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XPO.N - Q2 2023 XPO Inc Earnings Call

EVENT DATE/TIME: AUGUST 04, 2023 / 12:30PM GMT

OVERVIEW:

Company Summary

CORPORATE PARTICIPANTS

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

Kyle Wismans *XPO, Inc. - Incoming Chief Financial Officer*

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

CONFERENCE CALL PARTICIPANTS

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

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

Eric Thomas Morgan *Barclays Bank PLC, Research Division - Research Analyst*

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

Jizong Chan *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate VP & Equity Research Analyst*

Jonathan B. Chappell *Evercore ISI Institutional Equities, Research Division - Senior MD*

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

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

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

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

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

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

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

PRESENTATION

Operator

Welcome to the XPO Q2 2023 Earnings Conference Call and Webcast. My name is Sherry, and I will be your operator for today's call.

(Operator Instructions)

Please note that this conference is being recorded. Before the call begins, let me read a brief statement on behalf of the company regarding forward-looking statements and the use of non-GAAP financial measures.

During this call, the company will be making certain forward-looking statements within the meaning of applicable securities laws, which, by their nature, involve a number of risks, uncertainties and other factors that could cause actual results to differ materially from those projected in the forward-looking statements.

A discussion of factors that could cause actual results to differ materially is contained in the company's SEC filings as well as in its earnings release. The forward-looking statements in the company's earnings release or made on this call, are made only as of today, and the company has no obligation to update any of these forward-looking statements, except to the extent required by law.

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

I will now turn the call over to XPO's Chief Executive Officer, Mario Harik. Mr. Harik, you may begin.

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

Good morning, everyone. Thanks for joining our call. I'm here in Greenwich with Kyle Wismans, our incoming Chief Financial Officer, Carl Anderson, our outgoing CFO; and Ali Faghri, our Chief Strategy Officer.

This morning, you saw us report a solid quarter despite a soft operating environment. Company-wide, we generated revenue of $1.9 billion and adjusted EPS of $0.71. We also delivered adjusted EBITDA of $244 million coming in above expectations. In our North American LTL segment, adjusted EBITDA was $208 million, also above expectation.

I want to focus my comments this morning on the progress we're making with the 4 pillars of our plan for LTL 2.0. The first pillar is to provide industry-leading customer service. Last year, we implemented multiple initiatives to elevate our customer service levels, including a new incentive compensation structure for the field. We've made it clear to the team that customer service is our top priority. And we're seeing the impact of that in our key service metrics.

In the second quarter, our claims ratio for damages was 0.7%, which is an improvement compared with 0.9% in 2022 and 1.2% at the end of 2021. And in the month of June, our damage claims per shipment came in at the best level in over 7 years. Another key metric is on-time performance. We improved this by 10 percentage points in the quarter, year-over-year. Going forward, we're keeping up the momentum as we begin to roll out new tools for the field, including higher-quality straps, airbag systems and new storage racks in our service centers.

More recently, with the acceleration in July volumes, we've continued to improve key service metrics. During this period of industry disruption, we're protecting capacity for our existing customers and being disciplined in what freight we bring on into our network. While we've made considerable progress with service in a relatively short time, there's a lot more we can do. Our entire organization is laser-focused on providing the best LTL service in the industry.

The second pillar of our plan is to invest in our network for the long term. As you know, we anticipate allocating CapEx of 8% to 12% of revenue on average over the next several years. Now that we've completed our 2 spin-offs, we have more opportunities to invest in driving long-term growth in LTL, a business that generates a high return on invested capital. Most of our CapEx this year is being deployed to increase the capacity of our fleet. We've added more than 900 tractors which has brought down the average age of our fleet to 5.1 years from 5.9 years at the end of 2022.

We've also produced nearly 3,100 new trailers at our manufacturing facility in Arkansas, and we're on track to meet our targets for over 6,000 new trailers this year. In addition, we expanded capacity at our service centers in Norcross, Georgia and in Salt Lake City. This aligns with our plan to add new doors in markets where more capacity can sustain more growth, over time.

At this point, we've added more than half of the 900 net new doors contemplated in our plan and we expect to open the remainder by early 2024, primarily by expanding existing terminals. These targeted expansions will help improve network density and fluidity over the long term.

Given the recent market dynamics, we're evaluating the pace of our CapEx plan to see if we want to accelerate our investments in network capacity. There is a potential for our annual CapEx as a percent of revenue to exceed the high end of our target range in the near term.

The third pillar of our plan is to accelerate yield growth. We grew yield, excluding fuel, by 1.4% year-over-year in line with our outlook for the second quarter. We still had a headwind from mix, as we described last quarter. However, our underlying pricing trends remain solid with contract renewal pricing up by mid-single digits.

Yield is our single biggest lever for margin improvement going forward. And we have multiple initiatives underway to leverage the gains we're making in service quality and operating excellence. We started to see the impact of these initiatives grow in the second quarter, and we expect this acceleration to continue.

The fourth and final pillar of LTL 2.0 is to continue to drive cost efficiency. The main opportunities here are in purchased transportation, our variable cost structure and overhead expense. In the second quarter, we reduced our purchased transportation cost by 35% year-over-year by utilizing 2 levers. First, we continue to reprice contracts with third-party carriers to capitalize on favorable market conditions. At the same time, we reduced third-party linehaul miles in the quarter by 400 basis points versus last year.

This aligns with our plan to achieve a 50% reduction in purchased transportation cost as a percent of revenue by 2027. Labor is another opportunity to control variable costs in our field operation. We did that effectively in the second quarter. Our headcount and labor hours were down year-over-year, while our shipment count was up. We also made significant progress in reducing our corporate overhead, as we continued to rationalize our cost structure after the latest spinoff. While we're committed to becoming continuously more cost efficient, we're also careful to set the company up for long-term growth. This includes investments in new tools for the field to further improve service quality and the significant expansion of our local sales force.

Turning to Europe. Our business continued to perform well in a soft operating environment with organic revenue largely unchanged. Despite the macro uncertainty in parts of Europe, we continue to see a strong pricing environment across the segment, and our sales pipeline is robust.

I'll wrap up my remarks on the quarter by summarizing the progress we've made to date with our LTL 2.0 plan. We're continuing to generate some of our best service levels in years and this is enabling us to gain profitable market share. This has put the business on a path to stronger yield growth as we're able to price based on the increasing value we're providing to customers.

We're also continuing to make strategic investments in our network to capitalize on upturns in demand, we have a long track record of delivering high returns on investments in this business. And we're becoming more cost efficient by reducing our use of purchased transportation, managing variable labor costs effectively and rationalizing our cost structure at the corporate level. With our operational momentum and disciplined investments in long-term growth, we remain on track to deliver on our outlook for at least 600 basis points of adjusted operating ratio improvement through 2027.

In closing, I want to comment on the CFO transition we announced in July. Some of you already know Kyle, who will take over as our Chief Financial Officer next week. Kyle has been a senior finance leader with public companies for over 17 years, including a long career with General Electric, and he's been immersed in our business for the past 4 years, most recently as our Head of Revenue Management and Finance in LTL. This will be a seamless transition.

I also want to thank Carl our outgoing CFO, for his leadership of our finance team. Carl is rejoining a former colleague in an industry where he worked for over a decade, where I'm confident he'll have continued success.

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

Kyle Wismans - *XPO, Inc. - Incoming Chief Financial Officer*

Thank you, Mario, and good morning, everyone. I'm excited to step into the CFO role. We have a significant opportunity ahead of us to create even more shareholder value with a clear line of sight to our goals. And I'm looking forward to building on our momentum as we continue to execute on the LTL 2.0 plan.

Now turning to the second quarter. Revenue for the total company was $1.9 billion, down 6% year-over-year and up 1% sequentially from the first quarter. In our LTL segment, revenue was down 8% year-over-year and up 1% sequentially. Almost all of the decline was related to fuel surcharge revenue. Excluding fuel, revenue was down just 1% year-over-year and up 4% sequentially. LTL salaries, wages and benefits, in total, were 4.6% higher than a year ago, primarily due to wage increases.

As Mario noted, we did a good job of managing our field labor costs in the quarter. We handled more shipments per day with lower headcount and fewer hours than in the second quarter, a year ago. Purchased transportation expense was down year-over-year by 35% or $47 million as we in-sourced more line haul miles to reduce our use of third-party carriers.

We ended the quarter at 20.7% of linehaul miles outsourced, which was a 400 basis point improvement from the same quarter last year. We also paid significantly lower contract rates in the quarter as our renegotiated contracts cycled in with the carriers. Depreciation expense in the quarter increased by 24% or $12 million, driven by our investments in the LTL network. Our CapEx spend was primarily related to bringing in new tractors from the OEMs and manufacturing more trailers, in-house.

Next, I'll add some details to adjusted EBITDA, starting with the company as a whole. We generated adjusted EBITDA of $244 million in the quarter, down 16% year-over-year. We reduced corporate expenses by 71% for savings of $24 million, which we achieved by rationalizing our corporate cost structure following the RXO spinoff. Our adjusted EBITDA margin was 12.7%, representing a year-over-year deterioration of 140 basis points.

Looking at just the LTL segment, adjusted EBITDA was $208 million, down 24% from a year ago. Our gains and cost efficiency were offset by the aggregate impact of the current operating environment, namely lower fuel surcharge revenue, tonnage, wage inflation and lower pension income.

In our European transportation segment, adjusted EBITDA was $46 million, down $3 million year-over-year. Company-wide, we reported net income from continuing operations of $31 million in the quarter, representing diluted earnings per share of $0.27. This compares to income of $96 million and earnings of $0.83 per diluted share a year ago.

The year-over-year decline in income from continuing operations was partially due to higher transaction and integration costs and restructuring charges. We had $17 million of transaction and integration costs related to the RXO spin-off and another $10 million of restructuring charges across the segments. We expect that cost in both categories will step down materially by the end of this year.

On an adjusted basis, our EPS for the quarter was $0.71, which is down 38% from a year ago. And lastly, we generated $131 million of cash flow from continuing operations and deployed $126 million of net CapEx. Reinvesting in the business remains our top priority for capital allocation.

Moving to the balance sheet. We ended the quarter with $290 million of cash on hand. Combined with available capacity under committed borrowing facilities, this gave us $802 million of liquidity at quarter end. We had no borrowings outstanding under our ABL facility at quarter end, and our net debt leverage was 2.3x trailing 12 months adjusted EBITDA.

In May, we completed the refinancing of our $2 billion term loan. This doubled our weighted average maturity timeline to approximately 6 years, while our interest expense is effectively unchanged this year. And notably, we received upgrades on our secured debt from Moody's and S&P. We also now have 2 investment-grade ratings on our secured debt. Our capital structure gives us the financial flexibility to execute on the significant opportunities we have at XPO.

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

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

Thank you, Kyle. I'll start with a review of the second quarter operating results for our LTL segment. During the quarter, demand for LTL stayed below historical levels. This drove a 4.7% decline in our weight per shipment in the quarter. We offset some of this with a 1.9% increase in shipment count led by 15% growth in our local sales channel. These share gains are a direct reflection of the service improvements we're making in the network. As a result, we were able to limit the decline in tonnage per day to 2.8%.

On a monthly basis, April tonnage per day was down 2% year-over-year, May was down 2.3%, and June was down 4%. Looking just at shipments per day, April was up 3.1% year-over-year, May was up 1.8%, and June was up 0.9%. On a 2-year stack basis, monthly tonnage improved each month throughout the second quarter. In July, we moved even more freight through the network with tonnage up 4.2% year-over-year, and shipment count up 8.8%. On a sequential basis from June, July tonnage was up 2.6% and shipment count was up 3.2%.

Looking at yield on an ex fuel basis, increased by 1.4% versus last year, in line with our outlook. On a sequential basis, we increased yield, ex fuel, quarter-over-quarter, outperforming typical seasonality. While mix has continued to be a headwind to yield, our underlying trends remain solid with contract renewal pricing up 5% in the quarter versus last year. Also, our yield initiatives are continuing to gain traction and resulted in stronger yield growth as the quarter progressed into July.

As we look ahead, we're excited about the trends we see in yield and our outlook for the third quarter as well as the long term. We expect our year-over-year yield growth, ex fuel, to further accelerate in the third quarter versus Q2.

Turning to margin performance. Our second quarter adjusted operating ratio was 87.6%, which is unfavorable by 440 basis points compared with the second quarter a year ago. As part of our LTL 2.0 strategy, we have been increasing our capital investments to drive long-term growth. In the near term, there is a headwind to our margins from higher depreciation as these investments ramp. If we exclude the impacts of depreciation as well as fuel, our adjusted operating ratio in the quarter would have improved on a year-over-year basis.

On a sequential basis, we improved adjusted OR by 200 basis points compared with the first quarter. This outperformed our expectations. Moving to our European business, we delivered another solid financial quarter with organic revenue down slightly despite a soft macro backdrop. This was supported by a mix of new customer wins and contract renewals. Two of our key markets, the U.K. and Central Europe outperformed the European segment as a whole and our pricing in Europe was higher than the same period last year, outpacing inflation.

Before we go to Q&A, I want to highlight our significant progress we're making towards becoming a world-class LTL provider. We've meaningfully improved service and are rolling out new initiatives to drive further improvements. As we take on more volume like we did in July, we're maintaining strong service levels and being disciplined about the freight we accept into our network. We're also building yield growth and expect an acceleration in the second half of this year as our initiatives continue to ramp up. And importantly, we're carefully managing variable costs, while continuing to make strategic investments in the network. For all these reasons, we're excited about our trajectory and our momentum towards achieving our long-term targets.

With that, we'll take your questions. Operator, please open the line for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question is from Ken Hoexter with Bank of America.

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

Mario, maybe talk about the ramp in July, post-yellow. It seems like you were a little bit more guarded on adding freight in the discussion, but yet you're also targeting to accelerate. So should we see maybe an above industry average yield growth as you are selective on the freight you're adding. Is it that the freight moved really quickly and now it's realigning itself over time? And then contrast that with your comments on CapEx and how we think about how fast you want to grow to maybe absorb some more of those volumes.

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

First, starting with the July tonnage. So when you look at our tonnage, it was up 4.2% year-on-year in the month of July and shipment count was up 8.8% in the month of July. Now when you compare that to typical seasonality, usually June to July, we see shipment count be down 2.8%, but for us, this July, we went up 3.2%, so call it a 6% swing above typical seasonality. And same thing on the tonnage side, we usually see seasonality June to July go down 4.1%, while this July, we saw it go up 2.6%, so about also 6% to 7% higher.

Now when you look at the beginning of the month versus the end of the month, we already had seen positive tonnage and shipments at the beginning of July, and we saw that accelerate -- the shipment count accelerated in the high single-digit range from the beginning of the month until the end of the month. Now it's tough to tell what the rest of the quarter is going to do. It is a very fluid situation at this point, and we'll see how these numbers obviously shake out here for August and beyond.

On the capital side, so we have been investing more capital into our business as part of our LTL 2.0 plan to add more capacity. And with this much capacity coming out of the industry, we're looking to accelerate these capacity adds and this would be in doors and tractors and trailers. And just to give you an example, at our Searcy facility, we have the ability to produce 7,500 trailers per year and initially, we had planned to produce slightly north of 6,000 trailers for the year, but we could expand that production here to 7,500 trailers for the year, given what we're seeing. Our long-term guide is 8% to 12% of CapEx as a percent of revenue, and we expect to be at the high end of the range or above the high end of the range here on the near term as we add more capacity.

Operator

Our next question is from Tom Wadewitz with UBS.

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

I wanted to see if you could put it in like shipment count terms for us in terms of maybe like how many shipments per day you're seeing at the present time and what that would have been in, I don't know, 2 weeks ago, something like that, just to give a little additional perspective, I think you talked maybe in percentage terms.

And then I guess related to that, how well do you handle those shipments in terms of you get pretty strong incremental margins on those? Or is it something where you have to stretch to handle a big step up, so the kind of margin impacts maybe not, I don't know -- how do we think about the margin impact on that?

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

This is Ali. So as Mario noted, we did see positive tonnage and shipment counts on a year-over-year basis in the early part of July, but we did see that accelerate towards the end of the month. At the end of July, we saw roughly about a high single-digit increase in our shipment count versus the beginning of the month. So call it somewhere in that 3,000 shipments per day increase. I'll pass to Mario.

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

And in terms of the flow-through, so when we think about it, we have been adding quite a bit of capacity over the last 1.5 years. So we've added -- first on a rolling stock perspective, we've added more than 1,900 tractors, more than 8,000 trailers over the last 1.5 years. We've also added more doors in markets where we needed more capacity. Last year, we opened up 6 new service centers. This year, so far, we expanded 2 service centers. So on the rolling stock and the actual physical capacity, we're feeling good about where we are.

And on the people side, we have had headroom on the headcount side. But at the same time, in some locations where we're seeing higher demand, we're going to be adding more headcount and potentially lean into more purchased transportation if it makes sense as well.

The flow-through -- these additions of additional capacity do have a shorter-term cost impact associated with them. But at the same time, we do expect a good flow through on the additional business we're adding still being very selective.

Operator

Our next question is from Scott Group with Wolfe Research.

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

I just want to try one different way. Can you maybe -- because we don't really know intra-month seasonality just in the last like week or so, like what is tonnage or shipments tracking up year-over-year. I'm guessing it's something better than that 4 percent and 9 percent, but any color on the year-over-year just in the last week or so. And then just we want to just sort of get a sense on the run rate into August. And then any color on how to think about the OR sequentially Q2 to Q3, that would be helpful.

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

Scott, this is Ali. So in terms of the tonnage and shipment count, as we mentioned, in the month of July, tonnage was up over 4% year-over-year and shipment counts were up about 9%. Given the acceleration we did see towards the end of the month, you can assume that the year-over-year growth rates for both tonnage and shipment counts were up more than we saw for the full month. As we mentioned from the beginning of the month to the end of the month, shipment counts were up about high single digits sequentially.

Now when you think about the third quarter, I'll walk you through the moving pieces here. So from a tonnage perspective, normal seasonality is about a 4% sequential decline in tonnage Q3 versus Q2. Now that would imply Q3 tonnage down in that low to mid-single-digit range on a year-over-year basis.

We would expect to do better than that. July clearly outperformed with tonnage up slightly over 4%, but I would point out that the monthly compares do get more difficult as the quarter progresses. Last September, we saw tonnage inflect positive year-over-year. So overall, we would expect positive tonnage year-over-year in the third quarter, and we'll give another update on August in early September.

On the yield side, we did have strong momentum even before the recent industry disruption. Yield growth accelerated through the second quarter, and that continued into July. Our current baseline forecast is that Q3 yield ex fuel will accelerate versus 2Q on a year-over-year basis, call it somewhere in that 3% year-over-year growth range. And then lastly, from an operating ratio perspective, typical seasonality is about 230 basis points deterioration, Q3 versus Q2. Given how the month of July played out, we would expect to outperform seasonality for OR by at least 100 basis points.

Now the magnitude of that outperformance versus seasonality, that's going to be driven by how tonnage performs through the rest of the quarter. And as Mario noted, there are some incremental costs to consider related to that uptick in volume. For example, we may need to increase field labor and also tap into purchased transportation as a source of supplemental capacity on a short-term basis. But overall, we would expect to outperform seasonality by at least 100 basis points, and we'll have a better idea on the magnitude as the quarter progresses.

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

Okay. Helpful. And then just, Mario, just real quick, like Yellow leaving, how does it change, in your mind, the timeline of getting to that low 80s, 80 percent operating ratio that you want to get to?

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

When you look at the long-term target, Scott, there's a good likelihood that the current market disruption would enable us to accelerate price and volume growth beyond our original targets. Now with what's happened over the last few weeks, it's a bit too early to tell how it's going to manifest itself for the long term. Our focus continues to drive OR meaningfully lower in the years to come. And that's why we've always said it's at least 600 basis points by 2027, and we still feel very comfortable with that.

Operator

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

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

So Mario, given kind of the focus on service and obviously, that being strategic priority for the long term, how is the network handling this kind of uptick in volume seen in July versus Q2? And how are you making sure that you maintain that momentum on the service side? And related to that, maybe like from a pricing perspective, is there an opportunity to accelerate the mid-single digit in the back half of this year just given the environment we're in now?

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

Thanks, Fadi. I'll start with the service piece and turn it over to Kyle for yield and pricing. Well, service is our top priority and it will continue to be our top priority. And Dave and the team are doing a great job being able to handle that additional influx in freight that we're seeing here. And just to give you an example, Fadi, in the month of July, we've seen shipment count go up 9% year-on-year yet our service metrics improved relative to June. When you think about claims filed per shipment, when you think about on-time service, we see those continue to pick up in the month of July.

Now there's a few reasons for that. One is that, as I mentioned earlier, we have been investing in capacity over the last 1.5 years, where we've added more doors in markets where we needed to have those doors here recently in Salt Lake City and Norcross, Georgia. We've been adding more to our rolling stock. We've added more than 1,900 tractors since we initiated LTL 2.0. We've added more than 8,000 trailers since we initiated the program as well. Also, a lot of the changes we implemented on improving service are now cultural.

That's a part of what we do every day, including incentive comp changes, including new technology and how we load trailers, including overall recognition programs around service. And moving forward, that momentum is building through new training programs we're launching, new tools we're launching, our people in the field as well. Now that we have Dave on board driving a lot of these initiatives.

On the labor side, as Ali mentioned, if we need more labor in some of the sites where we're seeing more volume. We are adding the headcount where we need it. We could also lean more into purchase transportation in the near term if we need it as well. Then finally, we're very focused on being selective on the freight we take on. A lot of it goes down to being picky on the freight.

We want 4x4 feet pallets or skids that we onboard from our customers that fit well in LTL network. And at the same time, we're looking for margin-accretive business that would improve our OR over time. So we're being very disciplined and our service product is -- continues to be our top priority as we move forward from here.

Kyle Wismans - *XPO, Inc. - Incoming Chief Financial Officer*

This is Kyle. So as Ali mentioned, our yield growth strengthened in the second quarter and into July as a lot of our internal initiatives gained traction. And as Mario mentioned, our focus continues to be on providing excellent service. But given there is less near-term capacity, we are taking pricing action with customers. We implemented a GRI with our transactional 3PL business, and we've also moved up our target for contract renewals.

Now some of these actions will take hold very quickly like the GRI. Others with annual contracts will take time to realize. But our customers understand when you take 10% of capacity out of the market, it's going to cost more to move freight. But as we said, our baseline expectation is 3% year-over-year growth and these initiatives could help us move above that range, but it's too early to tell what that's going to look like and we'll update you later on.

Operator

Our next question is from Ravi Shanker with Morgan Stanley.

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

Mario, just -- obviously, you guys kind of have been on the growth path for a while. So it makes sense that you're stepping up your investments, but what would you say to those who believe -- I mean just to reference the point you just made that you take 10% of the capacity out of the market and pricing goes up for everyone, but do you think there's a natural backstop to how much capacity this industry will add so that rising tide stays high? Or do you think that the industry kind of backfills that capacity over time?

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

Thanks, Ravi. When you look at the overall industry capacity, it has been fairly tight for a long time. Over the last decade, the number of service centers in our industry has stayed flat. And now when you look at taking out 10% of capacity, that's obviously a big hole in terms of the amount of capacity that is available. Now there are a few carriers adding more capacity, us included, but these adds will take time to materialize when you think about the service centers and doors to be added across the network, these won't happen overnight.

So we do think that over time, so the freight gets absorbed first and then over time, you will see us and a few other carriers add that capacity, but it's going to be a longer-term process to be able to get there.

As Kyle said, it's still early to tell what the impact on pricing is going to be. When you look at LTLs, pricing has always been very disciplined, given the dynamic of shortage of capacity versus demand and growth and when you take out this amount of capacity, we would expect yield to see tailwinds in the quarters and years to come here. And you couple that with a potential freight recovery as we head into 2024, that's going to accelerate from there as well.

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

Got it. And I guess, squeezing a really quick follow-up. Kind of shifting gears a little bit kind of away from the cycle and what's going on, on LTL. Obviously, you are a tech geek, I don't think you will mind me calling you that. So if you can just kind of help us with kind of understanding everything you're seeing out there with AI/ML kind of -- obviously, XPO has been leveraged on the LTL side for a long time, but kind of what are some of the 1 or 2 things that really excite you about the new tech at your disposal?

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

Well, first, as you know, Ravi, technology has been part of our DNA since the onset of the company and all of our systems in LTL that operate the network are proprietary. And when you think about an LTL business, we're very much in the data business because we move more than 50,000 shipments a day and we have a lot of data points on how we move those shipments across the network.

But just to give you a couple of examples, how we operate our linehaul network. Our models do use AI and ML to optimize how many loads we're building in each hub in the network. And we're launching new technology in how we do things like directed loading as an example, to improve how we build trailers to bypass service centers and improve efficiency, similar thing on how we plan labor and how we manage labor in the field, similar technology and how we run our pickup and delivery routes. And on a net-net basis, at the end of the day, all of these things lead to better results to the bottom line. Just to give you an example, in the second quarter, our shipment count was up roughly 2%, but our labor hours and headcount was down 2% and these tools enable us to build these efficiencies into the operation.

Operator

Our next question is from Brian Ossenbeck with JPMorgan.

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

So I just wanted to come back, I guess, maybe for Kyle. How do you see -- I think you mentioned that there's a GRI that was already implemented. Maybe you can just touch on that in terms of the timing and what you'd expect for the rest of the year. Because I guess what I'm trying to get at is, is there a little bit of a lag here in terms of the additional costs offset by a little bit of operating leverage on the new volumes before you can really get some of that -- some of those pricing gains to be reflected in the network, whether it's through additional GRIs or new contract negotiations?
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Kyle Wismans - *XPO, Inc. - Incoming Chief Financial Officer*

So when you think about the GRI we took, that was the transactional 3PL business. So that's really the broker business. There was an expected GRI later in the year. So that's kind of steady state, maybe pull forward slightly. So we wouldn't expect too many differences there.

We're not anticipating at this point other GRIs as we progress, and we'll continue with our yield initiatives to drive up profitability in the back half. But when you think about the initiatives, again, some of those are going to be immediate impacts like a GRI and others as you work through contractual renewals will take time to realize.

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

Okay. Then if I can just ask a quick one for Mario. You mentioned accelerating the CapEx as the capacity comes out of the market, is there any opportunities, I'm sure you are evaluating them, maybe pick up some stuff that comes to the market? Or do you feel like this is something that you'd rather do internally based on your current network versus what might be available out there?

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

If there is an opportunity for us to accelerate our capacity growth, we would definitely look at it. Now our focus is to continue to execute on our long-term plan to expand capacity, which has been a core pillar in our LTL 2.0 plan. Now regardless of if this capacity becomes available, we are looking at continuing also our expansion where so far, I mentioned earlier, we expanded 2 service centers so far this year, and we have another dozen or so projects for expanding other service centers in key markets, especially in the Texas area and Florida and Arizona. So in a number of markets. Now again, if these facilities go on the market, then we'll definitely look at them as well.

Operator

Our next question is from Stephanie Moore with Jefferies.

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

I wanted to touch a little bit on kind of maybe the strategy in which you're managing this dislocation in the market? And if you could touch a little bit on with -- your immediate focus is more so on kind of capturing the volume opportunity? And how do you kind of manage that strategy with your pricing and kind of maybe more of a longer-term opportunity here. So maybe just talk a little bit about the initial reaction to the volume and flow.

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

Thanks, Stephanie. Well, we are looking at it in a very balanced approach. Step number one is making sure that we safeguard the capacity to existing customers, and we keep honoring the capacity commitments we had with them. But when you think about the influx of volume, we are assessing those opportunities to bring incremental freight on a case-by-case basis, both from existing and from new customers.

We are already using that as an opportunity to improve the mix as a whole for our customers. And as I mentioned earlier, we're looking at it in 2 main criteria. One is making sure that the customers that we are onboarding freight for have 4x4-feet-type skids that fit well in an LTL network. And we're also looking at it from an OR perspective and making sure that we are onboarding margin-accretive business as we are adding it. So we're being very disciplined into the shipments and tonnage we're bringing on to our network.

And now on the pricing side, when you take out, as Kyle mentioned earlier, 10% of the capacity in the market does cost more to move freight for your customers. And also, we want to make sure we're charging a fair price given the value that we are offering our customers as well with the improvements we're seeing in our service product over time as well. So we're looking at it in a very balanced way in terms of being disciplined how we add volume, while leaning onto the price lever as well.

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

Great. No, that's very clear. And then maybe switching gears entirely. Could you give us an update on your European business? And any strategic changes you might have selling that business and kind of where we stand today?

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

Well, we announced stopping that process in the near term in the month of December, but our goal long term continues to be being a pure-play North American LTL company. Now that said, this business is operating really well, as you heard from Ali and Kyle, we're doing really well despite the softer macroeconomic environment in Europe. Our organic revenue is largely unchanged on a year-on-year basis, and the team there is doing a fantastic job servicing customers.

Operator

Our next question is from Chris Wetherbee with Citi.

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

I guess, Mario, you talked about the potential for pricing improvement and closing the gap with peers. And I think when we talked to you guys back in May, there was the opportunity for maybe double digit over a multiyear basis. But obviously, what's going on, I think, is accelerating pricing and yield opportunities. As you think about that, particularly as it relates to your longer-term operating ratio targets, how much return -- is there a way to think about what the sort of nearer-term opportunity is on that 10% for that operating ratio. I want to get a sense of sort of what the pricing dynamic, how much of that's being pulled forward over the next couple of years and to maybe the next couple of quarters?

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

So when you think about it, this is still a very fluid situation here given the disruption that's happened in the market. So Chris, it's tough to evaluate how quickly the pace of improvement is going to go here in the near term. But over the next weeks and months, we're going to have a better picture on where things are shaking out.

But it's fair to assume that you would see an overall yield and price acceleration. And also, the way we look at it, it's all about charging a fair price for the service that we are offering our customers. When you look at these service improvements, I'm incredibly excited about having Dave on the team and all the progress that our operating teams are doing, on keep on improving the service product, as I mentioned in my opening remarks, we are adding new tools to the field, such as higher-quality straps, airbag systems, racks in service centers.

We are improving the instructions of how we load trailers and training associated with that. And all of these will lead to better service, which over time, would also lead to a higher yield. Now again, the pace of the disruption here that we're seeing would accelerate, but it's tough at this point to predict what it's going to look like, given it's all fairly new over the last few weeks.

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

Okay. That's very helpful. And then one point of clarification. Do you expect more share to come over in the coming weeks? We talked about the run rate exiting July, entering August. But is that share shift largely done? Or do you think there's incremental room for that to go from here?

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

Chris, this is Ali. It's hard to know at this point how much incremental share is going to come our way. As Mario mentioned, we're being very disciplined with the freight that we're bringing into the network. Our priority is to make sure that it's good freight that fits our network and most importantly, is margin accretive. And so that's our strategy as it relates to the incremental volumes. And then we'll give you another update in terms of August trends, in early September.

Operator

Our next question is from Jon Chappell with Evercore ISI.

Jonathan B. Chappell - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Ali, quick one on Europe. I mean is there any update there on the sales process or even the desire to do that as the market continues to evolve? And I asked mostly for an update, but also there is this gain on equipment and sales -- are you looking to maybe sell that off in piecemeal when you get opportunities? Or are you still kind of holding off for a big sale when the market is conducive?

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

So in the fourth quarter of last year, we did announce that we won't be selling the European business in the near term. And we're not going to address the potential sale further beyond what we had said in that December filing. That being said, our long-term plan remains to be a pure-play North American LTL carrier.

Having said that, as Mario noted, that business continues to perform well in a soft macro backdrop, organic revenue was down slightly. And we saw constant currency revenue growth in both our U.K. business as well as our Central Europe business as well.

Jonathan B. Chappell - *Evercore ISI Institutional Equities, Research Division - Senior MD*

So what did the gains then relate to?

Kyle Wismans - *XPO, Inc. - Incoming Chief Financial Officer*

The gains are related to the asset turn-in. So it's part of the normal process, Jon, for turning in equipment out there. So part of normal business.

Operator

Our next question is from Jordan Alliger with Goldman Sachs.

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

Maybe sort of thinking about volumes differently -- from a capacity perspective, I think if memory serves, last quarter, I think you talked about maybe 20% spare capacity at the terminals given the soft demand conditions. Maybe I might not be right on that, but given all that's going on with yellow and given where your network is today, where do you feel comfortable drawing that down to? I mean, can you go to 5%, 0%? Just curious.

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

Well, first on the capacity side, we ended the second quarter at roughly 20% excess capacity from a physical capacity perspective, so think doors and service centers and that moderated down, call it, to the mid-teens here in the month of July as we've seen that impact and higher volumes. Now usually, on a longer-term basis, we want to be in that 20% to 25% range of excess capacity.

Now as you know, in an LTL network, it's not linear. So you have some markets where we have excess capacity and then we have other markets where we already are -- we are at capacity and the goal is to add these -- in these markets where we need those extra doors, the additional physical capacity.

On the rolling stock side, we are feeling very good based on where we are now over the last 1.5 years. As I mentioned earlier, we've added more than 1,900 tractors, and we've added more than 8,000 new trailers. So the rolling stock side is feeling very good for us. And we are planning on accelerating some of these investments here in the near term.

The third part of capacity is on the people side. Today, we are staffed to current volumes, and we have some headroom. But also in some markets, we also are looking to add more headcount and potentially lean into purchased transportation if we need it as well. The good news there is that the labor markets are very ripe for hiring people. And just to give you an example, Jordan in the second quarter, the applicants per open rec that we had went up threefolds on a year-on-year basis.

So it's a very good market to be able to add people. But these are the different aspects of capacity. And again, on the door side, we're going to continue on adding doors to get to that 20%, 25% excess free capacity that we can leverage for longer-term growth.

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

So just as a -- in the near term, at least, I get the 20%, 25%, but the near-term at least between rolling stock headcount, et cetera, you could probably drawdown that excess capacity further if need be.

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

That's correct. And again, it will depend on some of the markets where we are at capacity, then these obviously will -- we need to add more in the near term as well.

Operator

Our next question is from Eric Morgan with Barclays.

Eric Thomas Morgan - *Barclays Bank PLC, Research Division - Research Analyst*

Best of luck to Carl, and congrats to Kyle. I wanted to come back to service, maybe from just a higher level. Obviously, you made some good progress here in a pretty short time frame, just looking specifically at the claims ratio. And so just kind of wondering if you have any thoughts on the runway from here. have you captured most of the low-hanging fruit and maybe the next 50 bps improvement in that number is tougher. It takes a little bit longer than the first 50 bps or do you have line of sight to improving at a similar pace going forward?

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

Our long-term goal is to get to a claims ratio of 0.1%, but the improvement won't be linear, and it will take a number of years for us to get there. And now having Dave on the team and the experience of him driving a better service product over time, is going to allow us to get there on a faster time line, but it still will take us a number of years to get there.

Now when you look at what we've done so far, I mentioned earlier over the last 1.5 years, we tied incentive compensation plans to improvements in service. We tied the recognition programs at the service center level to the improvements in service, and we've also launched technology that enables us to rate every trailer that we load across the network every single night and having a rating of quality of loading for that particular load.

And moving forward, we are launching new tools, as I mentioned earlier, to the field, including new airbag system across all of our service centers, storage racks that help with how you unload and reload appointment freight, higher quality straps. We're also improving how we are operating training and loading procedures for our dockworkers to further improve service.

Again, our June claims per shipment was the best in 7 years, and our goal is to keep on improving. But again, it won't be linear from here all the way down to 0.1%, but the expectation is to continue to see that service product improvement over the years to come.

Operator

Our next question is from Bruce Chan with Stifel.

Jizong Chan - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate VP & Equity Research Analyst*

Mario, maybe just to come back to your comments about people. You recently had a terminal that voted to decertify the union. That's probably perhaps even more of an achievement given the current climate. But just want to see if you could talk about some of the work that you've done on the employee engagement side and then you had your annual wage increase. Any comments on where you stand relative to peers and whether you anticipate any maybe wage cost pressure given some of the new contracts that have come through in the rest of the industry?

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

This is a topic in terms of employee engagement and satisfaction that is very important for all of us. And here recently, our latest quarterly employee engagement service -- survey we did here in the month of July, had another record of employee engagement and satisfaction across our organization.

And our latest frontline employee survey for dock workers and drivers was a company record since Conway started measuring it back in 2009. And the way we've been able to achieve those numbers is that the entire organization is spending a lot of time in the field. Just to give you an idea, last

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year for me personally, I visited 50 to 60 service centers, so 1 to 2 per week where we -- and this applies for -- Dave has been with us now for 3 months.

He's out in the field every single week. Same thing with the folks who run our East and West divisions and all the entire leadership team is spending time in the field getting feedback from our employees and how we can improve what we're doing with them. And some of these could be how we manage work. Some of it could be around compensation. Some of it could be around tools that we offer them.

And when you listen and take action, you see that your workforce wants to be part of the company, a growing company and providing great service for the customers as well. So a lot of these are things that we're doing, and we continue to see here record employee engagement. On the wage increases, we typically do those on April 1. And this year, we have taken -- we've also given all of our folks in the field that wage increases in the beginning of April.

Operator

Our next question is from Scott Schneeberger with Oppenheimer & Company.

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

Congrats, Kyle. Mario, could you just speak to what you see out there as far as the demand environment across your end markets, obviously, a lot of focus on what happens, post-yellow. But just on the general environment heading into the back half of the back-to-school season, peak holiday. Just what are you seeing? How are you feeling about where we are in the cycle?

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

I'll first start with the first half of the year and then what we're seeing pre-disruption or what we saw pre-disruption. Well we saw the trough in the first half of the year from a freight demand perspective in the month of March, and volumes modestly improved in April and May and then got weaker again in the month of June.

Now July, ahead of the disruption in the first half of the month, we had seen our shipment count and tonnage flip to positive, signaling a slightly improved freight demand environment.

Now if you break it down today, 2/3 of our customers are industrial companies. And what we're seeing there is that the ISM, which is an index we look at for manufacturing has been trailing below 50 for the past 9 months. It did modestly improve in the month of July versus June, and we're hearing that from our customers. There is mixed feedback. Some portions of the industrial economy are doing well, others are seeing softer demand in the back half. So it's fairly mixed. Namely automotive and industrials are doing very, very strongly here.

On the retail side, we continue to see improvements in managing elevated inventory levels. Most of our retail customers have worked through that inventory and do expect stronger demand in the back half and they do expect also a decent holiday season coming up here. So it does look like the freight markets have troughed from a demand perspective, but we'll see how things roll forward here, over the next couple of quarters.

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

And then just curious accessorial charges is an initiative of yours. I don't think you were going to really delve into that too much until the back half of this year, and that's a long-term initiative. But could the Yellow situation help you jump start it? I know you're about low double digits of overall revenue right now, where you see that moving? How quickly? And just a progress report on where that is.

Kyle Wismans - *XPO, Inc. - Incoming Chief Financial Officer*

Sure. Thanks for the question. So when you think about accessorials, it's one of our many pricing initiatives we're excited about. And certainly, this disruption will enable us to drive some of this maybe more quickly. When you think about what we're doing, most recently, we put in place technology and process improvements to ensure we're consistently capturing location-based accessorials. We're also consistently making updates to our tariffs, not just to make sure we get paid fairly for the services we provide. We also see opportunities around certain services we don't have now, really value-added services and all these things can help us accelerate really in the back half.

Operator

We have reached the end of our question-and-answer session. I would like to turn the conference back over to Mr. Harik for closing comments.

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

Thank you, operator, and thanks all for joining us today and for all your questions. This is a very dynamic environment in our industry and we remain focused on unlocking the massive potential we have in our company by continuing to provide great service to our customers.

One month into this quarter, and we have a lot of great momentum. We're making further investments in capacity. We're moving more freight in our network, and we're driving higher yield growth. We look forward to seeing you guys again in the call in November. Thanks all.

Operator

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