GXO
Conference Call

November 2, 2021

GXO

Q3 2021 Earnings Conference Call

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Presenters

Malcolm Wilson, CEO

Baris Oran, CFO

Mark Manduca, CIO

Q&A Participants

Scott Schneeberger – Oppenheimer

Brian Ossenbeck – JP Morgan

Stephanie Moore – Truist

Amit Mehrotra – Deutsche Bank

Hamzah Mazari – Jefferies

Bascome Majors – Susquehanna

Ravi Shanker – Morgan Stanley

Operator

Welcome to the GXO Q3 2021 Earnings Conference Call and Webcast. My name is Doug, 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. If you have a question, please dial *1 on your telephone keypad. 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, the use of non-GAAP financial measures and company guidance.

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

The company also may refer to certain non-GAAP financial measures as defined under the applicable SEC rules during this call. 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. Unless otherwise stated, all results reported on this call are reported in United States dollars.

The company would also remind you that its guidance incorporates business trends to date and what it believes today to be appropriate assumptions. The company's results are inherently unpredictable and may be materially affected by many factors, including fluctuations in foreign exchange rates; changes in global economic conditions and consumer demand and spending; labor market and global supply chain constraints; inflationary pressures and the various factors detailed in its filings with the SEC. This guidance also reflects the company's estimates to date regarding the impacts of the COVID-19 pandemic on its operations. It is not possible for the company to accurately predict demand for its services, and therefore, its actual results could differ materially from its guidance.

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 Malcolm Wilson. Mr. Wilson, you may begin.

Malcolm Wilson

Thank you, operator. Good morning and welcome to GXO's third quarter earnings call. With me here today are Baris Oran, our Chief Financial Officer; and Mark Manduca, our Chief Investment Officer.

This is our first quarterly update following our successful spin-off in early August. In accordance with our can-do culture, GXO's listing was completed in only eight months. This was thanks to the collective hard work and dedication of our 95,000 exceptional team members, the support of our loyal customers and our shareholders. We are extremely excited for the journey ahead as we pursue our secular growth opportunities.

In the third quarter, our operations delivered the highest quarterly revenue and adjusted EBITDA in their history. Not only did we beat market expectations, we surpassed a stellar second quarter.

This was the third consecutive quarter of double-digit organic revenue growth. As a result, we are raising the midpoint of our full-year revenue guidance to $7.7 billion and raising our midpoint of our pro forma adjusted EBITDA guidance to $622 million.

In the third quarter, we won contracts with an aggregate lifetime value of over $1 billion, taking the value of our total wins year to date to $4.3 billion.

Wins in this quarter included global blue-chip customers such as Raytheon, a global aerospace manufacturer; Ross Stores, a large chain of department stores here in the US; Zalando, one of Europe's largest e-commerce companies; and Zara, a global omnichannel fashion retailer. We also won business with a leading US semiconductor company. These contracts have an average duration of five years. We also implemented solutions in the quarter with Abercrombie and Fitch, Apple and Currys (formerly Dixon's Carphone), and we expect new customer wins to have a $700 million dollar uplift to our 2022 revenue, underpinning our growth for next year.

Today, approximately 50% of our revenue now comes from customer relationships that span more than one country. The massive tailwinds of automation, e-commerce and outsourcing remain unabated, and our blue-chip customers rely upon us for our best-in-class solutions and to stand up technology-proficient warehouses with speed, reliability, and at scale, on a global basis. Our land-and-expand strategy, underpinned by our global scale and technology leadership, is a key differentiator, as evidenced with customers like ASOS, Disney and H&M. Year-to-date, we've expanded our operations with 16 of our top 20 customers across 22 new locations. On average, we now operate in three countries for each our top 20 customers.

As we navigate global supply chain disruptions and a tight labor market, we believe being an employer of choice is critical. We continually hire throughout the year, not just for peak, but to meet our growth needs, and we strive to ensure our employee value proposition is compelling. As a company, we pride ourselves on creating a workplace where safety is paramount, diversity and inclusion are valued, and competitive compensation and benefits programs are offered. Against this backdrop, we are working hard to meet our warehouse recruiting needs.

At the same time, we are increasing the deployment of automation, implementing our best-in-class software, and leveraging our e-commerce and warehouse solutions know-how. We have found that the use of technology boosts productivity, improves safety, and enhances our employee experience overall. After spending a few weeks visiting our teams and distribution centers across the US, I've seen firsthand that a good balance of GXO team members and technology makes for a winning combination.

I am also pleased to note that the quarter saw numerous awards granted to GXO highlighting our leadership in technology and diversity. The Institute of Innovation and Knowledge Exchange recognized GXO for two decades of innovation with Virgin Media, and we were also recognized by the Human Rights Campaign on the Corporate Equality Index for LGBTQ+ inclusion. I would also like to take this opportunity to welcome our new Vice President of Diversity, Inclusion, and Belonging: Letitia James. Diversity and inclusion are at the core of GXO's values.

Earlier this year, we jointly held a diversity and inclusion strategy workshop with one of our largest omnichannel retail customers to find ways to make our distribution centers more inclusive, recruit from a diverse talent pool and serve the community as a strong corporate citizen. We launched a joint Diversity and Inclusion Advisory Board that tracks and measures progress on our diversity goals. All of this enables [sic] to be an employer of choice and a great place to work as our partnership expands.

Finally, it gives me great pleasure to announce that we have been awarded a ‘AA’ ESG rating from MSCI, placing GXO as the highest ranked among its largest industry peers. This rating recognizes the importance that our company places on environmental, social, and governance. It also acknowledges the clear targets that we have presented in recent months, including our firm goal to be carbon neutral by 2040.

As a business, we want to set the benchmark for ESG across the supply chain, and we are already making good progress on our targets set out at our investor day.

We feel confident about our future as a newly formed entity. We are excited to deliver on our vast growth potential as the largest global pure-play contract logistics company.

I will now pass you over to Baris to talk you through our financial performance. Baris, over to you.

Baris Oran

Thank you, Malcolm, and good morning everyone.

Today, I'd like to walk you through our third quarter financials, as well as our upgraded guidance for 2021.

In the third quarter, we generated revenue of $2 billion, net income of $72 million including $42 million of one-time tax items, and adjusted EBITDA of $163 million.

This revenue represents a year-over-year increase of 24.6% and is up 12% on an organic basis, with FX contributing 2% and M&A contributing 10%. The 12% organic growth is notable in the context of the 8-12% organic growth rate for next year that we are reconfirming today.

Year to date, revenues from our top 20 customers have grown approximately 37%, demonstrating the success of our land-and-expand strategy. Quite simply, we view ourselves as the scaled third-party logistics partner of choice for global brands.

One of the great benefits of our model is its visibility, and, as we stand here in early November, we have a strong view on the revenue trends of our business heading into 2022 and even 2023. Moreover, looking back, we would like to note that from 2016 through the end of the third quarter, we've delivered an organic revenue CAGR of 7.3%, reflecting the high-growth nature of our business even through a pandemic.

Moving to earnings, the growth in our adjusted EBITDA reflects the robust revenue growth we've delivered via a combination of new customer wins and existing customer expansion, as well as efficiency gains. We had particularly strong open-book contract wins.

Our contracts are structured to provide resiliency with pass-through cost mechanisms, and, in an inflationary environment, our third quarter results reflect this.

We recorded a positive tax adjustment of approximately $42 million in the third quarter. This is a one-time P&L item resulting from the spin-off. Separately, in the fourth quarter, we expect a negative impact of less than $20 million in cash tax effects related to spin.

Our cash flow from operations in the third quarter was $105 million. We spent $55 million in net capex. Specifically, we spent approximately 50% of our total capex bill on automation, technology, and software. We invested for our high-growth future, with an associated increase in working capital due to new starts and our recent acquisition. Overall, we generated free cash flow of $50 million, which represents just over 30% of our adjusted EBITDA.

Turning to the balance sheet, we had a net debt of $757 million at the quarter-end, which included roughly $800 million of notes and about $180 million of finance leases. Our leverage ratio is 1.3x trailing twelve months' reported adjusted EBITDA. This is well within the previously discussed net leverage range of 1-1.5x. We also have an available $800 million revolving credit facility at our disposal and are committed to our investment grade credit rating.

I'll now turn the call over to Mark.

Mark Manduca

Thank you, Baris.

As Malcolm and Baris highlighted, this is a rare breed of company; one that combines high growth with resiliency and dependability.

I am going to expand on the secular themes that Malcolm and Baris highlighted. Our position, as the largest global pure-play contract logistics company, puts us at the forefront of the growing demand for technology-driven logistics solutions. This is due to the three secular megatrends that Malcolm mentioned: automation, e-commerce and outsourcing. These three tailwinds continue to drive our double-digit revenue and adjusted EBITDA growth.

Firstly, automation and technology are key differentiators for GXO in the marketplace, helping boost efficiency and productivity of our solutions and resulting in revenue and margin uplifts for our customers. In the third quarter, we increased our technological leadership via the deployment of more than 1,000 new units of technology implemented across our solutions. Total technology and automated systems across our warehouse footprint grew 139% year over year in the third quarter, and within that, total goods-to-persons systems grew at 135% year over year. We are also currently testing over 100 new technologies in our sites. Some of this technology has the ability to transform our solutions, bringing further benefit to existing and new customers and inevitably speeding up the cadence of outsourcing.

There are multiple technologies across our network that generate value for our team members, customers and also, GXO. For example, we recently trialed and will be implementing a new autonomous collaborative robot capable of transporting heavy weights. It improves safety, reduces manual tasks and increases picking efficiency by 70%. This technology brings a cash payback of significantly less than three years and offers a very high return on invested capital.

Secondly, on e-commerce, we continued to benefit in the quarter from strong secular and persistent growth. Our outbound e-commerce, omnichannel retail and technology aggregated revenue increased by 22% year over year in the third quarter, and our reverse logistics revenue increased by 21% year over year. Looking forward, we expect our customers will increasingly use e-commerce channels to get their products into consumers' hands as fast as possible.

And finally, on outsourcing, the runway remains significant, with a massive potential addressable market of $430 billion, of which $300 billion is still yet to be outsourced. Year to date, our wins have come roughly 40% from new outsourced contracts, 31% from existing customers expanding their scope, and 29% won from competitors. Our record sales pipeline indicates continued growth opportunities from never-before-outsourced contracts.

Now, as Malcolm mentioned, we have secured contracts with almost $700 million of brand-new revenue uplift for 2022. This is equivalent to a gross revenue growth rate of 9%, even before we consider the opportunity from further wins from our strong pipeline in the fourth quarter and in 2022. In conjunction with our gross win announcements, I would note that our 12-month trailing revenue retention rate has also improved since our investor day. And our pipeline, at the moment, as of the third quarter, is valued at approximately $2.3 billion. Now, given our leadership in this vertical, it won't come as a surprise to note that more than 50% of our wins year-to-date are from that very same e-commerce, omnichannel and technology vertical.

I'll now hand the call back to Baris to discuss the outlook.

Baris Oran

Thank you, Mark. At our investor day in July, we highlighted that the majority of our revenue growth comes from net customer wins, and our strong performance year to date gives us confidence for the fourth quarter of 2021 and into fiscal 2022. As a business, we have good visibility given our long-duration contracts with blue-chip customers. We look forward to a fourth quarter with strong growth, and to 2022 being another year of double-digit revenue growth at the midpoint of our range in this high return on invested capital business.

We continue to monitor supply chain disruptions closely and remain focused on mitigating the impact of any deterioration in the macro environment, including input shortages of components and labor.

We upgraded our full-year 2021 guidance in light of our strong third quarter results and the visibility we have. We are seeing an increased demand for solutions that tackle direct-to-consumer e-commerce fulfilment, inventory optimization, faster speed to market and the ability to reuse returned products. We are delivering tremendous value to our customers at this challenging time.

We now expect that we will generate $7.6 billion to $7.8 billion of revenue in 2021, and $607 million to $637 million of pro forma adjusted EBITDA. Meanwhile, our expected tax rate has been lowered to 25-27%. We have also updated our capex guidance to $225 to $250 million.

Our 2022 financial targets are unchanged. These are 8-12% organic revenue growth, alongside $705 million to $740 million of adjusted EBITDA.

In the present tough supply chain environment, we're incredibly pleased with our progress, and remain vigilant. We demonstrated strong growth while maintaining our high return on invested capital, grew our sales pipeline to a record level, and built a world-class team and enviable platform set to deliver long-term sustainable shareholder value.

We'll now open the call up to Q&A.

Operator

Thank you. Ladies and gentlemen, at this time, we will be conducting a question and answer session. If you'd like to ask a question, you may press "*" "1" on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press "*" "2" if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the "*" key.

Our first question comes from the line of Scott Schneeberger with Oppenheimer. Please proceed with your question.

Scott Schneeberger – Oppenheimer

Thanks very much, and good morning, everyone. I'm curious about the, the ramp-up timing of announcing a new win and when we might see it in results, and also the margin profile of initial new wins, and how long those margins take to ramp to optimal margins. Thanks.

Malcolm Wilson

Thanks, Scott. It's Malcolm Wilson here. I'll cover the first part of that question, and then I'll hand it over to Baris to talk about the margin profile. So new contracts, I mean, they come in all shapes and all sizes. Typically, today, because we implant a lot of automation in our facilities, a normal startup period can range between three months and nine months, depending upon the level of automation that's going into the facility.

Due to our scale, clearly, we're seeing a relatively good availability of warehouse stock. We're working with all of the large industrial landlords. So we're not hampered in anything other than just the working with our customers, the detailed planning, the work together in terms of the connection of our IT software's to optimize the flow of goods through the warehouse. But, you know, three to nine months is normal. It could be a little longer if we're doing a very detailed design and build facility where we're actually starting with a blank canvas, and where it's going to be a very, very highly automated warehouse. In those circumstances, typically, the building is physically designed to suit the level of automation. But that, I hope that gives you a flavor of the situation. Regarding the margins, Baris, maybe you can add.

Baris Oran

Sure. Sure, Malcolm. Hi, Scott. When we start the operation, depending on the size, the scale, and technology involvement, it takes roughly six months to a year for us to ramp it up to a full scale and to have the margins at a certain level. And remember that the more technology we employ in a facility – which is increasing these days, a lot of automation and technology is being employed – the margins tend to be higher. On average, we see 200 basis points to 400 basis points higher margins in the higher-technology facilities that we operate.

Mark Manduca

And Scott, as you know, adding to Baris's point about our business, this is a contractual business model. It's not a transactional business model. We have great visibility when we write those contracts that Baris and Malcolm talked about. And with all our contracts at the moment, we aspire to be profitable on day one, aspire to have cash paybacks of less than three years on any capex and working capital deployed, and project-level returns of more than 33%.

Scott Schneeberger – Oppenheimer

Great, thanks all. Appreciate that. And then, as a follow up — a bit of a, kind of a current events question, but I'm just curious: Baris, you touched on it briefly, but if we can go a little bit more in depth, how are you doing with regard to labor availability? And then, if you could speak to how wage inflation may be covered in your contracts from a, from a total company perspective. Thank you.

Malcolm Wilson

Yeah, Scott. Hey, it's Malcolm, let me cover that. And in fact, I'm in an ideal place. I've literally just come back from traveling around our US business, for the past month. And I've visited, oh, a huge number of locations. What we're seeing is: it is key that we provide competitive compensation and benefits solutions. And the way we do that is we analyze, on the ground, right down to the ZIP code level. We have our HR organization very heavily involved in that. And we work hand in hand with our customers to figure out what is the best solution for each specific location.

Customers actually come to us, checking to make sure that we're aligned with the market, because everybody realizes that such a valuable resource is, in fact, our GXO team members. It's super important to keep those team members in place. And clearly, in the current environment of tight labor, it's imperative that we make sure that we're abreast of all of the latest compensation and benefits needs. And we're doing that.

And, as an overview, the last thing I've got to mention is, you know, we do work hard to make GXO a great place for people to work. You know, the combination of lots of technology, we're really, you know, encouraging people to come into the business, and they like to be a part of an organization that's working with a lot of technology. So those factors combined, give customers and employees a great solution.

And of course, the robust boilerplate environment that we have, in terms of our contracting with customers, ensures that those costs go fully back, you know, to our customers. It's a pretty seamless environment, works very, very well, and, you know, it's, has really put us in good stead, as you've just seen in our Q3 earnings.

Scott Schneeberger – Oppenheimer

Great, thanks. I'll turn it over. Congratulations on a great start.

Malcolm Wilson

Thank you.

Operator

Our next question comes from the line of Brian Ossenbeck with JP Morgan. Please proceed with your question.

Brian Ossenbeck – JP Morgan

Hey, guys. Good morning. Thanks for taking the question. I just wanted to ask you about 2022. You talked about these large amounts of new contract wins, especially ones that are going to roll forward into next year, which, as Mark mentioned, I think these are gross wins, rather. So, it looks like you got about almost 10% of revenue growth already underpinned. So maybe you could talk a little bit more about that. Why not raise the guide at this point, especially when it sounds like you've got some revenue retention rates that are also increasing throughout the year?

Mark Manduca

Good stuff, Brian. Thanks for the question. It's Mark here. So a couple of good points that you've raised. First of all, the $700 million that, as you know, we've won year to date. And, if you accumulate that up, and you put that into next year's revenue growth, you will see, as you mentioned, 9% gross wins coming for growth next year. So that's the first point.

The other thing to combine with that is, obviously, to go from gross to net, you clearly need the revenue retention rate. And you'll be pleased to know that, since the investor day, that revenue retention rate has improved. The second part of the growth algorithm for the 8-12%, as you know, already, you're in the scoring zone with that 9% growth rate. But you need to think about not just new customer wins, but also existing customer growth. And there's good stuff going on there as well. Two things to think about. We talked about 3-4%, if you remember, for existing customer wins. Well, we're running at or slightly above that run rate at the moment, as of the third quarter, given what's going on in regards to our price escalators in an inflationary environment, as Malcolm talked about. So we've got good confidence going into next year for 8-12%. I'll hand over to Baris to talk about the inputs of the guidance.

Baris Oran

Thank you, Mark. Remember, we're writing our contracts with an expectation of three-year cash-on-cash returns and 33% return on invested capital. We can clearly grow faster, but we are careful to grow with the right vertical, right customer, with the right credit rating, and also, right potential. We want to grow with the customers where we make a difference, our solutions can make a difference, and we get a good return on an invested capital basis.

Brian Ossenbeck – JP Morgan

All right, thanks, guys. I think the other one I wanted to ask was just the incremental margins, here in the quarter and then out to next year, specifically for 3Q. It didn't look like we got a tremendous amount of dropdown, into profitability from the top line. So, maybe it was some of the startup costs you mentioned earlier. But if you can clarify that and how it's trending into the fourth quarter, that'd be helpful, along with just the building blocks for 2022, because even if the guidance is unchanged right now, it is underpinned by the growth you just talked about, and we are still looking at a pretty decent pickup in margin expansion into next year.

Baris Oran

Thank you. We saw margin expansion organically in Q3, and our guidance at the midpoint also shows that, margin expansion on an organic basis. Q[4] is generally overall a lower margin compared to the prior quarter. It's a fulfillment business. Q4 is the, peak period that we have Black Friday and where we have Christmas. Therefore, we generally have lower margins compared to Q3. But on a year-over-year basis, our margins are up both for Q3 and in Q4 on an organic basis. And looking into 2022, clearly, we have a lot of confidence in our growth, in our pipeline, in our model overall. And our guidance is reflecting that with a margin expansion.

Mark Manduca

And just to add to Baris's excellent point, Brian, if you look at that midpoint of the range for the full year – so implicitly, we're taking $7.7 billion at the midpoint for revenue and $622 million at the midpoint for EBITDA, to help you with this maths. I'll give you some numbers so you can get a sense: 8% organic growth is what that's implying for Q4. So clearly, underwriting to a certain degree, what we're talking about for next year. And then, for Q4 EBITDA, if you take that $622m at the full year, the implied Q4 midpoint would be $155 million. As Baris said, the business had Q3 margins up organically. So ex-acquisitions, margins were up in the third quarter. The same is true for the fourth quarter, at the midpoint of the range. So we're confident.

Brian Ossenbeck – JP Morgan

All right, guys, thanks for the time.

Operator

Our next question comes from the line of Stephanie Moore with Truist. Please proceed with your question.

Stephanie Moore – Truist

Hi, good morning.

Baris Oran

Good morning.

Stephanie Moore – Truist

I was hoping you could discuss, you know, maybe your current new customer demand environment, as well as how you balance profitable growth. And really just on the latter, how the returns of your maybe recently won contracts compared to your current return profile and just where you think that can go over time, just given the investments that are being made.

Baris Oran

Sure. We are writing contracts on average around 33% return. And that is still continuing and we start with – we are a growing company. What we see recently is, there's a lot more technology involved, automation involved, in, as we are helping our customers resolve challenges that they currently have in their supply chain – supply chain processes.

So, we see margin expansion, especially in high-tech solutions that we provide. The more automation we provide, the higher margin we get. And as I mentioned earlier, that's roughly 200 basis points to about 400 basis points higher compared to a manual solution. So overall, return on invested capital, we see, on the context we're writing, is roughly 33% at the project level.

Mark Manduca

And to Baris's point, Steph, it's all about technology at the moment. There isn't a single contract that we're looking at or have written in the quarter that doesn't have some element of automation or technology within it. So as Baris says, that's a positive for returns for our business. That's a positive for margins for our business.

If you think about the way that contracts are going, there is a flywheel effect that's taking place in the industry right now, as you know, and it's all coalescing around four forces. One, contracts are moving towards the scale players in the space. Two, contracts are moving towards 3PLs that are global, i.e., have a multinational footprint. Three, good balance sheets, i.e. good counterparty, matters a lot. And as Baris said, it's all about technology advancements for number four. That really spells out, those four tenets spell out GXO.

Stephanie Moore – Truist

Great, thank you. And then, more in the near term, we're seeing a lot of, just, headlines and commentary from other large companies about how supply chain disruptions, whether it's production issues or lack of supplies, are, you know, impacting production availability. How does that impact your business, you know, even just in the near term, if, simply, goods are just taking longer to get to kind of their end destination, and certainly your warehouse?

Malcolm Wilson

Yeah, Steph, it's Malcolm here. Let me, let me give you some overview on that. Obviously, you've just heard, Q3, good results, and Q4, outlook is very positive. What we're seeing on the ground is, clearly, manufacturing disruptions on a global basis. In North America, we've seen that now channel into port disruption, port congestions. But actually, a lot of that cargo, a lot of those products, now, are channeling into our warehouses, and that's where GXO can make such a difference for all of our customers.

What we've been actively doing over the past months, is working with our customers to ensure that we prioritize the right goods, that they can be very efficiently processed through, moved across to the consumer. To do that, we've been, as Mark mentioned, we've been layering in incremental technology across our business, a lot more robotics are implemented. And also, we've been recruiting, not just for the peak, but as we've mentioned, you know, for the business that's coming along during 2022. It gives us a good head start.

So the fundamentals are all unchanged. The issues that we're seeing right now, we believe, are very much temporary. We're anticipating to continue to see them probably into Q1, maybe even into Q2, but definitely it's a temporary issue. It will abate. And, again, just to reiterate, you know, we're incurring incremental costs to solve problems for our customers. But our contractual arrangements really allow us to pass those costs efficiently through to our customers, who, who are really working with us as a true partnership to ensure that all of the different aspects that go for a successful peak season are achieved.

Stephanie Moore – Truist

Great. Thank you so much.

Baris Oran

Thank you.

Operator

Our next question comes from the line of Amit Mehrotra with Deutsche Bank. Please proceed with your question.

Amit Mehrotra – Deutsche Bank

Hey, thanks. Hi, everyone. Baris, I just wanted to come back to the margin question, maybe just a slightly different way. If you look at your guidance this year, ’21, you raised it by $100 million on revenue, but only $2 million on EBITDA. Can you just talk about that? Because obviously, that implies very, very little drop-through and, you know, this is a relatively, obviously, new standalone company, and so what I'm just trying to understand is that, it could be, obviously, related to startup costs, which, which could be a very good thing, because your growth is very impressive, and I know you write your contracts for ROIC, but your guideposts are EBITDA. So I think it’s, you know, it'd be helpful to just understand, kind of peel back the onion for us on that revenue-vs.-EBITDA move in this year's guidance and just talk about why, maybe, there's some near-term kind of headwinds associated with that drop through.

Baris Oran

Amit, we have seen margin expansion in Q3 organically, and we are seeing, we are looking to another margin expansion in Q4, year-over-year basis. But this is a fulfillment industry, and Q4 margins should not be compared to Q3 margins, as there a number of things that's happening in Q4 that are not generally happening in Q3. Those are related to the peak, how we peak, how we scale up our business, and how that delivers.

There is a lot of startups, yes, that's true. But despite the fact that we have a lot of startups and phenomenal growth, we are showing further margin expansion in Q4 on a year-over-year basis, and we are confident in 2022 margin expansion as well.

Amit Mehrotra – Deutsche Bank

Yeah, I get that, I just, you know, implicitly, though, the margin of the business for this year, entirety of 2021, is lower than it was two days ago, right? Because you raised revenue $100 million bucks, and you raised EBITDA guidance $2 million. And so, I think the question I'm just asking is, is that, what changed? Is it just you're growing so quickly, and so there’s startup costs, or what, what changed, in terms of implicitly lowering the margin for this year? If that makes sense.

Baris Oran

Yes, we do have sizable growth elements embedded. And as we discussed earlier, the initial periods of, the first couple of quarters of a startup is not as profitable as at, you know maturity stage. Clearly, there is some impact associated with that. And also, the integration of acquisition is taking its time. It's progressing quite well, but still is not, margin-wise, it's now improving our margin. It's diluting our margin right now. Ex-acquisition, ex-K+N, our margins are better compared to the year before.

Amit Mehrotra – Deutsche Bank

Got it. Okay. That's very helpful.

And then, just a quick follow-up, if I could: Malcolm, you made this comment in the release about remaining vigilant, given the tough environment. I wanted to see if you could provide a little bit more color on that, Malcolm. What specifically are you referring to? And, you know, I don't know if this is a general comment in how GXO serves as the services provider to this, or does this "vigilant, given the tough environment" comment mean there's maybe a little bit more risk to the 2022 guidance than maybe you contemplated six months ago or something like that? If you can just give us a little bit more color on that.

Malcolm Wilson

Yes, for sure, Amit. What I'm referring to is that we are having to challenge, somehow, the norm this year. So all this supply chain disruptions, it's really created an unusual year. So in the past, where we would have been quite satisfactory to review wage levels and incentive plans, maybe, on a six-monthly basis – what we found this year is, it's pretty essential to do it every other month, in some of our locations. You know, people are in huge demand; lead times for equipment are extending; and we're having to leverage all of the buying power, all of the scale, clout, we can say, that GXO has.

So it's meaning that we are more vigilant than ever, in terms of these key issues, to ensure that we're not caught out suddenly, in a local market condition where we're under the norm from a wage perspective and we've not been quick enough to recognize a change – and suddenly, you know, we're losing some of those valuable resources. So we've been, we've had to stand up whole new ways of working, locally, on the deck, as it were, on the floor, down in each ZIP code. Our customers have been very supportive. You know, this is an environment where, I've never seen more an environment where, customers and GXO stand together, you know, in a kind of common environment, common difficulty of labor availability. It's been really very pleasing to see.

But that's really what we mean by "vigilant." It's an environment where we have to really be very watchful, laser-focused, as we are. And I think you're seeing that in the results that we're providing today, and in the outlook, in the outlook that we're, we're giving you for Q4 and for the future.

Amit Mehrotra – Deutsche Bank

But does it, does it make it harder to achieve your guidance in that context, or does it make it easier, or does it have no effect because of the way your contracts are structured?

Malcolm Wilson

In terms of the way our contracts are structured, it has no effect. I mean, our contracts, we've mentioned on a number of occasions, we've really got a very robust environment. What I would say is, it makes it easier, in a way – it's much easier to have a discussion with people to recognize these inflationary pressures when they're so visibly and so well reported. But at the same time, we're having to work in slightly different ways just to ensure that we keep that laser-focused attention on these key metrics.

So contractually, way of working with customers, no real difference. But in terms of internally, how we're working, you know, we are having to be even more focused than, maybe, last year, on certain areas of the business and metrics. But I think, you know, the results demonstrate we're doing a pretty good job of that.

Mark Manduca

And Amit, just going back to – it's Mark here – just going back to the point that I made earlier with Brian in terms of the midpoint of the range: if you were to take the top end of the range that we've obviously updated today, in terms of revenue for the full year, and were to work back to Q4, we're implicitly at the top end of the range, implying 14% organic growth rate, in revs. And I wouldn't, I don't have to remind you of the fact that the comp has become significantly harder between Q2 and Q3 and Q4, over those three quarters.

So, there is vigilance. Cautiously optimistic. We're fighting on the ground. But at the same time, we've put out guidance today that, obviously, is a confident move in the right direction.

And bringing it back to the pipeline, as well, Amit. The $2.3 billion of pipeline. This is a business that has exceptional visibility.

Amit Mehrotra – Deutsche Bank

Congrats, guys. Malcolm, I'm – [inaudible]

Operator

As a reminder, ladies and gentlemen, it is "*" "1" to ask your question. Our next question comes from the line of Hamzah Mazari with Jefferies. Please proceed with your question.

Hamzah Mazari – Jefferies

Hey, good – good morning. Thank you. I think you had mentioned, you know, retention rates improved since the investor day. Maybe just a little more color as to what they're trending, you know, is there, do you have a target around retention? And as part of that, I know you mentioned 29% of wins from competitors – maybe just talk about the other side a little. You mentioned contracts are going to scaled players and tech leaders. In what instances do you sort of lose to competitors?

Mark Manduca

I'll take the first portion of that question. You'll remember what we said at the investor day, Hamzah, in regards to our 93%. What we've said since then is that revenue retention rates have improved, modestly. That is all the tenets, obviously, of a healthy business, as I mentioned, in terms of that flywheel effect.

In terms of your point, in regards to the mix of business, we've talked specifically about the fact that, within our year-to-date contract wins, new outsourced contracts come to around 40%. So that's obviously extremely healthy, first-time business, coming to market, choosing to come to us. Expansion of scope, so an existing customer increasing their warehouse footprint, that same store sales footprint, going up, is around 31%. And wins from competitors, as you rightly say, is 29%.

What I would echo is, to the point earlier, in that these contracts are gravitating towards scaled players, customers – to Stephanie's question – that have an e-commerce backbone, i.e., can get direct to the consumer, not having to go via brick and mortar, which takes an extra two to six weeks, getting that consumer product into the hands of the consumers quickly, having an e-commerce backbone, as we do in this 3PL, is a big, big advantage. And that's why we're winning that very healthy mix of business that we're talking about.

Malcolm, is there anything that you want to say in terms of customer mix?

Malcolm Wilson

Just to really round off the answer, because I think there was a question of, well, when we do miss out on a new piece of business, what's the real reason? Well, you know, most of the customers that we work with are big global organizations. Some of the statistics that we saw on the call, about the expansion that we've had with our top customers, the number of countries that we're working with, they're really pleasing for us, because that's really our, our drive.

But of course, in every country where we work, there's always going to be some lower-cost operator, some local type of company. And as Baris mentioned, you know, we are picky. We're picky and we're choosy. We can be in that situation, because we're in a very strong place as an organization. So we want, we want to contract deals that are really geared towards very high levels of return. We're not going to follow a price down. And, you know, that's typically the environment where we might find that eventually, you know, we choose not to progress. But those kind of customers tend to be more local type of customers. The big international brands, which is really the bedrock of our business, they really prefer, as Mark mentioned, to work with big scale players where, you know, they can be satisfied on all of the metrics.

The ESG rating that we announced, that's really important. Big international companies, oh, they love to work with companies that have the same values that they have. And coming out of the gate with that highest rating from MSC, in, amongst all of our largest industrial players, after less than 100 days of being a public company – wow, you know, that is just amazing for us. And we were so pleased to receive that.

So it, it tends to be a very local environment when we, when we ultimately, you know, don't move forward with a customer.

Hamzah Mazari – Jefferies

Got it. And just my follow up question, I'll turn it over. Just any, any thoughts on how to think about free cash flow conversion, sort of, going forward, as you think about next year? And then, you know, just any comments on the M&A pipeline that, that you have today. Thank you.

Baris Oran

Yes. On the free cash flow conversion, we have provided over 30% conversion from EBITDA to free cash flow in, in the third quarter. And on a year-to-date basis, excluding $50 million of one-off items weighted to spin, our free cash flow conversion rate was also 30%.

Looking into fourth quarter, there are two one-off items that we should be mindful of: there are local country taxes related to spin, which will be paid in Q4, amounting to about $20 million. And a payment deferred via the US CARES Act, which is about another $20 million, will be paid in Q4. Those should be taken into account when we are looking forward to our free cash flow in, in the fourth quarter of 2021.

And for 2022, you can use the benchmark or, rule of thumb we have provided: 30% EBITDA to free cash flow conversion rates, that's going to come on top of a very high rate of organic growth. Funding our organic growth, and delivering free cash flow on top of that.

Hamzah Mazari – Jefferies

Got it. Thank you.

Operator

Our next question comes from the line of Bascome Majors with Susquehanna. Please proceed with your question.

Bascome Majors – Susquehanna

Yeah. Good morning, and thanks for taking my questions.

You know, we spent a lot of time on ‘22. I wanted to talk a little bit about the pipeline and what it looks like for implementations in ‘23 and beyond. And, you know, I mean, what type of RFPs are you bidding on today that would start to drive organic growth beyond ’22? Any problems you're being asked to solve and, and how they're different than what you're doing this year and next, as far as new business? Thank you.

Malcolm Wilson

Yes, let me jump in on that. It's Malcolm. So, as we've mentioned, pipeline is incredibly strong. It's populated with a whole range of different opportunities, across the broad spectrum of the different verticals that GXO is working in. A lot of that is e-fulfillment related. That represents around 50% of our overall business, so no surprise on that. And a lot of that, an increasing amount of that, is encompassing a high level of automation. And I think that's just a response to, relatively recently, the tightness of the labor, more people want automation in their facilities. But it's also a response to, generally, automation becoming much more available and more usable in a direct application. So Mark mentioned earlier about a new goods-to-person robot that’s capable of carrying very heavy weight. That might not seem a lot, but actually, that's a real innovation for us, and it opens the door for use in a lot of different customers.

Typically, the projects that we're signing today are being implemented in the first half of 2022. But some of those projects go longer, and some even into 2023. And that's a kind of normal profile that we see. I think the longest project at the moment we've got visibility on even stretches towards the end of ‘23.

And that's why, as Baris mentioned, we have this very long visibility, long runway of visibility on what's happening in terms of the top line, and how that will crystallize and cascade down through our numbers. So overall, we're in a very good position, you know, very strong pipeline. As Mark’s already mentioned, where is that pipeline forming from in terms of the mix, I think, I think we're in a very enviable position.

Baris Oran

One thing I would like to add to that, Malcolm, as we go through contract by contract, I see a lot of examples of our global brands switching to direct-to-consumer. Therefore, our capabilities of serving them, on the e-commerce side and returns management side, the reverse logistics side, is becoming more and more enhanced, and I see a lot of proposals and contracts coming in with high automation and large facilities across the world. I mean, in Europe, in US, elsewhere, that's a trend that you're seeing.

Malcolm Wilson

Yeah. And, and listen, just to finish the point, it's Malcolm here again, I'm glad Baris came in on that. And the fact he's explaining what he's seeing, I just want to make the point: this is a business that has incredibly strong governance. All of these deals that we set up with customers, they go through a rigorous vetting process. That's why we talk about being ultra-focused, you know, in terms of our financial returns.

Everything, ultimately, is signed off by our finance organization, Baris at the lead. Everything comes to myself also. So it's a very rigorous process that we have. You know, we, we're not making very good levels of financial results by accident. It's a very detailed effort that goes into this. Thank you.

Bascome Majors – Susquehanna

For, and, you know, to naturally bridge that, I don't know if you want to comment, but I mean, how do we think – I mean, clearly, the visibility is huge. But how do we think about the longer-term sort of revenue and, and EBITDA trajectory through the cycle, when we're through some of this exceptionalism that we've seen in '21 and '22?

Baris Oran

As far as the growth is concerned, e-commerce is only 30% penetrated. It's sometimes lower, so there's a lot of room for growth on that side. Automation, our industry is only 5% automated. Outsourcing is only 30% currently, out of a $430 billion total addressable market. So all these three flywheels are driving us forward. And we see phenomenal growth opportunities moving forward.

And as mentioned earlier, we see more and more technology being used, a lot more automation being used, in our, even our, even as we renew our existing contracts, we have to put more automation, more technology. So you would, you should see a margin expansion as we embed more technology, software, and hardware into our facilities.

Mark Manduca

And you'll know, obviously, Bascome – its Mark here – over the last 20 years, this business has roughly done a revenue CAGR of around 16%. And if you were to look back into the sands of time and compare that against the 8-12% organic growth that we're talking for next year, logically, I think one could conclude, it wouldn't be crazy to conclude, that the 8-12%, just based on history alone, is what one could describe as a normal year for this business.

Bascome Majors – Susquehanna

Thank you, everyone.

Baris Oran

Thank you.

Operator

Our next question comes from the line of Ravi Shanker with Morgan Stanley. Please proceed with your question.

Ravi Shanker – Morgan Stanley

Thanks. Morning, everyone. Just a couple of follow ups here, maybe a short-term one to kick it off. You guys have elaborated quite a bit on how you are “fighting on the ground” to, to kind of make the best of the current environment. But what about your customers? Kind of, do you see risk to volumes if your customers are struggling to, to, to manufacture or procure products? I mean, obviously, Apple has made very clear that they're struggling with semiconductors. I mean, you, you, they are a customer of yours. How do you see that, as a potential risk, for the next couple of quarters? And also, your own ability to automate, and kind of procure robots, kind of, are you seeing any of that being impacted because of the semiconductor shortage?

Malcolm Wilson

Hi, Ravi. It's, it's Malcolm here. So in the, the first part of your question, no, we're not seeing any significant risks in regards to our own operating model. So we've seen some, some of our customers are very busy, almost unaffected by the current supply chain difficulties. Some we can see clearly, you know, they have been waiting for products.

I would describe it that this year’s peak is kind of feeling like it's going to be a longer peak season, and probably, in the end, more condensed, from probably middle of November through to the end of the year. And that, and I say that, because what we are seeing now is some alleviation of the port congestions. I mean, it's going to go on for months, but we're definitely seeing some alleviation of that. We're seeing lots of containers, traffic, coming into our facilities. And that's why I mentioned, you know, it's really important now that we're working so closely with our customers to identify those priority goods and get them out to the, to the consumer. So in that regard, I think, I think we're in good shape.

And as I mentioned, you know, the incremental costs that we might incur in that, our contractual model pushes that back into the customer.

Mark Manduca

And, Ravi, in regards to, in regards to the good shape that Malcolm talked about – remember, we've given guidance last night, reiterating it because we believe it. We're confident.

And the question – which is a very timely question, by the way – it sounds very much like a typical RFP process, when you ask it. You provide us with a problem, and GXO offers you a solution. That's why customers come to us: they want to have their problem solved.

Malcolm Wilson

And, Amit, the other part of your question was about, then, the availability of materials. I, I think you're referring to kind of what we need in the warehouse. And that's really, again, I want to really make a strong point. We're the largest outsourced contract logistics company in the world. It gives us colossal buying power. You know, we're one of the top ten warehouse real estate rental, renters, basically. So we have big power with the industrial landlords. That's enabled us already this year alone to set up over 60 new warehouses – another 15 planned between now and the end of the year. And we work very collaborative, very closely with all of the big automation organizations. We're not reliant on any single individual company. But by having these strong relationships, they see us as a big partner, they see us as buying a lot of material from them. We're always at the front of the queue when it comes to getting what we need to stand up our facilities in a timely manner. And again, it, it just really encourages more and more customers to want to work with GXO, because they see that that builds into the reliability proposition that we give them.

Ravi Shanker – Morgan Stanley

Got it. And Mark, if I can just touch on, you said earlier that the, the new business wins have a tremendous visibility. Obviously, that's a key tenet of the business here. As we head into 2022, any chance we might get longer-term guidance from you guys, just given the visibility you guys have in the business?

Mark Manduca

For a business such as ours, the capability of being able to give long term-guidance is definitely there. In terms of your question, in regards to ability to see out into the looking glass, we've already got around 98% visibility this year, and roughly 80 to 85% revenue visibility for next year, to give you a sense, Ravi.

Ravi Shanker – Morgan Stanley

Great. Thank you.

Operator

Ladies and gentlemen, that is all the time we have for questions today. I'd like to hand the call back to management for closing remarks.

Malcolm Wilson

Thank you. Thank you, Operator.

Well, I just want to reconfirm: very strong third quarter for our business. We're a very successfully spun off company. You know, it's been achieved in a, a relatively record time, and we've done it very well.

This is a strong organization that's set for a very good future. We're going to benefit from all of those strong secular trends that we're talking about. More and more organizations outsourcing; more of our customers, and many customers, moving the business more to an e-fulfillment model; and, of course, automation is becoming a huge play in the, in the environment that we're in.

We've reported, in this quarter, 12% of organic, 14% growth on EBITDA, and margins and core business all expanding, year over year, very strongly. So we're very satisfied with the results. We're very pleased that you were able to join with us on this call today, and I'd just like to thank you for all of your support. Thank you very much.

Operator

Ladies and gentlemen, this does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time, and have a wonderful day.