FedEx Q2 FY20 Earnings Call Transcript – December 17, 2019

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

Good afternoon, and welcome to FedEx Corporation's second quarter earnings conference call. The second 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 1 year.

Joining us on the call today are members of the media. During the Q&A session, callers will be limited to 1 question in order for us -- to allow us to accommodate all those who would like to participate.

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 forwardlooking 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 the 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 VP 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; Don Colleran, President and CEO of FedEx Express; Henry Maier, President and CEO of FedEx Ground, who's on the phone; and John Smith, President and CEO of FedEx Freight.

And now Fred Smith will share his views on the quarter.

Frederick W. Smith
Chairman, President & CEO, FedEx Corp.

Thank you, everyone. Good afternoon, and we appreciate your participating in our second quarter FY '20 call. As we've said before, we continue to be in a period of challenges and changes. Before addressing specific issues, let me thank over 490,000 FedEx team members around the world for delivering an outstanding peak season for our customers.

First, let me deal with the challenges. The quarter just ended is an anomaly because of the compressed shipping season before Christmas, necessitating a significant bow wave of expenses to handle volumes that will largely fall in our third fiscal quarter. In addition, this quarter has seen significant effects on the industrial economy due to continuing trade disputes, including reductions in international air freight and tepid, at best, B2B domestic parcel and freight shipping.

Despite these issues, we remain highly confident in our strategies which we believe will begin to bear fruit by our fourth fiscal quarter and then into FY '21, absent negative macroeconomic developments.

Now the changes. As we announced last summer, FedEx is aggressively expanding North American package services for the rapidly growing e-commerce market to include year-round 7-day delivery, in-sourcing most SmartPost volumes formerly given to the postal service, standing up more dedicated Ground large package facilities given the remarkable growth in demand for the delivery of oversized items, and new unique short-haul services. While these are the most visible changes, numerous other new technologies and operating processes are being deployed to ensure we can profitably deliver increasing numbers of lighter weight residential packages.

These strategies are being well received in the marketplace with record peak volume -- package volumes, which are substantially above last year and well over forecast with excellent service levels and high overall customer satisfaction.

In the fourth fiscal quarter, we forecast FedEx Ground margins will again be in the teens. The second area of strategic changes in FedEx Express international operations to include the completion of European ground interoperability in the fourth quarter of fiscal year '20. Also, we are taking down intercontinental capacity right after Christmas as our hopes for a restoration in trade growth expressed last June has simply not materialized due to the trade disputes. Given these 2 major initiatives as FedEx Express rolls into FY '21, we believe we will improve profitability in the segment.

While we have numerous other programs underway in FedEx Freight, FedEx Logistics and FedEx Office that are extremely important, there are 2 additional areas that deserve comment, our focus on yields and Capex, which Brie, Raj and Alan will cover in detail in their remarks.

In regard to Capex, let me just emphasize, we are deferring capital, if not essential for safety, service or replacement or obsolescence. Longer term, by fiscal '22 year-end, the replacement of 159 A310 and MD-10 aircraft will be complete. This will lead to a significant reduction in the corporation's ongoing capital expenditures on both an absolute basis and percent of revenues from FY '23 forward.

Now Brie, Raj and Alan will comment, then we'll answer your questions. Brie?

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

Thank you, Fred. Good afternoon, everyone. I'll open with our economic outlook then dive directly into commercial strategy and how we're delivering some incredible solutions for our customers that will position FedEx to drive increased profits. Economic growth in the U.S. slowed in calendar year '19, and we continue to see a split between solid consumer economy and a struggling manufacturing sector. Consumers are supported by, robust labor market while manufacturers have been hampered by trade policy uncertainty and ongoing inventory correction.

The latest developments on trade are positive, but uncertainty remains. The avoidance of tariffs on approximately $160 billion of goods scheduled for December 15 and the reduction of tariffs in the September 1 list on $120 billion from 15% to 7.5% is, in fact, good news. We look forward to continued progress in the signing of a Phase 1 deal in January.

Further, we believe that the U.K. is now in position to manage a more predictable and orderly Brexit. Our economic outlook does not reflect any continued trade momentum beyond the 2 changes mentioned to the tariffs above at current.

In the Eurozone, manufacturing production appears to be stabilizing at low level. Germany's industrial sector, however, is still in decline. Looking ahead to calendar year '20, European GDP growth rates will likely remain in line with where they are now.

In Asia, China's slowdown is expected to continue through the first half of the year, but should have some opportunity in the back half of 2020. Total trade between the European Union and China slowed significantly in calendar year '19 as slower growth and impact from trade tensions have weighed on trade flows. Global trade volumes contracted year-over-year again in calendar quarter 3 and will show contraction for the full calendar year. We should see a return to positive growth for calendar year '20, assuming no re-escalation in trade tensions.

Now turning to what we can control. We are laser-focused on executing strategies centered on 5 areas: e-commerce; international profitability; market-leading revenue quality; B2B growth; and operational excellence and innovation, which Raj will cover.

We are evolving our global portfolio and are already winning significant new e-commerce business. While we are excited about the future of e-commerce, we continue to have teams dedicated to the growth of our core B2B business. Also, we have found great opportunities to grow within the B2B market by leading with our innovative e-commerce portfolio, which I will come back to in a moment.

At FedEx Ground, we have the market-leading e-commerce portfolio. We continue to see strong demand across all customer segments with our new 7-day service. We will increase our speed advantage in the new year. Our Sunday rollout will speed up some lanes by 1 and 2 full transit days. This will increase our advantage significantly. And as you know, we are already faster by at least 1 day when compared to UPS' ground service in 25% of lanes. It is also really important to note, our speed advantage and 7-day service is also very valuable for the premium B2B sectors, including health care and perishable shippers.

We are equally excited about our returns offerings, which are growing at double-digit rates year-over-year. With our expanded retail presence and low returns market share, I am confident we will see this growth accelerate and continue for many years. Returns is a quickly growing market with 15% of e-commerce orders are returned. Returns are an attractive growth segment because it's basically a B2B move.

In FY '20, we've seen significant growth of our retail locations, including Walgreens and Dollar General as well as the volume within these locations. Year-to-date, we have expanded our presence in 1,800 Dollar General stores, reaching 14,000 staffed locations where customers can come and retrieve their packages. We will continue to expand in the new year, and by peak season of next year, 90% of the U.S. population will be within 5 miles of a FedEx drop-off and pickup location.

At FedEx Express, we are enhancing the value propositions we are famous for, our premium time-definite services for commercial shippers. We are rapidly innovating to leverage technology to increase control, security and visibility for our Express customer base. We will continue to lean into sensor-based technology to differentiate our services for health care, aerospace and high-tech segments.

Turning to Freight. Last quarter, we discussed our FedEx Freight Direct service which provides freight deliveries right to or through the front door. Freight Direct currently covers 81% of the U.S. population and is anticipated to cover 90% by this coming July. FedEx Freight Direct is a market-leading value proposition including a 2-hour delivery window, to your room of choice with full packaging removal delivered, of course, by our FedEx team members. We have a strong pipeline and expect some prominent retailers to begin using the service in January. The pipeline for B2B customers for Freight Direct is also very strong as we see great opportunities to deliver to spas, dental offices and schools.

Revenue quality is 1 of our 5 key strategies. We will continue to deliver strong market performance in this area. First, we are excited about our momentum in the small business segment. Secondly, we continue to strategically manage our portfolio of large customers. And finally, we continue to manage both annual increases and contract negotiations to ensure we are appropriately compensated for the comprehensive service we provide.

As an example, we announced rate increases for large packages for Jan -- this coming January. FedEx continues to experience strong demand for transportation of larger and heavier packages. The rate increases reflect our commitment to continually invest in our business while responsibly managing capacities through our network to maintain outstanding service for these larger packages.

Turning to international and our focus on improved profitability, I am confident in our growth prospects in Europe. We have seen year-over-year momentum and growth in our parcel volume intra-Europe and intercontinental to the U.S. from Europe. We have the strongest pipeline and activation for commercial that I have seen since the beginning of integration. We are creating momentum as a result of having the sales integration behind us now.

Further, we are leveraging our world-class U.S. domestic network to penetrate the e-commerce market from Europe to the U.S. As I mentioned on our last call, we are far less penetrated in e-commerce outside of the U.S. compared to our competitors. We have quickly pivoted to develop necessary solutions and are confident this represents a significant opportunity for both our Europe and our APAC regions.

Finally, FedEx kicked off the peak season with a stunning Cyber Monday and a feat made possible by the best team members in the business. Raj will discuss peak in more detail, so let me now turn the call over to him for his remarks.

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

Thank you, Brie, and good afternoon, everyone. I, too, would like to start by extending a sincere thank you to our more than 490,000 team members who are working relentlessly to deliver a successful peak season for our customers. And we are off to an exceptionally strong start this compressed peak season.

As data indicates, we moved 37.8 million packages on Cyber Monday. This exceeded our published projections of more than 33 million packages and represents a 17% increase over Cyber Monday last year. Additionally, December 9 and December 16, which is yesterday, both were historic volume days for FedEx. Our outstanding service during peak is supported by our people and the significant investments we have made in the FedEx Ground network over the past 2 decades.

Now turning to Q2. I am not pleased with our financial results. And to that end, we have focus areas across the enterprise, on B2B, e-commerce, international profitability, market-leading revenue quality and operational excellence. In the short term, this includes targeted actions to shore up our financial performance. We expect a reduction in intercontinental and domestic air capacity post-peak and an overall reduction of costs in our Express business. This action should result in the decrease of international and domestic flight hours by about 6% to 8% year-over-year in Q4. Additionally, we are permanently retiring our fleet of 10 A310s. The reduction in flight hours would allow us to temporarily park 14 aircraft by the end of fiscal year '20. We'll also permanently retire another 29 aircraft over the next 30 months.

It is imperative that while we reduce our cost to serve, we also drive higher yields to improve profitability. Capacity reductions will bring greater focus on revenue quality as we generate more compensatory volume through the network. As Brie mentioned, we're once again implementing our rate increase in January and have added further increases on accessorials and surcharges.

Yields will also benefit from gains in our share of the small and medium shipper market and renewed focus on B2B shipments. At FedEx Freight, we continue to focus on yield management, profitable growth and aligning our cost structure to the lower volumes throughout FY '20. These efforts have enabled FedEx Freight to significantly offset the impact from softening economic conditions. This is yet another example of matching capacity to demand.

FedEx Ground is experiencing cost headwinds as we undergo a remarkable transformation to 7-day service. With the late Thanksgiving this year, we incurred peak ramp-up costs in Q2, with none of the revenue benefit. Additionally, due to the slowdown in industrial production and other macroeconomic factors, commercial traffic has not been what we expected.

Our B2B business provides greater density and stronger yields than B2C. And so we are renewing our focus on commercial traffic, which makes up a significant portion of our Ground volume. However, recognizing that e-commerce is the fastest-growing segment in our business, we are working to position FedEx Ground as the B2C player. We've spent years enhancing our network. And today, our FedEx Ground network is well equipped for handling this rapidly growing market, including 7-day operations for the majority of the U.S. and a dedicated large package operations for handling the growth in heavy and bulky items moving through the Ground network.

We're also increasing efficiency through technology as part of this network transformation. This includes offering technology to our service providers, which we call Dynamic Route Optimization, or DRO, to assist them in preparing for increased residential volume associated with e-commerce growth. DRO technology provides near real-time data that service providers can use to optimize route planning. Additionally, service providers may use this data to make decisions regarding their vehicle mix and workforce to accommodate the increase in both small and large packages. This new technology and data visibility allows service providers to make dynamic decisions about the most effective and productive way to run their business as well. All of this is expected to drive efficiency while further strengthening the reliability of both residential and commercial FedEx Ground service. Looking ahead, our investments in this business ensure we are optimizing capacity and productivity in the long term.

Now turning to Europe, we are on track to meet the May 31, 2020, target date for interoperability of the intra-European ground networks. This will lower cost as the related FedEx Express operations are optimized. In fiscal year '21, the next key milestone will be the completion of the integration of the remaining pickup and delivery operations in Europe. And during the first half of fiscal '22, we'll complete the air network integration, bringing to close the physical network integration of TNT into FedEx.

We're progressing towards important milestones, and we have significant commercial momentum. Our sales pipeline is strong, and activation is the best it has been since we started the integration. As we grow our intra-European parcel business, it will benefit from a lower pickup and delivery cost.

And looking ahead, the rationale behind the TNT acquisition remains sound. The value that we estimated at the beginning of the process remains largely achievable. As I have said before, FedEx remains committed to delivering long-term profitable growth. In the near term, we are focused on decreasing cost and improving revenue quality. We continue to be very excited about our prospects ahead as we transform the Ground company, complete the TNT integration and right-size our network.

Given a more stable economic environment, these measures should produce strong results for the corporation. Now let me turn it over to Alan Graf to provide details on our financials. Alan?

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

Thank you very much, Raj, and good afternoon, everyone. Let me start by saying our second quarter results were very disappointing, and I will discuss the drivers and actions we are taking. But first, let me take a minute to provide further context around our strategy and the decisions we have made.

For many years, a fundamental component of our strategy and investment was capitalizing on the growth of global trade which has powered economic development around the globe since World War II. As recently as 18 months ago, we were seeing accelerating returns from our differentiated international network with greater capabilities imminent as we continued with the TNT integration. While we are encouraged by and supportive of the recent trade agreement with China, it is clear that the dynamics of trade growth have changed, and we must adapt accordingly.

In addition, following the passage of the Tax Cuts and Jobs Act in December of 2017, we reviewed our capital priorities and accelerated intentionally the essential replacement of our oldest aircraft due to the incentives within the TCJA. These investments amidst the current environment are impacting our financial performance.

Getting back to second quarter results, weak global trade and manufacturing drove less-than-expected demand for our most profitable package and freight services across all our business segments. These conditions are especially challenging in Europe, where capacity and network reduction opportunities are limited due to the current stage of integration as we are operating duplicate road and air networks.

As we've discussed, cost headwinds at FedEx Ground are largely driven by the expansion of 6- and 7-day delivery due to a minimum number of employees required to staff and operate the new schedule prior to the volume and revenue coming on. The loss of volume from Amazon had a larger negative impact to the second quarter than the first quarter since the FedEx Ground contract with Amazon expired in August.

Year-over-year comparisons for the second quarter were also negatively impacted by the later timing of Thanksgiving, as Raj mentioned, and I can't emphasize enough, which resulted in the shifting of Cyber Week revenues into December.

The headwinds of the expansion of 6- and 7-day delivery, the loss of Amazon volume and Cyber Week shifting to the third quarter accounted for approximately 60% of the Ground margin decline year-over-year. Higher self-insurance accruals also negatively impacted Ground margins by approximately 90 basis points.

Package and freight yields across our businesses have been negatively impacted due to a mix shift to lower-priced services, lower weight per shipment and an increasingly competitive pricing environment. The depreciation increased with strategic investment programs, including the modernization of FedEx Express aircraft and hubs and investments in technology across the enterprise that will further optimize our networks as well as enhance safety and capabilities.

Partially offsetting these negative factors were the benefits from a tax benefit of $133 million from the recognition of certain foreign tax loss carryforwards, an approximate $65 million decrease in variable incentive compensation and increased revenue per shipment at FedEx Freight who is doing quite well. FedEx Express recorded asset impairment charges of $66 million related to the permanent retirement of 10 Airbus A310-300 aircraft and 12 related engines. The company is continuing to evaluate if additional aircraft retirements are warranted.

For fiscal 2020, we are now forecasting adjusted earnings per share of $10.25 to $11.50. Our revised guidance reflects lower-than-expected revenue in each transportation segment and higher-than-expected expenses, driven by the continued mix shift to residential services. In response, we are implementing reductions to the global FedEx Express air network to better match capacity with demand. We are also further restricting hiring and pursuing opportunities to optimize our networks, including investments in technology aimed at improving our productivity and continuing to lower our costs.

Year-over-year adjusted operating profit comparisons should improve in Q3 and Q4 relative to Q2. And as Fred said, we are optimistic about FY '21. We now expect to incur approximately $325 million of TNT integration expenses in FY '20 and $1.7 billion in total through FY '21.

We expect to begin realizing synergies from the integration of FedEx Express and TNT ground networks during FY '21. And these synergies are expected to increase significantly after the completion of the air network integration in FY '22.

Improving residential package density is a key aspect of Ground strategy to combat residential delivery cost challenges. We expect delivery density to improve as we further integrate the delivery of FedEx SmartPost operations into our standard Ground operations in calendar year 2020. Ground's performance will also benefit as we roll out technology solutions, like Dynamic Route Optimization and more automated small package orders to more locations in 2020.

Our FY '20 effective tax rate prior to the year-end mark-to-market retirement plan accounting adjustment is now expected to be 23% to 26%. We continue to expect FY '20 capital spending to be approximately $5.9 billion and FY '21 capital spending is anticipated to be similar to FY '20. We are continuing to review our planned spending. And as Fred stated earlier, our capital intensity is expected to decline significantly after FY '22 as committed aircraft deliveries are substantially lower in FY '23 and beyond.

Our forecasts assume moderate U.S. economic growth, current fuel price expectations and no further weakening in international economic conditions. A further ramping in anti-trade measures and/or adverse changes in international trade policies and relations would likely drive additional weakness in our business.

In conclusion, we are disappointed with our current results, but we are optimistic our long-term performance will benefit from an increased focus on revenue quality, reductions to the global FedEx air network to better match capacity with demand, a more competitive solution for European customers through the completion of our TNT integration, modernization of our Express aircraft fleet and hubs, better utilization of FedEx Ground assets from the expansion to 7-day operations, improved residential density through the further integration of FedEx SmartPost packages into standard

Ground operations and continued investments in technology across our business to automate and optimize operations, reduce costs and enable more real-time decision making.

With that, operator, we now can open it for the questions.

QUESTION AND ANSWER SECTION

Operator: Our first question today will come from Allison Landry with Crédit Suisse.

Allison Landry
Analyst, Credit Suisse Securities

I just wanted to ask about the Ground segment and specifically, the 6% inflation in cost per piece and the flat revenue per piece, which I think is the biggest delta of going pretty far back in history. I know there's an element of timing of the Cyber Week, but how should we think about the cadence of these metrics in Q3 and Q4? Basically, just trying to understand how we can get comfortable with the margins snapping back to the double-digit level by Q4.

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

Allison, thank you for the question. Let me just start off, and then I will have Henry answer the details here. But the most important thing that happened to us here was the timing. We have -- as we -- on the calendar, we incurred a lot of the costs of running up to peak in Q2 with none of the revenue benefits as we talked about. And that -- you combine that with the slowing down of the commercial segment resulted in the results for Q2.

Let me turn it over to Henry to see what he has to add.

Henry J. Maier
President & CEO, FedEx Ground

Yes, Allison, the thing I would add here is that most of the cost you're seeing is the timing of peak and the 6- and 7-day operation being set up. We began operating 7 days a week on November 3. And it's going to take a while for the volume and revenue and the network to catch up and cover the expense.

And I think I didn't hear the full part of your first question, but I think it had something to do with yields. And I think that, as Raj probably said, is due to mix.

Operator: Our next question will come from Chris Wetherbee with Citi.

Christian Wetherbee
Analyst, Citigroup Global Markets, Inc.

I guess I wanted to pick up where Allison left off on the Ground side and maybe understand things a little bit better and kind of get into those cost inflation that we're seeing here. So you outlined a couple of different items there that I think were somewhat unique to the quarter, I think about 60% of the margin degradations that you called out from the 6- and 7-day, plus the timing shift of Cyber Week and then 90 basis points for insurance. When you think about the revenue growth of $170 plus million, your profit still fell by almost $40 million. So how do we think about that sort of relative $200 million of incremental cost that you incurred outside of those specific items? And kind of how do we think about sort of the walk from that kind of core run rate to something that, I guess, looks like teens in 4Q?

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

This is Raj again. And thank you, Chris. I think -- I'm not sure what else I can add other than to say that we had a run-up on costs, putting a 7-day operation in place and then getting ready for peak. We're going to -- there's a significant demand for 7-day. We are going to be differentiated with the competition when the customer demand is very high, and that's going to come on post peak, and that's going to be very helpful for us. And then in your recovery we see in the industrial segment of the economy and driving B2B, which is a renewed focus for us, that will be very helpful. Henry?

Henry J. Maier
President & CEO, FedEx Ground

Well, I'm not sure what more I would add there. I mean, we've talked about this. Most of the cost, 60% of the margin impact, as Alan pointed out, is the timing of peak this year. And by the way, it's a peak that's 6 days less than last year. So you have this volume that has to be handled in a much shorter time line than it did last year that takes more drivers, that takes more package handlers, that takes more line haul, et cetera, across the operation to get done.

And then there is a bow wave of costs with the implementation of 6- and 7-day that wasn't in these numbers last year. Every day at FedEx Ground is now a service day, and it takes a minimal number of people in order to staff these operations to provide the service.

Operator: Our next question will come from Jordan Alliger with Goldman Sachs.

Jordan Alliger
Analyst, Goldman Sachs & Co. LLC

Just, sorry, following up on that again. I mean I understand the timing issues and mix shifts, et cetera. But can you maybe talk a little bit more going forward, how do we avoid these sort of issues? Because it seems to me that the macro really didn't get that much worse. So this must be largely cost related and what have you. And I just want to make sure that going forward, with the stuff that you're doing, this type of event and timing that will be minimized. Because I'd imagine we knew about the shorter peak season. So I'm just a little confused because the hit was just so big.

Frederick W. Smith
Chairman, President & CEO, FedEx Corp.

Well, this is Smith here. I don't know, again, how much more of that Raj and Henry and Alan can say about it. Standing up to 6- and 7-day network was very expensive for us. And the expense for peak in general, which was always put upfront, was a total drag. And we certainly anticipated some of it, but we probably underestimated the cost of standing it up.

And then when we went into the peak season, as Raj also said, we had an unbelievable response. We had 37 million packages on Cyber Monday. And our plan was for 33 million. So we have said clearly that we believe, by the fourth quarter, Ground's margins will be back into the teens. We're not able to show you our spreadsheets, but that's our cost projections. And yes, there's no question, we spent more to put the network up than we thought. But we never put up a 6- or 7-day Ground network before for permanent thing. So there's a little bit of -- a little bit of new ground for us.

But no question we missed on the cost side. But it's up and operating. As Raj said, we probably never had response in the recent past from our Ground customers like we've had. Brie can perhaps add to that on 7-day. And it's an entirely differentiated product, and it's also something that's going to substantially change the e-commerce business.

In the last weekend that just finished, we delivered over 14 million packages on Saturday and Sunday. We weren't even delivering packages on the weekend a couple of years ago. So we're pretty confident where we're going. And clearly, we didn't do the greatest job of forecasting our cost, and we were hit with a couple of other things like the insurance reserves which are looking backwards some period of time. That's basically because of the litigious society we live in and the more expense that's required to operate a transportation company in general, which is a huge issue to a small transportation company.

So we’ve answered it 3 times, and we're pretty confident about the fourth quarter, and we gave you some aiming stakes, but I don't know that it's productive to plow this ground anymore.

Operator: And with Stephens, we'll hear from Jack Atkins.

Jack Atkins
Analyst, Stephens, Inc.

So I guess asking a Ground question not related to the 6- and 7-day. But kind of thinking about your pricing commentary, both in the press release and in the 10-Q. You referenced increased pricing competition there, which is sort of eroding pricing power, and we certainly saw it this quarter. So whether it's Henry or Raj or Brie, could you maybe talk about sort of what's going on there from an industry perspective? And why is pricing power eroding given the obviously significant demand for home delivery services?

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

Yes, great question. Thank you, Jack. I think a couple of things to clarify. One, as Henry mentioned, the primary yield pressure we felt at Ground in the past quarter was really due to a mix and the pressure on our commercial business, which is obviously a very important segment to us, and that was linked directly to decrease in industrial production. When we think about revenue quality and our ability to continue to command a premium in the market, which we do in every segment that I measure, we actually get a competitive premium over the service. Number one, the 7-day value proposition is opening doors like it never has before for us. So we really do believe that, that gives us great ability to negotiate. Number two, we are managing the revenue quality and ensuring that every pricing sell contributes. So you saw that addition what we made for large packages. But as we're managing our large customer portfolio, not all customers are equal. We're making sure we get the B2B and the B2C bundle. And we're also making sure that when we grow with 7-day that we've got a strong mix of small business, which we have seen, I just looked at the 7-day activation report and it is very strong. Customers are actually switching to FedEx during peak to be ready for the 7-day launch in January, which is really something quite unprecedented.

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

This is Raj again. At the risk of being repetitive, I cannot under emphasize our focus on revenue quality. We are -- our renewed focus on B2B, gaining on small and medium segment and all the things that Brie just talked about is very important for us.

Operator: Our next question today will come from Scott Group with Wolfe Research.

Scott H. Group
Analyst, Wolfe Research LLC

So Fred, I want to ask, we've got record low margins, I think, here. And I heard you talk about restricting hiring. But why are we talking about more drastic cost and head count reductions? I know it's maybe different, but it strikes me that some of the rails are cutting head count, 10%, 15% without severance costs. Do we have any opportunity to do anything like that?

And then just separately, I know you talked about Express profits improving next year. Do you have any visibility on Ground profits for next year?

Frederick W. Smith
Chairman, President & CEO, FedEx Corp.

Well, I'll have to ask Alan if he's prepared to make a forecast for FY '21, which I doubt, because he hadn't forecasted it to me. But the reality is, to your first question, the rails are not even a remotely comparable business to FedEx. It's essentially a business of maintaining tracks and automating to the extent possible. You have an OR of 60%. It's not labor-intensive. It's getting less labor-intensive. And when you follow the precepts of Hunter Harrison and smart railroading or whatever it was you're calling, that's what's allowing the precision railroading. That's what's allowing the rails to lower their costs. They are quasi monopolies certainly in the geographic areas and certainly to particular customers. So I don't know that rail is significant.

The second part about this business is we're, in many ways, hooked to our customers for long-term relationships. And if you walk away from customers and disadvantage them and if you break the morale of your troops by not investing in service quality, that has long-term deleterious effects. That certainly has been a consideration in Europe for mention in TNT.

So of course, we could have done some more drastic things. But I think at the end of the day, the focus on the short-term financial results only based on what we see for the fourth quarter into '21 and the strategies we're exercising, we have not decided to go down that road. Now maybe somebody else feels differently about that, but I don't think you can keep the Purple Promise laying off thousands of people. And I think that's one of the considerations, again, we've had in Europe is to make sure that people over there we acquired with TNT were fairly treated. We're invested in delivering the kind of FedEx service.

So it's a value judgment. No question we could have been more draconian, I guess, in certain areas, but we're, as we've said several times, pretty optimistic about where we're headed and going into January, assuming there's no more macroeconomic deterioration.

I might also say that I think in this country, there's a little bit of misunder -- estimation of what's going on in the rest of the world, the e-commerce growth, the technology sector that we had, the tax cut, all of these things have led us to have a high increasing employment. It's led us to have reasonable GDP growth. That's virtually not true any place else in the world. And the industrial economy, particularly in Europe, which was hit by the ricochet bullets of the U.S./China trade war almost went into recession this time last year. And it still hasn't recovered. And Germany, in particular, is extreme.

And I think one of the things that Raj has said and Brie has said that's extremely important here, the U.S. industrial economy which is much more tied to international trade. And of course, the GM strike and now the Max shutdown, it's been negative for months now. And so our B2B Ground volume is growing. And our -- what is it, John? What's our Freight volume? It's up a little bit or about flat?

John A. Smith
President & CEO, FedEx Freight

It's flat to down.

Frederick W. Smith
Chairman, President & CEO, FedEx Corp.

Yes. And so that's a reflection of the industrial economy and a large truckload carrier that just went bankrupt, Celadon, so it's really a tale of 2 economies. And the stock market, of course, is very bullish. But the industrial economy does not reflect any growth at all, worldwide to speak of.

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

So let me try to give you a little bit more detail on that. First of all, a couple of things we didn't mention about our miss here in the second quarter. We got substantially less commercial volume at Ground than we had forecast, which was a big impact, high density, higher yield, heavier packages that didn't materialize. Our commercial growth is about flat.

Secondly, we operate in extremely competitive labor market these days. We've seen wage inflation in certain markets due to increased competition for personnel. That was a little higher than we anticipated. So having said that, we are at the bottom. Our adjusted operating profit declined year-over-year is horrific, and it's going to improve. It's going to improve in Q3, and it's going to improve substantially in Q4 versus their prior year's adjusted operating income.

It won't be -- the miss is so bad. We might -- we might not be back to where we were last year, but we will be a lot closer, obviously, than how wildly we were in the second quarter.

The other thing is, is that I think if you think about all the positive things we've said and that we're seeing, as we get into '21, we will start lapping Amazon. We will have a lot more of the 6- and 7-day on our belt, and we're going to be delivering millions of packages on Sunday for the rest of this fiscal year, rolling into '21. We'll finally start getting -- turning the corner in Europe with the operational synergies that we'll start seeing and those will grow during the year. I've got nothing in this current range for any sort of a trade deal because, again, we haven't gotten one yet. And we have some upside there. If that happens, we'll even have more upside into '21.

So without giving you specifics, we're at the bottom, and we're going to come up off the mat, and we're going to improve through the rest of this year and into the next.

Operator: Our next question today will come from Allison Poliniak with Wells Fargo.

Allison Ann Marie Poliniak-Cusic,
Analyst, Wells Fargo Securities, LLC

Just kind of going back to your commentary around Europe. Obviously, seeing some stabilization there. The German sentiment in tax is starting to trend a little bit more optimistically. I guess any color on maybe a potential improvement there and your ability to flex that network as you're bringing some of these aircraft or parking some of the aircraft now?

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

Yes. Again, thanks for that question. Yes, we are actually -- the commercial velocity that we are seeing in Europe is quite good. As we talked about earlier, it's the best we've seen since the beginning of the integration and our parcel volume growth, intra-Europe and in Europe is starting to perk up here. So -- and at the same time, we are starting to click off our integration milestones. And next -- as I pointed out earlier, we will -- by end of May of this fiscal year '20, we are expecting to be interoperable and then proceed on to fiscal year '21. So we're not waiting for the full integration to get all the benefits. We are generating those as we speak. And we are seeing the volume growth come in good commercial velocity.

I'm going to turn it over to Don for any comments he may have on Europe.

Donald F. Colleran
President & CEO, FedEx Express

Thanks, Raj. Thanks for the opportunity to add a little bit of color to what you've already shared. Like you and the rest of the team, I remain very confident in our strategy in Europe and what we're seeing relative to the plans we're executing. I think it would help a little bit when we talk about interoperability and integration on the ground to kind of define what that means. So what that really is, it's our ability to flow volume between networks, supported by the proper technology that allows us to do that in a very efficient way.

So what does that mean? So that allows us to link import and transit clearance processes, enables cross-sort capabilities for our packages in a dual network. It allows us to enable intercept capability, and it links our air hubs and our ground networks.

So what are we seeing over the short term? And what are we seeing in our business right now. So as we communicated on previous calls, we remain on schedule to have the ground interoperability completed by the end of this fiscal year which is made for us. And on the air side, in October of '21, calendar '21.

We realize benefits each and every day as we complete our integration task. To give you an example, we've sped up almost 1,800 lanes in our European theater. That's 40% of our total lanes either faster by 1 or 2 days. And our customers are responding very positive to that. Raj and Brie talked about the pipeline activity, and that's all well and good. But what I measure our results are, what we're seeing in our airplanes and our trucks. And we're seeing some nice revenue momentum in our business right now. That's really where we begin to see the synergies and leverage in our business. As we integrate the networks and at the same time, we add possible volume into it, that's where the music really begins to happen. So I feel very positive about where we are. We remain on schedule. We had the European team in here last week. Raj and I and Brie and Jill. We spent a lot of time in Amsterdam with the team. So we're on schedule. As we've communicated, we're beginning to see some of the benefits and we'll continue to see the benefits as we transition in the back half of this fiscal year into the next fiscal year.

Operator: And our next question will come from Scott Schneeberger with Oppenheimer.

Scott Schneeberger
Analyst, Oppenheimer & Co., Inc.

Touching on TNT, you've essentially reiterated kind of the time frame of integration. I'm just curious, you mentioned the sales pipeline is strong and I think it was activations were the best that they've been. Could you elaborate a little bit on that? And please speak to the competitive dynamic you're facing as you're trying to repenetrate there?

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

Well, I think we've really answered this. This is Brie speaking. I think Don and Raj and I have covered most of this. I think I got 2 things. One, to Don's point, commercial volume intra-Europe for parcel is growing, and we are very excited about that growth. It has been the strongest we have seen. The next lever we really are pulling as quickly as we can is e-commerce. From a competitive comparison with our -- in our Express business, that is something that our competition is ahead of us. They have about 5% to 6% -- or 5% -- 5 to 6x the amount of e- commerce volume that we have intra-Europe. So that is really buoying their results. We are moving very quickly. A year ago, just to put this in context, we had 9 leads on e-commerce. And I'm giving you that number to show the momentum that we have. We are now actively managing 1,000 e-commerce customers through our sales pipe in intra-Europe alone. We have very quickly pivoted. Because of the economic conditions, we have to grow in e-commerce.

And to Don's point, the European network is ready to grow from an e-commerce perspective as we've been able to improve our value proposition and grow in Europe. So number one, we're growing commercially intra-Europe. Number two, we've got strong momentum from an e-commerce in Europe that's coming now.

Donald F. Colleran
President & CEO, FedEx Express

The only thing I would add to that. What's encouraging to me is the fact that this growth is happening in light of what's not a very strong macroeconomic set of circumstances. So team is out there. We believe it's taking share, they're growing our business aggressively. We're hoping as both, I think, Fred and Alan mentioned earlier, on a more macro level, the certainty that comes along with, hopefully, some good news on Brexit also has us encouraged, although we haven't dialed that into our plan.

So I like where we sit. I like how the team is executing right now as we go into the back half of the year.

Operator: And next, we'll hear from Ben Hartford with Baird.

Benjamin John Hartford
Analyst, Robert W. Baird & Co. Incorporated

Just interested in your perspective on AB 5? And what changes, if any, it may have to the way that the Ground model is constructed or any potential benefits that they may bring about in the market, given some of these disruptions? Just -- would appreciate an update there as it relates to AB 5 and some potential consequences.

Henry J. Maier
President & CEO, FedEx Ground

Ben, it's Henry Maier. AB 5 legislation relates to the legal test under which an individual's employment classification should be determined under California law. Since 2011, FedEx Ground has only contracted with independent incorporated companies, not individuals, and they must classify and treat their staff as employees under applicable state and local laws. So at this time, we don't believe it impacts us. Thanks.

Operator: Our next question today comes from Brandon Oglenski with Barclays.

Brandon R. Oglenski
Analyst, Barclays Capital, Inc.

So I guess, coming back to the analog between the rails. I guess the question does make sense from the perspective that the rails didn't earn a great return on capital for a long time. Then there was a bold new way to run the business. And so I guess, along those lines, when should shareholders expect that FedEx goes under like a portfolio of products review of everything offered at Express? And where is the plan to get those products earning their cost of capital in the future? Because there's just a history of that not happening.

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

This is Alan. We’ll we've done that. We were asked earlier about is there some big bold move. I don't think you have any idea how big 8% reduction of flight hours is, but it's tremendously large. We're not going to grow our fleet, we're just replacing it. We're tightening up and reducing flight hours. Express domestic margins are fine. So it's international that we got to keep working on. We've been dragged down by TNT, some of it is self-inflicted, some of it macro. We're handling the flight hours. I think we're doing everything that we can that we should be doing. Well, our CapEx is going to drop significantly after we get past FY '22. As I said, those are essential aircraft replacements, which we need.

If we're flying more flight hours then we'll be retiring MD11s faster than we anticipated, but we don't expect any growth there beyond that. I think a 6% to 7% of revenue in '23 and beyond will start to show a significant improvement in our

ROIC and ROE. So as I look out there, again, it's -- I'm frustrated, I'm sure our investors are frustrated we're here at the bottom, but we can see a way out.

Operator: Next, we'll hear from Tom Wadewitz with UBS.

Thomas Richard Wadewitz
Analyst, UBS Investment Bank

Alan, you just mentioned that the magnitude of the cost takeout from the, I guess, 8% air network capacity reduction is pretty significant. Is there any way that you can help us think about how to translate that to cost? I think in the past, you had talked about international, like -- as U.S. frequencies being kind of $50 million to $100 million and operating income impact for taking out of frequency. I just -- is this hundreds of millions of dollars of cost savings? Is it $50 million? Just any way can you help us think about the magnitude?

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

Well, I don't want to get in exactly those details because it depends on where the flight hours are and everything else. It's a significant number. And at the same time, we expect to be improving the revenue quality on it significantly. So we should get it from the top line and the bottom line. And I'll turn it over to Don. I mean, he's been leading the planning on this, and I think it's outstanding.

Donald F. Colleran
President & CEO, FedEx Express

Thanks, Alan. I won't get into the specific -- on the numbers, as you suggested. But what I can tell you, we've made -- we have made and will continue to make significant reductions in our flight hours, both in the U.S. as well as outside the U.S. As we mentioned, our business in the U.S. is in a pretty healthy position, but we lost a significant customer. So what have we done in response to that? Well, we've taken significant costs out of our U.S. business inclusive of flight hours in a significant amount, labor savings, aircraft maintenance and vehicle savings.

So we're looking at this everywhere. Not only in terms of what we're doing in the flight hours, but corresponding costs that are associated with that both in the U.S. and our intercontinental business. The number that Alan had quoted, 6 to 8, is inclusive of both. But we're looking at flight hours everywhere in ways we can optimize our network and match lift to load.

Operator: Our next question will come from Helane Becker with Cowen.

Helane Becker
Analyst, Cowen & Co. LLC

I just want to follow up on the flight hours question. So we estimate that from public data that about half your pilots will retire over the next decade. And I'm just kind of wondering, A, the pilot hiring and your ability to attract pilots to the company. And B, how much of the reduction in flight hours is the result of the pilot retirements?

Frederick W. Smith
Chairman, President & CEO, FedEx Corp.

Let me start off on this one and have Don speak to it. This is Smith speaking. First of all, when the economy started deteriorating a year ago in Europe. And we were hopeful for trade deals as we went into fiscal year, as we expressed to you in the June analyst call, we began to put constraints on pilot hiring and we have not been hiring pilots for some time now.

On an attrition basis, I believe Don and Greg Hall, our Head of Air Operations, told me that we will have a net reduction of several hundred pilots next year just due to retirement. And of course, that corresponds to the flight hour reduction. So this is something that we've been thinking about for a long time if things didn't materialize.

In terms of female pilots, FedEx has been the leader in this. This has been something that's been a project of mine for a long time, female and minority pilots. We -- percentage-wise, at one point, I'm far away from the Express business, this level of details. At one time, we had the highest percentage of both, I'm sure that's different now. But we work very hard and we participate in female and minority hiring longer term. We're among the prized jobs in the aviation industry, and we do not have any problems hiring aviators to date. But in the future, with the military releasing so few of them, that may be a different story. But Greg has done a great job for Don, developing, grow your own pilot program. So we put a lot of thought on this. Our pilot attrition is going down. And so we anticipated this.

Raj, Don, do you want to -- Don, do you want to say something?

Donald F. Colleran
President & CEO, FedEx Express

Yes, just one thing I'd like to add to that. I've had the opportunity since I've been in this role to spend a lot of time with our pilots. And we have an absolutely amazing group of pilots, without question the best in the industry. And they're the best source of our pipeline. So because the brand is so strong, because they do such a great job for us, they are helpful in the recruitment of pilots across the world.

So first of all, we have an amazing group of pilots that do a fantastic job for us as they have during this peak season. I mean the dispatch reliability of our aircraft and what our pilots are doing is nothing short of amazing. So they're the greatest source of recruitment that we have and they're the best pilots in the industry bar none.

Operator: And that concludes today's question-and-answer session. Mr. Foster, at this time, I'll turn the conference back over to you for any additional or closing remarks.

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

Thank you for your participation in FedEx Corporation's second quarter earnings conference call. Please feel free to call anyone on the Investor Relations team if you have additional questions about FedEx. Thank you very much.