Baird Transcript – November 12, 2024

Garrett Holland
Analyst, Robert W. Baird & Co.

With that, we'll get started for our last transport session of the day. Again, my name is Garrett Holland, Senior Analyst covering transportation and logistics here at Baird. We're very pleased to have the FedEx team participate at our Industrial Conference again this year. From the company, we've got John Dietrich, Executive Vice President and Chief Financial Officer. We also have Jeni Hollander, Vice President of Investor Relations as well as Matt DeBerry and Steve Hughes from the IR team.

So, we're going to jump right into Q&A. And if you have a question, please submit it through the portal. I'll be sure to get it and relate it to management. But with that, I'll turn it over to Jeni for some opening disclaimer.

Jenifer Hollander
Vice President-Investor Relations, FedEx Corp.

Thanks, Garrett. We're excited to be here. Certain statements may be considered forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995 and are subject to factors that could cause actual results to differ materially from those expressed or implied. For additional information, please refer to our press releases and filings with the SEC.

Please refer to the Investor Relations portion of our website for a reconciliation of the non-GAAP measures discussed today to the most directly comparable GAAP measures. Guidance discussed today was effective as of September 19, 2024, the date of our Q1 earnings call. Nothing discussed today should be construed as reaffirming or disaffirming such guidance.

Garrett Holland
Analyst, Robert W. Baird & Co.

Very well. All right. With that, John, it's been a very busy 16 months since you joined the company. Help us understand what you found when you came to the finance organization and how your prior experience inform your views on changes of the company going forward?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Sure. Well, first of all, Garrett, thanks for this opportunity, and thank you all for participating. It's great to be here to talk hopefully, a lot about our strategic priorities here. I'll start with that. A lot of exciting things going on at FedEx, which frankly, is one of the things that attracted me to the company. You're right. I've only been here for 16 months, but in my road leading up to taking the job, I was really excited about all the initiatives we have going on.

When you talk about our DRIVE program, which I know we'll talk more about along with our Network 2.0 initiatives as well as kind of the more recently announced Tricolor initiatives, there's really a lot going on, all the while with a focus on improving our earnings, our margins, our ROIC and all that. And as you've heard Raj, our CEO, talk about taking us to the next level from a digital transformation standpoint. So, all those things taken together is a really exciting time for me and for the company.

When I reflect on the last 16 months, particularly with respect to the finance organization, there's really a lot of opportunity to leverage the fact that we're bringing the companies together under One FedEx. It's one of the things I didn't mention, but just as a reminder, we, as of June 1, migrated to a One FedEx structure where from the Ground and Express companies that brought those two companies together, which is really a foundational step to more and more opportunity. And specific with regard to finance, it created a lot of opportunities to bring, for example, our FP&A function all in a centralized fashion, our procurement initiatives in more of a centralized versus bifurcated structure with their respective operating companies.

From a capital standpoint, it allowed us rather than the separate operating companies determining their capital strategies and approach, we instilled some centralized discipline to our approach to capital spend. So, all those things were very exciting, I guess the last point to your question that I'll say is from a personnel standpoint, we've got some amazing talent. And by bringing One FedEx together and some of these other initiatives, we've been able to cross utilize that talent across the organization, whereas before, they were operating quite separately. So, I've been really pleased with the progress of that talent. So again, exciting time to be here.

Garrett Holland
Analyst, Robert W. Baird & Co.

Very much so. Two of those initiatives, as you refer to DRIVE and Network 2.0, just to stay on those longer-term opportunities. Help us understand the cadence of those DRIVE savings as they flow through fiscal 2025. Some of those savings seem to shift out of Q1 to start this fiscal year. Help us understand that cadence as we work through the balance of the year and your confidence in realizing that full $2.2 billion of savings after chasing down $1.8 billion last year.

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Sure. Well, I'd like to start with $1.8 billion because I think it kind of sets the tone for some of the goals we've put out there. And I've been saying through fiscal 2024, we put that marker on the $1.8 billion, and we delivered on that marker. So that gave me a lot of confidence in the programs we already have in place. For FY2025, as we publicly stated, $390 million of that $2.2 billion we delivered. And sequentially through the year for each of the quarters, we'll continue to improve on that.

What I'd also like to say is that DRIVE is really more of a way of doing business. It's not just a cost-cutting initiative. And one of the things I've said both internally and externally is there are some of the DRIVE initiatives that overdelivered and on time, and there are some that underdelivered and not on time. And what we experienced a little bit in Q1 was some of those initiatives that we – frankly, we're pushing to complete in Q1, push to the right a little bit, but as reflected in our guidance, for example, we're committed to those numbers, and we're committed to the $2.2 billion in the same way we were committed to the $1.8 billion in FY2024.

Garrett Holland
Analyst, Robert W. Baird & Co.

And thinking about Network 2.0, the follow-through from One FedEx. You're obviously making progress along those fronts. What do we – what can we learn from the Canada start? And what are some of the risks and opportunities you roll that program out broadly across the network?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

So, Network 2.0 is really an exciting initiative, and it involves bringing really three legs to the stool together from a facility standpoint, from a personnel standpoint and from a technology standpoint. So, we're learning along the way on all three of those legs of the stool.

From a personnel standpoint, if you – if I were to think about some of the challenges, it's kind of a new way of working for our couriers and our contractors. Couriers, for example, are adapting to a new environment where they are required to deal with larger packages, for example, and our contractors, for example, have more time definite versus day definite. So, there's some learnings happening there.

From an IT standpoint, one of the reasons we're starting off with some of our smaller stations and focusing on areas where we can – I don't want to say get some of the lower-hanging fruit, but less complex that aren't reliant on some of our large hub and sort facilities. IT, that facilitates our pickup and delivery capabilities as we migrate to a more wholesome, fulsome network capabilities. So, on the IT side, a lot of great work being done there. And then the facilities, bringing what were two facilities together into one that can accommodate both the ground and parcel. So, all that's taking place in a very structured way.

I think an important point with regard to Network 2.0 as well. We set our timelines further out to year-end FY2027. And we did that quite intentionally knowing it was a substantial undertaking and knowing that there are times where we're going to speed up and there's times where we may have to slow down. And as we're in our peak season now, for example, we'll slow some things down, so we're not impacting our service during this critical peak season for our customers and then come first of the year, we'll ramp back up. So, it's a very fluid project as well as stepping back when we do each station and learning from some of our experiences, and I touched on some of the areas where we're getting better at all the time.

Garrett Holland
Analyst, Robert W. Baird & Co.

It's good to see and especially some of the encouraging results on that cost to serve. You mentioned peak season. It is here, a condensed peak this year. How are you and the team prepared to execute this peak season? What are you seeing in the marketplace? And what are your conversations? How are those conversations with shippers in forming your plan?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Sure. And I can reflect on my prior life as a supplier to FedEx. I think it's fair to say peak season planning starts on December 26 for the following year. So, a lot of planning goes into peak season planning. And I think in consultation with our customers, that's a key element to understand what their needs are, what their demand is going to be so we can adapt to that and prepare for that. What I can say is we are prepared for peak. The team is ready from a staffing standpoint, from a capacity standpoint. So, we're looking forward to delivering for our customers.

Garrett Holland
Analyst, Robert W. Baird & Co.

Now I want to focus on the long-term opportunity, the near-term dynamics, another near-term development was the election, obviously. We're asking all the companies at the conference, just to help us understand and handicap the net impacts as we understand them today from tariffs and taxes and deregulation. Obviously, FedEx is a meaningful international exposure. How do you interpret the election results and what it means for your business?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Well, I'll start by saying my top advisers here are my kids at home and I have two very different views from them. But look, FedEx, as you say, is global, and we're totally international in what we do, and we serve every market. We're going to work together with the administration. We do support free trade. So, I think the nice part about our business, Garrett, you and I talked a little bit about this earlier is we're adaptable. We're in 220 countries, and we can adapt to wherever that demand is generated. And China is going to continue to be a producer.

To what extent with tariffs or whatever may come, we're prepared for that. If the demand and the volumes go elsewhere, we're well equipped to adapt to that, and we're watching it very closely. And of course, looking to promote the interest of our business in Washington, D.C., and we have some very good relationships in Washington and spend a lot of time there making sure that our interest in our business is heard.

Garrett Holland
Analyst, Robert W. Baird & Co.

I guess maybe shifting back to the business fundamentals. It'd be great if you could review some of the peak pricing surcharges that you announced. I think it's reflective of a disciplined pricing approach. But what are you seeing in the marketplace? Obviously, there's always some fears about pricing competition within parcel. What do you see in the marketplace and describe your approach with the pricing surcharges?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

So, from our standpoint, we're encouraged by what we've been able to do up to this point on the pricing front. We came into the year with certain expectations in certain areas. Again, this channels into what I've said publicly about how we set our guidance. We came into the year certainly anticipating in GRI but came in a little bit higher than we anticipated.

Peak surcharges, we've been able to implement a little bit higher than we anticipated. So, on the revenue side, encouraged by the capture and we're encouraged by our ability to pass that along. And the pricing environment remains rational, but it's competitive. And we're competing in the market and adapting to that very competitive environment.

Garrett Holland
Analyst, Robert W. Baird & Co.

And you're working through some unique factors as work in the fiscal second quarter. But you expressed some confidence that there was opportunity for quarter-to-quarter improvement as we think about profitability. Just help us understand some of those drivers, perhaps DRIVE. But what's the offset as we think about the loss of the Postal Service business and the shift in Cyber Week?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Yeah. And those are some factors that we identified. We're looking at what we've said is, somewhat below typical seasonality for Q2 because of the shift in Cyber Week from Q2 to Q3. We have identified, we do have some headwinds with the expiration of the Postal Service contract. We'll start to feel the effects of that on a monthly basis, more significantly in Q2, and then that should ease through the year into Q4. On a quarterly basis, we'll feel more of the impact of that.

But some of the things I've talked about already focused on DRIVE and adapting to the expiration of the Postal Service contract. I mean we took immediate action. It was not a phased wind down. It was pretty much a cutover from the end of the month to the first of the month. And we were prepared for that. From an aircraft scheduling standpoint, we took out a lot of the flights in the network, and we're working on a daily basis to pull out more of that variable expense tied with the Postal Service contract. And we'll continue to do so. We'll continue to look for opportunities for the capacity that's been released to us, particularly in the daytime network that largely served the Postal Service business to adapt that network to our liking and not necessarily the customer's liking.

So, all those things are in play, similar to what I described about peak season. There was no big surprise to us that we were going to transition out of this contract. So, we were preparing for that for months before it ultimately expired. We were preparing for it to get extended as well, should that be, but it was not to be. So, a lot of great work is done for pulling that cost out.

Garrett Holland
Analyst, Robert W. Baird & Co.

And as we think about that operating income walk for fiscal 2025. Another one of the headwinds is the mix shift that we've seen into deferred services. Describe that product mix shift and the tail that you would expect to see there. Should we expect that mix dynamic to stable – to stabilize going forward? Or what are your expectations or potentially a reversal of that trend as we think about the next few quarters or even years?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Sure. So, I think if you reflect on the numbers, we were impacted by reductions in our highest-yielding products. The priority products. We saw roughly a 5% decline in both domestic and international priority products. And you couple that, the yields held relatively stable. But when you couple that with the economy deferred products that saw an increase of roughly 34%, 35% with an 8% decline in yield, that's going to put pressure on your earnings and your margins.

But you have to keep in mind the market macro environment we're in. And I think it's pretty well known the macro environment has been pretty challenging. Industrial production is down. In fact, the ISM PMI index is down 23 of the last 24 quarters (Correction: Months, not quarters). And I think, in October, was its lowest in some time. That's bound to improve, and we're going to be well positioned to take advantage when it does improve. That said, e-commerce is going to continue to grow, and we're planning for that.

So, in the meantime, while all this is taking place, we're focused on those things within our control, and that brings me back to DRIVE and the DRIVE initiatives. And I'll just share a little bit of perspective to kind of validate the credibility of the DRIVE initiatives. In FY 2024, we saw multiple quarters where revenue was down and op profit and op margin was up, and that really hasn't happened in FedEx's history. So, we're excited about the leverage we get from DRIVE, and that's why we're so energized by staying focused on it.

Garrett Holland
Analyst, Robert W. Baird & Co.

I appreciate that. Turning to European operations. Help us understand the road map back to profitability or to improve profitability in Europe? What has been accomplished to date, what lies ahead and the level of urgency to improve that performance?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Yes. Look, DRIVE is a significant opportunity for us. And with the sense of urgency, I can tell you it is a top priority of mine. I can't speak to the past, but what I can tell you is there are significant intangible steps that we're taking. I think in Europe, there were some setbacks along the way, right, for the company for FedEx, particularly between a cyber event and a facility event. So, what we've been focusing on is gaining profitable share through improving our service, and we have seen significant improvement in our service. We have new leadership, and that's not in any way to disparage prior leadership, but we have new leadership both on the commercial side as well as on the operational side.

And we are implementing a lot of the expertise where we've been successful, for example, here in the U.S. in our ground network to focus on continuing to improve our ground network with a different strategy of truck fly truck versus flying more than we may need to. Hub and station efficiencies, reductions in force where we can. Some of these things in Europe take a little bit more time. But it really has been a clean slate approach with an aggressive sense of urgency, and we're looking to improve and have seen improvement, particularly in our service quality.

Garrett Holland
Analyst, Robert W. Baird & Co.

And picking up on that last point, you’re referring to Tricolor. Just, can you give us a review of that program but also some of the milestones that we should expect to see from the company as you roll that out over the course of fiscal 2025?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Sure. Tricolor by its design is designed to put the right assets to work with the right products, right? And just in rough terms, the purple is our purple tail network for express products and was designed to be an express product. The white that is for white tail where we look to leverage commercial capacity, third-party capacity for lower-yielding e-commerce deferred products.

And then the orange network, which is utilizing FedEx assets to leverage really the priority freight market on an international level, coupled with improving density to facilitate other products to maximize density, take advantage of the time we have on the ground, not necessarily in the night express operations, but taking advantage of the daytime operations and more ground time to improve on density with the orange network.

So, the network has been built out and we're in the process of procuring some of that white capacity. We have the purple capacity already. And we're not looking to grow the fleet to accommodate Tricolor necessarily. We're looking to kind of redesign the network and leverage the assets that we have, with the exception of the white capacity, we'll be purchasing incremental capacity on the white and bringing a lower cost to serve in that lower-yielding business.

I think an important point on that as well for Tricolor, from my perspective, from an operational perspective and efficiency perspective, it allows the hubs like Memphis hub to do what it's designed to do, and that's accommodate the express network. So, the orange tail that I referenced, and the white tail will not be feeding into Memphis, for example, the way it was in the prior structure. They will be feeding to other points and picked up by our very expansive ground network. And that eases the congestion at the hub to accommodate the purple express business.

So very exciting. Like I said, the networks are being built. We're working on density and the technology associated with maximizing the leverage there.

Garrett Holland
Analyst, Robert W. Baird & Co.

And staying with ground operations, just to take a different view on the competitive landscape. Do you still see significant excess capacity in the parcel market for ground operations? Obviously, you're doing your part in taking capacity out. But where do you see, do you see a capacity imbalance today? Or has that been corrected?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

I think a large part of that, when I hear conversations on the excess capacity, is attributable to the Postal Service. There's a lot of excess capacity there. What I can say from FedEx standpoint is we monitor our capacity on a regular basis. And especially for peak season, we're prepared to take on that volume. And as we get beyond peak season, we'll be monitoring that and making adjustments as needed, both plus and minus.

Garrett Holland
Analyst, Robert W. Baird & Co.

When you think about the volume growth outlook, especially your focus on profitably growing your business. What does the slope of that line look like? What do you think are some of the longer-term growth drivers on the volume side?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Yeah. Well, as I said, industrial production, we expect will be a contributor. I think it's a matter of when, not if. So, we'll be well positioned, as I said, for that. E-commerce is going to make up a large percentage, probably up to 90% of the volume growth that our ground network and our freight business will be the beneficiary of. So can't ignore that, that volume is going to be there, we just have to find the right cost structure to accommodate it.

Garrett Holland
Analyst, Robert W. Baird & Co.

And maybe shifting gears and talking a bit about the freight business, too. Some different capacity dynamics going on in LTL. How do you appraise the industry landscape following Yellow's demise and the excess capacity dynamics that perhaps exists in the LTL market?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Yeah. Any time there's new capacity that comes in the market, you pay attention to it. But what I can say is the pricing environment has remained rational and disciplined. There's plenty of capacity in the marketplace for sure. And I think you're seeing some of the heavier freight go over to the truckload business that has a lot of excess capacity. So, we're continuing to take a disciplined approach, focus on revenue quality and manage our capacity until we get to a point of return of volumes. You're seeing volumes are softer as well as the kind of weight per shipment is down slightly, roughly 3%, but we're seeing a 5% improvement in the per hundred weight. So, you have a strong pricing environment, and we'll be very capable of adapting to the return of the volumes.

Garrett Holland
Analyst, Robert W. Baird & Co.

That's helpful and good to hear, rational pricing there. I guess what do you see is the margin potential for this business or the role FedEx Freight plays from a linehaul standpoint with FEC?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

The role freight plays with FEC?

Garrett Holland
Analyst, Robert W. Baird & Co.

Yeah, just from a linehaul, the integration between the business.

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Yeah. So, freight plays a role and particularly in peak season provides some extra capacity during the peak season, and will continue to do so. Freight also does a lot of drayage for FEC. So yes, it's a very complementary relationship, and I expect that to continue.

Garrett Holland
Analyst, Robert W. Baird & Co.

And you previously announced a strategic review of the freight business, I guess, are you still expecting that process to conclude by the end of calendar 2024?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Yes. We said that we expect that assessment to conclude and expect to announce the outcome of that assessment by the end of the year.

Garrett Holland
Analyst, Robert W. Baird & Co.

That's great. I guess just thinking about the guidance as it stands today, fiscal 2025, you're looking for earnings power at $20 to $21. What are the key sensitivities that you see as you recently adjusted that range, achieving the low end or achieving the high end?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

So, when it comes to guidance, and I've referenced it a couple of points in this conversation, it's something I take very seriously. And when I look at the mechanisms in place that are going to impact our year as we go forward here. We've got DRIVE, which I said we haven't given up on the numbers, and we haven't. We're committed to that $2.2 billion. But we have those revenue actions that I talked about between the GRI, the peak surcharges and fuel adjustments as well.

So, several of those pricing actions, as I said, came in higher than we expected coming into the year. So that's all factored into how we come up with our guidance. And it's a demonstration of our commitment to the numbers and where we think we're going to land. And so, it's early in the year when we announced earnings and so we’re focused on continuing to deliver.

Garrett Holland
Analyst, Robert W. Baird & Co.

I think one of the changes investors should expect is a different approach to capital allocation. Specifically, we see it with the CapEx, the rev target, it's less than 6.5%, describe your approach and the priorities for capital allocation as we look out for the next couple of years?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Yes, this is an area that I'm really excited about in our progress in this. My compliments to the company and the way they went about investing in the aircraft and the fleet, and what I can say, they bought the best airplanes that are out there coming from the airline side, the 777 is a great airplane, the 767 is a great airplane. So, we have a modern, efficient fleet, probably the youngest fleet in the space in what we do.

Now it's time to reap the benefits of that fleet. And we've turned our attention to Network 2.0 and investing in those areas where we get the most return on our invested capital. And from an ROIC standpoint, I think it's important to note that now is a part of our incentive compensation. So, we're focused on investing our capital where it will deliver the most returns. That includes a lot of the modernization we're doing on our ground network and our hub modernization. Some of you may have seen recently in the press Memphis opening of the new Memphis hub and so a lot of investment there. It's just going to make us more efficient.

So, my approach to this as we've seen the decline from roughly $6.3 billion, $6.4 billion a couple of years go down to the $5.2 billion. We expect another $5.2 billion this year. And again, focusing on the highest returns and continuing to be disciplined on where we spend. I think what I referred to earlier about the program we have in place with capital review board that takes a more holistic centralized approach versus a separate operating companies before. That's already yielded results where we're questioning the organization. Do you need that? Do you need that now? Can you combine that with other projects that some of the other parts of the business are working on? So, there's a whole new disciplined approach to capital.

Tied in with all this is our capital return to shareholders. We're excited about the share repurchases we've done as well as the dividends and the sequential increase in our dividend. So, all that taken together, I think we made some very good progress there.

Garrett Holland
Analyst, Robert W. Baird & Co.

And we talked about, hopefully, a recovery in industrial production activity. But the block for the operating income walk for revenue net of cost increases is pretty low. But the FedEx business has significant leverage during the freight market recovery. Help us dimension that opportunity and potential as you've outlined $100 billion of revenue potential as we think about long-term targeted profitability.

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Look, it's something we're focused on. We were disappointed in Q1. And I think to improve on that performance is exactly all the things we've been talking about here today, both on the revenue and the cost side. So that's how we're approaching the business. It's getting daily attention. And so, we're looking to continue to improve on that.

Garrett Holland
Analyst, Robert W. Baird & Co.

And I guess we covered a lot of ground today. But just to summarize for investors, why is this time different at FedEx? You've clearly got some structural – some fundamental changes going on at the company with DRIVE and Network 2.0 and the execution has improved, as you talked about through fiscal 2024. Why is this time truly different at FedEx?

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Well, I think it's important to let the facts speak for the company in response to that question. I referenced before the FY 2024 results were the first time really in the company's history, in a declining revenue environment, improved on earnings and operating margin. And that was no fluke. I just talked about the reducing the capital intensity. I talked about the DRIVE initiatives, bringing the companies together.

It's a new day. And the company has done an amazing job operating with the separate operating companies and building the companies into what they are today. I'll use freight as an example. FedEx built the freight into the largest freight LTL operator in the country. So – but the things we're doing now, the steps we're taking, One FedEx, Tricolor, all these initiatives, hopefully prove based on the fact that it's a new day.

Garrett Holland
Analyst, Robert W. Baird & Co.

Well, with that, we're out of time. Special thanks to John and the FedEx team for being here. Great perspective. And thanks for all for a great day one of the conference. Appreciate it.

John W. Dietrich
Executive Vice President & CFO, FedEx Corp.

Thank you.