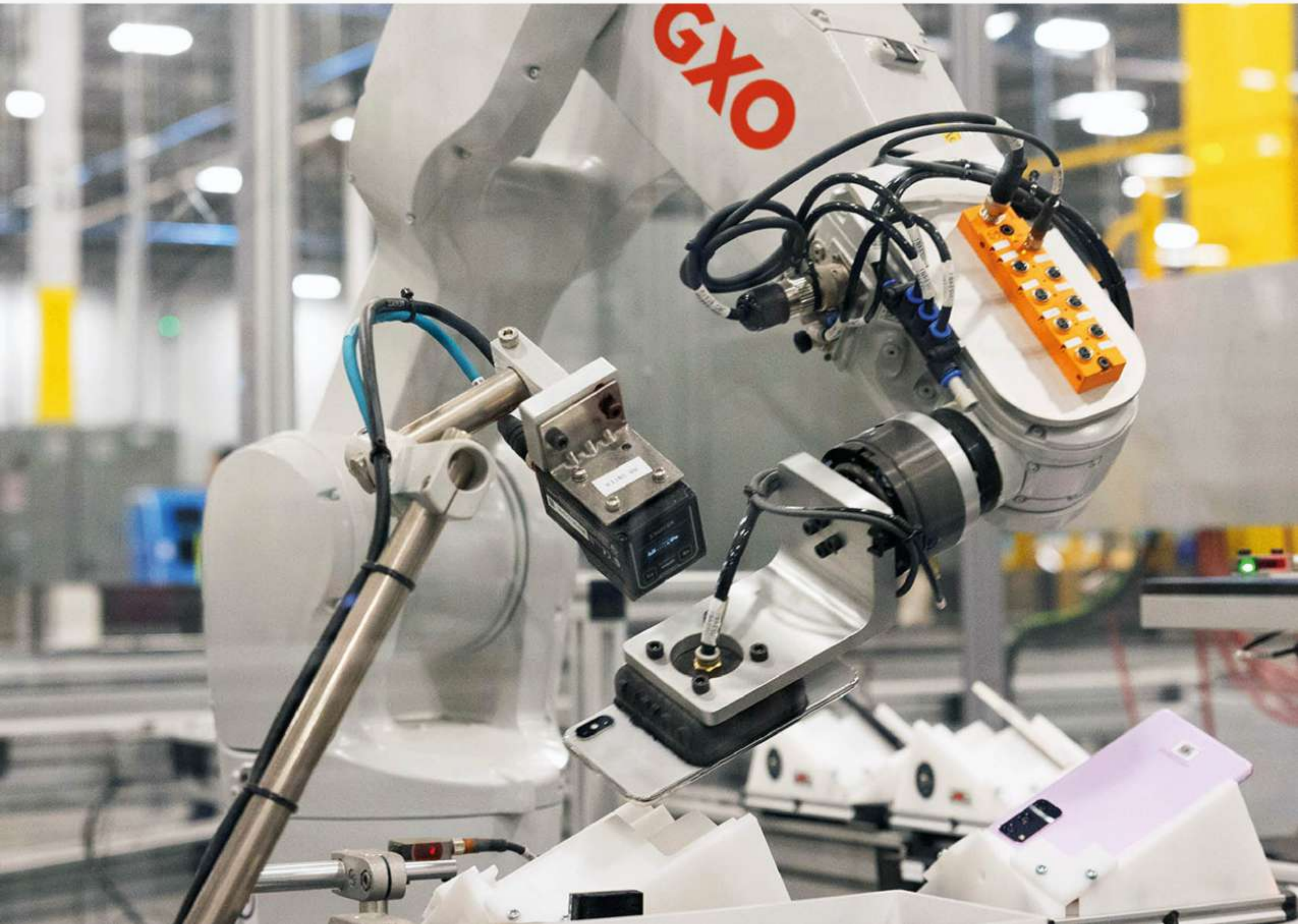
GXO Q1 2023 Earnings Call

May 10, 2023



GXO Logistics Q1 2023 Earnings Call

Presenters

Malcolm Wilson – Chief Executive Officer

Baris Oran – Chief Financial Officer

Bill Fraine – Chief Commercial Officer

Mark Manduca – Chief Investment Officer

Q&A Participants

Stephanie Moore – Jeffries

Chris Wetherbee – Citigroup

Scott Schneeberger – Oppenheimer

Bascome Majors – Susquehanna

Ben Moore – Deutsche Bank

Brian Ossenbeck – JP Morgan

Allison Poliniak – Wells Fargo

Ravi Shanker – Morgan Stanley

David Zazula – Barclays

Bruce Chan – Stifel

Operator

Welcome to the GXO, First Quarter 2023 Earnings Conference Call and Webcast. My name is Cheri, 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 anyone should require operator assistance during the conference, please press star-zero 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 the Company's 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 and 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 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 are on its website.
- Unless otherwise stated, all results reported on this call are reported in United States dollars.
- The Company will 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.
- It is not possible for the Company to actually predict demand for its services, and, therefore, actual results could differ materially from 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 of the Company's website.

I will now turn the call over to GXO's Chief Executive Officer, Malcolm Wilson. Mr. Wilson, you may begin.

Malcolm Wilson – GXO Chief Executive Officer

Thank you, operator, and good morning, everyone. Thanks for joining us today for our first quarter 2023 earnings call.

With me in Greenwich are Baris Oran, our Chief Financial Officer; Bill Fraine, our Chief Commercial Officer; and Mark Manduca, our Chief Investment Officer.

We’ve started off 2023 in great shape: we’ve delivered a strong quarter; we’re progressing ahead of schedule on our integration of the Clipper business; and we’ve laid the foundations for delivering our strong 2027 targets.

Our revenue in the first quarter was $2.3 billion, growing 12% year over year. Organic revenue growth was 7%, at the midpoint of our full-year guidance range.

Our adjusted EBITDA was $158 million in the quarter, up year over year and ahead of our expectations. As a result, we are raising our full-year adjusted EBITDA guidance by $15 million, bringing the midpoint of our range to $730 million.

It's been a great quarter of signing exciting new business and implementing automated solutions for our customers. Through the end of April, we've secured more than $800 million worth of incremental revenue for 2023, signing new partnerships and expanding relationships across multiple verticals and markets with a fantastic group of customers, including Google, Kellogg's, Unilever, and Vivienne Westwood.

In particular, I want to highlight the new project we announced in April with Sainsbury's, a leading UK grocery retailer. With a lifetime value of nearly one billion dollars, this is the largest annual revenue contract awarded in GXO's history. Bill will talk more about this in a moment.

These stellar new business wins demonstrate our unique value proposition, as we bring our global scale, deep expertise, and tech-enabled solutions to bear for our customers.

In the quarter, we again set a new record for the deployment of operational tech, increasing our total tech and automated solutions by 64% year over year. Today, operations utilizing automation or adaptive tech make up nearly 40% of our revenue, a number that will only increase to meet the enormous demand going forward, both in new implementations and for retro-fitting of existing operations.

We are also accelerating our deployment of machine learning and artificial intelligence, which boost productivity significantly on top of the benefits of the warehouse tech itself.

In short, we're seeing unprecedented demand from customers for solutions involving tech enablement, and our leadership in this space continues to drive our growth and profitability, underpinning our confidence for both our 2023 guidance and our 2027 targets. To fully capitalize on the demand of our services in this area, we're also strengthening our teams to support significant growth in the years to come. We'll have more news on these initiatives next quarter.

Also in the first quarter, we were pleased to announce that GXO Direct, our shared-user solution, has gone global: we've launched Direct across the UK, with the rollout into Continental Europe planned for later this year. This expansion comes through the blending of the best of both the GXO and legacy Clipper capabilities and expertise to create a differentiated offering.

And, finally, just two weeks ago, we published our second annual ESG report. In it, we've highlighted our progress on ESG, from emissions reductions to development and belonging initiatives for our team members worldwide. We also outlined our new ESG goals, including safety targets.

ESG is important for our customers, as we saw in the significant Sainsbury's win, where our enablement of sustainability in their daily operations was a key factor in their decision to expand our business relationship.

We've had a great start to the year, we're raising our guidance, and we're looking forward with confidence.

We've delivered strong wins, we have a robust sales pipeline, and we've set the foundations to achieve our 2027 targets.

With that, I'll ask Baris to come in on the financials. Baris, over to you.

Baris Oran – GXO Chief Financial Officer

Thank you, Malcolm, and good morning, everyone.

We are proud of our results this quarter, as they continue to showcase both the strength and predictability of our business, and to deliver on our promise of robust growth and resilient margins.

As Malcolm mentioned, for the first quarter of 2023, we generated revenue of $2.3 billion and delivered 12% revenue growth, of which 7% was organic. In particular, our reverse logistics business grew organically at nearly three times the rate of our group organic revenue growth. Geographically, our business in Europe has performed above our expectations, and we've seen particular strength in the US across the technology and aerospace verticals, balancing consumer demand.

Our adjusted EBITDA in the quarter was $158 million, growing year over year and reflecting the strength of our business model and our solid execution. Our net income attributable to GXO was $25 million. Our adjusted diluted earnings per share for the quarter was $0.49, and our free cash outflow was $43 million, reflecting normal seasonality.

We have accelerated our investment in initiatives to grow our adjusted EBITDA faster, particularly in the automated facilities. At our Investor Day, we discussed the integration of Clipper and our central efficiencies program. I am pleased to tell you that both are running ahead of plan:

First, Clipper is performing strongly and contributing above our expectations. The integration of the two organizations is progressing ahead of schedule, driving higher-than-expected results in the first quarter. The strength of the Clipper business also gave us a foundation to launch GXO Direct in the UK.

Second, we continued to execute our central efficiencies initiatives. These include making our organization leaner, as well as optimizing our technology infrastructure, supplier network, and real estate. We accelerated the benefits of these projects into the first quarter.

So far this year, we have won $1.7 billion of lifetime contract value. We have maintained our rigorous controls for writing high-quality contracts, and our operating return on invested capital in the first quarter grew year over year and remained well above our 30% target. Bill will give you more visibility on our great sales performance so far in 2023 in just a moment.

We are reiterating our full-year guidance for both organic revenue growth of 6-8%, as well as free cash flow conversion of approximately 30%, which will drive our net leverage levels down to around 1.5x by the end of the year. With respect to our balance sheet, we will continue to deploy our capital in the best interests of our shareholders, including continuous deleveraging, buybacks, and M&A.

We are also pleased to raise our full-year guidance for EBITDA and EPS:

We're raising adjusted EBITDA, by $15 million, bringing our full-year range to $715 – 745 million. This is due to a combination of accelerated synergies from our integration of Clipper, early delivery on our central efficiencies initiatives, and better-than-expected trading in the first half of the year.

We are also raising adjusted diluted earnings per share, by $0.10, reflecting an increase in our operating profitability, bringing our full-year range to $2.40 – 2.60.

In summary, we delivered solid growth this quarter, we made excellent progress on our long-term targets, and we secured major new business wins that will continue to propel our growth in the quarters and years ahead.

These results and our upgraded guidance reflect, yet again, how resilient GXO is through cycles. This is the hallmark of our infrastructure-like business, serving global blue-chip customers, where prices are escalated in line with inflation, and we benefit from the tailwinds of automation, outsourcing and e-commerce – all enabling GXO to deliver extraordinary returns.

And with that, I'll hand you over to Bill to talk about our wins to date and what we're hearing from our customers.

Bill Fraine – GXO Chief Commercial Officer

Thanks, Baris. Good morning, everyone.

2023 is looking like a very exciting year for GXO.

In the first quarter, we did $162 million in new business wins. And, in April, we've won an additional $230 million of business. Combined, we've banked nearly $400 million in year-to-date wins through April.

By the end of the first quarter, we had secured $782 million of incremental 2023 revenue; by the end of April, this has increased to over $800 million. This equals year-over-year revenue growth of 9%, year to date.

On top of that, we have a further $362 million of revenue locked in for 2024, which puts us 38% ahead of where we were at this stage last year.

Our pipeline of opportunities is $2.3 billion as of the end of the first quarter, and this has risen further through April. Don't forget, this increase in our pipeline is after the significant Sainsbury's win.

As we look into our pipeline, we are seeing a greater weighting towards first-time outsourcing business, which makes up over a third of our opportunities. And our record pre-pipeline has doubled year over year, reflecting the increased demand from customers to invest in larger, more holistic partnerships.

What our wins and opportunities speak to, and what we're seeing on the ground, is that more and more customers around the world are recognizing that "business as usual" is no longer a viable strategy. As a result, the growth in the number of large global companies coming to GXO to help them redesign their supply chains, lower costs, and improve their service quality, is accelerating.

Let me walk you through a couple of examples:

One of the world's largest food service companies, who started off asking for an operation on the West Coast, has now progressed to asking how can we help them optimize their network across North America and Europe.

And, two other customers – an e-commerce company and a consumer products company – initially called on us to bid on regional solutions, and, based on our proposals, realized the value of expanding the conversation to include a holistic review of their entire US network.

What I'm trying to say is that companies come to us with one solution in mind and are now working with GXO on a much larger scale.

These are large, transformative deals – or "big, bold changes" as one of our customers recently called it. As the scale of what we are being asked to do grows, so does GXO's position as a trusted partner of choice.

In addition to strategic partnerships with new first-time-outsourcing customers, we're also seeing continued expansion of our relationships with our existing, long-term customers around the world.

As Malcolm noted, in April we announced a new project with Sainsbury's. This record-setting win developed through a long-term partnership, that we've grown from running reverse logistics to, now, operating all of Sainsbury's outsourced fresh and frozen distribution centers. We're partnering with them to drive, in their own words, one of their "key competitive advantages" for the future. This value-based partnership is now a cornerstone in cementing our status as a leader in the food and beverage logistics sector.

Building these deep, long-term relationships is just in our DNA. In the first quarter, we grew with a number of existing blue-chip customers, including Kellogg's and Google. And we've also just won our ninth site with one of the world's largest consumer packaged goods companies. These are all great examples of "The GXO Difference" in action.

Finally, we are very excited about the expansion of GXO Direct to the UK. To date, we have a network of about 30 Direct sites in the UK, serving such brands as ASOS, L'Oréal and Marks & Spencer. Customers' response to Direct has been strong, and we look forward to growing Direct even further. We will launch Continental Europe later this year, and this will expand our growth opportunities.

And with that, I'll turn you over to Mark. All yours, Mark.

Mark Manduca – GXO Chief Investment Officer

Thanks, Bill.

Indeed, 2023 is off to a great start, as GXO continues to take share through our global scale, our tech leadership, and the tremendous value that we create for our customers.

This is a business that combines predictability and growth at its bedrock.

First, touching on our predictability:

Unlike the transportation industry, where transactional pricing is driven by short-term supply-and-demand conditions, our holistic pricing structures are dictated by long-term contractual agreements with minimum volume thresholds and inflation protection embedded within them.

And, combined with our growing, diversified pipeline and our record pre-pipeline – which Bill touched upon in his comments – it shouldn't come as a surprise that we've already secured well over 95% revenue visibility for this year.

Secondly, on the growth side:

As of the end of April, we've won contracts worth the equivalent of 9% gross revenue growth on our 2022 revenue base of $9 billion.

And if our pipeline is anything to go by, we will inevitably secure additional wins in the coming months that will propel our growth in 2023 even further. Moreover, for 2024, we've already secured $362 million of incremental revenue through April. This puts us 38% ahead of where we were at this point last year, and, given our buoyant pipeline of $2.3 billion, we're confident that we'll see revenue growth accelerate next year.

Altogether, considering our low attrition rate in an inflationary environment, you can see why, as a team, we're confident about our 6-8% organic growth range for this year, and our broader 8-12% CAGR through 2027.

We've delivered seven quarters without missing a beat; we're on track to hit our 2027 targets; and our business is firing on all cylinders.

This is a management team that delivers on its promises.

And with that, we'll turn to Q&A.

Question-and-Answer Session

Operator

Thank you. If you would like to ask a question, please press star-one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star-two if you would like to remove your question from the queue. And for participants choosing speaker equipment, it may be necessary to pick up your handset before pressing the star keys.

Our first question is from Stephanie Moore with Jeffries. Please proceed.

Stephanie Moore – Jefferies

Hi! Good morning and congrats on a good quarter.

My first one is for you Malcolm.

I'd love to hear what you're seeing just from a macro perspective in both the U.S. and Europe, as well as across industry verticals.

And then, as kind of a second one, and this one's probably best for you Bill, what are you hearing from your customers and potential customers that give you so much comfort in the full year guidance and really that this rather strong pipeline can be converted and maybe not elongated on any kind of macro hesitations from your customers? Thanks so much.

Malcolm Wilson – GXO Chief Executive Officer

Hi! Good morning, Stephanie and let me talk about the macro and I'll hand over to Bill to explain what's going on on the ground as it were.

So we've delivered good organic growth across every region in the last quarter. All of our regions, we're seeing very strong verticals: industrial as an example, technology, aerospace in particular. These verticals are really doing very, very well and they are compensating for what we can see. Equally, we've got some softer consumer-related parts of our business -- nothing that we didn't expect, or in fact, nothing that we weren't sharing back in January on our Investor Day.

I do want to make a few mentions of a particular note, Baris touched on it a moment ago. We've seen really strong performance from our European business. All of our management teams, talking with our customers, what we're seeing, what we're feeling, is that those markets, we really saw probably the worst of the softer environment in the second half of last year. 2023 is really shaping up very nicely for us on those markets.

In other areas of softer trading, we shouldn't forget that our customer contract model is really protecting our profitability. So, in this less certain macro environment that we're in right now, actually it will do pretty well.

Some other topics of interest: wage inflation across every region that we operate in is definitely moderating – what we're seeing is sort of mid-single digits – and the good news is wage inflation, wages are actually catching up, so that's broadly good news for the consumer.

And the final point I want to make, standout really, in the quarter and what we're seeing going forward, is a standout on our sales pipeline. They are near record levels, as we kind of expected, very strong demand across first-time outsourcing, drive to put more and more automation into new sites, into existing sites, retrofitting those existing sites. So, overall, we're really feeling confident for ‘23, and because of that long runway of visibility, ’24. We're feeling good about it.

But Bill, maybe you can touch on a bit more detail.

Bill Fraine – GXO Chief Commercial Officer

Thank you, Malcolm. Hey! This is Bill, good morning.

So we've talked a lot about pipeline and pre-pipeline. Actually, as of today, the pipeline is $2.4 billion, and the pre-pipeline has doubled in the last few quarters, which is a great show for what we see coming forward.

To explain these two things, the pipeline is very simple. These are accounts we're directly engaged with. We've given them a proposal or we've been shortlisted down to one or two folks and we're in direct negotiations to sign a contract. So that's what we call pipeline.

Pre-pipeline are accounts that we have analyzed, we've looked at, we've quantified, and we're now working solutions for them. So we'll be writing pricing and they will move into the pipeline. So that's when we talked about those two. And lately, it's a great wave breaking towards the beach. That's what we're very excited about.

And what we're seeing inside the pipeline is a few things, the return of the $100 million deals. So we have quite a few that are that large and it happens from what I said earlier. A customer comes to us to look at one thing, and as they see the capabilities we bring and the returns we bring around that first thing, they ask us to expand that to the U.S., Europe, or the world.

And then the final thing I'll tell you that makes me excited is we have spent a lot of time improving our sales processes in the last year to really focus on making sure our 2027 targets are achievable, and our team is ready. And one of those things we focused them on was going after non-outsourced customers. This is the two-thirds of the industry that we don't see as much as we do the ones that are already in the industry. One-third of our pipeline today comes from that group. So we're now monetizing the two-thirds of the industry that hasn't been available in the market. And we do this because of the same thing; we go after them and take over a site. We take their worst site, we improve it for them. And when they see that result, they'll bring us two or three more sites, and then we come with an answer of ‘well, why don't we combine those into a new site and have given you one site that's automated and set for the future.’ That's really what we're seeing in the market. That's why our customers come and that's really where the GXO Difference comes to life.

Stephanie Moore – Jefferies

Really helpful, thank you.

Bill Fraine – GXO Chief Commercial Officer

Thank you.

Operator

Our next question is from Chris Wetherbee with Citigroup. Please proceed.

Chris Wetherbee – Citigroup

Hey! Thanks. Good morning, guys.

You know, maybe wanted to hit on the Clipper synergies and the central efficiencies that you guys are running. I guess that's, in my opinion, somewhat of a key for the back half of the year, and I guess as you've raised guidance, there's an expectation of margin improvement as we move through the rest of the year. So maybe you could talk to the progress you're making and maybe how we think about the cadence of delivery of some of those efficiencies through the rest of this year.

Baris Oran – GXO Chief Financial Officer

Hi Chris, it's Baris here.

As I mentioned earlier, we have progressed fast around the two key initiatives that we planned, ahead of expectation, driving part of our 2023 EBITDA upgrade, and also our confidence into our 2027 targets. Our teams have done a fantastic job of bringing Clipper and GXO into one, and they are focusing on the accelerating growth of our combined business.

We expect to deliver roughly $26 million benefit in this year, which accelerates into next year, from both of these initiatives. Two-thirds of the spend, expected cost, in 2023, is already spent, one-third is left. So our spend will drop significantly in the coming quarters. Our payback period for these initiatives is less than two years.

As you remember, back in our Investor Day, we were targeting about $135 million adjusted EBITDA uplift to 2027 from these programs. We reviewed these processes post-spin with Accenture, to take advantage of our global scale and size, and we are putting that into action.

So what is included in these efficiencies programs, to remind you, it includes procurement savings, streamlining customers, IT infrastructure including hardware, outsourcing non-core activities.

To give you a sense of this program, we already enacted on a large part of the efficiency program and reduced our non-operational, non-customer facing headcount, about 540 people – 10% already. And payback of this entire program is one to two years and gives us a lot of confidence looking into 2027.

Chris Wetherbee – Citigroup

Okay, that's helpful color, and I guess maybe sort of leads into my next question, which is less about '23 and more about '24.

So I think we understand some of the dynamics that are working through, which do include FX in the numbers in '23. I think '24 is very interesting. Obviously you guys are building a book that Bill had talked about in terms of new revenue for next year. So when you think about the combination of what the pipeline looks like, and the delivery of that pipeline into revenue for '24, and then the opportunity to maybe sort of have a higher run rate from the synergies and the central efficiencies, it's early I know, but how do we think about sort of shaping up the potential growth on the EBITDA or an EPS basis for '24? I mean, you have to put a pretty big down payment to get towards those '27 targets. So how do we think conceptually about '24?

Baris Oran – GXO Chief Financial Officer

As far as the run rate for the efficiencies, as we go from '23 to '24, we're going to be having a run rate around $40 million. So the benefit of the integration and the entire efficiencies program will be increasing to 2024 over 2023. As I highlighted, it was $26 million in 2023; that's one thing.

Secondly, we are going to see some positive tailwind coming from FX in '24. We are only seeing $1 million in Q1 of 2023. But as we go into 2024, that's going to be a tailwind around $10 million, so you'll see the benefit of that.

As you look into the top line though, we have about $2.3 billion of top line. As Malcolm mentioned, almost record top line at the end of Q1. And that pipeline turns roughly twice a year, sometimes more than that. That gives us RFPs or new business opportunities of $4.6 billion plus for us to go after as of today. If we win our fair share, let's say a quarter of that, that gives us over $1 billion of new business opportunity into 2024, and that's what makes us feel so comfortable about our long-term growth trajectory.

If we achieve roughly 11% CAGR from '24 to '27 in our top line, in our revenue, we are right on with our 2027 targets. And EBITDA is going to come from the efficiencies, technology deployment, and all the other things that we're going through and we're going to be driving a higher margin.

Chris Wetherbee – Citigroup

Okay, that's helpful color. I appreciate the time. Thank you.

Baris Oran – GXO Chief Financial Officer

Thank you.

Operator

Our next question is from Scott Schneeberger with Oppenheimer. Please proceed.

Scott Schneeberger – Oppenheimer

Thanks very much, I appreciate that.

I guess I'd like to start by asking about automation. A lot of numbers thrown around and a lot of development there. I'm just curious, did I hear, Malcolm, in your part that you are now 40% automated across your facilities? I thought that was a 2027 target, so maybe I misheard that, and then I don't know how automated a win like Sainsbury's could be. So could you delve in maybe on what you won in the quarter on automation and how that's developed and just put some color around it relative to where you had been prior? Thanks.

Malcolm Wilson – GXO Chief Executive Officer

Absolutely, Scott. It's Malcolm.

So you're quite right. We're really accelerating automation deployment. I mean, I can say we're inundated with demand from customers for this. New projects that Bill refers to, high levels of automation requirement. I think it's a combination of obviously over the past few years wage levels have increased, it's making automation, tech enablement so much more attractive.

Right now, we're well on target for increasing the number of highly automated sites, but increasingly what we're also seeing is, where we're taking over in situ, it's lending itself very well to us placing a lot of tech enablement. It's not maybe possible to fully automate the site, because we're starting with an existing building. So really what we're capturing here is just the sheer volume of sites now that are getting a really big deal of automation being incorporated into them.

And as I mentioned earlier, one of the things that we're very mindful about is it's really – we're, even ourselves, a little surprised at just the sheer demand now that we're seeing across our customer base for automation.

So we are strengthening our teams and I don't want to say too much for that, but more to come on our quarter two earnings call. But definitely automation, it's a big play for us in quarter one. It will be in every quarter of this year. And as I mentioned earlier, not just automation, we're more and more using cutting edge, artificial intelligence. It's remarkable what we're doing with it, putting it into our existing automation. It's helping us eek out even greater efficiency, and we've just seen some great examples recently across our business. So very, very positive on the overall thing.

Scott Schneeberger – Oppenheimer

Sounds good. It sounds like it's helping you win a lot of business.

I want to touch on, since it's quite relevant in the first quarter, reverse logistics. It sounds like that went very well. So if you could just talk about your development year-over-year in that area and what you see going forward, particularly in the upcoming quarters for reverse logistics, which I guess wouldn't be as seasonally strong, but sounds like you're building a lot of momentum. So I'm curious how that's playing into maybe some of these new wins and what we should see over the balance of the year. Thanks.

Bill Fraine – GXO Chief Commercial Officer

Very good. It's Bill here.

A couple of things. Customers come to us because of the automation; that is definitely a key driver. We mentioned this at Capital Markets Day that we have – our sites around the world are incubators where we bring people to and they get to see not just the automation live, but the returns the customers are gaining from that automation.

And our reverse business is growing organically across our portfolio. It's also a significant percentage of our pipeline; 36% of our current pipeline is request for automation.

But you mentioned you had the question about Sainsbury. So Sainsbury is clearly a drive towards automation. That's really why they wanted us to take the sites over. That's what the meeting with their board really showed, was from the team that's been working with them a long time, was our abilities in automation and what we could bring to the table, and the resulting benefit that would bring in their costs and their performance.

So that's just really a bellwether for us. And I would say today it's what people look at us for in the marketplace – is that ability to automate and us having the sites to prove that makes a big difference.

Scott Schneeberger – Oppenheimer

Thanks very much.

Bill Fraine – GXO Chief Commercial Officer

Thank you.

Operator

Our next question is from Bascome Majors with Susquehanna. Please proceed.

Bascome Majors – Susquehanna

Earlier you talked a bit about some of the quantitative visibility that you've gained into 2024. I was hoping you could talk a little more qualitatively about that. How does this rising pipeline and significant sales and visibility into revenue growth change how you can manage the business into 2024 and 2025, and ultimately deliver on the top- and bottom-line goals you've shared with your investors for the four-year view? Thank you.

Bill Fraine – GXO Chief Commercial Officer

Thank you. This is Bill again. I'll give you a short answer and turn you over to Baris.

For me what it does is, having the size pipeline we have and the size pre-pipeline we have, it really helps us make sure that we're hitting our ROIC, all the returns we want to hit. We are not – we can be more selective in the accounts we're bringing through the pipeline. We understand the work in front of us. So we're making sure that everything we have is going to hit the returns we've committed to for '27. And then I'll turn it over to Baris to talk about what it means to our bottom line.

Baris Oran – GXO Chief Financial Officer

Sure. Our business is growing quite robustly. We're selling new business. Our automated revenues, for example, this quarter has increased 18%. Our organic revenue growth from the reverse, which is also higher margin business, was triple the rest of the business. So it's all going up from that angle.

When you look into beyond our business, there are a number of things I have highlighted. The run rate of – at the end of this year, we're going to be generating about $26 million of incremental benefits from this integration and central efficiencies program. You should take $40 million as we go into 2024 from those. That's our calculation right now. That's going to be the benefit. That's going to be incremental in 2024 and there's going to be somewhat around $10 million of tailwind coming from FX as well. So that's going to further improve our margins. Our mix is going to improve our margins, but also these initiatives will also help us improve our margins into 2024.

Bascome Majors – Susquehanna

Thank you for the time.

Baris Oran – GXO Chief Financial Officer

Thank you.

Operator

Our next question is from Amit Mehrotra with Deutsche Bank. Please proceed.

Ben Moore – Deutsche Bank

Hi! Yes, this is Ben Moore on behalf of Amit at Deutsche Bank.

Focusing on the cost side to drive your margin expansion, what's your outlook on direct operating costs over the next few quarters? And do you think you can hold a line there or even bring it down? And also, what's your outlook on SG&A costs as you see the payback on your restructuring actions?

Baris Oran – GXO Chief Financial Officer

Thank you. This is Baris here.

Our operating costs will go in line with the growth of our business, that's what we expect. In fact, we expect, when you look into our Q1, excluding FX and pensions, our margins were steady. As we look into Q2, Q3, and Q4, we expected somewhat of a margin expansion excluding these headwinds in the rest of the year. So that's going to be reflected in our operating costs, somewhat growing slower than the rest of the business, that's one.

On the SG&A side, when we took over Clipper, the SG&A as a percentage of sales was much, much higher than GXO. So we took a lot of measures: as I highlighted, we have eliminated around 10% of our non-customer facing, non-operational team to reduce our SG&A in Q1, and you'll see more of that benefit for the rest of the quarters in 2023. So both sides should help us to mildly improve our margins in the rest of the year.

Ben Moore – Deutsche Bank

Great, thanks. And on your Sainsbury contract that you won, we're assuming it’s mostly open-book given it's in the U.K. And can you talk about the return profile of all the new business from Sainsbury and if it's going to be accretive, neutral, or dilutive to margins?

Bill Fraine – GXO Chief Commercial Officer

Yes, it is open-book. That is the business we have and then I'll turn it over to Baris to give you the numbers on the account.

Baris Oran – GXO Chief Financial Officer

Sure. We are writing contracts for return on invested capital, and we have high quality expectations for where we write business. As you see from our results, our operating return on invested capital has increased 3% year-over-year. And we'll continue to write high quality contracts and our book of business is reflecting that. We are pretty picky in who we work with and in how we create value for our shareholders.

Ben Moore – Deutsche Bank

Okay, thanks so much.

Baris Oran – GXO Chief Financial Officer

Thank you.

Operator

Our next question is from Brian Ossenbeck with JP Morgan. Please proceed.

Brian Ossenbeck – JP Morgan

Hey! Good morning. Thanks for taking the question.

So Malcolm, I know you talked about some of the new initiatives that are coming, perhaps in the next quarter. I wanted to see if you could just give us a broad sense of what those are in terms of perhaps headcount investments or strengthening the teams. Because, one thing you obviously need to deliver on this pipeline, with all the opportunities, are people in the field to execute: program managers, and designers, and the like. So maybe you can just give us some sense as to how that team looks like currently and just a broad view of what you're looking to add.

Malcolm Wilson – GXO Chief Executive Officer

Yeah, well Brian, thanks for that question. One of the things what we're doing at the moment, we've been redesigning how our teams operate in the field and, as Bill mentioned, we did that earlier in terms of our sales organization, and we've been mirroring that across how we deploy technology and it's part of the learning.

Our company now, we're approaching two years of age and we've learned along the way. We had Accenture in early on as Baris just mentioned. That's helped us greatly in terms of streamlining some of our back-office areas and that's all going into our 2027 plan. And we're now just incorporating the same situation across our tech organization. It's evolution, not a revolution. That's the most important thing to say.

I think the other important issue is, it's still a tight market for high quality talent. And from a GXO perspective, it's one of the benefits we gain. We work hard at making this company a great place for people to be a part of. I can say that when we open our doors to graduate programs, we are inundated with the best talent in the industry, wanting to work with GXO. It’s often we're hearing that people, employees, new employees, they see us as the benchmark of the industry.

So it's really, we're just strengthening our business, getting ready for what we're actually increasingly seeing is a tidal wave of tech demand. And we just want to make sure that we can keep the good pace that we have with all of our customers, and that'll help fuel all of our key metrics. It'll get us to our 2027 plan.

Brian Ossenbeck – JP Morgan

Okay, just a follow up for Baris, just on capital allocation. Just a little bit surprised, paying down some debt. I think most of it is fixed already, investment grade. So can you give some context to that?

Maybe more broadly speaking, opportunities for capital deployment. How does the M&A look like? At this point, obviously, you just did one deal, but I'm sure there's others that might be of interest. So just some updated thoughts on that in light of the recent paydowns? Thanks.

Baris Oran – GXO Chief Financial Officer

Sure Brian. Our short-term priority is to generate free cash flow and maintain a strong investment grade balance sheet, and we expect to return to net leverage around 1.5x by the end of 2023. This gives us a lot of financial flexibility to take advantage of the opportunities.

Beyond this, in the long term, we will continue to evaluate all opportunities to create value for our shareholders. That includes accretive bolt on M&A and we'll take a look at potentially returning capital back to shareholders through a buyback. We have to weigh them.

Currently in the marketplace, the private companies available for M&A are trading higher than where the public companies are trading at. Therefore, we have to make sure we create a lot of opportunities in our pipeline to grow these companies faster, or take a lot of costs, to justify those accretive M&A. It has to be accretive, and we are keenly focused on creating shareholder value. And we are balancing investing in our company through a share buyback, or M&A, and we'll do whatever is in the best interest for our shareholders.

Brian Ossenbeck – JP Morgan

Okay. Thank you, Baris.

Baris Oran – GXO Chief Financial Officer

Thank you.

Operator

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

Allison Poliniak – Wells Fargo

Hi. Good morning.

Just want to ask about GXO Direct. I think you had mentioned 30 new sites in the U.K. and obviously rolling into Europe later this year. Any targets on the amount of sites that you're looking to open for GXO Direct this year in those regions? And any thoughts on how – any color really on the EBITDA contribution you're thinking of from those openings? Thanks.

Mark Manduca – GXO Chief Investment Officer

Hey Allison, it's Mark here.

So as you rightly say, we're very excited about the rollout. If you remember back at the Investor Day, we talked about the total addressable market of around $500 billion. If you think about the SME portion of that, it's roughly half. So that's what we were talking about back in January.

In terms of Q1 of GXO Direct, we outgrew the base business, you'll be pleased to know. And you'll also note that we mentioned at the last quarter that it's a very attractive market from a margins perspective. Last year, you'll note that we did about a 10.8% margin. So it's a good business, thick in the pipeline in terms of number of names that are going to be working with us from a GXO Direct perspective, and we're very excited about the growth going forward in that business.

Allison Poliniak – Wells Fargo

Great! And then just going back to reverse logistics, if you look at your existing customer base that could utilize that service, can you talk to the penetration of those accounts and what you think that target could be or where you are in terms of penetration by year end? Any color there? Thanks.

Bill Fraine – GXO Chief Commercial Officer

Yes, thank you. Most of our customers, especially on the e-commerce side of the business, have some form of returns that we're working with them on. What I would tell you is that on the newer customers, obviously we're bringing in the latest automation, the latest processes. On the existing customers, we get to go back and show them that. And so we have a long pipeline of customers that we have already in-house that we're bringing returns to.

And then finally, on the - for new customers coming onboard, that's really one of the main focus items they come to. They want to grow revenue, they want to hit the right EBITDA, and they want to make sure they manage their returns and this goes across all industries.

So, we have a huge opportunity in that area. It's why it's 36% of our pipeline and why it grows well each year. So very, very excited about the benefits of returns and the learnings we've had over the years to be a leader in this.

Allison Poliniak – Wells Fargo

Great. Thank you.

Operator

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

Ravi Shanker – Morgan Stanley

Thanks. Good morning, everyone.

Can you give us a little more color on what the macro environment in Europe is like? I know there's a lot of focus on the U.S. consumer, but what do you think happens with the European consumer if you consult your trusty crystal ball? And also, there's been some headlines on these retirement protests in France. I know you guys have a sizable operation there. So can you tell us if there was any impact on 1Q at all and kind of how you see that proceeding going forward?

Malcolm Wilson – GXO Chief Executive Officer

Yeah, hi Ravi, it's Malcolm.

So across Europe landscape, as I mentioned, what we're seeing is actually a resurgence. I think it's becoming clear to us, and in fact to our customers, that what we saw in the second half of 2022 was probably the lower point of the more softest part of the economy. And I think what was playing into that across all of the different geographies was very high energy prices, uncertainty of the macro, a lot of different dynamics, but it did have a cooling effect on the market.

Now you saw in our business, obviously again, it's a testament to our business model, our contracting model, but our business was actually very resilient, but nevertheless that was the lower point. I think what we've seen steadily from the start of the year is actually a recovery in those markets. And, in fact, now, they're doing very well. We're part way now through quarter two, so the trends are all established and we're really looking forward to actually a pretty decent year across our European business.

And I know that might be a little bit different than what we broadly feel or what we broadly see in the press, but that's what we're seeing on the ground; sales pipeline is very strong, a lot of big transformational projects, a lot of huge customers choosing to make very strategic business changes. And obviously we were so pleased to be working with Sainsbury's on one of the very big transformational projects.

Continental Europe, U.K., that's what we're seeing. Shouldn't lose sight. Here in North America, I mean it's performing very, very well for us. Across all of our business, we've got some absolute star verticals. We've got some customers doing record business, but at the same time, we have to acknowledge that there is a bit of a consumer tightness and we have got some customers that are performing a bit softer than we would like them to be, where they would like to be, but it's all in alignment to where we thought our year was going to play out. When we did our Investor Day all the way back in January, you'll have remembered that we did call out that we thought this year was going to be a little bit softer than previous years.

When we speak to our customers, what we're hearing universally is they expect that softness to start to dissipate as we approach the end of the year, and I would say, if we were on the golf course, we'd be right in the middle of the fairway now, along the way to 2027.

Ravi Shanker – Morgan Stanley

Got it. That's helpful color. Just to clarity, so no quantifiable impact from the France protests in 1Q and beyond?

Malcolm Wilson – GXO Chief Executive Officer

Oh! Absolutely, yes. Sorry, I didn't answer you on that point, but no, no. I mean, and again, it's one of those things. I lived in Paris for nearly 10 years and sometimes you get a very one view of what happens in Paris. No, we didn't see any impact whatsoever on our business coming from those. And the good thing is, I was in Paris recently with my management team. I can testify to the fact that all the trash has been collected. It's a beautiful city, and I can thoroughly recommend it to everyone.

Ravi Shanker – Morgan Stanley

Very good. Thanks Malcolm. Between your two responses, I really feel like going to Paris to play golf right now, and maybe I'll do that [laughter]. Thank you.

Operator

Our next question is from David Zazula with Barclays. Please proceed.

David Zazula – Barclays

Hey! Thanks for taking my question.

So I wondered if you could comment on the pipeline and specifically the composition of the pipeline, be it kind of traditional omni-channel, e-comm, reverse logistics. What are you seeing from that composition and how does it compare to the existing book of business?

Bill Fraine – GXO Chief Commercial Officer

Yes, thank you. This is Bill, thank you.

The pipeline right now, e-comm represents about 21% in the pipeline. I mentioned the reverse being the 36%, but also as you could imagine, in the industrial sector, aerospace is on fire. That's growing very well. You see the amount of orders that are coming in there.

You also have the new customers coming in that weren't outsourced before the two-thirds of the addressable market that's available and we've really made a big push on that. Our focus has been on showing the financial benefits to their business of outsourcing and what other customers are seeing. And obviously, we have the sites to take them to, to show them this is, in real action, what it looks like.

And once we get the first one of those on, I said it earlier, we call it a takeover in place. We win their worst site. Once we get that taken over, I'll give you an example of a tech, a kind of a home tech company that's selling to the masses here. We went with one of their products. We took over a non-automated site for them. We were able to run it 10% better than they were seeing it before and give them a great return, and then we sat down and showed them automation. They are now building a 2.2 million [sic] square foot site in Maryland that we're going to combine all their brands into.

So that's kind of what we see and that's why we see the growth so exciting. So the composition I would say is across all regions and it's across all verticals, because the value of what we're bringing to the market is equally powerful to any company out there.

David Zazula – Barclays

That's very helpful. Maybe just as a follow-up for Bill or Malcolm, whoever wants to take it. You mentioned earlier minimum volume commitments as part of your contracts, and I think there was some commentary on a little bit of softness in some of what you're seeing. I guess, how frequently is that minimum volume commitment coming into play and being executed and how does that compare to prior cycles?

Baris Oran – GXO Chief Financial Officer

Hi! This is Baris here. We have a very well-structured contract. As you would recall, about 45% of our business is open-book business, cost-plus. So whatever the cost escalation, volumes don't really matter. We are charging a management fee on top of our cost, and a percentage on top of that as well. So that's about half of our business.

In the hybrid, closed-book of our business, this is where we have inflation escalators, higher margin potential to reap the benefits of productivity gains and also minimum volume requirements.

The minimum volume requirements in our contract vary based on the customer. There are some customers literally doubled during the peak, and go down to prior year levels, and there are some customers that have very steady business. So we basically tailor them based on the demand and demand condition of that customer, and we have not seen too many customers triggering those volume commitments. It has been somewhat steady, but from time-to-time they trigger that, and we collect it, we are collecting those differences that gives us a lot of protection on the downside.

David Zazula – Barclays

I guess, could you compare that at all to what you had seen in prior cycles, maybe ‘15, ‘16 or more or less?

Baris Oran – GXO Chief Financial Officer

It is pretty similar. When you look into how our contracts have been structured, the benefit of this business is writing high quality contracts and we spend a lot of time on it. We have a lot of sales people, we have our separate pricing teams, we have separate solutioning teams, it comes to legal, it comes to finance. So that’s really like an – this is like an infrastructure business and contracts are at the core of this and we spend a lot of time on this.

David Zazula – Barclays

Thanks, Baris.

Baris Oran – GXO Chief Financial Officer

Thank you.

Operator

Our next question is from Bruce Chan with Stifel. Please proceed.

Bruce Chan – Stifel

Hey, good morning everyone and thanks for your time here.

Nice result this quarter. I wanted to follow-up a little bit on the macro, but more specifically around inventory trends, obviously something that we have been talking a lot about recently. Do you have a sense for whether we have bottomed here on the de-stocking? And then as you think about inventories more structurally, post-pandemic supply chain strategy and near-shoring and all that, are you seeing a push from your customers for structurally higher inventory levels?

Malcolm Wilson – GXO Chief Executive Officer

Hi Bruce! It's Malcolm.

So I think definitely we have normalized inventories. If I see our warehouses, when we're in the field and were in the field, whether it's in Europe with Richard or Paul or Gavin or here in North America with Eduardo, what we're seeing is inventory levels across the majority of our warehouses with a majority of our customers, they've normalized. They are back to a normal level.

So all the disruptive influencing of the pandemic, disruptions in the supply chain, I think it's gone. And where we did have elevated inventory levels in the second half of 2022 with certain parts of our business, that's really all normalized out. I think the learning that's come from the past three years of what have largely been quite disruptive an environment is – in fact, everybody's learning to accept that that has become the more normal environment.

Businesses, customers, they're all planning around maybe the potential of further disruption or just to really business continuity, to make sure that they're not caught as they were in the last few years. And what we're seeing is increases in near shoring, that's actively positive for us. Bill can come in and just touch on it. We're seeing customers moving manufacturing a little bit closer to the consumer, and we've seen also balancing of inventory levels, where maybe in the past we've seen just-in-time. Well, just-in-time doesn't always work if you don't have the inventory. So we've seen a little bit of normalizing.

But right now, I think we're in a very normal state and we would expect this environment to continue as we go through the rest of '23 and into '24.

And Bill, I mean, you're actively involved in a few projects right now, on getting customer activity and manufacturing nearer to consumer. Maybe you can just talk in a bit of detail.

Bill Fraine – GXO Chief Commercial Officer

Thank you, Malcolm.

Yeah, so what I would say is, to the first part of your question, is that, I see less customers, if any, that are really dealing with the inventory problems of the past. What they – they may have some inventory they are still moving out, but it's not still coming in to load up, that's not an issue.

What customers are focused on, and really they are kind of the thing that's triggering these $100 million and larger deals, is customers want to get their volumes more out to where the customers are. They want to have it be the right level of inventory and they need a system that really provides the detailed information.

So what that means is, maybe think of it as three or four or five sites in the U.S. on one network, because then they have all the inventory available, and then this is where AI comes in. And having the AI ability through automation, providing the data to be able to figure out what volume I need, and how I can react quickly. Those are the things we see happening to improve inventories and to make sure that the problems that happened in the past, you're not having these fits and starts, and we call it the bullwhip in the inventory, you're having a more smooth process. Think of it as a more demand generated process than a push.

Bruce Chan – Stifel

That's great color. Thank you. Thank you all very much.

Bill Fraine – GXO Chief Commercial Officer

Thank you.

Operator

Ladies and gentlemen, that is all the time we have for questions today. I would like to hand the call back over to Malcolm for any closing remarks.

Malcolm Wilson – GXO Chief Executive Officer

Thank you, Cheri and thanks again for hosting our call today. We all appreciate that.

Just a summary of our call. Look, we've started 2023 in a really strong manner and the raising of our 2023 adjusted EPS and EBITDA guidance, and importantly, I think it's setting the foundations for the delivering on our 2027 targets.

We're gaining market share, we're deploying more and more true technology across the near thousand [sic] different operating locations that we have. We're seeing, and we're winning, record sized customer contracts, that's what we've explained to everyone, and we're also seeing a truly exciting sales pipeline of further growth opportunities.

I think we've all but complete now on what has been a benchmark deal and integration of the Clipper business. This is a company that's got M&A where it's in our DNA. We can do it and we do it very well. We're focused on delivering great value for our shareholders and indeed all of our stakeholders.

So with that summary, I'd like to wish everybody a great rest of the day, and thanks for joining us this morning.

Operator

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