

2009 Baird Growth Stock Conference Transcript – May 13, 2009

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Jon Langenfeld

Analyst, Robert W. Baird

For our lunch presentation here today, we have FedEx Corporation and with us we have Rodger Marticke, who is the Executive Vice President and Chief Operating Officer of FedEx Ground. So as we often do with FedEx, we got to pick a division or comes – on a division that we pick down a little bit deeper into that one division and we are going to do that same thing here today. So Rodger has some general overview comments and if you have more questions on the overview, certainly in the Q&A or the breakout, ask them, but the majority of the presentation we are going to focus on the Ground division which I think as most of you know is the division that continues to grow and continues to take market share within the FedEx portfolio. So Rodger thank you very much for joining us. I will pass it over to you.

Rodger Marticke

Executive Vice President and Chief Operating Officer, FedEx Ground

Thank you Jon, appreciate it. Well, good afternoon everybody, it's great to be here in Chicago. Great to be a lunch speaker. I went through security at Pittsburgh airport and they confiscated my Flonase because I didn't have my prescription with me. So if you see me sniffing up here, I assure you it's not stage fright, it's simply my allergies acting up. We have a fairly ambitious agenda to cover in the allotted time. And I feel pretty good that we are going to – do all of our subjects justice – but only if I ask you to hold questions till the end, and if we do that, I think we will cover the material and I will be able to exit the stage somewhat gracefully without getting the hook.

But we are going to talk about really far ranging set of subjects today that cover not so much financial information, but really our company's culture, how we manage, the way we think about differentiation in the marketplace, a topic that has had a lot of publicity lately, our contractor business model and some of the legal decisions we've experienced lately and then talk a little bit about how all of those things combined to grow our market share and also say a few words about Green Logistics and our – what we call our secret weapon, FedEx SmartPost.

In the aggregate, we have four operating, primary operating units at FedEx. Express, Ground, Freight and Services. Collectively, they generated about \$38 billion in revenue in our fiscal year '08. A little more than \$2 billion in operating income, and also fundamentally important to us provided the livelihood

for about 290,000 contractors and employees around the world. One of the things that I remember most about marketing in business school, I wasn't a marketing major, by any stretch of the imagination, but in a service business, Ted Levitt used to say, people are the product and that's certainly true and interwoven in FedEx culture.

And to put it more directly, we spend a great deal of time, money, energy in people development in assuring a positive work environment and making sure that our people are motivated and trained to take care of our customers. And this slide simply suggests that there is some external recognition of those efforts and we are certainly never going to be finished on this front, but it's good to know that the marketplace has taken notice.

The color purple has many connotations or associations. Purple is often thought of as a color of passion. Purple is also thought of as the color of royalty. Purple is also the common logo color of all FedEx operating units. And we have a commitment that we make, it's called the Purple Promise and it's very simple. I will make every FedEx experience outstanding. The interesting thing about this is that it is common across all OpCos and it penetrates all organizational levels.

So if you happen to see a FedEx Express courier or a FedEx Ground contractor on the street, making a delivery or maybe delivering inside your office building, you might ask him or her what the Purple Promise means, and they may not get it exactly right, word for word, but they will be pretty close. And I am not saying, it's 100%, but everyday that passes that commitment to the Purple Promise becomes more and more deeply ingrained in all of our operations.

I guess the primary performance metric of any transportation company is on-time service and I am very happy to report today that our on-time service has never been better and I am going to talk a little bit about lane acceleration in a moment. This slide really just deals with reliability. In February of this year, we had our first full month of achieving 99 plus percent on-time service for the Ground network. And as you can see on this slide, we also had 99 plus percent on-time service in March and April and the fourth fiscal quarter for us will produce our first quarterly 99+ percent on-time performance number. So we are very happy with that.

We also have something at FedEx across all OpCos, it is called the Service Quality Index. The Service Quality Index that I am going to talk to you about today is specific to Ground. It measures these six categories of potential process failures and we treat these failures with a great deal of value, because in doing root cause analysis of them it helps us improve our operations. Another way of thinking about our

Service Quality Index is to view it as our report card on how well we are keeping the Purple Promise. And I want to spend just a few minutes talking about this, because perhaps more than anything I attribute our market share gains to the way we manage these metrics which are really the criteria that shippers use to select their package in freight carriers.

So we thought a little bit about the process area, scan compliance, pick-ups earlier or later than scheduled, missed pick-ups, late packages, lost packages, damaged packages, all of the things that can get in the way or undermine the customer experience. We quantify these into what we call our weekly SQI results and we are so committed to this approach to management, it's the first order of business every Monday when the officers convene and it's the last order of business late Friday afternoons when we get a preliminary view of what the week has been.

This is just an illustrative slide from week ending, 04/18 and what you see here, that I want you to take away isn't the numbers obviously, but you can look at the metrics, you can see in parenthesis, for example late packages, one day late, here late packages, two days late et cetera. You can see the categories that we are following and what the weights are. And the weights, whether it's 5 or 15, 10, 50 for example are applied based on customer research. In other words we are trying to replicate the importance of how customers think about their carrier selection process in the way we look at our performance in these areas.

Here we go. So, what's the power of the Service Quality Index? I think really, this slide tells a very powerful story. It really gives you some sense of the traction that we've been able to achieve, using this approach to management over the last eight years. It's a little complicated, I will walk you through it. We go back here to fiscal year '01 and we have a goal and you can barely see it, it is this red line and every year, the proverbial step function here, we raise the goals.

And these yellow bars, represent our percent variance from both fiscal year '01 all the way out through April of fiscal year '09. And so what you can really see is in this trend line, these are additive, and when you look at these yellow bars, what it really says is that we have through here, 70 to 75% fewer process failures in the elements of our SQI than we had eight years ago. So it's a classic example to continue this improvement and what rigorous quality-driven management can do for a company in terms of improving it's performance in the marketplace eliminating waste and creating a positive customer experience.

We have over 500 hubs and satellites throughout the Ground network. We don't think of our infrastructure as bricks and mortar, we think of it as a competitive

weapon. And there are some good reasons for that. Our hubs and satellites are the most automated in our industry. The day before yesterday, we opened our newest hub right here in Chicago, actually in Bedford Park, less than ten miles from here. So you certainly have an invitation to see first hand what I am talking about. But typically a package moving through our hubs is touched only twice, once to unload it from a truck, once to put it on a truck. All the intervening sortation is done with automated material handling equipment and robotics.

Fewer handlings mean fewer labor, which we like. It also means these are more package friendly to the packages moving through the system. We have used dynamometers to test the vibrations that are occurring to the packages, whether they are handled physically, manually versus our automated system. Automated always wins. We also attribute much of our service improvement to the technology increases or upgrades that we've implemented in the recent past. We now have high speed – high speed meaning our belts moving 550 feet per minute, conveyors that go through camera tunnels that have six-sided photographic capabilities. So it doesn't matter which way a package is oriented, the label is going to be read, the package is going to be processed during the first time through the system.

The hubs and satellites are the nodes of our network but our line haul system is what connects the networks. And the flexibility that we gain from owner/operators, the fact that we use teams, really enable us to accelerate packages on an intercity basis as well as through the hubs themselves. We use a war room approach to investigate any delay and we learn from our mistakes when they do occur. We also have something called the Transportation Management System, which is really more than an equipment controlled system.

It's a package visibility system that allows us to make decisions about which trailers that will work first, we have 150, 200 trailers in the yard, which one should you work first to make service. Which ones will make the difference? Our TMS allows us to do that. We talk about capacity in a number of ways. The most stringent ways, I was speaking a few minutes ago to Jon about, is hub capacity and the reason for that is hubs have the longest lead time, anywhere from two to four years and require the most capital investment, anywhere from 60 to \$120 million per copy.

We have a plan in place, our current five-year plan between FY10 and FY15 that increases our package handling capacity from 4.4 million to 5.6 million which is approximately a 27% increase and this is something that we monitor literally on a monthly basis. So as volume ebbs and flows, we adjust our capital spend in this area to hit a target capacity utilization of about 91 to 92%.

One of the advantages of the investment in infrastructure that we have is not only automation, but it's also the speed that the packages can move at through our network. Our investment in infrastructure extends the reach that we have of packages going through the system. And between June of 2003 and February of 2009, we accelerated more than half the lanes in the system, in fact about 58%, 70,000 plus lanes. And when I say accelerated, I mean literally taking one day of transit out of the schedule. So what used to take five days becomes four days. What was four days, becomes three days, et cetera.

There are consulting firms that advise our shippers about who has the fastest package transit times. I am sure that we can – if you are interested, connect you with one of our sales executives and they can demonstrate this, there are competitive service maps that are out there that third parties put up. We have approximately today about a 14% net lane advantage over our primary facing competitor on a system-wide basis. So, when speed is important and it typically is to most of our shippers, these competitive maps serve FedEx Ground pretty well.

I want to come to another key success factor for FedEx Ground and that's our independent contractor model. FedEx Ground was created using a highly entrepreneurial independent workforce and it remains so today. Our independent contractors of both of Ground and Home Delivery have a vested interest in keeping the Purple Promise and the reason that's so true is because every customer, every package that's won or lost has a direct economic bearing on the contractor. Contractor settlement is predicated not on time, not on hours work, but on stops made and on packages picked up or delivered.

So the more customers, the more stops, the more packages, the more density in that contractor's work area or work areas, the more money that they will be able to bring to their bottom line. We also like it because it's a variable cost structure. The way the system is designed, when there are fewer packages, fewer stops, its variable because that settlement isn't paid to the contractor and they adjust their operations accordingly.

So this really does a number of things for us. I will point out that it does free up a great deal of capital for us to invest not in things like tractors and P&D vans, but in information technology, automated material handling systems and state-of-the-art hubs. So it shouldn't surprise you, it certainly doesn't surprise me that there are people out there who would like to unravel this model for FedEx Ground and they include the plaintiffs for the Teamsters union and perhaps some competitors.

And fortunately we have had some very favorable decisions on this front in the past two months and I'm going to talk about two of them, one is called the Anfinson case which is Washington state case which was heard by jury. We had a total of 21 contractors that testified and pretty interesting because we really didn't have the opportunity to, what I would say prepare these witnesses because they're part of a class action nationally. Nonetheless they told their story to the jury and when they were finished the jury concluded that FedEx Ground contractors are in fact independent contractors not employees and they based their decision on three facts. Contractors hold themselves out as independent businesses and are treated as such.

They determine their own schedules. They determine who will drive their trucks, many other factors. They enter into a mutually beneficial relationship with FedEx Ground with eyes wide open. We tell them what the upside is and as in any business we tell them what the down side is and the jury found that we were forthright in that regard. And we also had the jury come back with the impression or the decision that the things that would cause some people to think about them as employees.

For example, a uniform or a logoed vehicle is really driven by regulatory requirements and customer requirements, not by management fiat. So the outcome of the Anfinson decision in Washington was that all 320 contractors were affirmed to be independent contractors and we're very happy with the fair and equitable decision of the good people of Washington that rendered that decision.

More recently we had a decision in the District of Columbia Circuit Court of Appeals that also affirmed that our independent contractors were in fact independent contractors and therefore not eligible to unionize under the National Labor Relations Act and this decision overturned a 2007 National Labor Relations Board decision that single work area contractors and two Boston Home Delivery terminals were eligible to vote in a union election. So further confirmation about the validity of the independence of our independent contractor workforce.

I don't expect plaintiff attorneys to fold up their tent and go away, tort reform is something in my opinion that is long overdue, but these two decisions certainly based on the fact that one is in a state court and one is in a federal court of appeals have significant precedent value for FedEx Ground.

We continue to enhance the contractor model, in terms of giving contractors more say in the design of their work areas, in what they negotiate as part of their operating agreement with us in terms of both financial and non-financial terms and we continue to recognize and reward them for demonstrating

entrepreneurial spirit and for making additional investments in their businesses to serve our mutual customers.

So what is the culmination of all of the things that I've talked to you about so far this afternoon of our customer centric culture, of our emphasis on people development and training, our investment in engineering, information technology and infrastructure, our willingness to compete on differentiated service. Well I think this slide gives as much of a complete answer as I could, it's our market share gains over the last eight years. And this is based on revenue not volume and it's based not on our own internal data, which I'm not at liberty to share with you, but on a third party consulting firm that happens to be headquartered in Atlanta called the Colography Group and by their reckoning we have picked up really about ten percentage points of market share since 2001. So this is based on revenue not volume and it excludes FedEx SmartPost, which I'll talk to you about in a moment.

We call FedEx SmartPost our secret weapon and basically it's a consolidator. It has a network that really targets sub five pound packages and uses USPS to execute the last mile, what we call final delivery. And very cost competitive, not as information rich perhaps as FedEx Home Delivery or FedEx Express, but very cost competitive, reliable and really fills out our portfolio to cover the entire spectrum of what we see our customers asking us for at a very good profit level.

We are also focused more and more on green logistics and environmental sustainability. In part because it's the right thing to do, we're citizens of the planet and also because it's good business. Through recycling efforts and many other things we've been able to generate incremental profits and we also find that our customers are increasingly asking us about the environmental impact of our various modes. To give you some example we can tell a customer today, because we've been asked, what their carbon footprint is of a package moving through our system and we can do by that mode, we can do it by length of haul, we can do it by package cheap and many other variables. And certainly not the majority, like many of the most advanced shippers are asking us for this kind of information, the Wal-Mart's of the world for example.

I've just mentioned a couple of these that are specific to Ground. We are in the process of installing the largest non-utility owned solar panel installation in North America at our Woodbridge hub. It will produce 2.4 million kilowatt hours annually. FedEx Freight just as an FYI also has significant solar panel installations at their Woodbridge and – excuse me at their Fontana and Whittier facilities and Express similarly has

significant solar panels investments in Oakland and Cologne, Germany.

We're also pioneering low emission technology at Ground which uses hydraulic brake power conversion. So Express is going down one road with their pilot and a purely electric hybrid we're looking and reviewing on a smaller scale the opportunity to convert the power generated through the hydraulic braking systems to converting that to motor power to improve our fuel efficiency.

So what does the future hold? Well certainly I'm biased, but my view is that we have at FedEx Ground all of the prerequisites to sustain our success. We have a corporate culture that really measures and rewards performance based on customer satisfaction and loyalty. We have the capacity in place to effectively assimilate the growth gains that we experience. We have an unequalled terminal network in terms of cost structure, service reliability and reach and we also have the engineered systems and work processes to continually increase speed, improve service reliability and drive productivity. And most of all, and it's a little bit like motherhood and apple pie, but most of all we have the Purple Promise which at the end of the day is going to determine who wins in ground small package transportation.

So with that I see that I have about five minutes before the hook comes down and the trapdoor opens and I'd be happy to entertain or respond to any questions that you might have.

Jon Langenfeld

Analyst, Robert W. Baird

I'll start off. When you think about the service improvement that you've had over the years, you kind of match your service improvements relative to your market share, they've gone hand in hand. Could you just reflect a little bit upon when you think over the last five, six, seven years, when do you think your service level matched that of your peers and then moving forward how do you think your market share gain just qualitatively, I mean how does your market share gain continue relative to your service levels?

Rodger Marticke

Executive Vice President and Chief Operating Officer, FedEx Ground

I can't really tell you Jon when we matched UPS. I'm not really sure we even measure service the same way that UPS measures service. What we focus on is continuous improvement and reducing transit time on the lanes and that really has been in place for the last, as I showed in my slide going back to June of '03 when we had a concerted strategy to accelerate our

network. Now in terms of market share and where we're going with market share, vis-à-vis service improvement, I don't know how long we'll be able to continue to accelerate the lanes in our network. To a large extent that depends on our volume growth and our inter-city lane density. I can tell you however in FY '10 we're not taking any pressure off, we're accelerating another 5,000 lanes in the coming fiscal year. So I'm optimistic that we'll continue to compete on service whenever the opportunity presents itself.

Jon Langenfeld
Analyst, Robert W. Baird

And then on your capacity expansion plan, rough and tough numbers, 5%. If you looked on an annualized basis looking at 5% growth of capacity over that five year plan in each year. How do you manage that relative to volumes, meaning if you're going faster or slower than that how much flexibility do you have to kind of move that around from?

Rodger Marticke
Executive Vice President and Chief Operating Officer, FedEx Ground

We have quite a bit. As the slide indicated in, going into FY '10 we have about 4.4 million packages per day capacity measured as our hub throughput. And over the next five years we're taking that up to 5.6. The reality is though we can flex by as much as 10% very quickly by extending our sorts, by applying more labor. But again we try, the sweet spot for us is to operate at about 91, 92% of our economic hub capacity and we've been very successful in doing that for the past certainly five or six years.

Jon Langenfeld
Analyst, Robert W. Baird

And then DHL was a big exodus from the package, parcel market here in the US this year, largely an express offering, the way they looked at it. But can you comment on how that has impacted your business again qualitatively relative to that share?

Rodger Marticke
Executive Vice President and Chief Operating Officer, FedEx Ground

I can – I'm not sure that it will be a totally satisfactory answer, but let me say that as far the DHL ground business is concerned they had significant residential volume, significant in terms of their overall package count. And many of those packages have gone into the FedEx SmartPost network because they were low weight and they ended up in that network

appropriately based on the cost structure and the service levels appropriate to the yields that those packages carry. Hoping that's not too esoteric but really for FedEx Ground itself some impact, not a lot for FedEx SmartPost, a significant impact.

Jon Langenfeld
Analyst, Robert W. Baird

Okay. Question from the group? If not then well why don't you join me in thanking FedEx. Rodger thank you for presenting.

Rodger Marticke
Executive Vice President and Chief Operating Officer, FedEx Ground

My pleasure. Thank you.