FedEx Q3 FY18 Earnings Call Transcript – March 20, 2018

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Investor Relations, FedEx Corp.

Good afternoon, and welcome to FedEx Corporation's third quarter earnings conference call. Third quarter earnings release, 31 page stat book and earnings presentation slides are on our website at fedex.com. This call and the accompanying slides are being streamed from our website where the replay and slides will be available for about one year. Questions are welcome through our e-mail address, which is ir@fedex.com. When you send your questions, please include your full name and contact information. Preference will be given to inquiries of a long-term, strategic nature.

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; Dave Bronczek, President and Chief Operating Officer; Alan Graf, Executive VP and CFO; Mark Allen, Executive VP, General Counsel and Secretary; Rob Carter, Executive VP, FedEx Information Services and CIO; Don Colleran, Executive VP, Chief Sales Officer, FedEx Corporation; Raj Subramaniam, Executive VP, Chief Marketing and Communications Officer, FedEx Corporation; David Cunningham, President and CEO of FedEx Express; Henry Maier, President and CEO of FedEx Ground; and Mike Ducker, President and CEO of FedEx Freight.

And now, Fred Smith will share his views.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Thank you, Mickey. Welcome to our discussion of third quarter earnings. First and most importantly, by far, we are very thankful there were no serious injuries from the package that was detonated earlier at our San Antonio FedEx Ground facility. FedEx has provided law enforcement extensive evidence from our advanced technology security systems designed to protect the safety of our teammates, our customers and the communities we serve. We continue to assist authorities.

Now moving to the business at hand, and specifically turning to the earnings. Execution of long-term growth strategies, customer demand for the unique value of our broad portfolio of solutions and healthy growth in the global economy are driving our performance. We expect strong operating performance in that regard during the fourth quarter in each of our transportation segments, and remain confident we will improve operating income at the Express segment by $1.2 to $1.5 billion in fiscal 2020 versus fiscal 2017.

We remain committed and optimistic about growing earnings, cash flows, returns and margins. Economic growth around the world remains broadly based, and we expect U.S. tax reform to continue to increase economic growth and investment.

FedEx is concerned about the prospect of increased protectionist tariffs as history has shown repeatedly that protectionism is counterproductive to economic growth. The better approach is to encourage open markets and free exchange of products and services, and to reduce barriers to trade.

Congratulations to our team members around the world for another outstanding peak season with record volumes and high service levels. TNT integration efforts are accelerating, and we are well positioned for profitable, long-term growth due to investments in our networks and people such as our recent commitment to $3.2 billion in wage increases, bonuses, pension funding and expanded U.S. capital investment.

FedEx is proud to be in the top 10 companies in Fortune magazine's World's Most Admired list and among its Best Companies to Work For. We believe this reflects our team member's dedication through our Purple Promise, which states simply, "I will make every FedEx experience outstanding."

Now, let me turn the call over to my colleagues for their insight. First-off, Alan Graf. Alan?

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

Thank you, Fred. We included additional information in today's earnings release, and I will provide additional detail during my discussion today, about our third quarter due to unusually complex operating results and the impact of the Tax Cuts and Jobs Act or TCJA. We will also provide additional details today regarding our expected fourth quarter financial performance, given the complexities of the TCJA, and third quarter results in order to help you understand the underlying performance of our businesses.

Our adjusted earnings per share for the quarter was $3.72, up 62% from an adjusted $2.30 last year, primarily due to benefits from the TCJA. Operating income increased slightly year-over-year to $1.11 billion with higher base rates at each of our transportation segments, increased volumes at Ground and Freight, and a favorable net impact from fuel.

These improved results were impacted by the timing of significantly higher variable compensation accruals, which were up $140 million in the third quarter. Variable compensation increased year-over-year due to sharing some of the benefits of U.S. tax reform with employees as we announced on January 26, our improved outlook for FY18, and the timing of recognizing expense in FY18 compared to FY17. Results were also impacted by higher peak-related costs at Express and adverse weather.

Before I talk about the operating results for the segments, I'd like to mention the tax benefits in our GAAP results since they were significant this quarter. We recorded a benefit of $1.53 billion from the TCJA. This primarily includes a provisional benefit of $1.15 billion from the re-measurement of the company's net U.S. deferred tax liability for lower tax rates, which we have excluded from adjusted earnings.

A benefit of approximately $200 million from an incremental pension contribution made in February and deductible against the company's prior year taxes at 35%, and a benefit of approximately $170 million attributable to the phase-in of the reduced tax rate applied to the company's year-to-date earnings.

Contribution to our U.S. pension plans of $1.5 billion was debt financed. Our U.S. pension plans are currently fully funded. While the funding shows up on the financial statements as a reduction in operating cash flow, it provided tremendous immediate returns in terms of tax savings as well as lower PBGC premiums versus funding the plan at a later date.

Turning to our segments and beginning with Express. Service levels at Express were excellent during peak. However, costs were impacted by lower-than-expected volumes during the first part of December, and higher peak-related costs. For Express, operating income for the quarter primarily affected by an estimated net negative impact of approximately $170 million year-over-year from the factors outlined in the release and listed on the slide.

Ground's operating income improved 23% to $634 million due to strong revenue growth and ongoing cost management, partially offset by increased purchased transportation, seasonal staffing and network expansion costs as well as higher variable compensation accruals. Ground margins increased 110 basis points to 12.1%. During peak, record volume was delivered with exceptional service through Ground's highly-automated and flexible network. We believe Ground results will continue to improve.

Freight's operating income increased 34% to $55 million, primarily due to higher LTO revenue per shipment, partially offset by higher variable compensation accruals. Freight's continued efforts to better balance volume, pricing and capacity are paying off. We are also benefiting from an improving U.S. industrial economy.

The adjusted earnings forecast for FedEx Corporation is now $15 to $15.40 per diluted share for FY18. We expect Q4 operating profits to be up year-over-year for the Corporation, and in all of our transportation segments.

Our forecast for Q4's adjusted operating margin is 11% to 11.8% for FedEx Corporation. As Fred mentioned, we remain committed to our target of $1.2 billion to $1.5 billion in additional operating profit for the FedEx Express segment in FY20 versus FY17, which includes TNT synergies as well as base business and other operational improvements across the global FedEx Express network. This target assumes current accounting rules and tax laws.

All of our forecasts assume moderate economic growth before year-end mark-to-market pension accounting adjustments and exclude expenses related to the TNT integration.

Our FY18 forecast also excludes the estimate of the re-measurement of the company's net U.S. deferred tax liability and certain first quarter FedEx Trade Networks legal matters.

On March 1, we realigned our specialty logistics and e-commerce solutions in a new organizational structure under FedEx Trade Networks in the Express segment. The realignment improves our ability to deliver the capabilities of our specialty companies to customers. This realignment will benefit Ground and Freight margins, and will negatively impact Express margins starting in Q4.

As we announced in January, following the enactment of the TCJA, we are advancing our 2018 annual pay increases for certain U.S. hourly workers by six months to April 1 from the normal October date, which will have an impact in our year-over-year salaries and wage expenses beginning in Q4.

Our capital spending forecast for FY18 is now $5.8 billion, down $100 million from the prior forecast due to lower projected capital spending at Ground. As we mentioned last quarter, we are optimizing CapEx to capture the benefits of 100% expensing to further grow and improve the business. Plans are underway to modernize our Indianapolis hub for Express, which is expected to cost $1.5 billion. We are also planning to modernize our Memphis hub for Express, which is estimated to exceed $1 billion.

Both of these projects will span multiple years. These hub modernizations will bring substantial improvements in operational efficiency and reliability. For example, the Memphis project includes construction of the large new sort facility with state-of-the-art sort systems, construction of a bulk truckload building and a new area to improve handling of oversized shipments that continue to increase with the growth in e-commerce.

During the quarter, Express entered into an agreement with Boeing to accelerate the delivery of one 777 Freighter aircraft to FY19, and three to FY20. We will announce our FY19 CapEx forecast in June.

Since our tax rates are fluctuating more than usual this year, I would like to provide some guidance for our estimated effective tax rates. All this guidance assumes no material impacts from future TCJA guidance or interpretation.

Our adjusted FY effective tax rate is expected to be in the range of 20% to 21%. The lower ETR range is due to the benefits from the TCJA combined with anticipated foreign tax benefits from our international corporate structure. This range does not include any impact from the items excluded from our FY18 adjusted EPS forecast.

In FY19, the TCJA's lower corporate rate of 21% will fully phase-in, along with other tax costs also enacted as part of the new law. While we are still in a very complex modeling stage, estimating these tax costs as we build our business plan, we currently expect our FY19 ETR to be in the range of 25% to 26%, excluding the impact from MTM – mark-to-market pension accounting.

The effective tax rate range for FY19 is expected to be higher due to tax benefits this year that will not reoccur in FY19. Sum it up, we are expecting a great finish for the year. We are meeting our profitability goals, our investments are paying off and our outlook is bright.

Now, I'll turn the call over to Raj to talk about the success we are having with our revenue quality initiatives. Raj?

Rajesh Subramaniam
Executive Vice President – Chief Marketing & Communications Officer, FedEx Corp.

Thanks, Alan. I'll open with our economic update and outlook and discuss our revenue performance and business conditions in each segment and provide some commentary on broader industry trends and enhancements to the FedEx portfolio.

We continue to see broad-based growth in the global economy. In the U.S., tax reform is improving investment incentives and disposable incomes, while measures of consumer and business sentiment are at the highest levels in years. As a result, our 2018 U.S. GDP forecast is 0.5 point higher than last quarter.

Internationally, trade and production growth are supporting solid momentum in the global economy. Last year's rebound in trade drove the best air cargo growth since 2010, with freight demand growing over 3 times faster than world GDP. Demand has outpaced capacity additions for 17 straight months.

The next few slides show details of revenue, volume and yield performance by transportation segment. It is clear, our pricing strategies that allow us to grow volumes to increase yields across the portfolio show continued success.

For our U.S. Domestic Express business, both revenue and yield increased 5%. Excluding the impact of fuel, yield per package increased 3% due to our continued focus on revenue quality. FedEx International Export Package revenue increased double-digits to 10% year-over-year in Q3, primarily due to yield increase of 9%. Excluding fuel and exchange rate impact, yields increased 2%.

Ground segment revenue also saw a double-digit increase at 11% in Q3 with volume and yield each up 6% as e-commerce continues to drive growth. Excluding fuel, yield per package increased 5%. At FedEx Freight, LTL revenue per shipment increased 8% mainly driven by our revenue quality efforts. Excluding fuel, LTL revenue per shipment was up 6%.

Let me now discuss some exciting new enhancements that we have to the FedEx portfolio. As we announced earlier today, we are going to increase our retail network footprint through the expansion of FedEx Office locations inside Walmart stores. We anticipate adding 500 FedEx Office locations over the next two years. This strategic initiative between FedEx Office and Walmart brings our brand even closer to busy consumers who are looking for reliable options for packing, shipping and receiving packages.

Another new offering that has launched this month is FedEx Returns Technology. This is a solution that provides e-tailers with increased visibility, flexibility and efficiency around returns management. And for consumers, it enables simple and early credit for the returns at FedEx Office locations as determined by their merchants.

FedEx experienced record-breaking volume through our global network during the peak season, much of it driven by growth in e-commerce shipments at FedEx Ground. This was the first peak season that we had more than 10,000 FedEx Hold locations, including FedEx Office and well-known retailers such as Walgreens.

We are pleased with how the retail network performed and expect this extensive convenience network to be a key part of e-commerce deliveries in the future. The approach we took on our peak pricing strategy of not applying a broad additional peak residential surcharge to all customers helped us gain significant business in the small and medium customer segment.

We are proud of the strong service levels we provided to our customers during this record peak, and we are excited about the portfolio expansions that are rolling out. We will continue to innovate to provide our customers with great service and value.

Let me now turn the call over to Dave Bronczek for his remarks. Dave?

David J. Bronczek
President & COO, FedEx Corp.

Okay. Thank you, Raj, and good afternoon to everyone. We are proud to report improved adjusted results at FedEx. We are especially pleased with the results at FedEx Ground, where we have improved our operating margins.

FedEx Ground segment achieved double-digit percent growth in revenue and operating income. We’re seeing benefits from ongoing cost management efforts and improved revenue quality through a balanced approach of volume and yield growth. We’re also reducing our long-term CapEx plans to better match capacity expansion with pricing and volume growth. And, as Alan has already talked about, FedEx Ground is having a great year. We expect the fourth quarter segment operating margin at Ground of 17% to 17.5%.

FedEx Express segment revenue growth of 9% was driven by our international business, despite the lingering impact of the cyberattack. We continue to see a runway for opportunity in international for years to come.

As Alan has said, Express had six factors that primarily affected profitability in the third quarter. But we expect the Express segment adjusted operating margins in the fourth quarter to be in the range of 9.9% to 10.4%.

The underlying fundamentals of the business remain strong with higher base rates across the board and volume growth in both international and the United States. As mentioned previously, we remain committed to our target of $1.2 billion to $1.5 billion in additional operating profit for the FedEx Express segment in FY20 versus FY17.

I also want to provide an update on our TNT integration. As you know, this was the most significant acquisition in our Company’s history, and dramatically improves our global capabilities and competitive posture. I’m happy to say that, at TNT, we are seeing strong service levels, and the integration is accelerating.

A key element of our acceleration plan was to enable the flow of packages between the legacy TNT and FedEx systems prior to full integration. This allows us to direct volumes to the highest service, but the lowest cost networks. This capability is expected to be in place by May 31 of this year. We are accelerating the migration of the FedEx clearance operations and systems as well, retiring dozens of legacy TNT applications.

Our investments in strengthening the IT environment continue on an accelerated pace. We have made significant investments to improve the TNT information security posture, and will continue to do so. The integration of our global sales force, originally expected to be complete in FY20 is now scheduled to be complete one full year early. During the third quarter, we accelerated the launch of customer migration activities in Europe and Asia by more than one full year.

Now FedEx Freight continues to show improvement in revenue and profitability as our pricing strategies drive revenue growth, while investments in the network improve safety, efficiency and lower our costs. As I've said just last quarter, we expect these improvements to continue.

FedEx Freight is indeed having its best year in over a decade, and we expect the Freight segment will finish the year with an 8% to 9% operating margin in the fourth quarter. Across the Corporation, we are making progress towards improving our margins, our cash flows, returns and earnings per share. And we expect every segment will have year-over-year increases in operating income in the fourth quarter.

And with that, we will now turn it over for your submitted questions.

QUESTION AND ANSWER SECTION

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Thank you, Dave. We have several questions on the marketing front, which I'll ask Raj to answer. One, how important are FedEx Fulfillment, FedEx Supply Chain and other logistics offerings to the long-term strategy at FedEx. How attractive are contract, logistics, end markets versus traditional courier business; that's from Brandon Oglenski of Barclays. Raj?

Rajesh Subramaniam
Executive Vice President – Chief Marketing & Communications Officer, FedEx Corp.

Brandon, thank you for your question. Our strategy is to really offer value-added services to our customers that result in more volume through all our core transportation networks.

And as Alan pointed out, we recently completed a reorganization that allows us to offer a portfolio of solutions in a more seamless manner to our customers. I also want to point out here that this is particularly important to our profitable small and medium customer segment as they expand their e-commerce offerings. Thank you.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Our next question on marketing is from Ken Hoexter of BofA Merrill Lynch. Raj, thoughts on postal commissions, rule-making, hearing process and potential impact to industry rates?

Rajesh Subramaniam
Executive Vice President – Chief Marketing & Communications Officer, FedEx Corp.

Ken, FedEx is not participating in the PRC Docket, but we expect a final ruling to be issued this year. However, we continue to monitor PRC regulatory developments with a view to the pricing aspect of it. And we totally believe that, over the cost of last-mile delivery, we'll continue to go up in the years ahead.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

From Matthew Reustle, Goldman Sachs. Reustle, I hope I pronounce that right, Matthew. Can you talk about your views on the future of consumer delivery? Do you think solutions such as FedEx OnSite can represent a material percentage of the market relative to residential delivery?

Rajesh Subramaniam
Executive Vice President – Chief Marketing & Communications Officer, FedEx Corp.

Matt, we don't view OnSite in terms of percentage of residential market. Rather, we think it's a matter of customer convenience. What we know from e-commerce demand as it continues to increase that there's increasing demand from consumers to have convenient options where they can reliably receive their packages. In this context, we're very excited about the rollout of our FedEx OnSite program.

As I mentioned earlier, we have more than 10,000 FedEx OnSite locations in the U.S. including FedEx Office and we've dramatically increased our presence with Walgreens adding more than 8,000 locations in the last year alone. And we're very happy with the performance of this network so far.

Let me add one other point, technology solutions are also going to be critical in this regard. I mean, that's why we're very excited about the fact that our FedEx Delivery Manager user base continues to grow significantly. Ultimately, combination of these things, including our retail network or technology, these things will result in win-win-win solutions for our shipper, for our consumer and for FedEx. Thank you.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

And Raj, I think, I'm correct. The 2000s Rite Aids that Walgreens acquired as soon as they are re-branded and put in the Walgreens system will be 2000 additional OnSite locations. Correct?

Rajesh Subramaniam
Executive Vice President – Chief Marketing & Communications Officer, FedEx Corp.

Yes. They will get added in the next few months here.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Let me give Raj a breather, and ask Dave Bronczek to answer a follow-on question from Matthew Reustle. Where is competition most fierce across your business segments, today? And is investment the only solution to offset this competition?

David J. Bronczek
President & COO, FedEx Corp.

Okay. Well, thank you for the question, Matthew. Of course, we face competition across the globe all the time throughout our full portfolio. The pricing environment is generally rational around the world, great news.

We've made significant investments in people. Our technology, of course, facilities over many years, and it's paid off by creating large, highly-flexible and the most automated transportation network in the industry. These long-term investments have differentiated FedEx from our competition. But we also have something else that differentiates us; it's our people and it's our culture. So thanks for the question, Matthew.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

So we have a question here on trade protectionism from Benjamin Hartford, which I'm going to ask Raj to answer more fully. But I would like to do two things before I turn it over to Raj. I'm reasonably certain everybody listening to this call has some sort of electronic device in your hand, a phone or an iPad of one sort or another.

Go to your Google button, type in D-E-F, meaning definition, and then put in the word tariff or tariffs, T-A-R-I-F-F by this table do it too. And what you'll read in the Google dictionary there or wherever it is, tariff, a tax or duty to be paid on a particular class of imports or exports.

So make no mistake about it, the great benefits that Alan talked about due to the tax reform bill to some degree will be offset by increased taxes due to tariffs. And if we have for national defense needs, particular aluminum or specialty steel requirements, we would suggest at FedEx that those be bought by the government the same way we buy F-35 fighters or M1A – Abrams tanks, respectfully.

On the overall trade front, I'd like to give you a couple of numbers here that probably will surprise you. Our trade deficit in total goods and services 10 years ago was 4.9% of GDP, it's now 2.9%. It's down by 2 percentage points of GDP for a couple of major reasons, the first of which is the fantastic technologies that are being employed in our oil and gas sector now, is called fracking, which has reduced our dependence on imported petroleums. Very strategic, given a lot of that petroleum comes from unstable and unfriendly parts of the world owned by national oil companies of governments that aren't necessarily friendly to the West.

And the second reason that has gone down is that, our trade surplus in services of which FedEx is a major component, has gone up almost $300 billion over the 10-year period. So as I mentioned in my opening remarks, and why I brought these two facts up, the correct way to go here is to deal with China on the issues with China. But overall, it's lower trade barriers, and lower tariffs around the world, not to engage in less trade.

In any case, Benjamin wants to talk about trade protectionism in more specific detail, and as the strength in the global airfreight market belies the increasingly trade protectionist tone from developed markets in recent months.

One, are there any immediate thoughts on the direct impact to trade from the recently announced U.S. steel, aluminum tariffs? And two, have you seen shipper behavior change in relation to supply chain design, given the risk of reduced trade openness, globally? Raj?

Rajesh Subramaniam
Executive Vice President – Chief Marketing & Communications Officer, FedEx Corp.

So Ben, we have not seen any quantifiable shipper behavior change based on recent developments in the U.S. trade policy. As I mentioned earlier, rebound in trade in 2017 drove the best air cargo growth since 2010. But all that being said, as the Chairman just mentioned, we do continue to advocate against any move towards protectionist trade policies that could slow economic growth and undermine all the positive impacts from the tax reform legislation. Thank you.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Okay. Let's move on to some questions about Express. What are you doing now to prepare for peak that's different from what you've done in the past? We'll start with Dave Bronczek, and then Dave Cunningham will amplify.

David J. Bronczek
President & COO, FedEx Corp.

Okay, great. Thanks Fred, and thanks David for the question. Obviously, we're very proud of our peak this year and we have been for many, many years. And I'm going to make some general statements here, but I'm going to have David Cunningham at Express, Henry Maier at Ground and Mike Ducker at Freight give a little bit more color to the answer. But generally speaking, we conduct our formal reviews of our peak performance really immediately after peak, which informs our actions for our coming years with our customers and with our employees going forward.

We are fully leveraging our big data. We have a lot of data, of course, and the artificial intelligence that we have. And we ensure we develop plans that optimizes our customers, volumes, our capacities and our service. In this regard, a big part of our success is the strong alignment of Don Colleran that leads our great sales and solutions team with our customers.

Overall, we were very pleased with our peak performance. We've said it before, I'll say it again. It's what we pride ourselves on is our relationship with our customers and our service. And with that, I'm going to turn it over to David Cunningham to talk about Express.

David L. Cunningham
President & CEO, FedEx Express

Thanks, Dave. I want to congratulate the Express team on the best peak service ever. In this age of e-commerce, our peak continues to evolve as the customers use both Express and our great Ground company to meet shipping needs.

As Dave said, we saw customers stay in the Ground system longer this year. This resulted in lower peak volumes at Express, and a more concentrated surge in a few days just before Christmas. Our peak planning is already underway, and we'll take the key learnings and dial that into next year's plans to ensure great service, but improve the efficiency and productivity.

Henry J. Maier
President & CEO, FedEx Ground

David, this is Henry Maier. I could not be prouder of the FedEx Ground team's performance this peak. Flawless execution in every aspect of the operation drove record holiday service performance, which I might add was greatly appreciated by shippers and holiday shoppers everywhere.

In spite of record-breaking volumes, more than 54 million packages were delivered at least one day early. This stellar service performance was due to a number of factors: one, planning that started in January and included close coordination with customers every step of the way. Two, the network investments we've made over the last few years resulting in the most highly-automated Ground network in North America, if not the world. Three, excellent recruiting, staffing and employee training leading up to the holidays; and four, the entrepreneurial real-time local decision-making of contracted service providers, which resulted in millions of outstanding customer experiences.

Michael L. Ducker
President & CEO FedEx Freight

Yeah. David, this is Mike Ducker. Let me just add a couple of brief comments. First of all, congratulations to the FedEx Freight team, who had a tremendous peak season as well. As you know, it occurs a little bit earlier than the Ground or Express. And as a result of that, we were able to provide some support for our other operating companies during that critical time of the year, adding to the overall performance of peak season. So very pleased, and again, congrats to our team for a job well done.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

The next question is, how is the recently-opened Shanghai hub been performing? And by the way, if I didn't give credit to who asked the question about peak, it was David Ross of Stifel, I may have said it. But this to David Cunningham, how is the recently-opened Shanghai hub been performing? You called out the hub as a cold chain center. What trends are you seeing in the healthcare industry and region? Does this limit the amount of e-commerce demand the hub can handle? This is from Helane Becker of Cowen. Dave?

David L. Cunningham
President & CEO, FedEx Express

Thank you, Fred, and thank you, Helane. The Shanghai hub is a fantastic, modern automated facility with all of our latest technology. The hub's a 134,000 square meter facility handling 66 flights that can process 36,000 packages and documents per hour. Healthcare is an important value-added sector for FedEx and the cold chain capability of temperature-controlled storage ranging from minus 22 to 25 degrees Celsius is a key part of all of our new facilities. Thank you.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Also to you Dave, what caused the network efficiencies? Do you anticipate gaining through the completion of the modernization and expansion projects at your Memphis and Indianapolis Express hubs? That's from Jack Atkins of Stephens. And a related question from Jairam Nathan of Daiwa, where are some of the opportunities you're seeing the automated increased capacity utilization at your Express facility?

David L. Cunningham
President & CEO, FedEx Express

Thank you for those questions. The investments in our Memphis and Indy hubs will modernize and automate these key facilities. Big data and our real-time ability to mine and improve efficiency and productivity of these facilities by directing packages most efficiently through the hubs. As Alan mentioned, at Memphis, where we will have a new bulk truckload facility, an oversized shipment handling capability, plus automated sorting and secondary sorting capability.

At Indy, we're increasing the box sort capacity from 111,000 packages to 147,000 packages per hour. We're putting in a small package sort system of 150,000 packages per hour. And we will have increased international sort capacity as well. These facilities will improve the reliability of our networks, lower costs, improve safety for a better place to work for the thousands of team members who work in these operations.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

So Dave, the last pre-submitted Express question, in light of the strong demand environment in international export, could you please update us on your progress managing capacity? Scott Schneeberger of Oppenheimer.

David L. Cunningham
President & CEO, FedEx Express

Thanks, Scott. Commercial linehaul continues to play an important role as we develop solutions to facilitate international growth, ensuring we move the right traffic in the right network, which enables us the growth of our priority products on the purple tail network.

By partnering with commercial carriers across various international gateways, we're able to avoid flying empty space where we experience imbalance trade flows, such as the Trans-Pacific eastbound lane. But we are experiencing constraints on some lanes, we're constantly working to balance and right-size the network with compensatory revenue.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

So let's turn to Ground now though, one from Benjamin Hartford of Baird. Henry, do you still view mid-teens as an appropriate segment EBIT margin target? If so, what is a reasonable timeline for achieving such a level? Northeasters notwithstanding and we're in the midst of the fourth one, I guess, I mean, I'd say, about two months should be about the target here as we announced. But anyway, with that little funny aside, how much of the incremental improvement from current levels is predicated from internal opportunities versus external help, either through pure pricing growth or the macro? Henry?

Henry J. Maier
President & CEO, FedEx Ground

Well, let me say – I agree with Fred. Mother Nature here is not being too helpful for us in this business right now. Listen, I mean, I think most of this is coming from the macro. Our business continues to be driven by strong volume and revenue growth largely due to e-commerce.

As I said before, we believe our investments in what is today, one of the most highly-automated networks in North America, if not the world. We'll continue to drive margin improvement as well as industry-leading service. And our focus at this point in time is on maximizing the utilization of those assets we've invested in and managing our existing capacity, driving reduced CapEx.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

So we move now to Freight. Kevin Sterling of Seaport Global, are you seeing any spillover of TL freight into LTL, given the tightness we're seeing in the truckload market? Mike Ducker?

Michael L. Ducker
President & CEO FedEx Freight

Kevin, thank you. First of all, the LTL volumes have been very strong, including good contractual renewals, our team has handled it quite well. Truckload shipments, 10,000 pounds or over, typically account for less than 2% of our total shipments. And while there's been some tonnage growth, it still remains a small share of our total tonnage. And we also have an excellent transportation management team assembled to monitor and take steps to manage truckload volume if that becomes necessary.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

So Mike, are rail service issues impacting your economy LTL offering? And that's also from Kevin Sterling.

Michael L. Ducker
President & CEO FedEx Freight

Kevin, as you well know, we have a very service-sensitive product. Therefore, we think it's really important to negotiate contracts with good service clauses in them, and we've done that with all of our key rail providers. Those providers are doing a great job for us as our rail on-time service levels have actually improved overall during the third quarter. And I think, my partner Henry at Ground has experienced similar strong service levels from our rail providers.

Henry J. Maier
President & CEO, FedEx Ground

Yeah. We've had great service, we're not seeing anything.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

So this next question for Freight also. This question comes from David Vernon of Bernstein. In the past, FedEx has discussed dimming LTL freight shipments. What is the status of those efforts? And what upside potential does the company see on that front? Mike?

Michael L. Ducker
President & CEO FedEx Freight

Thanks, David. We currently have about 90 dimensional scanners, and will soon be adding additional devices in many of our service centers across the network. Those devices serve a dual purpose. First of all, they allow us to capture incremental revenue on shipments that are density-based commodities. And secondarily, we capture information for our costing system so that we can more accurately develop pricing for our customers.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

And finally, for Freight, how much volume can the FedEx Freight network handle without significant real estate growth? And that's from David Ross of Stifel.

Michael L. Ducker
President & CEO FedEx Freight

David, thanks. First of all, let me give a shout-out to our planning teams, who have really done an excellent job in planning capacity in our network. We continue to make investments on the facility network and plan for the future. We add capacity strategically by market. For example, we just opened two new facilities in the Chicagoland market this January that added over 400 additional doors in the market, bringing total doors in the area to 1,500. So we're also investing in technology to improve the throughput in all the facilities that will provide additional capacity as well.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Now, we had a number of pre-submitted questions, which we did not answer because they were covered in the press release itself or in the comments that were made by Alan, Raj and Dave. But we do have one technology question, which I'll ask Rob Carter to answer before we turn to some of the questions that have come in since the call began. And that is, how will blockchain and use of cloud IT impact FedEx revenues and expenses? When will FedEx see this effect? And this is from David Campbell of Thompson Davis, Rob?

Rob B. Carter
Executive Vice President, Information Services and Chief Information Officer, FedEx Corp.

Well, thanks for the question, David. First, as a reminder, I want to point you back to last quarter's call, where we discussed points around blockchain, and our charter involvement with the blockchain in Transportation Alliance, otherwise known as BiTA, as well as the blockchain Research Institute. You can find those discussions in a little bit more detail on fedex.com from last quarter.

Of note, though, Fred and I will be joining Don Tapscott at Consensus, which is the blockchain preeminent conference in New York City in May, will much more – in a much more detailed fashion discuss blockchain initiatives and how blockchain can impact so much about our business going forward, and you may want to look at that.

With regard to cloud, our IT modernization initiatives are relentlessly focused on cloud technology. Cloud technology offers significant advantages for business agility and cost, things like the ability to tap into elastic capacity, which allows us to provide compute capacity that grows with our peak seasons and our peak times and cloud environments, improved security, improved performance and scalability due to the modernization of these applications, really terrific capabilities.

And equally as important, the proximity that cloud computing environments provide to our customers and our operations around the world. So the answer is, yes. We're leaning heavily into cloud technology with all of our IT modernization initiatives.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Okay. Thank you, Rob. From Tom Wadewitz of UBS. Capital expenditures in FY19 and FY20, are there offsets to the additional aircraft deliveries in FY19 and FY20 in terms of the total CapEx budget? Or should we add these to the $5.8 billion spend in FY18 in order to estimate the ballpark CapEx spend in FY19 and FY20? CapEx spend in Ground likely to be higher or lower in FY19 and FY20 compared to FY18, Alan?

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

Thanks for the question. We have a varied assortment of CapEx, pension tax rate and cash flow questions, and I'm going to try to answer in two minutes. First of all, remember that going forward, we've just made this huge pension contribution, as I said, we're fully funded.

So I don't believe at this point with the facts that I have today, that we're going to need to make big pension contributions going forward, not that we might elect to depending on circumstances, but we don't believe that's going to be an issue.

Obviously, with 100% expensing continuing and with a lower rate and improved offshore earnings, our cash tax rate is going to continue to remain low for the foreseeable future. And we're going to have stronger earnings, so all those support higher cash flows.

As for CapEx, it's really too early to talk about FY20. Although I will say we do have a few increased aircraft deliveries scheduled at Express through 2020, which might have Express' bumped up. But we have projects at every single opco right now with great engineering and finance teams working together with the ops teams to make our assets sweat more.

In the case of Express, for example, we can use passenger bellies to augment our international capabilities. At Ground, we are going to see, I think, going forward, reduced CapEx at Ground as we look at better ways to build out the network and still support the growth that we're anticipating at actually even lower costs.

Same as Freight, going forward, I don't think we're going to be needing to add as many doors per shipment as we've done in the past because of the great engineering work that's going on there, and a lot of these we'll talk about later on in the next several months as we go forward.

But I said, I will talk about FY19 in June. I would just say this. I don't think it's going to be much different at all than what 2018 is going to be. And as I said, 2020 might have a tick-up because of aircraft delivery. So from a cash flow standpoint, I think we're in fantastic condition.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

So Tom had another question here, which I think we need to answer. Is incentive compensation likely to be a significant year-on-year headwind to EPS in fourth quarter FY18, similar magnitude to the headwind in third quarter. Tom, I think, the nature of the question indicates a bit of a misunderstanding about this.

AIC is not going to be a headwind in the fourth quarter because, again, the weather will just stop. The fourth quarter is going to be gangbusters. And because of all the noise, that's why we gave you this one-time special deal of showing you what the anticipated segment margins were going to be in the fourth quarter.

So what happened here is, when tax reform took place, and we felt it was appropriate to do all of the things that we described to you, what that required us to do is to pick up AIC, which had been reduced because of NotPetya, and then it was put back in, in the third quarter for the company as a whole, and of course, it especially affected the FedEx Express rate.

So on a go-forward basis, it's baked in, and the fourth quarter, you can do the math with the range for the year that Alan gave you; it's going to be in the numbers and the quarter should be quite good year-over-year for all of the segments, again, I'll give the caveat, because if we're in the midst of some sort of weather system where the northeasters keep going to July, that's a different matter. But we're fairly confident that we're at the end of that.

Now, there's a question from Jeff Kaufman of Tahoe Ventures about electric vehicles for commercial trucks, many OEMs following suit, what's FedEx view on emerging green technologies? And where is the company in terms of adoption and commitment to green technologies? Does FedEx believe these technologies are ready to meet the Company's needs?

First of all, I would recommend to you, Jeff that you go on our website and read FedEx's social responsibility report, which shows our enormous efforts in terms of environmental efficiency in many, many different areas. And specifically, to the issue of the commercial trucks, I'm going to ask Mike Ducker if you'd just comment on that for a second.

Michael L. Ducker
President & CEO FedEx Freight

Yes. As a matter of fact, this Company has long been known for its innovation, so we're on the leading edge of many of these technologies. And we believe that the faster adoption of those will greatly improve efficiency and customer experience in the trucking industry. So we're heavily invested in our safety systems and artificial intelligence with many companies, and are using Advanced Driver Assist Systems, that includes platooning, telematics and many other features. So we're working hard on the new technology that are coming out to adopt and use the advantages that they provide for our system.

Tesla, as a matter of fact, soon to be announced that we will be purchasing some Tesla electric vehicles in the near future. Small order, but we think they will have great benefit in our system. We're testing them in the near future as soon as we can get them off the line.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

So here's a couple of related questions I'm willing to pass on to Dave Bronczek and Dave Cunningham, but I'll give you an overarching comment first. From Todd Fowler of KeyBanc, please discuss what drove the decline in international and U.S. domestic volumes within the Express segment in the quarter. How important is volume growth in achieving FY20 profit improvement plan?

The second is from Jack Atkins of Stephens. To what degree was the June cyberattack at TNT negatively impact 3Q results, I guess, it did negatively impact 3Q results at Express, and would you expect any lingering impact in the fourth quarter?

Now, I think these questions from Todd and Jack, and I'm going to ask again Dave and David Cunningham to amplify this, reflects a bit of a misunderstanding here, in that, please recall that when we started this fiscal year, we told you that we were no longer going to be talking about Express and TNT. So the numbers that are in the Express segment now are the combination of the two.

So the reality is, the FedEx Express volumes are growing, but the TNT volumes were adversely affected by NotPetya and we are now going back up to where we would have been had this attack not happened. And let me again give enormous thanks to our sales, our customer service and particularly our IT professionals that did the most unbelievable job of recovering from this attack, which the U.S. government now says was a government or a government-sanctioned attack on the Ukraine, and TNT was just a side victim of it. So the fourth quarter will – I think, began to show these at a more granular fashion. But we're not seeing decline in Express traffic, in the fourth quarter we will have recovered most of the NotPetya volume from TNT now, put some meat on that...

David J. Bronczek
President & COO, FedEx Corp.

Yeah. This is Dave. Thanks for the question. Fred's 100% right, the reason that actually we went through all the detail we did in the fourth quarter along with all the reasons that Alan talked about in the tax reform bill is to give you an idea of where the fourth quarter is forecasted to be, which is significantly different and better than the Q3 numbers.

In my comments, I said that they could run up to potentially 10.4% operating profit margin at Express, that's actually very strong revenue across all of Express. So the reason we put in Q3 and put in the six items that affected Q3 by far and away was the variable comp and so on. It was because of the reason that you just suggested that we talk about Q4, and it's very strong in Q4. David?

David L. Cunningham
President & CEO, FedEx Express

Yeah, I'd just add a couple of comments to what Fred and Dave just said. I think, first thing you got to remember is the effects in Q3 were mostly one-off type of effects. Q4 ends up being a seasonally strong quarter and we've already told you what that's going to be.

Our TNT network was fully restored and back to business as usual as of the end of 2017. The recovery of the business over the last five months has been remarkable. And given the value proposition of the TNT road networks, our freight volumes have been strong, and we are experiencing solid growth in these products.

The cyberattack continues to have a lingering effect in the third quarter, and our existing customer base has not been fully restored – has not fully restored all volumes as they continue to gain confidence in our ability to provide service and recovery of our business.

Our outstanding performance during peak is evidence of the strength of our network and our recovery and our sales teams are leveraging this in the fourth quarter, and growing and winning business.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Okay. A question from Ken Hoexter, BofA Merrill Lynch. In this robust growth e-commerce market, why were deferred volumes up only 0.001% on 1% growth comp and yields negative? Raj?

Rajesh Subramaniam
Executive Vice President – Chief Marketing & Communications Officer, FedEx Corp.

Thank you, Ken. I believe you're talking about the deferred in Express. And really, our volumes are impacted by the way we manage one large customer whose volume was at forecasted levels. If we look at the base volume growth, the underlying base, especially in the small and medium customer segment, we saw very robust growth. And oh, by the way, don't forget the strong growth we saw in the Ground segment, which also carries e-commerce traffic.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

So here's one from Scott Group, Wolfe Research. Now that Express includes GENCO and Custom Critical, do you plan to update your Express long-term guidance? Scott, we did. We told you that we intend to increase our Express earnings from FY17 to FY20 by $1.2 billion to $1.5 billion. So I hope that clarifies it.

A question from Christian Wetherbee of Citi. How much of the year-over-year Ground margin expansion expected in FY4Q is driven by the reclassification and how much of it is from core improvements? Henry?

Henry J. Maier
President & CEO, FedEx Ground

Core improvements represent about 100 basis points of margin.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Here's one again about Express FY3Q and FY4Q. I hope, I explained that. It's – six items where a big part of it was the variable compensation when we decided to – because of the tax act, as Alan described to you, increased wages for our hourly teammates, and the – we had the benefit of the tax bill. And so obviously, we weren't going to penalize our participants in our AIC program, which are thousands of our frontline managers that required a refunding, if you will, of the AIC in the third quarter. So the fourth quarter, it's essentially normalized.

Ravi Shanker, what was the strategic rationale for putting FedEx Office locations at FedEx – Walmart locations? Well, the strategic rationale, Ravi, is because they will make us more money. But the broader point you made, well, they just serve for customer pick-up and drop-off or also serve as omni-channel service points. Raj?

Rajesh Subramaniam
Executive Vice President – Chief Marketing & Communications Officer, FedEx Corp.

Well, Ravi, I think the strategic initiative that we have with Walmart's built upon a shared goal of providing customers convenience and value. And that really makes – both of us can save time and money as the Chairman talked about. As I mentioned earlier, this is an opportunity to serve our consumers who want – who are seeking secure, reliable options for packing, shipping and receiving packages.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

So Scott Schneeberger asked a similar issue about the financial impact of adding FedEx Office to 500 Walmart stores. I think – that obviously is a bow wave of small proportions when you open these things up. But remember, we said in our press release if you read it, we tested these at 47 locations.

We have a rapid payback, so this is going to be inconsequential on the expense side in the near-term. And I think, quite an important channel for us in our retail and customer convenience channel in the next several years after the opening expenses are, in essence, covered. But they're not significant in the scheme of a company this size.

And we've got three questions from Brian Ossenbeck, Matthew Troy and Allison Landry about DHL's launch of their new service. So I'll ask Raj and Dave if they want to comment on that, and then I'll turn the floor back over to Mickey and we've exhausted all of your questions. Raj?

Rajesh Subramaniam
Executive Vice President – Chief Marketing & Communications Officer, FedEx Corp.

So Brian, Matt, Allison, thank you for your question. We don't comment on specific competitive strategies, but there are multiple new tests and pilots where companies are considering variations of crowdsourcing or other options for last-mile delivery.

As you know, e-commerce is increasing demand for last-mile residential delivery. But there are operational costs, safety and brand considerations for final-mile delivery that need to be factored into the ultimate potential of any new offering. Now FedEx's unique capabilities in this regard, and we'll continue to work with retailers to provide a differentiated value proposition and ultimately, a superior service to the end consumer.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Dave?

David J. Bronczek
President & COO, FedEx Corp.

Yeah. The only thing I'd add, because Raj is, of course, right. I mean, we focus here at FedEx on our customers and our strategic value proposition. And I would direct you to our Dream video that's out there. We have it out there, and so you should take a look at that. I think it's very self-explanatory, it's how we feel about our business and everybody else's that we compete with.

Frederick W. Smith
Chairman & CEO, FedEx Corp.

Yeah. I think that's a wonderful way to end up before I turn it back to Mickey. I'd urge all of you who've not done it, the FedEx e-commerce video, it's fedex.com/dream. It's 2 minutes and 37 seconds long and it can tell you in that 2 minutes and 37 seconds what it would take us an hour to tell you. So thank you for your participation. And Mickey, close it out.

A. Mickey Foster - *VP*
Investor Relations, FedEx Corp.

Thank you for your participation in the 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.