FedEx Q3 FY19 Earnings Call Transcript – March 19, 2019

A. Mickey Foster
Vice President, Investor Relations, FedEx Corp.

Good afternoon, and welcome to FedEx Corporation's third quarter earnings conference call. The third quarter Form 10-Q, earnings release and stat book are on our website at FedEx.com. This call is being streamed from our website, where the replay will be available for about one year. Joining us on the call today are members of the media.

During our question-and-answer session, callers will be limited to one question in order to allow us to accommodate all those who'd like to participate since we have about one hour to complete the call, because Fred will be on CNBC following the call. The answers to the questions we receive from analysts prior to today have been incorporated into our opening comments.

I want to remind all listeners that FedEx Corporation desires to take advantage of the Safe Harbor provisions of the Private Securities Litigation Reform Act. Certain statements in this conference call such as projections regarding future performance may be considered forward-looking statements within the meaning of the Act. Such forward-looking statements are subject to risks, uncertainties and other factors which could cause actual results to differ materially from those expressed or implied by such forward-looking statements. For additional information on these factors, please refer to our press releases and filings with the SEC.

Please refer to the Investor Relations portion of our website at FedEx.com for a reconciliation of the non-GAAP financial measures discussed on this call to the most directly comparable GAAP measures. Joining us on the call today are Fred Smith, Chairman; Raj Subramaniam, President and COO; Alan Graf, Executive Vice President and CFO; Mark Allen, Executive Vice President, General Counsel and Secretary; Rob Carter, Executive Vice President, FedEx Information Services, and CIO; Brie Carere, Executive Vice President, Chief Marketing and Communications Officer.

Now, Fred Smith will share his views on the quarter.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Thanks, Mickey, and welcome to all joining our quarterly call. Let me offer sincere thanks to hundreds of thousands of FedEx team members for delivering an outstanding peak season despite weeks of tough winter weather in many areas.

Quarter three was a challenging quarter. Our FY19 plan envisioned top line revenue growth of approximately $6 billion. Mostly due to lower economic growth in international regions, we expect to end the year with about $4.5 billion in increased revenues. Of course, the profit flow through of the $1.5 billion revenue shortfall would, of course, been substantial in FY19. Nonetheless, the midpoint of the adjusted EPS guidance is up about $0.20 over FY18.

Five-year EPS CAGR, using the midpoint of adjusted FY19 EPS guidance, I might remind everyone, is expected to be 17%, and our target for long-term EPS growth rate is 10% to 15%. We have projected FY19 earnings growth despite a major expansion of FedEx Ground including: one, the opening of two major new hubs in Pennsylvania and Connecticut this past fall; two, expanded facilities for the rapidly-growing, oversized package e-commerce segment; and three, transitioning to a year-round, six-day FedEx Ground operation.

FY19 free cash flow adjusted to exclude voluntary pension contributions, cash expenses related to our voluntary employee buyout program, is expected to be approximately $1.5 billion. In addition, we expect free cash flow in the years to come to expand significantly assuming that we have reasonable macroeconomic situation. All that macroeconomic environment lately has presented challenges relative to our prior expectations, particularly at FedEx Express. We're quite optimistic we'll improve results in FY20 that begins June 1.

We're very enthused about the FedEx SameDay Bot developed with DEKA Research & Development that we unveiled on February 26. While we will have much more to say about this technology, we believe the economics of the FedEx bot are compelling, that regulatory approvals are highly likely over time, and we will enter a substantial new market segment that is a logical extension of FedEx capabilities.

Let me now turn to Raj, followed by Brie and Alan, for further remarks, and then we'll take your questions. Raj?

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

Thank you, Fred, and good afternoon. I'm very excited to be here with you on the call today in my new role, and I'm also very excited about the two appointments we announced last week; Don Colleran as our President and Chief Executive Officer of FedEx Express; and Jill Brannon, who is succeeding Don as EVP and Chief Sales Officer. I worked with both Don and Jill for many years, and I'm thrilled to have their leadership in these critical positions.

I would first like to take a moment to recognize the efforts of our team members to adapt to operational challenges this quarter. As you all know, we saw a number of severe weather events this winter in the U.S. During Q3, there were more than 70 instances of major highway closures or restrictions due to named storms. And in February alone, 50% of the FedEx Freight shipments were impacted by weather, a five-year record. Thank you to our team members for their hard work and dedication in delivering the Purple Promise to our customers in these trying conditions.

As I mentioned on the last call, one of my immediate priorities was TNT integration, and I'm pleased to share that we have made significant progress. The operational integration is complete in the U.S., Canada, and the Middle East. We have 35% of our international stations integrated, and our sales force will be substantially integrated by May 31, 2019. As we integrate stations, duplicate pickup-and-delivery schedules are eliminated and routes are optimized thus reducing costs. At the hub level, our road and air hubs are outfitted with technology that enables the injection of volume into the lowest-cost air or road network.

Now, I want to emphasize that we are not waiting for integration to complete to add value for our customers. On February 6, we announced a significant integration milestone with the ability to inject legacy FedEx Express intra-European shipments into the TNT European road network. FedEx intra-European economy parcel shipments transit time will improve on average by at least one business day on approximately 40% of the European lanes in the countries where the service is implemented. This service improvement's already launched in seven countries including Germany and the UK, and the full rollout, which includes a total of 28 countries, is expected to be complete by June.

This cross-utilization of the combined FedEx Express and TNT networks is a major step towards full integration of the operations. The benefits of this move are twofold: faster service for our customers at a lower cost. Additionally, we announced yesterday that we have improved transit on our TNT European Economy Express service from two days to one day on 1,200 lanes. Our service levels continue to improve and we are aggressively moving forward to gain new business. In fact, you're seeing positive momentum in our European parcel business as year-over-year revenue growth has sequentially accelerated every month for the past quarter.

These European value proposition improvements and cost saving opportunities represent a significant impact on the total FedEx international business. Before the TNT acquisition, our European revenue accounted for around 20% of our total international business. Today, it represents approximately 40% of the combined FedEx Express/TNT international revenue.

Looking ahead, the rationalization of the legacy FedEx Express and TNT core service portfolios and the upgrades and enhancements to supporting technology are scheduled to complete in the summer of 2020, and that will allow customer migration activities to begin thereafter. As you can imagine, there's a great deal of work underway on the IT side.

And I'm now going to turn it over to my business partner, Rob Carter, to comment on where we stand. Rob?

Robert B. Carter
Chief Information Officer & Executive Vice President, FedEx Corp.

Well, thanks, Raj. I believe it's well known that the systems at TNT suffered from an underinvestment prior to the acquisition. Since then, however, we've made significant progress to modernize and eliminate legacy TNT applications. More than 600 TNT applications have been retired to-date and many hundreds more will be retired over the coming year.

TNT's applications were historically very localized and bespoke. As we adopt the core FedEx applications, we're standardizing both business processes and applications at the same time. This results in improved security, reliability and speed to market, all of which improve customer experience. Due to this ongoing simplification, TNT systems' reliability is at an all-time high.

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

Thank you, Rob. So as we look beyond fiscal 2020, the integration has also uncovered numerous transformation and optimization opportunities that we will pursue. These include upgrades to financial systems, HR platforms, and simplification and standardization of transactional work in our back-office functions. While these activities will require additional investment, potential financial benefits are expected to be significant.

I want to reiterate that the value that TNT brings to us around the world is very clear. In Europe, we have an unmatched footprint and capabilities to deliver parcels and freight that encompasses more than 500 stations and 55,000 weekly road trips across 45 countries. In addition to the TNT integration, there continues to be significant media and investor interest on the potential for Amazon to disrupt the transportation industry. We have been clear that this is not a threat to our business because Amazon represents less than 1.3% of our total revenue, which is substantially lower than what our largest competitor carries. Nor is Amazon a threat to our future growth. I want to take this opportunity to provide some additional facts about the market we play in.

The size of the U.S. domestic parcel market is roughly 15 million packages per day. In addition, the global market for international parcel shipments is another 10 million packages per day, and we carry around 14.5 million packages per day today. Even if the e-commerce market did not grow one additional package, there's still substantial growth in the industrial sector of the market where we're extremely well-positioned to gain share due to our unmatched network and global portfolio.

So now, let's talk about e-commerce. This represents a significant additional opportunity for growth. We believe that we're able to add to our existing expertise and provide a market-leading value proposition here as well. We continue to invest and enhance our capabilities. We've already seen several examples such as Extra Hours, FedEx OnSite, FedEx Delivery Manager, and our enhanced return solutions. We are well-positioned to provide the best service at the appropriate price point, leveraging our current capabilities and targeted additional investments.

Now, there's an intense media focus on the "last mile", but very few people think about the first few thousand miles. When you see a FedEx truck on the road, it not only is carrying those local last mile shipments, but also the other shipments that are originated from all parts of the globe, creating density for last mile delivery and higher revenue per stop. This is an inherent advantage for players who have a global network in place. Any new entrant in this space will not have this benefit; and also not have any particular advantage on the input costs.

Our core business can be segmented in two basic categories; large customers and small and medium enterprises. Large customers of complex global supply chains with specialized needs. Our international network, expertise and broad portfolio enable us to serve these customers with very sticky, customized solutions. Our value proposition is far more sophisticated than just local last mile and we have bundled pricing across the portfolio.

Small and medium businesses seek simplicity and generally desire one-stop shop and they want a transportation provider who can handle their local, national, rural and peak needs. We also have a robust loyalty and earn discount pricing strategy for this segment that again rewards customers for bundling their business with FedEx.

So in short, we have a terrific portfolio that'll allow us to grow our core business segment and we are very well placed to take share in the rapidly-growing e-commerce segments. In the U.S. market alone, we expect the parcel market to double in size to more than 100 million packages per day by 2026. When you view the unprecedented growth opportunity in our industry in the years ahead and the very small number of providers that'll be able to address this opportunity, it becomes clear why we are optimistic about growth over the next few years.

Let me now briefly touch on some other key priorities. They include: offering leading-edge e-commerce solutions, reducing costs and improving revenue quality. We're investing in innovative automation that will enable lower-cost residential deliveries and will be a key driver of growth for years to come. We're enhancing our networks and building specific solutions to improve profitability such as expanding the footprint and convenience of our retail network with FedEx OnSite, driving growth in the FedEx Delivery Manager enrollments, and leveraging our FedEx Ground six-day network year around. I also want to assure you that all our units are intensely focused on driving down the cost-to-serve through technology, quality initiatives, load optimization, safety improvements and many other areas.

In summary, while significant work remains, I'm confident we're positioned for long-term success. We're making marked progress in our TNT integration which represents the largest lever for improved Express and overall company profitability. In the U.S., our revenue growth and market position are exceptionally strong and we're adjusting our revenue management and cost tactics to drive optimal performance. As we look ahead, my long-term priorities are profitable growth and shareholder value creation.

Now, let me turn it over to Brie for her update.

Brie Carere
Chief Marketing and Communications Officer & Executive Vice President, FedEx Corp.

Thank you, Raj. Good afternoon, everyone. Given that this is my first call, I wanted to take a moment to talk about our strategic growth priorities and why specifically I'm so excited about those growth priorities. At FedEx, we are laser focused on three key areas that will drive this growth: small and medium business, international and e-commerce; and let me briefly touch upon each of those now.

FedEx understands how important small businesses are to the growth of the economy and to FedEx. We have gained significant market share and revenue in this segment. We successfully delivered this growth through our efforts to optimize sales, marketing and digital capabilities and to optimize our cost of acquisition. This segment is especially really values the market-leading trends at the FedEx Ground. We also have strong programs in place that continue to gain momentum and loyalty with our small businesses, including our best-in-class loyalty program and our small business grant contest. It's programs like these that truly help set us apart.

On the international front, we are taking decisive action to improve our results, and Raj already covered our focus on TNT in Europe. We have the most comprehensive intercontinental cargo air network in the world, and we continue to lean into this strength while supplementing it with new and innovative value propositions. For example, we have FedEx Delivery Manager now in 59 countries outside of the U.S. and we are making strong progress on differentiating the e-commerce portfolio through our FedEx Cross Border offerings.

Raj mentioned e-commerce continues to be a significant driver of the growth in the U.S. domestic market. Currently, it's about 50 million ADV or average daily volume packages today and it will grow to 100 million by 2026. We have a very robust e-commerce portfolio with strong market differentiation. We are excited about the FedEx Ground six-day network and our Saturday advantage. As we move to six day, we added Monday while maintaining our advantage on coverage and commitment for Saturday.

Further, we expect one in four incremental e-commerce packages to be locally fulfilled between now and 2026. This is why we are so excited about our new innovations, including the FedEx SameDay Bot and capabilities such as FedEx Extra Hours. As a reminder, FedEx Extra Hours enables merchants to fulfill locally as late as midnight, while enabling their customers to shop in the evening with next day or two-day delivery.

Across all our strategic priorities, we continue to be very focused on revenue management. We see a very rational pricing market. We also routinely review our fuel surcharges. As we announced last month and effective yesterday, we updated the tables used to determine our fuel surcharges for FedEx Express U.S. domestic services and at FedEx Ground. Although e-commerce will put pressure on yields with lighter and shorter distance packages, we continue to make structural changes to address the profitability, which Raj just spoke to.

So with that, let me take a few moments to talk about our economic outlook. We see solid economic growth in the U.S., but somewhat below last year's pace. Internationally, performance is mixed across regions as overall growth moderates. The Eurozone and Japan still appears sluggish, while emerging markets growth eases at a gradual pace. A recurring theme in global surveys on economic activity is the negative impact from global trade frictions and heightened uncertainty. World trade is slowing and leading indicators point to positive but ongoing deceleration and trade growth in the near term.

Since our last earnings call, we have seen the overall China economy slow down further and this has impacted other Asian economies. Given the size of China, no markets will be able to absorb more than a fraction of what China produces, but customers continue to look to diversify from China. We have also seen some customers evaluate mode optimization. Our network and portfolio lets customers respond quickly and act locally for our customers in China as well as around the world.

In closing, our most immediate commercial priorities in the U.S. are to focus on yield growth for FedEx Express and to grow into our six-day network for FedEx Ground. In Europe, we are leveraging the value proposition improvements coming to market and are aggressively focused on gaining share. Despite economic headwinds, we believe we have growth opportunities from Asia to Europe, and we will leverage our new, expanded buyer base in Europe to acquire this share.

Let me now turn the call over to Alan.

Alan B. Graf, Jr.
Executive Vice President & CFO, FedEx Corp.

Thank you, Brie. Welcome to the team. Good afternoon, everyone. Slowing international macroeconomic conditions and weaker global trade growth trends continue. Asia volume weakness, which we experienced during peak season, deepened post Chinese New Year. Reflecting these macro challenges, FedEx Express international revenues declined year-over-year in the third quarter. U.S. volume growth continued to benefit from the expansion of our e-commerce solutions, but yields were pressured by this expansion, lower weight per shipment, and service mix changes. With that, total FedEx Express revenue declined 1% year-over-year in Q3 versus growth of 8% year-over-year in the first half of this fiscal year.

Our strategic management committee has been investing a significant amount of time identifying operational and financial steps to address the challenges we are facing. To mitigate the lower-than-expected revenue trends, we have further reduced our variable incentive compensation, launched our voluntary employee buyout program, and limited hiring and discretionary spending.

FedEx Ground and FedEx Freight both had strong volume and revenue growth in the third quarter. FedEx Freight continued to focus on balanced volume and yield growth and produced another strong quarter of operating results. FedEx Ground operating results were negatively impacted by the inflationary impact of the tight labor market on our purchase transportation rates and employee wages. Higher costs related to staffing and network expansion and the January launch of year-around six-day per week operations also impacted Ground's performance.

While the launch of six-day operations was a headwind for the quarter, the use of existing assets more efficiently is a positive for the FedEx Ground business, as it ultimately drives improved performance and enhances our competitive position. While these benefits are not always reflected immediately and may take time to be realized, we believe it is a winning strategy for the long term.

Looking forward, we are now forecasting fiscal 2019 adjusted earnings of $15.10 to $15.90 per diluted share. We expect year-over-year revenue and earnings growth at FedEx Freight will continue in the fourth quarter, driven by balance of volume and yield growth. While FedEx Ground year-over-year revenue growth is expected to remain strong in the fourth quarter, higher operating costs are expected to continue to negatively impact results. We expect earnings to decrease year-over-year at FedEx Express in the fourth quarter, due to lower yields and continued softness in international package volumes resulting from weakening global economic conditions, particularly in Asia and Europe.

Despite these headwinds, we are focused on executing actions to improve our performance. That focus includes the growth initiatives Brie just discussed earlier and the structural cost reductions we have been implementing. Next month we will know which U.S. employees will be leaving the company via the voluntary buyout program. They will begin exiting starting at the end of May.

The cost of our business realignment activities, including the voluntary buyout program, are expected to total $450 million to $575 million and will be recognized primarily in the fourth quarter of fiscal year 2019 with the remainder in fiscal year 2020. The business realignment program is expected to drive savings of $225 million to $275 million in FY20.

Similar programs are likely for employees in international regions. If we see evidence of a further decline in international landscape or a significant downturn in the U.S., neither of which we currently anticipate, we can take additional cost actions, including network capacity adjustments, labor hour reductions, salary and wage initiatives, aircraft delivery modifications, and deferring or extending project timelines.

The implementation of multiple long-term initiatives will also drive improved performance. Those initiatives include completing the TNT integration, continuing to reduce our cost to serve the e-commerce market, improving revenue quality, and improve leverage of our global scale to drive savings in our sourcing activities. As Raj stated earlier, we remain confident in the long-term strategic value of the TNT acquisition and the synergies to be realized through a single pickup and delivery network, single air and road network, back-office efficiencies, and enhanced revenue growth.

TNT integration expenses are now expected to exceed $1.5 billion cumulatively through fiscal 2021 and we may incur additional costs related to investments that will further transform and optimize the business. The timing and amount of integration expenses and other investments in any future periods may change, as our plans are revised and implemented. Forecast for fiscal 2019 integration expenses is down slightly to $435 million.

Ground is well underway on a number of strategic initiatives aimed at optimizing the Ground network through technology enhancements that enable real-time decision making based on applied data analytics. Each of these initiatives digs into opportunities to drive increased efficiency, while handling a growing number of e-commerce packages, both large and small. For example, advanced loading, sorting, scanning, and network operating technologies will provide near real-time data to improve planning and maximize productivity. This will enable us to optimize strategic decision making in multiple areas, including our use of rail and improving residential density in the last mile.

With the growth of both small and large packages due to e-commerce, teams are also planning how we best optimize the use of our already, highly automated assets by adding or extending sorts and increasing our capabilities for handling large packages. Again, tapping into real-time data, for example, about package characteristics, is integral to enabling this level of optimization for our operations and those of our service providers. Teams at Ground have made great progress and we expect several new technology tools will be implemented prior to peak, with benefits realized in FY20 and beyond.

Considering the Q3 tax benefit from the recognition of certain tax loss carryforwards, we now expect our FY19 effective tax rate will be 22% to 23% before year-end mark-to-market retirement plan accounting adjustments. We continue to expect our FY19 capital spending will be $5.6 billion. We are reviewing capital spending for FY20 and beyond and will have further guidance for FY20 with our fiscal year-end release.

I want to iterate that we have large strategic projects underway, including the modernization of our aircraft fleet and our largest Express hubs in Memphis and Indianapolis. We are also investing at Ground to more efficiently process large packages to reduce our cost to serve residences. These investments are expected to deliver significant, long-term value creation as we plan for the next several decades.

We are committed to returning a significant amount of capital to shareholders over the long term. To provide some context, since the beginning of fiscal year 2014, we have returned nearly $14 billion to shareowners through repurchases and dividends, including an 18% reduction in our outstanding shares and in more than quadrupling of our quarterly dividend.

During the third quarter, we repurchased 555,000 shares at an average price of $168.43. We maintain a balanced, disciplined approach to capital allocation. Dividends and share repurchases have been and will continue to be a significant part of that. At the same time, we are making significant investments in the business to continue to position FedEx for superior performance in the decades to come.

We balance these priorities and decisions to invest or return capital based on what we expect to achieve, highest returns and drive the highest long-term shareowner value. It is also important that we maintain a strong balance sheet and ample liquidity to ensure our continued ability to operate and finance the business efficiently and deliver excellent returns to shareowners.

As I end my comments, I will reiterate: Management is focused on improving our performance, positioning FedEx for long-term success. Investments in our networks are multiyear propositions. The success of these investments cannot always be measured quarter-to-quarter, but we are confident these investments will drive long-term earnings growth and improve margins, cash flows, and returns.

Now, I will open it for question and answers. Thank you.

QUESTION AND ANSWER SECTION

Amit Mehrotra
Analyst, Deutsche Bank Securities, Inc.

Thanks, operator. Hi, everybody. Fred, when you started your remarks, you talked about 17% compounded annual growth in the adjusted earnings base of the Company. I also think, I guess, it's important to note that free cash flow per share has gone from significant positive territory to negative territory over those years as well. So, while I fully understand and we all fully understand the importance of having a long-term investment horizon, the margins of the Company are basically stagnant at best and in many periods down on a year-over-year basis. So, if you can just give us some of your thoughts on how you think about the moving pieces between balancing capital investments and returns, given the performance in recent years. Appreciate it. Thank you.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Well, I don't know much what I could add to the comments that you just heard from Alan and Raj. Basically, the perspective of Wall Street is always give me the money. The perspective from inside FedEx is what's the best thing we can do for the long term. Now, there have been some exogenous factors that have happened. First, let me remind you that in June 27 of 2016, FedEx was in the middle of the largest state-sponsored cyber-attack in history, the so-called NotPetya account.

It brought the British healthcare system almost to a halt. It cost hundreds of millions of dollars for Maersk, the big sea container line. I think I'm right, it cost $1 billion to Merck, the great medical company. So, had TNT been a stand-alone company at that time, it would have been bankrupt. We did the damndest job, Rob Carter and his people in recovering from that. So, I would say that the slowdown in the TNT situation on the Express side because of NotPetya was substantial as we reported at the time.

Second issue, but as Raj told you, we are very optimistic about our intercontinental network and the ability to improve margins in the Express business because of the integration. On the Ground side, the issue is very straightforward and that is the market changed from more business-to-business to business-to-consumer, so we couldn't basically have decided not to address that, but as Brie mentioned and Raj both, we decided that we wanted to play in that space and that we were not only going to play in it, we were going to be the market leader. And we've gained market share in that sector for 18 consecutive years. So, I think we've got a pretty good track record in that regard.

So, we started this fiscal year very optimistic about our ability to expand margins and to hit on all cylinders, but as I tried to lay out in my remarks, we anticipated a $6 billion revenue increase. We're going to end up with about $4.5 billion and this is a leveraged business and to the extent that the last few percentage of revenue points go to the bottom line at a very disproportionate rate. So, that hopefully answers your question. I mean we're not unmindful to the issues that you're talking about, but we do think we've got a good runway in the future because we've made those investments.

Christian Wetherbee
Analyst, Citigroup Global Markets, Inc.

Hey, thanks. I wouldn't mind picking up right through where you left off, Fred. When you think about the trends and sort of the revenue shortfall as the year has gone on, how do you think about sort of adjusting to that? A lot of what we're talking about are some very interesting and probably important long-term investments, but when you think about capacity in the short run, it sounds like you're not expecting trends to get worse, but at the same time it feels like maybe things are decelerating internationally. Can you talk a little bit about maybe what you're going to do in the next quarter or two to try to stem some of that profit/loss from the revenue shortfall that you're seeing?

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Well, part of the problem about reporting quarterly earnings is you're looking in the rearview mirror. The facts of the matter are that we actually are seeing a few green sprouts now as we go into the spring. Part of that may well be the significant weather issues that Raj and Alan both commented upon, and quite frankly were under-reported, I think, because of the government shutdown and the trade issues.

This was a very, very tough operational winter and in some cases unprecedented, but again somewhat under-reported. So, we are seeing some pickup across the Pacific. Our package business in Europe is now growing again. And so, we're feeling a little better about things and, obviously, the range of the fourth quarter and the fiscal year that Alan gave you is related to our caution of not putting too much of that in the bank. Alan may want to talk more about that.

Alan B. Graf, Jr.
Executive Vice President & CFO, FedEx Corp.

Chris, we don't have a capacity issue actually. As I tried to describe, we had some mix and yield issues at Express and on it Express is the issue. It's not Ground or Freight, the Express returns are what we have to work on the hardest. I think we described for you how we're doing that, but we're running pretty tight capacity right now. It's just a different mix than we had expected. So, if you look at Express' yields in the quarter, they were down year-over-year. And so, the mix had a big impact and a lot of that is the fact that we are striving to hit the e-commerce demands at the same time as we're reducing our cost structures, and we're getting there. We just aren't getting there as fast as we would like to.

In terms of Ground, what's going on at Ground is nothing short of transformational. Ground is going to be in a position to significantly drive down its costs in serving the residential market, and significantly increase its capacity with not much incremental capital expenditure, particularly in terms of hubs. We will be investing to be able to handle large packages. We love large packages. Keep bringing us large packages.

We'll invest in the business in handling those and we're going to streamline those operations even more. So, I'm not at all worried about Ground's particular margin situation here in Q3 and Q4 because I know where we're headed. So, at the end of the day, we're running pretty tight on capacity. We're expanding our capacity capabilities at Ground and Freight and we're very carefully monitoring what we have available out there for FedEx Express.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Let me just add one other comment here, I'll say perhaps and modestly, there's no organization in the world that knows more about aviation than FedEx, commercial aviation, not one. There's certainly some that are probably peers with us, but we have the finest aviation professionals that operate commercial airplanes. We have a lot of MD-10 airplanes that are 40 years of age. Now, we overhauled them and redid the cockpits and one thing or another, 11 of those airplanes will be retired in next fiscal year.

All of them, the MD-10-10s will be gone in FY21. So, we're not going to slow down on that. It's imprudent to do so and I think there was one suggestion from somebody that we ought to consider that, but that is not a correct decision in our view based on our understanding of the equipment and capabilities. And as Alan has told you on several occasions, these things have great accretive capabilities; they lower our costs and improve our reliability. So, hopefully we'll get some good news on some of this international traffic and it will go to the bottom line in the same rapid fashion that the top line diminution took it away. So, hopefully that's helpful.

Scott H. Group
Analyst, Wolfe Research LLC

Hey. Thanks. Afternoon, guys. So Alan, last quarter you talked about margin and earnings growth in fiscal 2020. Do you still feel comfortable with that comment? And then you also hinted last quarter at international head count reduction or profit plan. How come we don't have one yet? And then, is it sort of too late to get one that will get a full year impact or much of an impact in fiscal 2020?

Alan B. Graf, Jr.
Executive Vice President & CFO, FedEx Corp.

If you could tell me, are we going to get a trade deal done with China and is Brexit going to come out good, I could give you a lot better answer about FY20 than I can sitting here at the moment. But we sort of have to plan for both ways, and obviously the leverage right now that we have is in our international revenues on a very large fixed cost basis. So in terms of a plan, we have a plan. No question, we have a plan and we're executing.

And I think you heard Raj and Rob talk about what's happening with TNT integration, where we're now finally getting service improvements at lower costs. We're speeding up the network by a day on 40% of the traffic. Customers are coming back. So, it's just a matter of time. We have another year of integration to go, but we definitely need a little bit better economic environment in Europe to get the full benefits of TNT. We will get the full financial benefits of TNT, I have no doubt. It's just a matter of when.

Jack Atkins
Analyst, Stephens, Inc.

Great. Good afternoon, guys. Thanks for the time. Just wanted to go back to the comments around softening global macro condition and softening trade trends. I know you're specifically calling out Asia and Europe. But when you look through your U.S. Express results, I think it's fair to say you saw volume declines in three of your four U.S. Express package subsegments. You also saw yield deceleration in your U.S. Express business. So if you could just sort of comment on what you're seeing in the U.S. I know you're talking about a fairly strong U.S. backdrop, but it seems like we're seeing deceleration there. We'd just be curious what's driving that.

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

Hey, Jack. This is Raj. I think on the U.S. side, our overall volume continues to increase at roughly 6%. And I think if you look at what's driving that growth, it is e-commerce. What we are surprised by is the fact that the weight per package has been lower than what we anticipated it is going to be, and that has impacted our yields. So, we are doing – first of all, as I said, we are in a position to gain share on e-commerce.

We will adjust our cost structure to make sure that we have the right cost to serve. We are very focused on driving overnight volume growth and we are focused on revenue management as well. So there's a lot of activity going on in the U.S. today, and I'm quite optimistic that we're going to get this right. And I don't know, Brie, if you want to add anything to it?

Brie Carere
Chief Marketing and Communications Officer & Executive Vice President, FedEx Corp.

No. Fundamentally, Raj is right, the volume is very strong. It is a lighter-weight package from an e-commerce perspective, which is why we have made the changes in our e-commerce portfolio that we have. FedEx Extra Hours is a great FedEx

Express service that leverages the existing infrastructure. And again, that lower yield has two things: it's lower weight and it's shorter zones. As we mentioned, we anticipate that the large retailers are going to continue to fulfill locally that's going to put pressure on that top line yield, but we have the right infrastructure to do so profitably which is where FedEx Extra Hours and similar products come into play. Those are the two issues.

Samantha Yellen
Analyst, Credit Suisse Securities (USA) LLC

Hi. This is Samantha Yellen on for Allison Landry. Thanks for taking my question. Can you give us some color on TNT mix? Specifically, have you been able to regain share in the European parcel market following the restoration of TNT service levels in early January? Thank you.

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

The short answer to that question is, yes, we are seeing higher year-over-year growths every month. From the last three months, we're seeing accelerating year-over-year increase in revenue and volume in the European parcel business and – as we have stabilized and improving now our service levels. So it's not a surprise. Despite the economic headwinds in Europe, we now have a terrific value proposition. As I said in the opening remarks, we're releasing new value to our customers, we improved our service and the customers are responding. So we are seeing increased revenue, increased volume in our core parcel business.

Brandon R. Oglenski
Analyst, Barclays Capital, Inc.

Hey. Good evening, everyone. Thanks for taking my questions. Fred, I wanted to come back to your response to I think the first question which is, Wall Street always wants to see the money. Well, I tend to agree that we can be short-term focused and you guys have definitely proved over the long run to be very growth focused. I guess, if we look back 2006, I think your margins peaked out near 10%. We saw that in the beginning of 2016 and it's always associated with a lot of CapEx, a lot of assets and then we go through slower periods where you have to take involuntary separations – or voluntary, but cut incentive comp and things like that.

So maybe, just given the size of FedEx today, is it a new phase where we don't need to bring on as many assets, spend as much capital, maybe focus more on returns and margins because I think that's what investors would like to see; some more consistency in returns and margins over the long term.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Well, so would we. I don't know what to say. The programs we have again are not driven because we are profligate in terms of spending capital. It's the nature of the business. We fly an airplane fleet of 700 planes. We built the business quite frankly with used airplanes, and our largest competitor when they came into the air express business was eight times bigger than we were. We're now roughly at parity with them.

So we are in the midst of spending a significant amount of capital to replace our very old airplanes and to expand the Memphis and the Indianapolis hubs. But again, I think that the year turned out the way we had hoped it would at the start of the year. And remember, it was still in October or November when the Fed was being chastised by the President and others because they were going to raise rates all through calendar year 2019. So you see the change perspective right now. So there is no disconnect between what Wall Street wants and what FedEx wants.

It's the matter of whether we would be prudent and stopping doing what we were doing if we think that they will improve our margins, and I think I gave an answer previously to the question. We did have a big setback with NotPetya, I think we would be having better results in terms of margins of Express at the moment. And secondarily, the Ground market has moved much more to the residential delivery and we've moved with it. That's why we went to six-day-a-week operations beginning January 1, because that's what our e-commerce folks wanted. So, we believe very strongly that we will improve our margins and our returns, as Alan said a few moments ago, and we will get the benefits of the TNT integration.

Alan B. Graf, Jr.
Executive Vice President & CFO, FedEx Corp.

I just want to add that a lot of the CapEx that we're spending over the next few years is not to increase capacity at Express, and it's to replace the 40-year-old MD-10s and to drive better throughput, efficiency, productivity and lower cost at our two main hubs in Memphis and Indianapolis. Those are big projects. Those have to be done for the long term of this Company, and we do manage this business for the long term.

Where I sit and what I can see about future cash flows is pretty impressive. I'm not going to sit here and make projections, but I'm just telling you that we don't have to expand capacity at Express for quite a period of time. We need to at Ground, but we're doing that in a unique way. We're sweating the assets, we're going to run the network more days and we're going to be a lot busier out there as we lower our cost to serve the residential delivery areas.

We had a bad quarter, no doubt about it. I'm disappointed in it. But I'm not letting one bad quarter decide how we're going to manage this business for the next five years. I think that would be imprudent and not in the best interest of our shareholders. Quite the contrary, we've got to redouble our efforts to get those costs down in those areas where we're seeing shorter zones and lighter weight, so that we can be as profitable as we need to be and that's what we're working on.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

And by the way, let me just add, in the December meeting on the voluntary buyout, we listed three reasons for those buyouts. First is, the multiyear transformation that we've been underway at FedEx called Project Renewal, where we have taken down hundreds and hundreds and hundreds of legacy mainframe systems and moved these applications into the cloud. So, we're moving the last mainframe installations in the next year or so, and there are people whose skillsets don't fit or they're in the wrong location. So we're offering them a great opportunity, but we didn't want to stop renewal because that's where technology is taking us.

Second, as Alan mentioned in his remarks, one of the things that we have which is extremely important are very, very sophisticated analytics on the pickup and particularly on the delivery side. So what you basically do is you substitute information for math and we're not the only ones doing that; UPS talks about it. But this is going to be a profound transformation in the next few years. So the use of AI and then robotics is also making folks that have been in staff positions, we don't require the same level of manning.

And then finally, as has been mentioned on a couple of occasions here, there will be people leaving on a volunteer basis from the legacy TNT system as the integration completes. These weren't layoffs and they certainly weren't because we were profligate or not watching our waistline. They were from those three reasons and we think culture and service orientation is the most important thing at FedEx. So we're not going to treat people roughly and layoff a bunch of folks. We're doing it in a way that that's consistent with our values and with the type of service that FedEx is known for.

So, I think it's important to reiterate what I said in December about those voluntary buyouts because that was completely missed by a lot of people. In fact, right after the earnings call, some of the major media was talking about layoffs at FedEx and they weren't layoffs at all. They were voluntary buyouts driven by those three issues.

Benjamin J. Hartford
Analyst, Robert W. Baird & Co., Inc.

Hey. Thanks for the time. Just want to clarify some of the TNT integration-related expenses. Obviously, you raised that target a little bit. You pushed the timeline out to 2021. Just wanted to clarify, is the integration now going to take a little bit longer than expected and cost a little bit more? How should we interpret that data, particularly the greater than $1.5 billion target? And how do we reconcile that in the context of the fact that the integration-related expenses here in fiscal 2019 are coming at a little bit less than expected? Thanks.

Alan B. Graf, Jr.
Executive Vice President & CFO, FedEx Corp.

Well, Ben, I would say that – what we have found is that – what we've been talking to you mostly about were the operational integration costs of putting these networks together. Again as Raj talked to, I mean we're starting to get there and we're going to pick up a lot of momentum in FY20.

What we're seeing, however, is that as Rob's team continues to bring those antiquated systems up to current standards and beyond, that we probably have some back-office and other areas where we can do further investment. And so, we'll keep you updated on that. But as far as operationally, we tend to think we're going to be there by the end of FY20 and that's the biggest part. So don't be scared about a lot of additional integration money; there won't be a lot of additional integration money.

David G. Ross
Analyst, Stifel, Nicolaus & Co., Inc.

Yes. Thank you. Good afternoon. Fred, you did mention something looking past 3Q about green sprouts that you guys are seeing in March. Can you elaborate a little bit on what you're seeing today, the past two to three weeks, both domestically and internationally?

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Well, let me let the Chief Operating Officer talk about that, because he's closer to it than I am and I'm responding to you earlier, I made those comments based on what he's telling me.

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

Hi, David. I think just to put it in perspective here, the inventory to sales ratio in the U.S. ran up in Q4 of calendar year 2018. And so, we knew that the – it was slowdown coming in Q1, it was just – it was the pre-Chinese New Year, the peak was very muted; and the post-Chinese New Year was very, very soft.

Having said that, in the last few days, we were starting to see some pickup in the business and I think that's looking good. Whether I'm going to sit here and project, that's going to – what's going to happen for the rest of like quarter four? I cannot do that at this point. There's too uncertainty in the market. But if the trend continues then, of course, it'll be good news.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Let me add. I think this has been well reported in the trades. But prior to January the first, there was a significant amount of traffic that was put on the water beginning in late summer and in the fall, based on the deadline of January 1 for the imposition of new tariffs. Now, the President decided to delay those, but there was a lot of inventory that was moved into the U.S. and you sort of saw the opposite side of that from China into Europe where they didn't have the tariffs, so it was quite a different profile.

So some of the fallow activity during the first quarter, I think, was a reflection of that inventory to sales ratio that Raj just mentioned to you. So hopefully now, with the anticipation of a trade deal or at least a more collegial conversation going on about it in terms of tariffs, maybe we'll go back into a more normal cycle.

Brian P. Ossenbeck
Analyst, JPMorgan Securities LLC

Hey. Good evening. Thanks for taking my question. Just wanted to go back to Ground for a minute. If you can talk about just the headwinds in the quarter? I know you mentioned high labor cost inflation, the six-day network filling up. But you almost – you never see sequential decline in margins for that business, especially not to this degree.

So maybe if you can give us some context as to how much longer you expect those to persist, especially the type of volume that you're filling up in the Ground network?

And then lastly, on the transformation. You know what? I guess what gives you the confidence that you're able to get the cost to serve down to the right level? And did that actually included increasing stock density in a meaningful way? Thank you.

Alan B. Graf, Jr.
Executive Vice President & CFO, FedEx Corp.

Well, if I answer the second question I'm sure that the board of directors and Fred would throw me out of here for giving away a competitively sensitive data and information. So I'm just going to tell you that it's going to be transformational. I'm highly confident about where we're headed. I've got a very good feeling about what our costs are going to be and how much volume we're going to be able to run through the Ground network.

As to the current trends, we did have a 3% yield increase in Ground. Frankly, we thought we were going to have a higher one. Same thing as Brie and Raj have been talking to you about. Mix change, honestly, a little faster than we thought. Cost structure we'll get there, and we're not – I'm not worried about Ground's margins in the longer term although I did tell you that I don't think they're going to pop back up in Q4 like we sometimes see because we have a lot of investment going on for these transformational things that we have underway. So, all I can tell you there is standby, but I'm confident about our Ground's long-term potential and to maintain those margins that you're used to.

David Vernon
Analyst, Sanford C. Bernstein & Co. LLC

Alan, maybe just kind of following up on that question. Is there any way you can help us understand of the sort of 170 basis points of margin compression here? Is business conditions shortfall versus investment in the business versus cost inflation? I mean, this seems like a pretty market turndown in the margins near term, and I know you guys may have been expecting this from an investment standpoint, but it does seem like a little bit of a surprise from the outside looking in. If you could help us understand how long this investment period is going to last, what is the impact on inflation and when that should lap off, or maybe when that should end. That would be helpful.

Alan B. Graf, Jr.
Executive Vice President & CFO, FedEx Corp.

Yeah. Same thing. I mean, we're working on our FY20 business plan right now. Our largest customers have grown really fast at Ground; and of course, they enjoy the best pricing. We're attacking, as Brie and Raj told you, the small and medium enterprises. We don't have our fair share yet at Ground in that area. We will. And then as I said, we're working really hard on our cost structure for residential and shorthaul deliveries, and there'll be more to come on that.

A. Mickey Foster
Vice President, Investor Relations, FedEx Corp.

Thank you for your participation in FedEx Corporation's Third Quarter Earnings Conference Call. Feel free to call anyone on the Investor Relations team if you have additional questions about FedEx. Thank you.