucking where people -- drivers are on the road for a week or two at a time.

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

What are your thoughts on the intermodal market, particularly just given the tremendous tightness we're seeing in trucking, and as we think about intermodal and bid season for 2018 and beyond?

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

Intermodal has gotten a lot better, but it was pretty easy to get a lot better because it was pretty bad there for a long period of time. With capacity really tight, with trucking rates going up, customers look to intermodal for cost, but they also look at it for capacity. It's another alternative for capacity. In the fourth quarter, our intermodal organic revenue growth was 7.3%. And last year, we signed up two intermodal contracts, one with a big automotive customer, another with a retailer, and those are now ramping up very, very nicely. I think intermodal is going to stay relatively positive for a while here because of the tightness in truck capacity. The weather disruptions did create some congestion in early January volumes in intermodal, and some of our other business lines, too, for that matter, but that's all come back once the weather came back.

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

Got you. Okay. And then one last question here. As we think about the tightness in the truck market kind of staying on that theme and shippers come to you desperate for capacity, are you using this as an opportunity and your sales force using this as an opportunity to really cross-sell into other products? Am I thinking about that right?

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

Yes, cross selling is going very well. 28% of our sales in the fourth quarter came from secondary service lines, up from 24% a year ago, up from mid-teens percent two years ago. If you look at our top 100 customers, 94 of them now are using us for multiple service lines. That's up from 86 just a year ago. So cross-selling is absolutely gaining lots of traction, lots of momentum. It's partly because of the capacity, but it's partly because we've gotten great products to offer and we're presenting that to customers that we have established relationships with in other service lines. So it's a natural evolution. It's something we've been focusing on now intensely for the last couple of years, and it's showing results.

Operator

The next question is from the line of Allison Landry with Crédit Suisse.

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

As we think about rising truckload rates, and I believe you guys outsource about 1/3 of your LTL line haul, I guess, what are your expectations for TL contract rate increases in 2018? And how does that flow into what you're assuming for purchased transportation expense? And then finally, is that figure incorporated into the guidance for 100-200 basis points of OR improvement?

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

It is. Rates are going up. About 1/3 of our line haul we do with third party, 2/3 we put on our own trucks with our own drivers. We've been increasing the percentage that we've been giving to our own fleet, and we -- that's one of the reasons why we've been investing in the fleet, but the increased cost of those line haul moves is already factored into our budget.

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

Okay, great. And just thinking about your -- you guys are investing pretty aggressively to capture growth, how variable are these incremental investments that you're adding, such that if there was a slowdown to occur at some point, and since right now, you may not be capturing the full margin expansion, would we see higher-margin degradation, let's say, if there was a slowdown in 2019?

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

Well, we have fixed costs, we have variable costs. We always can adjust our cost structure to the market. We've done that over the years, and that's part of the model. But we do not see a slowdown right now. We are seeing the same synchronized global growth in all 30-plus countries that we're operating in right now. We're seeing positive GDP, we're seeing low unemployment. We're seeing growth. We're seeing growth in the industrial economies, we're seeing growth in the consumer economy. It's looking positive out there. So we don't see that in the near-term horizon. Sooner or later, someday, the cycle will turn and then it will contract, but we don't see that happening in the near -- in the visible future, absent some unfavorable geopolitical events. If -- when that does happen someday, we'll adjust our cost structure very easily.

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

Okay. And that -- would that include scaling back some of these investments, even though it sounds like the returns on investment are pretty good?

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

Well, we don't want to scale back LTL sales for the fourth -- for any time in the near future, because the market is great and we want to go out there and capture that market. We don't want to slow down our investment in the last mile hubs, because that's among our fastest-growing part of the business. We certainly don't want to slow down the implementations, the two implementations a week that we're doing for contract logistics customers, and we want to continue to invest in all these great products we're developing in our technology. So we don't see ourselves slowing that down for quite a while.

Operator

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

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

Just a couple of quick ones here. Is there -- I know the tax law has changed since we first started talking about it and went into -- and when it went to effect, but is there -- as you kind of digest all the puts and takes of that, are there any implications from the regs, as you understand them now, for potential M&A, either in North America or in Europe?

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

It's not really going to affect our M&A strategy. Our M&A strategy is to buy a great company or two at a reasonable valuation. One that's strategically compelling. One that's very, very accretive to our earnings. One that our -- one or two that our customers really like us doing, and one or two that our shareholders will like us doing. The tax law is sort of a side issue in terms of what we're doing there.

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

Okay, so no real friction costs when it comes to splitting it on the value of the deal or what it could bring to XPO?

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

Taxes would be the tail wagging the dog. It's not the driving force, not changing our strategy at all on M&A.

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

Got it. Okay. And then the other one just about the growth in contract logistics. Two per week sounds like a pretty hefty pace. What's the overall appetite in the market for prime warehouse and other real estate automation equipment? Of course, you're doing more and more on that front. So labor is still tight, but you're trying to offset some of that. Are there any gating or limiting factors in terms of keeping up that sort of growth, either here in North America or in Europe?

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

The main gating -- well, it's not the real estate. We're able -- we have a very active real estate department. We grew our contract logistics square footage around the world to 170 million square feet now. We have the second-largest footprint of anybody. It's not access to labor. That's one of our core strengths, is being a prime employer in all the key markets. And we're good at accessing labor, and we pay fairly and we attract good people. The gating factor really is we want to keep a very high level of standard of quality of service that we provide, high levels of inventory accuracy, high levels of moves, everything very precise. And we just want to make sure our QA/QC stays as high as it is right now. We have 50 Lean Six Sigma Black Belts that are traveling around and making sure that we're having the best practices possible in all of our sites, and that really is the gating factor. We do feel comfortable with the pace that we're on and there's good growth implicit in that.

Operator

Our next question comes from the line of Matt Reustle with Goldman Sachs.

Matthew Edward Reustle - *Goldman Sachs Group Inc., Research Division - Senior Equity Analyst*

You mentioned tax reforms having a favorable impact on the customer base. I know we're still early stage here, but have you noticed a shift in the types of business that your customers are looking for and interested in? Is the margin profile of what's being added to the pipeline or negotiated materially different from what you were seeing previously?

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

Not really, Matt. It's across the board. Well, of course, we see -- we have a big exposure to the industrial economy because of our LTL business here and because it's part of our contract logistics business too. And we're seeing more buoyancy there, we're seeing more confidence. We're seeing small customers that used to have 4, 5 pallets to pick up, now they have 5 or 6 pallets to pick up. We see some of our large customers that were not doing so well a couple of years ago are doing fine now. So there's a pickup there, but it's not limited to the industrial economy. We're seeing on retail, good growth. Obviously, everything e-commerce-related is good growth. Food and beverage is doing well. It's really across the board. When you look at the economy, we don't see any one pocket of the economy that's doing poorly. I guess the one that's a slight laggard to the rest of them is auto, automotive. It had a real nice growth spurt there for a number of years. But even auto, they're -- in Europe, auto is still growing. And here in United States, it's okay. It's not great, but it's okay. But when you look at every other service line -- every other vertical line, it's strong.

Matthew Edward Reustle - *Goldman Sachs Group Inc., Research Division - Senior Equity Analyst*

Great, that's helpful. And then just in terms of how you're thinking about the business, I know it's kind of been brought up a few times here, but in terms of asset-light and asset-heavy, it seems like the value of the asset-heavy business and the value of the assets themselves are showing up in a tight market today. Can you just talk about the strategy around that? Has your view shifted at all in terms of the right portion of those two businesses together, and whether this cycle has any material change on your outlook there?

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

Our perspective on that has not changed. We like having a blend of assets and asset-light, with the majority of our business being asset-light. And that's the complexion that we're doing.

Operator

The next question is from the line of Jack Atkins with Stephens.

Jack Lawrence Atkins - *Stephens Inc., Research Division - MD and Airline, Airfreight and Logistics Analyst*

Just, I guess, Brad, to kind of start off, when you think about the EBITDA, incremental EBITDA growth between 2018 and 2017, I think it's about $230 million-or-so from your guidance. How much of that is tied to continued progress on the cost initiatives and the synergy initiatives that you put in place? Following the Con-way transaction, they still seem to have a little bit of a tail to them. And how much of that would you attribute to underlying business growth?

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

First of all, hello, Jack, haven't talked to you in a while. It's both. In LTL specifically, our first order of business was to get the cost structure right-sized, we've done that. We're not going to let up, we're always trying to find ways to becoming more efficient on the dock, on P&D, on line haul, and we always will have an attitude of continuous improvement with the costs there. But our main emphasis for growth going forward in LTL is now that we've got that optimal cost structure, let's grow on to sales line. And so that's what we're developing on that. Was your question specifically about LTL or was it more general?

Jack Lawrence Atkins - *Stephens Inc., Research Division - MD and Airline, Airfreight and Logistics Analyst*

No, it was more general because I know that there were a number of continuous improvement initiatives that you put in place. And I -- there was -- if I remember correctly, there's still a little bit of incremental synergy that, I think, the point was to capture this year versus the initial plan. So just when I think about that incremental dollar growth in EBITDA in '18 versus '17, just sort of how much of that is from those initiatives sort of continuing to bear fruit versus underlying business growth for the consolidated company overall?

Scott B. Malat - *XPO Logistics, Inc. - Chief Strategy Officer*

Sure, Jack. It's Scott. It's a combination of both. It's 50-50 in terms of cost saves versus savings. On a gross basis, our cost savings will be more like a $150 million of that. Although, we are making investments in the sales and the technology and all things that are driving the productivity loop to have faster growth in 2019. But it's about half and half when you net that.

Jack Lawrence Atkins - *Stephens Inc., Research Division - MD and Airline, Airfreight and Logistics Analyst*

Okay, great. And then I guess just a -- as a follow-up, a balance sheet cash flow question for John. Great job on the cash flow this year, but when we look at net debt, declined about $350 million roughly year-end versus year-end, you had $375 million in free cash flow, and then you had the equity deal midyear, which contributed, I think, about $275 million or $300 million in proceeds. So that drives us to about $650 million in cash, but net debt was down about $350 million. Can you help us sort of bridge that $300 million difference there?

John J. Hardig - *XPO Logistics, Inc. - CFO*

Well, Jack, there are a bunch of things that you didn't pick up on in terms of the analysis on the cash flow, but you had fees related to our refinancing that we did last year. You had -- the cash balance that you see actually on the balance sheet is about $40 million short due to a piece of real estate that we sold that's sitting in a noncash account, a restricted cash account, because we're going to put that capital back to work in the real estate space. So there are number of puts and takes on there that help you bridge to that number.

Jack Lawrence Atkins - *Stephens Inc., Research Division - MD and Airline, Airfreight and Logistics Analyst*

Okay, that's helpful, John. Then last question as a follow-up to that: when you think about the $675 million (sic) [$625 million] in free cash flow expected for 2018, absent that deal, would you expect all of that to go to debt reduction?

John J. Hardig - *XPO Logistics, Inc. - CFO*

Well, yeah. I mean, we're -- right now, we have -- our budget is our budget for the year in terms of where we're going to put the capital to work, and so we're going to be -- we're going to save about $75 million in cash taxes versus what we were forecasting earlier. And that's going to go into the budget, as we are articulated, in terms of what the Capex budget is, what the budget is for other operating expenses, investments and things of that nature. So absent an acquisition, it would go into debt reduction.

Operator

Our next question is from the line of Ariel Rosa with Bank of America.

Ariel Luis Rosa - *BofA Merrill Lynch, Research Division - Associate*

So I wanted to touch quickly on the contract logistics side. If you could maybe discuss the mix of business there and your end market exposure. As I recall, Europe, you had a little bit more e-commerce exposure. Is there an active strategy to try increase that on the North American side? It seems like that would line up well for cross-selling across your business, so maybe if you could delve in to the balance of end market exposure across North America and Europe, that'd be helpful.

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

Sure. We actually have a lot of e-commerce business in our contract logistics business here in United States because of the -- all the reverse logistics, the returns management that we do and because of the omnichannel distribution. But our contract logistics business is broad: we have 11 different verticals. We have omnichannel retail, we have aerospace and government, we have automotive and industrial, technology, food and beverage, chemical, healthcare, oil and gas, agribusiness, consumer packaged goods, and a small portion is managed transportation. And that's -- so it's really broad-based, and that's reflective of our whole company. We are exposed to every part of the economy all across Europe, North America and a few places elsewhere.

Ariel Luis Rosa - *BofA Merrill Lynch, Research Division - Associate*

So let me ask you a little bit differently, does the margin profile vary between those types of customers?

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

They do. They do because the tight -- the complexity of service that we provide in those different verticals varies from one to another, and we have different levels of competition in them.

Ariel Luis Rosa - *BofA Merrill Lynch, Research Division - Associate*

So in terms of the growth that you're expecting for 2018 and the customers that you're onboarding, how might that impact margins in that segment?

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

I don't expect margins to change a whole lot, and we're going to continue to grow with our customers. So in contract logistics, we mainly grow with our existing customers. Those are long term contracts. The contracts tend to expand in scope as we find more things we can help our customers with. They usually get renewed and are very sticky. And so I don't see the business mix changing a real lot in contract logistics, either here or in Europe. It's true, though, that the e-commerce-related ones are growing faster than the non-e-commerce-related ones, but we're growing elsewhere as well.

Ariel Luis Rosa - *BofA Merrill Lynch, Research Division - Associate*

Okay, great. That's helpful. And then just for my second question, I wanted to touch on labor market tightness. I know somebody already asked about, obviously, the driver shortage, but maybe if you could expand that a little bit more broadly. And if you're seeing that at all, whether it's warehouse workers or any other area that maybe you're feeling a little bit of challenge in terms of recruiting, and how that might impact margins in 2018 and 2019?

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

Well, recruiting is always a challenge in part of the economy, because we're not just looking for anyone. We're looking for great, great workers. Whether they're worker -- they're dockworkers or whether they're drivers or whether they're warehouse workers, we want really excellent workers, who are safe and who are productive and who are collegial and fit into the culture. So we're selective in who we hire, even ones that we hire on a temporary basis. We've been successful at accessing the labor markets because we put a lot of effort into it, and we pay competitively. But there's no question about it, there is wage inflation globally. Wages are going up, and we move with the market.

Operator

Our next question is from the line of Bascome Majors with Susquehanna.

Bascome Majors - *Susquehanna Financial Group, LLLP, Research Division - Research Analyst*

I wanted to get your updated thoughts on the capital structure with respect to M&A financing. Just, a lot has changed since you raised equity around $60 last July. I mean, your cost of equity is arguably lower with the share price up 50% since then. Cost of debt is probably higher with bond yields going up and the U.S. tax shield coming down a bit with tax reform. Can you just let us know kind of how you're thinking about financing in total deal size, if any of that's changed at all?

John J. Hardig - *XPO Logistics, Inc. - CFO*

No, we -- our thoughts around that really haven't changed much. We are, obviously, monitoring the market very closely. We're always looking for opportunities to optimize our cap structure. And in terms of M&A capital needs, I mean, we've already raised with the equity raise last year. We have dry powder up to $8 billion for another acquisition, and we think that's sufficient without raising any additional equity. But we're constantly watching the market. We don't have any concrete plans in place right now.

Bascome Majors - *Susquehanna Financial Group, LLLP, Research Division - Research Analyst*

And from an interest-deductibility standpoint, is -- in your scenario analysis, is there any point where you might get snagged by the EBIT deduction limitation?

John J. Hardig - *XPO Logistics, Inc. - CFO*

Based on our assumptions for cap structure around an acquisition, we don't anticipate any limitation on interest deductibility.

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

Okay. Everyone, it's -- we are one minute away from the market opening. We don't want to hold you from all the excitement that's going on in the market. Thank you for the hour you've given us, and look forward to talking to you again in 90 days. Have a great day.

Operator

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