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Company: **XPO Logistics, Inc.**

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COMPANY PARTICIPANTS

- Bradley S. Jacobs - XPO Logistics, Inc., Chairman & Chief Executive Officer
- Ravi Tulsyan - XPO Logistics, Inc., Chief Financial Officer
- Matthew J. Fassler - XPO Logistics, Inc., Chief Strategy Officer
- Mario A. Harik - XPO Logistics, Inc., Chief Information Officer & President-Less-Than-Truckload
- Drew Wilkerson - XPO Logistics, Inc., President-North American Transportation

OTHER PARTICIPANTS

- Scott H. Group - Analyst
- Chris Wetherbee - Analyst
- Ken Hoexter - Analyst
- Allison PoliniakCusic - Analyst
- Thomas Wadewitz - Analyst
- Ravi Shanker - Analyst
- Jonathan Chappell - Analyst
- Scott Schneeberger - Analyst
- Jason H. Seidl - Analyst
- Ariel Rosa - Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Welcome to the XPO Logistics Second Quarter 2022 Earnings Conference Call and Webcast. My name is Paul and I will be your operator for today's call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Please limit yourself to one question when you come up in the queue. If you have additional question, you're welcome to get back in the queue, and we'll take as many as we can. 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 the call, the company will be making certain forward-looking statements within the meaning of applicable securities laws, which by their nature involve a number of risks, uncertainties, and other factors that could cause actual results to differ materially from those projected in the forward-looking statements. A discussion of factors that could cause actual results to differ materially is contained in the company's SEC filings as well as in its earnings release. The forward-looking statements in the company's earnings release or made on this call are made only as of today and the company has no obligation to update any of these forward-looking statements, except to the extent required by law.

During this call, the company also may refer to certain non-GAAP financial measures, as defined under applicable SEC rules. Reconciliations of such non-GAAP financial measures to the most comparable GAAP measures are contained in the company's earnings release and related financial tables or on its website. You can find a copy of the company's earnings release, which contains additional important information regarding forward-looking statements and non-GAAP financial measures, in the Investors section of the company's website.

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

Bradley S. Jacobs

Good morning, everybody, and thanks for joining our call. With me today in Greenwich are Ravi Tulsyan, our CFO; Matt Fassler, our Chief Strategy Officer; Mario Harik, President of LTL; and Drew Wilkerson, President of North American Transportation.

Before we get into earnings, I want to comment on the succession plan we announced yesterday. Once we complete the spin-off, Mario will succeed me as CEO of XPO and I'll remain with the company as Executive Chairman. I'll be the non-Executive Chairman of the spin-off RXO.

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Appointing Mario as my successor was an easy decision for the board and me. Mario has a deep understanding of the nuts and bolts of our LTL operations. He's been hands-on with LTL as CIO for seven years, because as soon as we acquired the network, we started developing technology for it. He also worked closely with the LTL sales team in his role as Chief Customer Officer and he's been running the entire LTL business since last year.

Mario is mission-critical to XPO. He was the third person I hired back in 2011 and we've worked side-by-side on every major initiative since then. He's been instrumental in the successful integration of 18 acquisitions and he's spearheaded countless innovations that have given us a tremendous commercial advantage. Now, Mario and his management team will take the reins of our growth strategy for LTL and lead XPO into its next chapter as a pure-play LTL carrier.

I'm proud to report a very strong second quarter. All of our reported metrics were ahead of guidance and consensus. We had our ninth straight beat on adjusted EBITDA and, in fact, we generated more adjusted EBITDA in the second quarter than in any quarter in our history. Like adjusted EBITDA, our adjusted diluted EPS was a new record for any quarter.

In our North American LTL business, we're continuing to build tremendous momentum. What a difference nine months make. Kudos to Mario and the team for delivering LTL revenue and adjusted EBITDA that were records for any quarter.

Our adjusted operating ratio, ex real estate, inflected positive in the quarter by 70 basis points to 80.4%. That's another company record for any quarter and it puts us right on track for an improvement of more than 100 basis points this year compared with 2021.

Also in the second quarter, we maintained our highest level of LTL network fluidity since 2020. So it's not surprising that we've seen a significant increase in our customer satisfaction scores, as measured both internally and by third parties. The LTL team has increased its focus on customer service over the last nine months now and it's gratifying to see us continue to build high satisfaction levels after a V-shaped recovery in our service metrics.

In North American truck brokerage, we continue to sharply outperform the industry. Our gross profit was a record for any quarter at 20.8%, up year-over-year by 610 basis points. And it's not just a price play, we grew volume year-over-year in the quarter by 16% in truck brokerage. This is a best-in-class business that's both highly profitable and taking share quarter-after-quarter.

In Europe, our operations continue to perform well despite the war in Ukraine. Our organic revenue growth in Europe was 7% year-over-year, which was a sequential improvement from the 5% we reported in the first quarter. And in constant currency, we grew adjusted EBITDA year-over-year by a robust 14%.

Company-wide, a key part of our success has been to pay rigorous attention to return on invested capital and free cash flow. And I'm pleased to report that as of the end of the second quarter, our trailing 12-month company-wide ROIC was 38% and significantly higher in our North American LTL and truck brokerage businesses. It's worth noting that since we bought the LTL business in October 2015, the business has generated net cash of over $3.8 billion.

And lastly, over the first six months of the year, we brought our net leverage ratio down from 2.7 times to 1.8 times. It's gratifying to see XPO perform so well across the board and our strategic actions on track. This includes the planned spin-off of our tech-enabled brokered transportation platform, RXO, in the fourth quarter. Finally, I'd like to profoundly thank all of our 43,000 XPO employees who are delivering a phenomenal quarter on route to a record year.

Now, I'll pass the call over to Ravi to go through the financials.

Ravi Tulsyan

Thank you, Brad, and good morning, everyone. Today, I will discuss our second quarter results, our balance sheet and liquidity and our outlook for the balance of 2022. I'll start with our results. We delivered strong year-over-year growth with record second quarter revenue and the highest adjusted EBITDA and adjusted diluted EPS of any quarter in our history. Revenue in the quarter was $3.2 billion. Adjusting for the sale of our intermodal business, our year-over-year revenue increased 11%. We grew adjusted EBITDA year-over-year by 23% to $405 million, or 29% excluding intermodal and gains from real estate sales. This reflects the strong earnings growth across all our businesses.

FX negatively impacted EBITDA by $6 million in the quarter. Our adjusted EBITDA margin was a record 12.5% and this was a year-over-year improvement of 210 basis points. Operating conditions in the quarter were favorable and the firm pricing environment more than offset inflationary pressures for labor and purchased transportation.

Our corporate cost in the quarter, excluding onetime expenses related to strategic initiatives, was down year-over-year by 29%. This reflects continued rationalization of our corporate cost structure. Our interest expense for the

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second quarter was $31 million compared to $58 million in the year-ago period. This reflects the paydown of approximately $3 billion of debt last year and over $600 million of debt during the second quarter. The effective tax rate for adjusted EPS for the quarter was 24%.

Our adjusted earnings per diluted share was $1.81, which was up from $1.22 a year ago, an increase of 48%. The increase was primarily driven by higher adjusted EBITDA and lower interest expense. We generated $199 million of cash flow from continuing operations, spent $130 million on gross CapEx and received $4 million of proceeds from asset sales. Gross CapEx was up $69 million year-over-year, primarily allocated to growing our LTL network.

Our free cash flow was $73 million. This includes $28 million of cash outflows related to transaction cost that were not contemplated in our free cash flow guidance. Excluding this transaction cost, our free cash flow was $101 million for the quarter. Looking at the balance sheet, we ended the quarter with $436 million of cash. This cash, combined with available debt capacity under committed borrowing facilities, gave us $1.4 billion of liquidity at quarter-end. We had no borrowings outstanding under our ABL facility.

Our net leverage at quarter-end was 1.8 times adjusted EBITDA. We are ahead of schedule on our deleveraging plan and are well within our target leverage range of 1 to 2 times adjusted EBITDA. In light of our strong results in the first half and our expectations for the second half, we updated our guidance after market closed yesterday. Our new full-year guidance for adjusted EBITDA is $1.4 billion to $1.43 billion. This increase primarily reflects our second quarter outperformance and does not include the impacts of our planned spinoff or the divestment of our European operations.

We still expect to have up to $50 million of gains from real estate sales and we currently expect all of these gains to be realized in the fourth quarter. We also issued guidance for the third quarter adjusted EBITDA of $330 million to $345 million. Pro forma for the intermodal sale, the midpoint of this range implies a third quarter adjusted EBITDA growth rate of 18% over the prior year.

Our outlook for full-year 2022 adjusted EPS anticipates a range of $5.55 to $5.90. This reflects our higher EBITDA outlook and slightly lower interest expense. The midpoint of our new full-year guidance for adjusted EPS implies year-over-year growth of 33%. On the cash flow front, our outlook for full-year cash flow is now $425 million to $475 million, up $25 million versus our previous outlook. As a reminder, this excludes all transaction-related cash outflows.

We expect interest expense of $145 million to $150 million, which is down from our prior target of $150 million to $160 million. There is no change to our previous guidance for depreciation and amortization expense, CapEx and the tax rate. In conclusion, we had a very strong first half of 2022 and we're entering the second half with good momentum. The execution of our strategic plan remains on track and we're excited about creating two pure-play transportation powerhouses.

I will now turn things over to Matt.

Matthew J. Fassler

Thanks, Ravi. I'll review our second quarter operating results by segments, starting with North American LTL. We grew LTL revenue 15% year-over-year to $1.2 billion, the highest revenue of any quarter in our history. LTL adjusted EBITDA grew by 14% year-over-year, or 16% ex real estate.

We had a 5.5% decline in tonnage per day from the second quarter of 2021. Demands from our major verticals was mixed. The year-over-year trend in agricultural verticals which are seasonally significant in Q2, decelerated, while automotive accelerated. Industrial, by far our largest vertical, tracked the overall trend, as did our second largest vertical, retail and e-commerce. Year-over-year growth in tonnage per day improved through the quarter.

Yield, excluding fuel, accelerated to an 11% improvement year-over-year from 9% in Q1, reflecting a solid pricing backdrop to the industry and the benefit of our proprietary pricing tools. Pricing is a major focus of our technology development in LTL and we've added top talent to our pricing team. We increased pricing on contract renewals year-over-year by 12%.

Our LTL adjusted operating ratio of 80.4% was 70 basis points better than the second quarter a year ago. It's also a 530-basis-point improvement sequentially from Q1. On our last earnings call, we said we expected to achieve at least 400 basis points of sequential improvement, so we outperformed that expectation. I'll note that these adjusted operating ratios exclude gains from real estate sales.

Our success in improving network fluidity is driving improvement in our cost strengths. As we procured third-party line-haul capacity more effectively, the year-over-year headwind from purchased transportation, measured as a percent of revenue, moderated from 250 basis points in Q1 to just 10 basis points in Q2. Those are the financial highlights of the solid second quarter performance in North American LTL.

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Our other segment is Brokerage and Other Services, and I'll remind you that intermodal was reported in this segment until we sold the business late in Q1 of this year. Segment revenue as reported declined in Q2 by 4% year-over-year, but excluding intermodal, revenue increased by 9% to $2.1 billion. In addition, FX weighed on revenue growth by 3 percentage points. Adjusted EBITDA increased 17%, or 29% ex-intermodal, to $152 million. Adjusted EBITDA margin for the segment expanded by 140 basis points to 7.4% from 6% a year ago.

The largest revenue and profit driver in the segment is our North American truck brokerage business, which had another outstanding quarter. This will be the core business of our planned spin-off of RXO in the fourth quarter of this year. We increased our brokerage loads per day by 16% versus a year ago and by 61% from two years ago. Second quarter truck brokerage revenue rose 24% year-over-year.

Our truck brokerage growth reflects our strong execution in a dynamic market. Drew will speak more about the specific drivers in a minute.

As Brad mentioned, organic revenue in Europe grew 7%, accelerating by 2 percentage points from the first quarter. We saw acceleration in organic revenue growth in all three of our major regions, France, UK and Iberia, and the platform continues to deliver results, both top line and profits, despite the geopolitical backdrop.

And lastly, we're grateful for some external recognition we received during the quarter. XPO was named a Top 100 3PL by Inbound Logistics magazine for the ninth year. Ford named XPO a Best Place to Work in Spain for the fourth consecutive year. We were named a Best Place to Work for Disability Inclusion on the Disability Equality Index for the second consecutive year. And we served as the official transport partner for the Tour de France for the 42nd year and expanded our partnership as the official transport partner for the women's addition of the tour.

Now, I'll turn it over to Mario for his comments on North American LTL.

Mario A. Harik

Thanks, Matt, and good morning, everyone. Before I begin, I want to thank Brad and the board for placing their trust in me. XPO has an enormous opportunity ahead and it will be a privilege to lead the company and continue working with Brad as Executive Chairman. It's also humbling to be entrusted with continuing the transformation we're executing in LTL. I've run the business for almost a year now and I'm constantly inspired by our best-in-class team, and we're going to accomplish a lot more together.

As Brad said, we continue to see tremendous momentum in our LTL business. This has accelerated over the last quarter with the actions we're taking to drive improvements in network fluidity and service and grow our network capacity.

In the second quarter, we gained significant traction in all these areas with measurable results. We achieved the highest level of network fluidity since before the pandemic. We also reached a new high for customer satisfaction according to Mastio, a third-party industry consultant that tracks our Net Promoter Score on a quarterly basis.

In addition, our investments in capacity are on track. The five terminals we added since October are fully operational. Now we're evaluating sites in Salt Lake City, Houston, Atlanta, Kansas City, Dallas and Philadelphia. We're being very disciplined about the network expansion. We've done the analysis and we're adding new terminals or new doors to existing terminals in markets with growing demand for LTL service. We expect these markets to continue to grow over the long-term. The 345 net new doors we've added to-date bring us over a third of the way to our goal of adding 900 net new doors by the end of next year.

Looking beyond our footprint, we're investing in capacity where we have a competitive advantage. For example, last quarter we announced that we added a second production line at our trailer manufacturing facility in Arkansas. That investment had an immediate impact and in the second quarter we produced a record number of trailers for our fleet. Our target is to manufacture more than 4,700 trailers this year. This will expand our in-house line-haul trailer capacity by over 10% to an all-time high. We've reaffirmed our plan for LTL CapEx at 8% to 9% of revenue this year.

On the driver side, we've been ramping up our hiring with targeted recruitment efforts and training more drivers in-house at our 130 training locations. These two channels are working well at solutions to the ongoing driver shortage. June was a particularly strong month for recruitment. The hiring environment overall is still tight, but it looses (00:21:22) significantly in the second quarter. We had a 44% average increase in the number of applications for each job we posted in the quarter.

Now I want to switch gears for a minute and talk about our record Q2 adjusted operating ratio of 80.4%. That's a year-over-year improvement of 70 basis points ex real estate. We had promised a second quarter inflection to year-over-year improvement and we delivered that. I'm also pleased that we overachieved on sequential improvement, which, as Matt noted, was 530 basis points from Q1 to Q2. We're on track for our target of more than 100 basis points of year-over-year improvement this year.

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Looking at the underlying drivers, we expect yield to remain strong throughout the balance of the year. Our pricing technology is mission-critical in getting us fair value for our services. In the second quarter, we saw the early impact of our pricing tools with strong yield on contract renewals. From a sales standpoint, we won a record amount of new business in Q2 and our sales sustained a positive trajectory each month in the quarter.

Last week, I met with a large shipper at our new Atlanta terminal. They just signed on with XPO and they're our newest top 10 customer. They're very happy with their onboarding experience and they're already committed to incremental volume with us. In addition, we're in discussions with two more brands this quarter, both of these would be top 10 LTL customers for XPO. This would set us up well for 2023.

As we onboard more revenue, we're also focused on cost management. This is another area where our technology excels. In the second quarter, we introduced proprietary cost models to enhance the team's visibility into cost management levers. We also have a new piece-level tracking capability that has the potential to significantly improve customer service and visibility.

One of our largest costs and a large opportunity is purchased transportation. We'll continue to moderate purchased transportation costs as we move through the back half of the year, driven by more efficient network operations and newly negotiated carrier rates. There are times when third-party line-haul is the optimum solution. But as we continue to add drivers and equipment, we expect to over time insource more third-party line-haul miles. This should drive material cost savings.

We have a lot of initiatives underway and, to sum it up, our goal is pretty simple, we want to be the best. We're creating a world-class LTL carrier by maintaining an intense focus on every part of the business. We have a highly engaged team that's determined to delight our customers. This year, we expect to generate at least $1 billion of LTL adjusted EBITDA and more than 100 basis points of year-over-year improvement in adjusted operating ratio ex real estate.

Going forward, we have company-specific levers that can expand our margin and improve our operating ratio well into the 70s. We'll take more volume share for our investments in fleet, doors and people, and capture a high return on those investments over time.

Over the last nine months, we've made major advances in positioning XPO to become a world-class LTL carrier from every perspective, and we know exactly where we're going from here. We'll provide more details on our growth plan at our LTL Investor Day as we get closer to the spin-off. We'll also announce our long-term outlook for XPO as a stand-alone company.

Now, I'll hand it over to Drew to cover truck brokerage. Drew?

Drew Wilkerson

Thanks, Mario. North American truck brokerage had another strong quarter, as we continued to sharply outpace the industry. I'll start by giving you four metrics from the quarter that highlight the stellar performance the team delivered. Then I'll talk about what's driving these results.

First is volume. We grew loads by 16% in the quarter, and it was the seventh consecutive quarter of double-digit load growth for our business. Second, we delivered a gross profit margin of 20.8%, up year-over-year by 610 basis points. This is a record performance for us in any quarter. Third is gross profit dollars, which we grew year-over-year by 76%. We have a long track record of growing gross profit through economic cycles and we're confident we'll continue to do that. And the fourth metric is an adjusted EBITDA margin of 10.6%. That's 420 basis points higher than Q2 last year and it's our first double-digit adjusted EBITDA margin.

We achieved these four metrics through a powerful combination we've built over many years; scale, cutting-edge technology and deep customer relationships. Scale refers to our access to massive capacity of 98,000 independent carriers in North America that allow us to serve more than 5,500 customers, including nearly half of the Fortune 100 companies. These are carriers who have registered to do business with us on our XPO Connect digital platform and come back week-after-week because of the immense volume that flows through our network. To a carrier, these are income opportunities.

Truck brokerage is a highly fragmented industry and there's a lot of competition for carriers, especially with the driver shortage. We make it more efficient for carriers to do business with us. Our digital platform is easy to use and we have a national carrier rewards program that saves them money on things like fuel, tire and roadside assistance.

And to shippers, our scale means reliable capacity on demand. The automation and machine learning we've built into the platform allow our people to focus on being more productive for our customers. We're known as dependable problem solvers who have a strong understanding of market dynamics.

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We work with our customers to make sure we have the appropriate amount of spot versus contract business based on the current market conditions. For instance, we made a deliberate shift in the second quarter to operate at a favorable revenue mix of 73% contract and 27% spot. A year earlier, that mix was 66% contract and 34% spot. Our technology gives us the agility to manage that change.

In the early days at XPO in 2011, we had the vision to develop a fully automated brokerage system and we've been building on our first-mover advantage ever since. I'm privileged to lead the team that made this vision a reality over the last 11 years and I'm even more excited about the next decade because of the opportunity to leverage our platform to continue to serve more customers and outpace the market.

Every dollar we put in our digital platform continues to pay off. Even now, years after we introduced XPO Connect, it's still growing at a rapid flow. Our mobile app has been downloaded more than 800,000 times. The number of weekly average carrier users on the platform increased year-over-year by 74%. And 80% of our truck brokerage loads were created or covered digitally, up from 74% in the first quarter. It's exciting to see the tremendous demand for our platform drive additional share gains for us.

Soon we expect to spin-off as RXO and, once that happens, I'll continue to work closely with Yoav Amiel, who will be our Chief Information Officer. Yoav currently leads the ongoing development of XPO's digital brokerage platform, which will be called RXO Connect and will be the technology backbone of the new company.

For us, the strategy of becoming a brokerage pure play makes sense on every level. We're a high-growth platform with a long runway for value creation. As a new public company with the sole focus on asset-light transportation, we'll continue to deliver best-in-class results for our employees, customers, carriers and investors. I look forward to meeting many of you at our Investor Day this fall where we'll be sharing our long-term outlook.

That concludes our prepared remarks. I'll turn it over to the operator and we'll go to Q&A.

QUESTION AND ANSWER SECTION

Operator

Thank you. We will now be conducting our question-and-answer session. Thank you. Our first question is from Scott Group with Wolfe Research. Please proceed with your question.

Analyst: Scott H. Group

Question – Scott H. Group: Hey. Thanks. Good morning. Brad, first, can you give an update on the process with Europe? And then, Mario, I wanted to ask you about some of the LTL items. So, nice sequential margin improvement. But if I look at the implied guidance for third quarter, implies a bigger sort of step back in margin than some of the other LTLs. So, any thoughts on the sequential margin into third quarter and any way to quantify the savings you think you'll get from more insourcing?

Answer – Bradley S. Jacobs: Hi, Scott. Good morning. The sales process in Europe remains very lively, very buoyant. It's a great opportunity for a buyer to buy an asset that's scaled and has pan-European strategic value. It's a very attractive platform. The base case scenario is, we'd be signing a deal to sell it in the fourth quarter. And probably wouldn't close by the time of the spin; it could, but probably not. In that case, we'll just have it as discontinued operations and we'll show the numbers with and without it.

Mario?

Answer – Mario A. Harik: Hey, Scott. On the sequential margins and overall LTL, as you said, in the second quarter we delivered a great sequential improvement of 530 basis points and 80.4% adjusted OR. When we look at the third quarter, we expect an improvement of at least 150 basis points on a year-on-year basis, which is a typical – in the neighborhood of our typical seasonality going from the second to the third quarter.

Question – Scott H. Group: Is there something you think you could do to sort of lessen that seasonality going forward to be more consistent with some of the other LTLs? And then, I also had just asked about the insourcing and any way to quantify it.

Answer – Mario A. Harik: Yeah. So, let's start with insourcing. So we do expect purchased transportation cost to continue to moderate through the course of the year. When you look at the second quarter, our line-haul miles that were outsourced were roughly 24.7%, which was up 80 basis points from last year, which is what we said we would do, but we're going to lean a bit more on purchased transportation this year.

Now, we don't expect to insource purchased transportation as much in 2022. That's more of a longer-term strategic initiative for us and how we expect to drive that. However, we do expect the rate on a per mile basis to continue to

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moderate through the course of the year. As we improve network fluidity, we can be much more predictive in how we purchase transportation.

And just to give you a few stats, the cost per mile for up in line-haul was up on a year-on-year basis by 33% in the first quarter and it was up 14% in the second quarter, with newly negotiated rates with carriers that went into effect in the month of May. So, as we head into the back half of the year, we would expect that to continue to moderate and give us a portion of the cost tailwinds we expect in the back half.

Now going back to your question on, if we can accelerate further the OR improvement, obviously OR goes back to volume, to price and other cost improvements that we're doing, and there are multiple paths for us to get to our guidance of at least $1 billion of EBITDA and at least 100 basis point of OR improvement.

Question – Scott H. Group: Okay. Thank you, guys.

Answer – Bradley S. Jacobs: Thank you.

Operator

Thank you. Our next question comes from Chris Wetherbee with Citi. Please proceed with your question.

Analyst: Chris Wetherbee

Question – Chris Wetherbee: Yeah. Hey. Thanks. Good morning, guys. So Mario, maybe I could stick with you on the operating ratio sort of implied for particularly the third quarter. And I guess, last year you had a step-up I think in the neighborhood of 300 basis points from 2Q to 3Q and that was when you had some challenges in the network. I think the implied guidance is maybe in the 200-ish type of range in terms of increase in the OR sequentially.

So I just want to make sure I understand sort of the moving parts around cost and some of the progress you've made in terms of efficiency in the business, because it seemed like the second quarter was a big step forward. I'm just wondering if there are some (00:35:03) dynamics that maybe change from 2Q to 3Q and maybe there's some tonnage discussion that need to be had within that comment. But just want to maybe get a little bit more color on what's happening from 2Q to 3Q from a cost perspective.

Answer – Mario A. Harik: Yeah. Sure thing, Chris. So when we look at the – if we follow sequentially, so from an OR perspective, obviously it was favorable in the second quarter 70 basis points on a year-on-year basis. And now when we go to the third quarter, starting first with pricing, we expect the pricing environment to remain very robust. Our yield in the second quarter was up 11% versus 8.7% in the first quarter and we expect yield to continue to remain strong for the course of the year, although we'll have tougher comps as we head into the back half. But our contract renewals were up 12% in the second quarter and we continue to be up double-digit in the month of July.

And from a volume perspective, we were down 5.5% in the second quarter and we expect the third quarter to be down in the low- to mid-single digit on the tonnage front. But we're excited about the momentum we had in sales. As I said in my prepared remark, we saw record new business wins in the second quarter and that trend improved through the quarter. We landed a new top 10 customer in the second quarter.

Just recently here I met with them and they're sending more business our way. They were very happy with their onboarding experience. We're in top-quartile in terms of quality that we offer them and they're going to send more business our way. And we're having great momentum here early in the third quarter with two potential top 10 customers as well. So, that would lead to obviously volumes improving through the course of the year.

And then finally, on the cost side, I mentioned third-party line-haul cost and overall line-haul cost. It will moderate through the course of the year. And we also had a number of efficiency actions. We had the best network fluidity we had since pre-pandemic and that's going to lead to better results as well.

Question – Chris Wetherbee: Okay. And just to clarify, is around 200 basis points you think the right sort of seasonal transition from 2Q to 3Q in the business? There's been a lot of volatility, so kind of just curious about what the right number is as we think about that going forward.

Answer – Mario A. Harik: Yeah. Our typical seasonality is in the, call it, 200 to 250 basis points range in terms of OR change from the second quarter to the third quarter.

Question – Chris Wetherbee: Okay. That's helpful. Thank you very much.

Answer – Bradley S. Jacobs: Thank you.

Operator

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Thank you. Our next question is from Ken Hoexter with Bank of America. Please proceed with your question.

Analyst: Ken Hoexter

Question – Ken Hoexter: Great. Just to round that out, Mario, you mentioned three new top 10 customers potentially coming online. That's a lot of new business coming or leaving. Maybe talk about the process, the risk to your routing structure or service levels or how you prepare for that.

And then just to clarify that your EBITDA is up. I think you raised your target about $50 million with the $40 million, $41 million beat this quarter, so – or above $45 million overall. So, are you just saying the back half is kind of no change to that despite the large beat in the second quarter? Just want to understand your vision on that guidance raise in outlook.

Answer – Mario A. Harik: Yeah. But, first, I'll take the customer question and, Ken, then I'll turn it over to Matt for guidance piece. But when you think of our – the way we look – I mentioned also earlier that we launched new costing technology in the second quarter with its proprietary costing model. So, we have a very deep understanding about how a customer (00:38:24) would impact the network as a whole. And we price according to where we have excess capacity or imbalanced lanes where we'll get more volume in lanes that we want to be able to fill the back haul for and better balance our network.

So, this is how we look at these large relationships in terms of, one, how we price them; but, two, how we analyze their data to what fits with the network and we have the new technology that helps us make these determinations easier and better. And these will be accretive both in terms of volume and profits as well.

Answer – Matthew J. Fassler: And then as it relates to the guidance, Ken, you're right, we beat the midpoint of our guidance by $40 million. We raised the midpoint of our new guidance for 2022 by an additional $5 million beyond that. You can think about that as relating to strong visibility in both LTL and in brokerage services. You asked about LTL in particular. In the first half of the year, in LTL, ex real estate, we had an adjusted EBITDA increase of about 11% and we're more like mid- to high-teens in the second half of the year. So, we have very good visibility on the first half to second half acceleration for LTL.

Question – Ken Hoexter: And then I think you mentioned earlier 70% OR moving forward. Is that your near-term target? Was that just a throw out number? And what levers do you need to get there?

Answer – Mario A. Harik: Yeah. When we think overall about getting to the 70s from an OR perspective, that's our goal. So, if we think about our strategy that we've started in Q4 of last year, we expect to improve OR by hundreds of basis points to get well into the 70s over the years to come.

And the strategy is focused on the customer where we want to delight our customer by providing outstanding service and on-time damage performance (sic) [damage-free performance] and all the aspects of service.

We want to continue to grow volume by adding capacity. Historically we've spent the maintenance CapEx to expand margins. Now we're pivoting to a strategy where we're investing in more doors and more people and more equipment, leveraging our data manufacturing facility there. Obviously, pricing will continue to be firm in our industry moving forward.

And then, finally, we want to leverage our proprietary technology to keep on optimizing our cost structure and insourcing line-haul miles where it makes sense. So, over the years to come, we expect to improve our OR hundreds of basis points to get well into the 70s. And we'll give more color on that in our Investor Day later early fall and how the model looks like over the years to come.

Question – Ken Hoexter: Thanks, guys. Appreciate it. Good luck on the spin.

Answer – Bradley S. Jacobs: Thank you.

Operator

Thank you. Our next question is from Allison Poliniak with Wells Fargo. Please proceed with your question.

Analyst: Allison PoliniakCusic

Question – Allison PoliniakCusic: Hi. Good morning. Mario, in line with that, should we see this accelerated industrial softening into next year? A lot of investment into that proprietary technology. Can you maybe walk through how we should think of the competitive advantage that proprietary technology would bring you to better manage the down this cycle, whether through market share gains or even the agility on the cost side?

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And then secondly, just I guess this is more on the brokerage side. Expansion although is covered digitally, was that expansion leading more towards new customers attracted to XPO Connect or existing customers moving more into digital capabilities? Just any thoughts there? Thanks.

Answer – Mario A. Harik: You got it, Allison. I'll take the first one then I'll turn it over to Drew. But, first, starting with the macro on the industrials, so today two-thirds of our customers are industrial companies. And we hear mixed feedback from these customers. When we look at many of these companies have had pent-up demand from their customers, where they couldn't produce enough parts to fulfill open POs that they had from their customers. And as things are easing up in their supply chain, they're actually being able to move products faster, which is leading to stronger demand.

Others, they're not seeing that. Others are actually seeing softness in demand that is impacting overall how much they're shipping. But generally we see the industrial economy very much in recovery and that's going to become a tailwind as we get through where things are today.

Now in terms of technology and how we use technology, and for us, technology has a number of components. Number one is the focus on pricing where we launched proprietary pricing technology. And as I mentioned earlier, we just launched our new proprietary costing models that allow us to better understand the cost structure of a given shipment and how we can price the freight for the customer, so we can get the highest yield possible. And also bridging that yield gap we have with some of our competition as well. It also helps with automation technology like dynamic pricing and reducing manual processing as well.

And then we have a slew of technologies around cost efficiency and overall operational excellence, and these start with line-haul. And this is where we're doing things like better balancing the network and our algorithms that operate line-haul to optimize how much head-hauls do we build in the network. With improved – the more than $1.1 billion of spend, we'll spend on line-haul over time, and then similarly, with pickup and delivery to increase route density and on the docks to optimize labor efficiencies.

And finally, from a customer-facing perspective, we believe in technology to help with our service to the customer. And case in point, we just launched new technology called piece-level tracking, where we can give customers visibility to the pallet level of where every pallet is moving through the network and then giving them better visibility on in terms of when they're going to receive their shipments.

Answer – Drew Wilkerson: And good morning, Allison. This is Drew. On the second part of your question, it was both new and existing customers, but there was also both new and existing carriers that we're working with. When you look at the carrier side, the last quarter we talked about having 88,000 carriers in our network. This quarter, we have 98,000 carriers. But all of our stats on both the carrier side and the customer side are up and to the right.

Our year-over-year registered carriers on XPO Connect are up 47%. The registered customers are up 29% and the carrier usage is up 74%. So, when you look at our performance that we've had for the past several quarters, technology is the main reason that we've been able to do that and that's because we began investing in it in 2011.

Question – Allison PoliniakCusic: Great. Thank you.

Answer – Bradley S. Jacobs: Thank you.

Operator

Thank you. Our next question is from Tom Wadewitz with UBS. Please proceed with your question.

Analyst: Thomas Wadewitz

Question – Thomas Wadewitz: Yeah. Good morning. And Mario, congratulations on the future, I guess, on leading LTL and being future CEO of XPO. And congratulations on the transition as well, Brad. Wanted to ask about the volume side on LTL. The 5.5% decline in 2Q is a bit greater than I expected or a bigger decline than I would have expected. I don't know if that's a time lag between improvement in the network performance and the volumes, or what's happening within that. But it just seems like you've had a pretty quick bounce back in the network. You're talking about customer satisfaction scores that are improving.

So, do you think that the weakness in volume in 2Q is just a time lag or how should we think about that? And then, I guess, how does that affect second half? Like, could you get to volume growth in 4Q? Just trying to understand the kind of positive commentary versus the weak volume in 2Q in LTL. Thank you.?

Answer – Mario A. Harik: No, you got it. On the first – thank you for the well wishes. But as you said, our Q2 tonnage was down 5.5%, which was within our guidance. But when you think about the sequential tonnage trends from Q1 to Q2, these were favorable relative to peers.

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Now when we think about what drove that, I mean, some of it was – I mentioned earlier on the mixed feedback from customers. When you look at the existing customer base, there was a slight softness compared to – if you compare that to last year, as an example, and the environment that was leading to that.

Now what we are excited about, though, is the momentum we have from a sales perspective, with the significant improvements we've seen in how we're performing and the network fluidity that is back to pre-pandemic levels. We have great sales momentum from our sales force where we've had record business wins in the second quarter, and that accelerated through the quarter as well. So, when we think about it, that's going to be new customers and new volumes that will get onboarded in the back half as we head into 2023 and add more volume to our network.

Question – Thomas Wadewitz: Well, I guess, one other element within the discussion. You talk a lot about technology as a way to improve the customer experience. What about culture of the employee base at LTL? I think if you look at like an Old Dominion, they have this remarkable culture on service and focus on getting employees focused on service. Is that something that there's opportunity to improve or need to improve as well as really having a strong technology?

Answer – Mario A. Harik: Yeah, you're spot on Tom. This is very much ingrained in our culture, where the culture of one continuous improvement, but focus on the customer and keep on improving service. And just to give you an example, we have a number of ongoing initiatives that actually help drive that. Starting first, our sales team is working with our customers on freight packaging best practices. And for customers who load that on trailers, we actually have feedback loops where we now give them feedback on how well their dock workers are loading these trailers.

We're also – we launched a number of changes in the incentive plan for our people in the field to actually have quality as a whole as part of that incentive plan. And we also have a number of initiatives where these are new technology initiatives, but that are ingrained now in the culture where if you're a dock worker or a driver, whenever you open up – or a freight operation supervisor, whenever you open up or you close a trailer, you actually take a photo of it and you rate the quality of the loading of that trailer in terms of using our quality methods of loading these loads. So, that's very much ingrained in what we're doing and there's tremendous amount of momentum in focusing on the customer and the quality we offer our customers.

Question – Thomas Wadewitz: Great. Thank you.

Answer – Bradley S. Jacobs: Thank you.

Operator

Thank you. Our next question is from Ravi Shanker with Morgan Stanley. Please proceed with your question.

Analyst: Ravi Shanker

Question – Ravi Shanker: Thanks. Good morning, everyone. And I'll echo my congrats to you, Mario, very well deserved. Maybe the first question's on brokerage, either for Brad or for Drew. Brad, I think you mentioned in your opening comments that brokerage is taking a lot of share in the marketplace. Can you give us a little more detail on that, like, who is that taking share from? Is that growing the pie? Is it coming from asset-based carriers? Is it coming from other incumbent brokers, coming from digital guys? Kind of where is that share coming from?

Answer – Drew Wilkerson: Good morning, Ravi. This is Drew. It's coming from both. When you look at the trend that's been going on for years in the brokerage industry, brokerage as a whole is taking share from asset-based carriers. I know I've said this before, but whenever I started in the brokerage industry, brokerage had about 10% share of the for-hire trucking market. Today it's 22% and it's continuing to grow. And I'm confident that it will continue to grow for the next several years going forward.

So it's coming from asset-based carriers, it's coming from other brokers. And it's because of the service that we provide to customers, the technology that creates solutions for customers and the team that they've got strong relationships with. Our top 20 customers have been with us for 13 years on average. We've got a long history of service and continuing to create solutions for the customers.

Question – Ravi Shanker: Got it. It's always dangerous to ask an incoming CEO where he thinks his share might max out because I don't think you think there's a limit, but I'm going to ask that anyway. Kind of is there a natural kind of share limit? Like, when you compare to some of the larger incumbents that you compete with as well as the long fragmented tail, like, what is a kind of steady-state share target do you think?

Answer – Drew Wilkerson: Ravi, I'm going to keep it simple. Right now, we've only got 4% share in the brokerage market and we've got a long way to go.

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Question – Ravi Shanker: Got it. Brad, I'm sure you're going to stay extremely busy with XPO, RXO and any other ventures. But if I can ask you kind of what your plans are as Executive Chairman of XPO and Non-Executive Chairman of RXO? Like, what are some of the priorities going to be?

Answer – Bradley S. Jacobs: I couldn't hear the very last part of your question, Ravi, just the very end.

Question – Ravi Shanker: I asked what are some of your priorities going to be as Executive Chairman of XPO and Non-Executive Chairman of RXO?

Answer – Bradley S. Jacobs: Oh, priorities, yes. So obviously, as Executive Chair at XPO, I'll be spending much more time, but I'll still be involved. I will perform the customary duties that you're expected of, of a Non-Executive Chairman at RXO. And I'll be spending the normal customary duties we expected of an Executive Chairman at XPO. So there'll be more time invested in XPO than RXO. But I'll also be involved in RXO.

Question – Ravi Shanker: Great. Thank you.

Answer – Bradley S. Jacobs: Thank you.

Operator

Thank you. Our next question is from Jon Chappell with Evercore ISI. Please proceed with your question.

Analyst: Jonathan Chappell

Question – Jonathan Chappell: Thank you. Good morning. Drew, as we think about that 16% volume growth in the second quarter, is there any way to give a breakdown on a month-by-month basis and where you ended up in July? Just trying to think about if the falloff in the trucking market throughout the second quarter was a benefit to you or a bit of a headwind.

And then also as we think about that, breaking the 20% threshold on the gross profit margin, if volume does become a bit of a headwind, does that enable the margin to kind of improve as you scale more the technology, the network, et cetera? Or does it kind of go hand – does the gross profit margin kind of go hand-in-hand with any potential volume headwinds?

Answer – Drew Wilkerson: Yeah. So when you look at it, the volume growth started off strong in April, came down just a little bit in May and then picked back up again in June. So it's pretty consistent throughout overall for Q2. When you talk about the potential of volume falling off in the future, yes, there is the opportunity to expand net revenue margins. And you saw us do that by putting up 21% in the second quarter, and July was operating around that same gross profit percentage.

Question – Jonathan Chappell: Okay. So just to frame, I mean as 16% starts to decelerate, is 20.8% gross profit margin kind of the new floor as we think about the back half of the year in 2023?

Answer – Drew Wilkerson: I wouldn't call it the floor. There's a lot of unknowns for the back half of the year. So what I'm confident in is that we'll outperform the market because the investments that we've made in technology that we'll have best-in-class gross profit percentages going forward.

Question – Jonathan Chappell: Okay. Thank you, Drew.

Answer – Drew Wilkerson: Thank you.

Answer – Bradley S. Jacobs: Thank you.

Operator

Thank you. Our next question comes from Scott Schneeberger with Oppenheimer. Please proceed with your question.

Analyst: Scott Schneeberger

Question – Scott Schneeberger: Thanks very much. Good morning. Congratulations, Mario; and Brad, to you as well. Drew, I'm going to keep it on you. I'm curious, in the back half for truck brokerage, what are you anticipating for kind of the industry dynamic in spot rates. And how do you intend to manage contract versus spot? It looks like you've improved that toward the contract side year-over-year. And any color you can share about what time of year you may renew contract rates more so than others? Thanks.

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Answer – Drew Wilkerson: Yeah. So the spot rates have come down on a year-over-year basis. They're below contract rates. I don't think that they can fall too much further from where they are right now overall. When you look at the back half of the year, there's still some unknowns in the macro, but I'm confident that we'll outperform. Whether the market tightens or loosens, we've built a model that can perform well in either market.

And so, the second part of your question, I forgot. Will you repeat that?

Question – Scott Schneeberger: Yeah. Just the management of contract versus spot.

Answer – Drew Wilkerson: Yeah.

Question – Scott Schneeberger: And is there a sort of time of year where you renew contract more than other? Thanks.

Answer – Drew Wilkerson: Yeah. Typically, our annual contracts come up in the fourth quarter and in the first quarter, but rates with customers is always an ongoing discussion. And that's something that we managed through the second quarter and it's why you saw our contract volume go up to 73%, which was perfect for the market that we're in.

Question – Scott Schneeberger: Great. Thanks.

Answer – Drew Wilkerson: Thank you.

Operator

Thank you. Our next question is from Jason Seidl with Cowen & Company. Please proceed with your question.

Analyst: Jason H. Seidl

Question – Jason H. Seidl: Thanks, operator. First of all, Mario, congratulations on the CEO role going forward. Wanted to stick with you here on the LTL side. You talked a little bit about the cost savings from in-housing a lot of the line-haul. Can you talk about the differential between in-house line-haul and outsourced line-haul in terms of operational performance? Is in-house line-haul more reliable and should we expect, as you in-house more, that your performance numbers will go up?

Answer – Mario A. Harik: Yeah. Sure thing, Jason. First, thank you. So when we think about – first starting with cost, there is roughly a differential of 30% to 40% cost per mile differential between outsourced line-haul and insourced line-haul. And now in terms of service, if you go back in the back half of last year, on-time service for carriers were generally in a much tougher place. So the differential on on-time service between internal and external was fairly wide. But since then, that gap has narrowed quite a bit. So, carriers now outperforming at a much better level of on-time service.

However, internal is always better, because internal – obviously it's your drivers, your employees, your equipment, so you effectively have full control over it and it's usually 100% of the time there. So it's still slightly better for internal, but that gap has closed significantly since the back half of last year.

Question – Jason H. Seidl: And how should we look longer term at your terminal footprint? How comfortable are you that right now this is the right footprint to have? And what changes might you think about making if you want to make any?

Answer – Mario A. Harik: Yeah. On the terminal opening, so obviously we have a plan to add 900 net new doors that we initiated in October of last year. And so far we've added a net 345 doors. And these are all in markets where we are either seeing demand from our customers where we don't have enough capacity to handle that demand or improving the operation of our line-haul networks.

When you think about the freight moving through our network, if we have certain docks where we're seeing that are already tapped out of capacity or running close to capacity, this is where we're looking to expand those. To give you an example, the Atlanta market is a market where we were seeing both demand in the local market as well as demand for market to flow in the south of the country, for example, down to Florida.

So by us adding the new terminal there, that gives us effectively more capacity to handle that local volume as well as move more freight through the line-haul network. And this is what's driving our strategy.

Question – Jason H. Seidl: Yeah. Thank you very much for the color and I appreciate the time, as always.

Answer – Bradley S. Jacobs: Thank you.

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Answer – Mario A. Harik: Thanks so much.

Operator

Thank you. Our next question is from Ari Rosa with Credit Suisse. Please proceed with your question.

Analyst: Ariel Rosa

Question – Ariel Rosa: Great. Good morning. And I'll echo others' comments in terms of extending congrats to Mario on the promotion or the anticipated promotion to CEO. Mario, I wanted to stick on that topic of kind of negative tonnage growth versus adding door capacity. It seems like those two things are in conflict. So, I guess my question is, as we think about 2023, is the expectation that tonnage can be up year-over-year as you start to bring onboard some of these new customers? And maybe you can talk about that logic, is it really just filling out the network and improving service capacity? And do you anticipate maybe idle capacity maybe a little bit more elevated than what it has been relative to history?

Answer – Mario A. Harik: Thanks, Ari, on the wishes. Bu when we think about capacity, we think of it as being a long-term investment for us to be able to drive grabbing market share and growing volumes. And historically, since we first acquired Con-way, our CapEx investment strategy in LTL was to actually keep volume steady but expand margins. And case in point, we generated $3.8 billion of cash since we acquired Con-way and the goal was not to expand volume.

That said, moving forward, when we think about these investments, the short-term again we're seeing that mixed feedback from customer and softer demand than what we saw last year. But generally, over the years to come, that demand is going to pick up and we're going to have the investments and capacity to be able to capture that demand, both from a network perspective, from a real estate doors perspective, as well as adding more fleet to be able to handle that as well.

For 2023 guidance, we'll obviously give more of that later in the year. And I'd definitely encourage you to attend the Investor Day we're going to be holding in the fall.

Question – Ariel Rosa: Okay. Great. And if I can sneak in a quick follow-up. I just wanted to ask Brad because we're probably not going to get too many more opportunities to have Brad on these calls I would imagine. Brad, just given your experience with XPO and spending a decade building this business, any reflections on kind of what went well, what went less well and thoughts on the future for the broader industry in terms of both LTL and brokerage?

Answer – Bradley S. Jacobs: I look back over the last 11 years and I feel very proud. I feel very proud of the team. I feel proud of what the team has accomplished. We started off buying a relatively small company back in 2011, Express-1. It had about $170 million of revenue and less than $10 million of EBITDA and look what we've grown the business to right now. And we've done it with being very careful with how we spend the money that our shareholders have given us and our lenders have lent us. And we've had an intense focus on return on capital and generating free cash flow. And this is what creates value over time.

So I like where the company is positioned. I like the fact that we've cultured management and people have grown so much over the last decade to the point where I feel comfortable dividing the company up in three. We've already divided up the warehousing business with an excellent CEO running that. We're spinning off brokerage and we've got an excellent CEO to run that. And RemainCo will be run by an excellent CEO Mario Harik and LTL business will be very strong.

The second part of your question is what do I think about the future of the LTL business and truck brokerage. I think they're both good businesses. I think particularly the way we're approaching those businesses. In truck brokerage, Mario and I, I mean, right from the very beginning in 2011, said we have a vision here. Let's automate this business and let's make things that are done by humans done by the computer. And that's what we did.

And we spent so much money investing in developing what was originally Freight Optimizer. We were going to call it Super Mario, but the name was taken. And then developed into XPO Connect, and XPO Connect, the adoption rates are off the charts. And there's a lot of elements that have gone into making our brokerage business very strong, but the technology is the main one in my opinion. So I think brokerage has got a bright future because it's tech-enabled and we provide a service that shippers need and we provide a service that carriers need. So, I'm good with the business.

In terms of LTL, different business plan there. There that's something completely levered – not completely, but predominantly levered to the industrial economy. So we have to go up and down with the industrial economy. And we've had an approach there to – in Phase I of LTL up until now, to run the business for cash, to run the business for not growing the top line, not growing tonnage, not growing head count, not growing a fleet, but to run the business more intelligently, run the business more efficiently, run the business more productively.

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As a result of that, we've taken a business that was doing 300-something million dollars of EBITDA when we bought it and now we're on track to do $1 billion of EBITDA. And we've taken the margins up by 1,290 basis points and all the while generating $3.8 billion of cash. I can't emphasize that enough because anybody can put lots of CapEx into a business and you're going to see volume growth, of course you will. But to take a business and not put money into it in a big way, but instead generate cash with it and grow profit growth from that, that's really something I'm very proud of what the team has done.

Now, in Phase II of LTL, we're going to continue our discipline of growing the margin, eliminating waste, reducing inefficiencies, running the business in a way that customers love us, and at the same time we're going to invest in the fleet and we're going to grow the top line as well. Very big inflection point in terms of Phase I of LTL, which we were sweating the assets, and Phase II of LTL, we're going to continue to focus on the optimization of the assets, but also invest in the business and grow the top line. So I think the future is very, very bright there. And I think Mario is inheriting a very good platform and I'm confident he's going to bring it to a whole new level over the next few years.

Question – Ariel Rosa: Great. Thanks for all the color and congrats on the strong results.

Answer – Bradley S. Jacobs: Thank you. And congrats on your new position, Ari. You have big shoes to fill.

Question – Ariel Rosa: Thank you so much. I appreciate that.

Answer – Bradley S. Jacobs: Thank you.

Operator

Thank you, our next question...

All right. Well, we had a lot of record results to talk about on this call, including our highest adjusted EBITDA of any quarter. In LTL, we reported our best adjusted operating ratio ever. Truck brokerage is continuing its phenomenal run with another quarter of double-digit volume growth. The process with Europe is going well and the sales there should help us to continue to de-lever. And the spin remains on track to the fourth quarter.

After the spin, each company will have a rock solid CEO, Mario for LTL, Drew for brokerage, and we'll have a long runway for earnings growth in both of them. So, thank you, everyone. It's been a pleasure and we'll talk again soon.

Operator

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

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