FedEx Q1 FY21 Earnings Call Transcript – September 15, 2020

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

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

Joining us on the call today are members of the media. During our question-and-answer session, callers will be limited to one question in order to allow us to accommodate all those who 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 forward-looking statements are subject to risks, uncertainties, and other factors which could cause actual results to differ materially from those expressed or implied by such forward-looking statements.

For additional information on these factors, please refer to our press releases and filings with the SEC. Please refer to the Investor Relations portion of our website at FedEx.com for a reconciliation of the non-GAAP financial measures discussed on this call to the most directly comparable GAAP measures.

Joining us on the call today are Fred Smith, Chairman; Raj Subramaniam, President and Chief Operating Officer; Alan Graf, Executive Vice President and CFO; Mark Allen, Executive Vice President, General Counsel and Secretary; Rob Carter, Executive Vice President, FedEx Information Services and CIO; Brie Carere, Executive Vice President, Chief Marketing and Communications Officer; Don Colleran, President and CEO of FedEx Express; Henry Maier, President and CEO of FedEx Ground; and John Smith, President and CEO of FedEx Freight.

After our Q&A session today, Fred and Alan will have some additional comments. And now, Fred Smith will share his views on the quarter.

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

Thank you, Mickey. First and foremost, my sincere thanks goes to our team members for their outstanding and ongoing efforts to respond to COVID-19 challenges. At FedEx, keeping the world connected in good times and during periods of great need is who we are and what we do every day.

But safety is our first priority. We work tirelessly to keep the world's industrial, healthcare, and at-home supply chains flowing during the pandemic. Detailed planning is underway at FedEx to distribute vaccines at scale world-wide once approved. Our earnings growth underscores the importance of our business initiatives and investments over the last several years. In many ways, the world has accelerated to meet our strategies, and we remain very confident in the future of FedEx.

This will be Alan Graf's last earnings call and we are very, very grateful for his more than 40 years of dedicated service. Alan has been a part of every significant decision and helped navigate tremendous growth, strategic investments, international acquisitions, and global and market change. FedEx would not be the globally admired corporation it is today without Alan's leadership.

Mike Lenz will assume the role of CFO beginning 22 September, and Alan will remain a Senior Advisor until the end of December. At the end of this call, I will ask Alan to say a few words.

I would also like to thank John Edwardson, who is retiring from the FedEx Board of Directors, for his wise counsel and more than 17 years of service. Our Board of Directors has approved resolutions of appreciation for both Alan and John that provide in greater detail their invaluable contribution to FedEx's success. I will share the highlight of these at the 21 September shareholders' meeting, and the resolutions themselves will be posted on our Investor Relations website.

Let me now ask Brie, Raj and Alan to provide their comments, after which we will take your questions. Brie?

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

Thank you, Fred. Good afternoon, everyone. The economic outlook remains uncertain due to the continued impact of COVID-19 around the world. Until a vaccine is available globally and the virus is contained, forecasting the economic recovery remains challenging.

In the US, spending that would normally have gone into services has shifted towards goods, with goods spending boosted further by pent-up demand. Retail sales are growing again year-over-year and e-commerce is booming at holiday levels, and of course, more to come on that in a moment.

The service sector, severely impacted by the pandemic and high unemployment rates, continues to weigh on growth. Outside of the US, recovery has taken hold as well as coronavirus-related restrictions have been loosened. Manufacturing output is improving off the April low and trade activity is on the mend.

Trade – global trade volumes, which declined 10% in the first half of calendar year 2020, have resumed sequential growth. However, given the depth of the downturn, we expect global GDP and trade growth on a year-over-year basis to remain negative for the remainder of this calendar year. There are two trends that have had substantial impact on our industry and showcase FedEx's incredible value proposition. The first key trend is the dramatic reduction of air cargo capacity as a result of the significant loss of commercial airline capacity.

Current estimates indicate that freighter capacity now accounts for 66% of total air capacity on the transatlantic lane, 83% on the transpacific, and 80% on the Europe to Asia lane. This compares to pre-COVID freighter capacity of 33% for transatlantic, 59% for transpacific and 50% for Europe to Asia.

FedEx Express is incredibly well-positioned to benefit from a constrained air capacity market. We've experienced elevated demand, enabling both the expansion of existing customer relationships and the development of new customer relationships.

Ultimately, we believe this is an opportunity to disintermediate traditional freight forwarders' commercial relationships. Internationally, demand was the strongest on the Asia transpacific lane, with lower percentage of PPE shipments month-over-month. Europe's demand continues to be driven by the growth of e-commerce.

The international team has done an excellent job managing demand and mix. As you will note, our premium International Priority package volumes were up 31% year-over-year. We continue to monitor the air freight pricing environment and air freight yields remain strong. We are renegotiating base contracts to better reflect current market conditions and to establish longer-term commitments.

The second, and perhaps more profound, trend is the acceleration of e-commerce. Pre-COVID, we projected that the US domestic market would hit 100 million packages per day by calendar year 2026. We now project that the US domestic parcel market will hit this mark by calendar year 2023, pulling volume projections forward by three years from the previous expectation.

E-commerce, fueled substantially by this pandemic, is driving the extraordinary growth. In fact, 96% of the US growth is expected to come from e-commerce. While e-commerce as a percentage of total retail has declined from its apex in April, it remains elevated. E-commerce as a percentage of total retail for Q2 calendar year 2020 is estimated at 21% compared to 15% in Q2 calendar year 2019.

We have built a strong portfolio of e-commerce services and digital solutions that offer the best value proposition in the market with best-in-industry yields. In the United States, FedEx is unsurpassed when it comes to our ability to make residential deliveries seven days a week, year-round, to optimize network capacity and enhance the customer experience. Sunday coverage now reaches nearly 95% of the US population.

And as I have mentioned on previous calls, returns reinforces the integral value proposition of FedEx services in e-commerce, while increasing commercial business. Returns drives e-commerce volume into our retail channels. In the first two months of fiscal year 2021, more than 50% of Express and Ground returns were tendered at retail, increasing from 44% for the same period last year.

In August, we completed the Dollar General expansion. FedEx has more than 27,000 staff locations with 92% of the US population now living within five miles of a FedEx pickup or drop-off location.

Our vast network and proximity to consumers provides small and medium e-commerce merchants with the “buy online pickup in store” convenience without the brick-and-mortar expense. FedEx Delivery Manager enrollments increased more than 60% in fiscal year 2020.

And today, FDM enrollees are interacting with deliveries more than they ever have before. As we look ahead to peak, we believe e-commerce will keep volumes elevated and it will be a record-breaking peak. We have prepared for what we're calling the “shipathon”, and we are warmed up and we're ready to deliver.

As we prepare for a peak like no other, we continue to be very focused on revenue quality, while ensuring we are providing our customers with the best service possible during this challenging time. We will be implementing several peak surcharges to ensure that we are covering the increased cost of delivering shipments, and those customers who are consuming the largest proportion of capacity in our network are charged accordingly. These peak surcharges will help us manage increased demand, while maintaining strong levels of service for our entire base of customers.

We are collaborating with our largest e-commerce customers to leverage capacity and to develop creative solutions to smooth out demand spikes during the peak season. We are working diligently to protect our small and medium customers from the impact of most peak surcharges to ensure that their nascent recovery continues to grow post-COVID. The small and medium customer segment was our fastest-growing segment with high double-digit revenue growth in the quarter, and FedEx continues to champion and support their recovery.

Finally, as we prepare for vaccine distribution, we believe the most critical attributes needed to tackle the size and scale of this monumental supply chain initiative are visibility, extensive temperature control and intervention capabilities. That's why we were thrilled to announce the launch of FedEx SenseAware ID yesterday.

SenseAware ID is the latest in next-generation sensor-based proprietary FedEx technology, which provides enhanced package visibility for shipments using a compact sensor that transmits location every two seconds. SenseAware ID will initially be applied to First Overnight shipments within the US domestic Express network and is eventually planned to include other premium services.

We believe this innovation adds a critical feature to the anticipated vaccine distribution efforts and the continued movement of lifesaving pharmaceuticals and medical supplies. Beyond healthcare, we are confident this innovation will attract customers in other high-value industries such as aerospace.

With that, I'll turn it over to Raj for his remarks.

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

Thank you, Brie, and good afternoon. Let me start by first echoing Fred's sentiments about the valiant effort of our team members during this historic time. We are exceptionally proud and grateful of our FedEx team members who work diligently each day to deliver the Purple Promise, especially in the midst of the ongoing global pandemic. Thank you, Team FedEx, for your commitment and dedication during this dynamic time.

FedEx has nearly 50 years of experience flexing our networks to stay ahead of what's next. Over the past couple of years, we've launched a number of strategic initiatives to directly address e-commerce opportunities.

To recap, this includes expanding US Ground residential delivery to every day of the week; integrating SmartPost package volume into the Ground network; investing in technologies that enable real-time decisions and optimize virtually all aspects of our operation; building our network's capabilities to more efficiently handle an increase in large items such as furniture, exercise equipment and TVs; offering the FedEx's first FedEx branded through-the-door service, which moves larger, bulkier items into customers' homes and businesses; and accelerating the expansion of our retail convenience network with Dollar General, Walgreens and our own FedEx Office locations.

While our strategy did not change, the timing certainly did. The growth that we expected to see over a period of three to five years happened in a period of three to five months. Our strong financial results from the quarter are largely driven by the excellent execution of our aforementioned future-ready strategy coupled with the acceleration of e-commerce trends. We're also happy to note that our B2B volumes across the segments have continued to steadily improve over the summer with Ground B2B average daily volume in August exceeding prior year levels.

As we look to Q2, we enter what we expect to be a peak holiday shipping season like no other in our company's history. We are working closely with our customers and building solutions to enable them to succeed. We're also adding more than 70,000 positions in key markets across the United States.

New and expanded Ground facilities planned prior to peak will provide additional strategic capacity, including six regional sortation facilities each strategically located to provide short-haul solutions for large retailers, four new automated stations, eight new or expanded large package facilities, and 50 existing facilities are being expanded with additional material handling equipment and automation.

Additionally, we are optimizing the use of our existing capacity through seven-day year-round US operations, expanding and adding sorts at dozens of facilities and repurposing SmartPost facilities for Ground package sortation. Many elements of the Ground transformation are on track for completion this fall, positioning us to improve last mile efficiency as we serve the rapidly growing residential market.

As of this month, our route optimization technology is available to service providers operating out of 95% of our facilities, and Sunday residential deliveries available to nearly 95% of the US population. SmartPost integration will be completed next month, thus increasing density and driving down our cost to serve as Ground residential volume is sorted and delivered in one network this holiday season.

Now, turning to FedEx Express; Q1 marked a historic start to fiscal year 2021, driven by strong revenue trends globally and relentless execution of our ongoing strategic initiatives. With air capacity at a premium, we are positioning our assets towards our most profitable customers to enhance our revenue quality.

We continue to pursue actions to further transform and optimize the FedEx Express international business, particularly in Europe, including expansion of our e-commerce capabilities. The rationale for the TNT acquisition remains sound, and the benefits will accelerate as we complete full network integration over the next 18 months.

We expect to complete the final phase of international air network interoperability in early calendar 2022. The acquisition of TNT provides us with a strong portfolio that we can build on and compete with in Europe. Having said that, we clearly understand that there's a significant opportunity ahead of us to improve our performance in the region. Our European team is hard at work to execute that mission.

Let me also take this opportunity to highlight FedEx Freight for delivering outstanding results this quarter, including record quarterly operating income and the highest operating margin since fiscal year 2006. These results reflect Freight's commitment to profitable growth and revenue quality and laser focus on safety and their ability to manage the network to volume levels.

Collaboration between operating companies reached historic levels in Q1. Last Mile Optimization, which allows us to flex our network, reduce cost, increase delivery density for residential and rural packages has successfully launched in 57 origin markets.

FedEx Freight has provided more than 20 million miles of road and intermodal support, and delivered more than 750,000 non-conveyable shipments for FedEx Ground so far in fiscal year 2021.

To put this in perspective, Freight had never delivered a Ground package before May of this year. The support in Q1 alone far exceeds the less than 1 million miles that Freight had provided Ground throughout fiscal year 2019. And our FedEx Logistics and FedEx Express operating companies continue to work together to secure air charters for customers in the US.

Before I close, I'd like to circle back to Brie's comments about yesterday's launch of SenseAware ID and the value our sensor-based technology brings to the healthcare industry. We recognize that shipping vaccines is complex and critical work. The FedEx network is well-positioned to handle these shipments with our temperature control solutions, real-time monitoring intervention capabilities, and of course our unparalleled network.

Today, we have more than 90 cold chain facilities across the Americas, Asia, Australia and Europe, and plan to open additional facilities in the coming years. Simply put, FedEx is the transportation and logistics provider with the network, technology, and know-how to distribute vaccines when they are ready.

Let me close by making three broad points. Number one, everyone is, of course, aware of the value our global networks provide to the movement of the industrial economy, highlighted with such clarity by the healthcare sector in recent times. It is now also abundantly clear the critical role that our industry plays in the growth of e-commerce. Number two, within our industry, the FedEx portfolio is becoming increasingly differentiated. And number three, our foundation is solid, and I'm confident that the best years for FedEx are ahead of us.

Now, before I hand it over, let me also add my sincere thanks and appreciation to Alan for his more than 40 years of service to FedEx and incredibly almost 30 years as CFO. His contributions to FedEx are legendary. And on a personal note, I've certainly benefited from his wisdom and council especially during the past 18 months.

So, now, let me turn it over to Alan B. Graf for his final quarterly earnings remarks as Chief Financial Officer of FedEx Corporation. Alan?

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

Well, thank you very much, Raj, and good afternoon, everyone. I'm very proud of our first quarter performance. Adjusted operating margin improved 240 basis points year-over-year to 8.5% as FedEx Express adjusted operating income more than doubled and adjusted margin improved 390 basis points.

FedEx Ground operating income increased 30% despite a significant mix shift to residential delivery. And FedEx Freight operating income increased 41% despite a 9% decline in average daily shipments.

All totaled, our first quarter adjusted operating income increased 56% year-over-year, primarily due to International Priority volume growth of 31%, a surge in demand for US residential delivery, yield improvement at FedEx Ground and FedEx Freight, a $130 million benefit from an additional operating day, a $65 million benefit from a reduction in aviation excise taxes provided by the CARES Act, and a better alignment of our expenses especially at FedEx Freight. These factors were partially offset by higher costs driven by the package volume surge, and expanded service offerings at FedEx Ground, increased variable compensation expense, and an approximate $100 million in COVID-19-related cost to ensure the safety of team members and customers.

Variable compensation expense increased $195 million year-over-year with approximately half of the increase due to a reversal of long-term incentive plan accruals in the prior year period. Our effective tax rate was 22.5% for the first quarter compared to 25.2% in the prior year period. This year's tax rate was favorably impacted by changes in our corporate legal entity structure and increased earnings in certain non-US jurisdictions.

We ended the quarter with $7 billion in cash and cash equivalents and with $3.5 billion available under our credit facilities. Last month, we issued $970 million of Pass Through Certificates with a fixed interest rate of less than 2%. The Certificates are secured by 19 Boeing 767 and Boeing 777 aircraft. This transaction provides us additional liquidity flexibility as we move forward and affirms the availability of financing in the cargo aircraft market despite the uncertainties and unprecedent disruption in commercial aviation.

Looking forward, we are not providing a forecast of expected earnings per share for fiscal 2021. While business demand improved in the first quarter, continued uncertainties cloud our ability to forecast full year earnings. However, based on the current trends in our business, we anticipate increased demand to result in higher revenue and operating income at FedEx Ground and FedEx Express for the remainder of fiscal 2021.

In addition, yield management and improved productivity is anticipated to contribute to revenue and operating income growth at FedEx Freight in FY 2021. If our current trends continue, we expect certain expenses, including higher variable incentive compensation accruals and increased supplies and other costs related to the COVID-19 pandemic to remain headwinds in fiscal 2021.

We incurred $49 million in TNT integration expenses in the first quarter, down from $71 million last year. We expect to incur approximately $175 million of TNT integration expenses this fiscal year. The aggregate TNT integration expense is still expected to be approximately $1.7 billion through the completion of our physical network integration in FY 2022.

Our FY 2021 capital expenditure forecast has increased slightly to $5.1 billion driven by additional capacity initiatives to support increased volume levels. The new forecast is $800 million lower than last year's capital spending.

I'll conclude by reemphasizing that we expect to continue to benefit from our strong position in the US and international package and freight markets, yield improvement opportunities, and cost management initiatives.

Now the operator can begin the Q&A session.

QUESTION AND ANSWER SECTION

Operator: Thank you. We'll hear first today from Tom Wadewitz with UBS.

Thomas Wadewitz
Analyst, UBS Securities LLC

Yes. Good afternoon, and Alan congratulations again. Great career and, wow, what a way to sign off with such a strong quarter. Let's see, I wanted to ask how you think about the trends in the business in terms of were there some things that you think fell off in the quarter would fall off or do you think the performance Express, Ground from a revenue and margin perspective are likely to continue and you got to forecast earnings kind of accordingly?

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

Tom, thanks for your kind comments. I appreciate them. I will say this, knowing that I was going to get a couple of forecast questions, I did work really hard this time to give you two howevers and a reemphasize in my opening remarks. And I would think if you would go back to those, that's about as good as you're going to get from me today.

Mike Lenz is probably going to be in the same boat in December as I am today with all these uncertainties. It's just really too difficult to say. But I did say if current trends continue, I thought we'd improve our operating incomes at all three of the major OpCos in 2021.

Thomas Wadewitz
Analyst, UBS Securities LLC

Okay. I mean, was there anything that was one-time-ish kind of in the quarter or not?

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

Well, fortunately, for me, I had planned years in advance to have one extra operating day this quarter when I knew I was leaving. But other than that, nothing.

Operator: We'll hear next from Jack Atkins with Stephens.

Jack Atkins
Analyst, Stephens, Inc.

Great. Good afternoon. Congratulations on a great quarter. And Alan, let me echo Tom's congratulations on your retirement.

I guess this one is for Raj, but I would appreciate Brie's thoughts as well. The pulling forward of your 2026 domestic growth expectations forward to – by 3 years to 2023 indicates to me that what you're seeing is more than sustainable.

So, my question is, when you think about your Express, your Ground, your Freight networks, where do they stand today in terms of capacity utilization? How do you think about balancing the need to remain capital disciplined and upgrading your revenue on one hand versus the desire to grow and participate in such a strong market tailwind on the other hand?

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

Let me start first and then Brie can add to it. Clearly, we think the same thing. I think the e-commerce market is large and it's growing, and the growth has accelerated as pull forward by three years. And so that's clear now.

The second thing that's clear is the value that FedEx provides to the growth of e-commerce. We work strategically with several of retailers around the world and particularly in the US to provide the solution. So, we are in a way – when you hear of stories about e-commerce growth across different retailers, you can bet that FedEx is behind those stories.

And thirdly, we are going to be very disciplined in how we manage capital and our revenue quality going forward. But we are, most importantly, working to provide the best solution possible for our customers working hand in hand to be creative in solutions for e-commerce and working strategically with them. So, Brie?

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

Really not much to add. The only thing I will say is Henry and I are lockstep. We're trying to thread that needle of improving quality, but also again a reminder, we keep talking about Sunday as a delivery advantage from a customer perspective. It's also an incredible advantage from a capacity perspective.

And we are strategically leveraging that, partnering with customers who can pull volume forward into the weekend. And I really don't think that that has been factored in previously. And customers understand this and it's a huge strategic advantage going into this peak and several peaks in advance.

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

Brie, there's another one there. Why don't you take it? We just hand it to you there.

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

Sure. I've also got a question about Walmart's new subscription service, Walmart+. So, I can't talk a lot about the relationship. Obviously, it's one we value very much. It's strategic, it's long term and we're committed to growing with them. We have a very healthy partnership there. We're very excited about it.

There's also some questions here about SameDay. I want to highlight, as we think about the market growing, the market is essentially going to double in size by 2026. So, when I gave those numbers, I think that's the other thing that's been lost as the market is going to double by 2026. SameDay, from an e-commerce perspective, remains a very tiny percentage of the market. So, we continue to be focused on the remainder of the market, but we're very excited about our partnership with Walmart.

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

I should note when you talk about the seven-day network, it's not only capacity and the advantages that Raj and Brie mentioned. It also is very cost effective because it spreads the fixed cost across many more units.

Operator: We'll go next to Chris Wetherbee with Citi.

Chris Wetherbee
Analyst, Citigroup Global Markets, Inc.

Yeah. Hey, thanks. Good afternoon. I guess I wanted to ask about sort of the pricing strategy going forward. So, surcharges are coming in and appear to be having some decent impact on yields, particularly on the Ground side.

As you think about sort of maybe in the next six months or so, how you might attack sort of the pricing opportunity, how much do you think comes to the surcharges? Do they have the risk of being a little bit more temporary? And how much can you start to embed in longer-term contracts as you move through the next six months?

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

So, I think everybody is aware, from a domestic perspective, we put in our surcharges on June 8. That was the $0.30 and the $0.40 for SmartPost, the $0.30 being for the residential surcharges. We have announced that we've had to increase those surcharges as we head into peak.

The oversized portfolio will increase in early October, and then we will increase our holiday surcharges from November through to January 17. So, surcharges are certainly an important part of our revenue quality, but I would say that they are one piece of that. We have actively had conversations with our top 25 and now moving to our top 100 customers, and we've got a multi-tiered strategy here.

As I talked about earlier, we are rewarding customers that can pull volume forward. We are rewarding customers that can integrate their supply chain that are open to longer-term contracts. And, of course, from a capacity perspective, we are no longer just taking inbound forecast. We are working with customers, and we are having kind of a balanced conversation between base yield, surcharges and capacity management. So, it's a multi-tiered strategy.

Most importantly, we're planning for the long term. We want strategic relationships. We want to partner with customers that are going to win in the market, and we think we're doing a really good job of that. And my hats off to the sales team because they have just done an excellent job with this.

Operator: We'll move next to Allison Landry with Credit Suisse.

Allison M. Landry
Analyst, Credit Suisse Securities (USA) LLC

Thanks. Good afternoon. So, your main competitor signaled that SG&A could be a big focus for cost reductions. And maybe as we think broadly about FedEx's overall cost structure, do you also see opportunities to lower SG&A? In other words, what are some of the incremental cost opportunities that you have going forward beyond the TNT integration, SmartPost integration, et cetera, that we might be able to think about in terms of margin improvement going forward? Thank you.

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

Allison, I think we've done a really good job with SG&A. Obviously, one of the headwinds is a good one, is if we're able to pay additional incentive compensation to our teammates for the great job that they're doing versus what we've been able to do in the past. I think our SG&A is structured such that we can grow very rapidly with very little addition to our SG&A going forward. We're becoming much more productive.

I even have bots in the accounting department, and I'm very excited about where we stand in that regard. We'll continue to work very hard on productivity and density and stops per hour. Our new airplanes provide us greater reliability and lower cost, almost any way that you can measure it, and those will continue. So, I think that we're rigged for not only a great pricing and revenue performance, but also cost performance going forward.

Operator: And from Goldman Sachs, we'll move next to Jordan Alliger.

Jordan Alliger
Analyst, Goldman Sachs & Co. LLC

Yeah. Hi. Congratulations, Alan, on the retirement. My question is on margin seasonality. Realizing this is not a particularly typical year, would you anticipate though sort of typical ebb and flow of Ground and Express margins as we move through the quarters from here? Or what could be something that alters the normal patterns? Thanks.

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

I'd say that the history is probably not as good a predictor of this year as it otherwise has been. You're right about normally our summer is our weaker and our fourth quarters are stronger. But the acceleration of the traffic that we've been able to handle this quarter was so much bigger than a year ago as to be almost unbelievable. When COVID hit, obviously, we took some hits, so it's going to be spotty. And I'll stand by my two howevers and my reemphasizes as the rest of my forecast.

Operator: We'll move on to Duane Pfennigwerth with Evercore ISI.

Duane Pfennigwerth
Analyst, Evercore ISI

Hey. Thanks so much for the time. A question for you on Europe; some of the investors we spoke with were looking for better quantification of what a turn in Europe could be worth. Can you speak to how much TNT is holding back Express margins currently and maybe can you frame the opportunity for profit improvement in Europe?

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

Let me start and I'll give it to Don Colleran for his comments. Obviously, we're not going to be able to quantify the level that you like. However, we are – clearly, that's our biggest opportunity ahead of us in the international markets is to make sure that we perform better in Europe. I think the integration activities of TNT have gone apace, and we're in a position now to take advantage of the portfolio that we have to do exactly that.

Just to remind you, before TNT acquisition, we were heavily – we are intercontinental Express and intra-European Express, we were good, but we didn't have a presence in the intra-European ground or the domestic markets. Now we do. And so, this portfolio is going to stand us in good stead, and we believe that's a good opportunity ahead of us, and the team is very focused on executing against that plan. Don?

Donald F. Colleran
President & CEO, FedEx Express, FedEx Corp.

Thanks, Raj. A couple of comments, one about Express and I'll quickly get to what our plans are in Europe. First, I want to thank and recognize the amazing Express unit, men and women of that team that put together a fantastic first quarter.

Great planning, but even better execution supported wonderfully by our commercial partners in sales, marketing and IT that really made the quarter the historic look that it is.

However, at Express, as a coach from New England once said, we have moved on to quarter two. We've got our head down and we're focused on peak season planning as well as hoping that a vaccine is around the corner. And we're uniquely positioned, as Raj said earlier, to handle that with our global network.

When you think about Europe, though, you need to think about what Raj said earlier. We're essentially where we told the Street we would be in terms of our transformation and integration. By April of 2022, we'll hopefully be fully integrated on the air side. But we have really solid plans for our European theater.

We have an excellent team on the ground that's supported by an amazing team globally. And as we are, in our rest of our units and regions, we're focused on execution. And I just think if you watch the team execute on these plans, they are solid, and they have a track record of making things happen and we expect that to be the case in Europe as well.

Operator: We'll move on to Scott Group with Wolfe Research.

Scott H. Group
Analyst, Wolfe Research LLC

Hey, thanks. Good afternoon, guys, and best of luck in retirement, Alan. So, I wanted to ask if the demand is still there as we get into peak season, does the Ground network have the capacity to maintain 30% volume growth through peak? And then Express yields were still down year-over-year. With all the pricing strategies going on, do we see opportunities to start seeing Express yields increases?

Henry J. Maier
President & CEO, FedEx Ground, FedEx Corp.

Scott, this is Henry Maier. We've been operating at peak since March, so the stepping off point for peak this year is frankly not as much as it's been in years past. It's important to point out here some of the things that have already been said. We're operating a seven-day network every day of the week year-round.

We will have SmartPost fully integrated into the Ground network by peak, which allows us to repurpose 28 former SmartPost facilities for large and small package operations and Ground sortation. And I might add, that's pretty cheap capacity to get. We're running much higher yielding packages through it than we have in the past. And as Fred pointed out, better asset utilization lowers fixed costs across the whole network.

In addition, you saw the announcement on 70,000 new hires for peak. That's on top of a historic number of employees at FedEx Ground right now. Our service providers have stepped up and hired tens of thousands of new drivers since all of this began back in March. We're adding six regional sort facilities, four new automated stations.

We have about 50 projects underway, which include expansions of existing facilities, additional automated sortation capabilities and material handling, and then all the other things that we typically do at peak in terms of being able to squeeze additional capacity out of the network for a fairly short period of time. So, we're highly confident that we're going to have a great peak this year. It's going to be busy, but nevertheless, I would say that the Ground team is ready.

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

Let me take the international yield question. So, I think most important to understand is that if you look at the yield, half of the impact for both domestic Express as well as international Express was fuel. When you strip out the fuel impact, there was pressure from a weight per package perspective and the growth of e-commerce led by growth, when we're very excited about this growth, Europe outbound from an e-commerce perspective.

That being said, we're doing a really good job partnering with Don and his team on density, and the yield per pound is up significantly. So, you can't just look at international Express yields quite frankly just at the shipment level. You've got to look at yield per pound. And overall, from a network perspective, total Express yield per pound is up 7% year-over-year. So, we feel really good about the overall performance from a yield perspective with those things taken into consideration.

Operator: From Wells Fargo, we'll move next to Allison Poliniak.

Allison Poliniak-Cusic
Analyst, Wells Fargo Securities LLC

Hi, guys. Good evening. So just keeping on Ground, nice incremental operating leverage within that business. Raj, you had talked a little bit about maybe some – obviously some more incremental opportunity out there. But as you look at that business today, would you think longer term – is there anything structural that would hinder you guys getting back to sort of a mid-teen operating margin level in that business?

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

Firstly, the most important thing about the network that we have provided with Ground is the better value proposition in the marketplace that we provide our customers. And I think that's translating into more business and more profitable business.

And the things that we have put in place not yesterday, but over a period of the last year or two is now, as Fred pointed out, is paying off in many ways. So, the target is, of course, to continue to both improve revenue and margins as we go forward, and we believe we have the structure to do just that.
I don't know, Henry, if you want to add any more to that.

Henry J. Maier
President & CEO, FedEx Ground, FedEx Corp.

Allison, let me just say a couple of things to add on to Raj's comments. Now the first quarter of fiscal 2021 was FedEx Ground's highest quarterly revenue and operating income quarter in history. In spite of that, those results flow from a number of steps we took several years ago to transform FedEx Ground and position FedEx to prosper in a market increasingly dominated by e-commerce.

I've spoken of the integration of the Ground and SmartPost networks. I spoke of the expansion of seven-day. You can't do any of this without the introduction and use of world-class technology. We're about a week away from having completely rolled out our advanced route optimization software to all the drivers. I should point out to you that this was developed using SAFe/Agile methods and was rolled out across our network in the middle of a 100-year pandemic in 13 months. That's pretty damn good if you ask me.

Not only does this enable our service providers to better plan routes, fleet type, number of trucks, types of trucks, volume on trucks on a dynamic daily basis, but it's already improved significantly final-mile efficiency, specifically increasing stops per hour in the network in spite of everything we've already talked about in Q1.

The integration of SmartPost volume into the networks improved density both on a square mile basis and on a delivery basis, driving the average costs of our stops down. So, I think where we sit today, our best days are ahead of us and we still have a lot of work to do here.

Operator: We'll hear next from Brian Ossenbeck with JPMorgan.

Brian P. Ossenbeck
Analyst, JPMorgan Securities LLC

Hey, good evening. Thanks for taking my question. So, I want to come back to your execution into the holiday peak season. I guess last year is obviously a bit tough with Cyber Monday coming in well above plan.

You're entering the same period here with a lot more volume, but also a lot more initiatives and leverage to balance it all out, some of which you've talked about here or announced recently. So, stepping back, how confident are you that it's enough to have a successful peak? And do you feel like you can make adjustments and recover if needed?

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

Well, let me start and then both Brie and Henry can add. I think this is going to be a peak like none other, but we believe that we have now the capabilities and the flexibility to do a lot. I think the number one thing that the customer is now looking for is capacity, and we are working strategically with them to make sure that we can deliver that.

Again, having operations seven days a week helps a lot here too, and the technology that we have. So, between the flexibility that we have in our infrastructure that we put together, with the technology that we have and the customer solutions we put together, we're thinking that we're going to manage to this peak quite well. Let me turn it to Brie for her comments.

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

I'll certainly let Henry talk about the physical capacity element, but from a customer perspective, we're really working hard to set expectations with our e-commerce merchants. I think they are very well aware that this is going to be a peak like no other. The most important thing for our customers' customers is to set appropriate expectations and give them transparency to the appropriate transportation commitment.

And we're working very hard to do that to set expectations, to give visibility and to expose that through all our digital channels and our customers' digital channels. So, we're working very hard. You also saw that we adjusted our peak surcharge specific to Cyber Week to make sure that customers really pulsed in their volume and that we help out Henry and the team wherever we possibly can. Henry, anything else?

Henry J. Maier
President & CEO, FedEx Ground, FedEx Corp.

Yes. I think the only thing I would add here is that even at the operations level, we have conversations almost daily with all of our top customers. Once again, this is not a new event at peak, but this has been ongoing since all of this began back in March.

When you're operating a seven-day network – let me back up and say, we're in a new normal here. And there's a new normal for FedEx, but there's also a new normal for all of our customers. And when you're operating a seven-day network, we have untapped capacity existing within that network if customers want to take advantage of that untapped capacity.

For example, we have ample delivery capacity on Saturday, Sunday and Monday. We have ample pickup capacity on Friday, Saturday and Sunday. If everybody wants to ship on Monday, then we're going to have to have conversations with people about how we modify that demand to fit the available capacity we have on one day a week. If customers are flexible, I think we can accommodate most of what people wish to ship this year at peak.

Operator: Helane Becker with Cowen has our next question.

Helane Becker
Analyst, Cowen & Co. LLC

Thanks very much, operator. Alan, it will be very sad to do these calls without you. I think I knew you the whole time you've been CFO. Best wishes this year. And to Don, thank you for all the work you do on behalf of the children at St. Jude that work is very important and very appreciated. And so on to my question.

Can you just talk about the vaccine and your distribution capabilities in the sense of the ability to either store or move goods, the vaccines that has to be chilled to minus 80 Celsius? And how – if you've thought about how that gets handled in places like India and Africa and Brazil, where in some cases, we have very strong networks, how we should think about your ability to participate in that? Thank you very much.

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

So, as we talked about earlier, Helane, we recognize moving vaccines across a global network is very critical work, and we believe that we have the network, the technology, the solutions to do just that. We have engaged with several of our customers who are in this vaccine production mode and we are planning appropriately for it.

And again, the timing is TBD at this point, but the capability that we have in – around the world, including the physical network, the storage solutions as well as the SenseAware ID that we just launched and our enhanced visibility platforms and the ability to intervene as needed is unique. And I think we are well situated to handle these vaccines. Let me turn it over to Don for – because a lot of those are going to travel on the Express network.

Donald F. Colleran
President & CEO, FedEx Express, FedEx Corp.

Thank you, Raj, and thanks for the question. Yes, I would like to add a little bit of color to this because we look at this really as a supply chain design opportunity. First of all, for many months, as you can imagine, we were talking with the major manufacturers and customers in the healthcare space, along with HHS, CDC and the FDA, so this will be clearly a global team effort.

What's unique about this opportunity when you think it through is there's a very good chance that the raw ingredients are going to be made in one country, the manufacturing of these vaccines in another country, another region, and the consumption and the need for this is global. And this is why we're uniquely positioned. When you look at the 220 countries that we serve, well over 600 aircraft that we have in our network and the ability to integrate that with our air and ground, we're uniquely positioned to support this critical initiative. And we're ready for it.

We're planning. We're planning for the mother of all peaks. But within that, we're also looking at the ability to move, on a global basis, these vaccines when they become ready. We're obviously hopeful like everybody else is that it's sooner rather than later, but when they do come and they came off the manufacturing line, we'll be able to support those manufacturers on a global basis.

Operator: We'll move next to David Vernon with Bernstein.

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

Hey, guys. Thanks for taking the question. Henry, I wanted to come back to the topics you brought up around kind of working with customers and flexibility. Anecdotally, we've heard from a couple of different shipping consultancies that some of the on-time transit performance for the Ground network is maybe lagging a little bit.

I just wanted to give me a chance to comment on how you feel service levels are trending. And then also, as you think about the next two to three years, given the pull forward in volume growth you're going to be pushing to the network, does that change your thinking about the size of the CapEx envelope for the Ground segment? Thanks.

Henry J. Maier
President & CEO, FedEx Ground, FedEx Corp.

Well, David, I've been in this business for 40 years. I've never seen a more difficult operating environment from the one we're in. We're dealing with a 100-year pandemic, absenteeism as a result in certain facilities, wildfires, hurricanes, social unrest, unlike anything I've seen since the 1960s and I lived through the 1960s, so I remember it.

All of that places some pretty difficult challenges on an operation when you're trying to run a national network. This is highly engineered and as precise as the ones we operate. FedEx Ground people have worked tirelessly through all of this. And I have eternal confidence that we'll continue to provide world-class transit service going forward for our customers.

On the issue of CapEx, I would say to you that we have been very diligent in the past about this. I made a comment about SmartPost. We've got 28 SmartPost facilities we're repurposing for Ground. That's pretty cheap capital when you consider the fact that we convert those buildings for Ground growth and they're essentially already included in the network footprint.

Notwithstanding any of that, we're going to have to invest in the Ground network going forward for growth. I mean, Brie gave you the statistics on e-commerce. Between now and 2026, we can squeeze more capacity out of this existing network, but we're not going to be able to maintain these growth rates unless we invest in it. And I can assure you that that work is something that is ongoing and almost daily at FedEx Ground. Thanks.

Operator: Ben Hartford with Baird has our next question.

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

Hi, good evening. Again, Alan, congrats on your career and retirement. Just to kind of follow up on CapEx and just cash management as we transition over to Mike's leadership. Can you provide a little bit of perspective about how you're thinking about liquidity going forward?

We've got a little bit of a different operating environment from an Express standpoint. You've got free cash this quarter. You've got plenty of liquidity on hand. How do you think about CapEx needs over the next few years and uses of incremental free cash flow and cash on hand, debt paydown, et cetera?

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

Appreciate the question. We are, first and foremost, going to repair our balance sheet. We borrowed a significant amount of money in anticipation of liquidity needs that, fortunately, we did not have to have. But I can tell you, back in March, when we were sitting around the table here, we had no idea what to expect and so we got prepared the best we could. I think you could see from my comments, we have over $10 billion of liquidity today.

Obviously, we expect to have improved free cash flow, and so we'll be repairing the balance sheet first, but we haven't forgot about return to shareholders. Recall that over a number of years, we bought a significant amount of shares at a price of about $153, which looks pretty good today, didn't look so good in March. And obviously, we have a frozen dividend right now because of our agreement with our banks. So, we'll be looking at all of those, but first and foremost is the balance sheet repair.

Operator: Amit Mehrotra with Deutsche Bank has our next question.

Amit Mehrotra
Analyst, Deutsche Bank Securities, Inc.

Thanks for squeezing me in. Appreciate it. Raj, I was just hoping on the Ground business, one thing that we've noticed at least is that purchased transportation costs have continued to go up on a per shipment basis. Given what you guys are doing on SmartPost redirect, should there be an expectation or can there be a potential for purchased transportation cost per shipment to moderate significantly the inflation on emergence of big piece of the cost structure. I think it's important to address it.

And then just higher level, if we're sitting here in August or September of 2021, obviously, 30% growth in Ground is not sustainable in perpetuity. I understand the secular benefits. But if we're sitting here this time next year, the economy hopefully has pivoted because we have a vaccine towards maybe a more balance of your goods and services and growth is negative in volume. How is the profitability structure of the business in that environment, if you can address that as well? Thank you.

Henry J. Maier
President & CEO, FedEx Ground, FedEx Corp.

Well, I'll address the purchased trans question. The purchased transportation is driven by volume. I mean all of our transportation is purchased at FedEx Ground. We don't have company owned equipment. We don't have employee drivers. So, as the volume goes up, purchased transportation costs are going to go up.

I think that something that maybe somewhat obscuring some of the numbers in there is the transition of SmartPost to Ground because packages that formerly were treated as postage because we paid the post office to deliver them are now part of Ground settlement. That work will be done by the end of October with a few exceptions.

The Ground network is highly variable and highly flexible. We can scale up; we can scale down based on the volume. We contract with 5,300 small businesses that employ something north of 130,000 employees. They see the changes in the volume at the micro level much faster than any of us could see it operating out of a corporate headquarter structure, and they react almost instantaneously to any changes in volume, both up and down.

So, this is not something that we haven't been through before. I mean, we've been through up cycles and down cycles. Sometimes, it takes us a little bit longer to ramp up if we don't see it coming like this particular COVID-19 event. But I'll assure you that we can take the cost out of this network really quick if we have to.

Operator: And from Bank of America, we'll go to Ken Hoexter.

Ken Hoexter
Analyst, BofA Securities, Inc.

Great. Good afternoon. Phenomenal quarter, Alan, and congrats on beginning your next phase, and thanks for the comments over the past two decades. Maybe just my question is on maybe for Raj on the thoughts on margin benefits from Express to Ground.

I know Henry, you just mentioned kind of the parcel side of it, but you've also talked about moving Express packages over to Ground. Can you talk how that transition is going on volume or on margin side? And then just a clarification, Alan, have you delineated the benefits from the surcharges in terms of dollar size, scale?

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

I'll answer the second one. No, we haven't because it's all part of one giant orchestra and one conductor and all the pieces flow together.

Rajesh Subramaniam
President & Chief Operating Officer, FedEx Corp.

And on the first one, let me just make sure as to B2C, the residential volume continues to grow. They're definite and allows us the opportunity to optimize between networks. So, the residential and rural packages, we were able to move from one network to the other and optimized as a service. So, we'll see where it goes. As I told you, we have launched it in a few markets, and we'll monitor as we go forward here.

Operator: And at this time, I'd like to turn things back to Mickey Foster for closing remarks.

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

Okay. We have some final comments by Fred Smith.

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

So, as I said at the beginning, I'm going to give the microphone over to Alan to make a couple of remarks. Let me reiterate what I said at the start and several of our colleagues have said here at the table. On behalf of the Board and the Strategic Management Committee, we thank Alan for 40-plus years of outstanding leadership in this company.

He's been a great comrade and brilliant man not only in business, but his accomplishments and contributions and so many philanthropic endeavors: Chairman, University of Memphis; pro bono very heavily involved in establishing the FedExFamilyHouse, he and Susan, where I could spend half the evening here talking about Alan in that regard. But as I said, this is an earnings call. So, I'll make more fulsome remarks at the shareholders meeting next Monday and let me turn the microphone over to Alan who will say what he wants to say and then Mickey will tie off the meeting. Alan?

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

Well, thanks, Fred. In the fall of 1991, Fred took a chance on a 38-year-old Treasurer despite a significant amount of pressure to bring in a proven and seasoned CFO.

When he told me, he wanted me for the job, he said he had a tremendous amount of confidence in me and challenged me to always think long-term and strategically. Among other things, Fred was very clear that I should always communicate what I thought no matter how against the grain it might be. That was great advice and has been the basis for our partnership ever since.

As I finish my last of around 120 earnings calls, I want to give you a few thoughts of mine about where we are and how optimistic I am about the future of FedEx.
Believe it or not, I have always looked forward to these calls, no matter if the news was good or bad. I've thoroughly enjoyed preparing for the very excellent and well-thought-out strategic questions I expected to be asked. While I often did not get these insightful and penetrating questions, I did enjoy the occasional bantering. I always endeavor to answer questions from a strategic viewpoint, hoping to impart a deep transparent description to help you see what I see.

Over the years, any accomplishments attributed to me truly belong to an unbelievably dedicated and talented team. I'm referring not just to an incredible world-class finance organization, but to all of my 500,000 teammates, with whom it has been an honor to serve. I'm extremely optimistic about the future of FedEx.

Over the years, we have invested in building unmatched physical and technological networks that are keeping the world's supply chains moving with very high levels of reliability. Although our capital investments have sometimes been questioned, the past quarter provides a strong indication that these are providing increasing returns, and I am certain that that will be the case moving forward.

By the end of FY 2019, we made a strategic decision to go all in on e-commerce. We moved away from a large customer to focus on the broader market. We moved to seven-day a week Ground operations, allowing us to handle significant additional volumes using existing capacity. We moved SmartPost packages into the Ground network and repurposed SmartPost facilities to handle higher-yielding Home Delivery packages. We added advanced route optimization technology, maximizing route efficiencies and increasing stops per hour.

We serve every address in the US and 92% of the US population lives within five miles of a FedEx pickup or drop-off location. We are modernizing our air fleet in major hubs to lower cost and handle additional volume. We are transforming our international business and the benefits of the TNT acquisition are beginning to accelerate.

We have the right strategy in place, and our team is executing at a high level. We are a high energy organization and are always on the offense.

And now, I'm excited to hand the CFO mantle to Mike Lenz. Mike's performance during his tenure at FedEx has been outstanding, and he has the full confidence of Fred, the Board of Directors, and the Strategic Management Committee. He will be superb, and I look forward to watching him.

It has been a great ride, and I will be forever grateful for my time at FedEx. To my teammates, thank you for everything. I will miss you and I will enjoy your future success. To my wife Susan, my daughters Bridget and Carrie and their families, your love and support and patience have been my cornerstone. I wish everyone good luck and good health. Thank you, and farewell.

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

Hear, hear.

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

Thank you for your participation in FedEx Corporation's first 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. Bye.