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Gwin Myerberg:	00:00:00	Hello and welcome to the Price-to-Value Podcast with Southeastern Asset Management, where our Global Investment Team discusses the topics that are most top of mind for our clients from a Business, People, Price point of view. We at Southeastern are long-term, concentrated, engaged value investors, and we seek to own high quality businesses, run by capable people at a discounted price-to-intrinsic value (or P/V).
Gwin Myerberg:	00:00:28	I'm Gwin Myerberg, Global Head of Client Relations and Communications. On today's podcast, we'll be sharing the conversation between Southeastern's Vice-Chairman, Staley Cates, and FedEx's Chairman, CEO and Founder, Fred Smith, and EVP and CFO, Alan Graf. We own FedEx in our US and Global portfolios. They joined Staley in our Memphis office. Fred Smith started out the conversation by saying how important he believes it is for he, his executives and the IR team at FedEx to make themselves available to their large shareholders. We're very grateful that they did, and we hope that you enjoy the conversation.
Staley Cates:	00:01:08	Today, we're going to talk about FedEx in detail, and to do so, we're lucky to have Chairman, CEO and Founder, Fred Smith, and EVP and CFO, Alan Graf. Fred Smith needs no introduction, but we'll give one anyway. Everyone knows some of the key points, highly decorated Marine, all kinds of continuing service to the

military and to the nation since his two tours of duty in Vietnam, founder of FedEx, the Yale paper, etc.

- Staley Cates: 00:01:34 But as long-time students at FedEx and as Memphians, we would point out that even the most repeated stories don't give a complete picture, often leaving out some other amazing things. On the business side, what we find most remarkable is that if you look up an innovator's or a founder's hall of fame, he's in it. If you separately look up most respected CEOs of companies with hundreds of thousands of employees where the company is repeatedly cited as a best place to work and a most admired company, he's in that hall of fame also. You can count on one hand the number of individuals who have achieved both these things. Legendary founder and entrepreneur, but also a renowned CEO with long-term success running a huge organization and creating tens of billions of dollars in shareholder value. On the personal side, as a Memphian, I've watched him and FedEx do so much civic good, especially in the name of taking care of their associates, that it can't be fully articulated. Alan Graf has been EVP and CFO forever. No wait, actually since 1991, around the time we took our initial position. Alan has been a key, pivotal top executive at FedEx throughout our roughly three decades of owning the stock. Part of such an unusually long and successful tenure has been Alan's ever-increasing roles in operations and his deep knowledge of them, not just performing the narrow definition of CFO duties. He has been on the board of Nike since 2002 and Mid-America Apartment Communities also since 2002. Like Fred, his personal civic contributions are incredible. He has had various extremely important leadership roles at the University of Memphis and at Methodist Healthcare System, among too many other things to count.
- Staley Cates: 00:03:16 So welcome to you both, and thanks so much for being here.
- Fred Smith: 00:03:19 Glad to be here.
- Alan Graf: 00:03:20 Great to be here, Staley. Thank you.
- Staley Cates: 00:03:21 And we will remind listeners that there are [slides](#) on the website which will go along with the Q&A, as well as a FedEx [video](#). To start this off, let's talk about why does FedEx believe it will win in eCommerce?
- Fred Smith: 00:03:38 I suppose I will start it off and then let Alan come in with any comments. There are only two networks in the United States that can pick up, sort, transport, if necessary, sort again, and then deliver to every address in North America, and that is FedEx and

UPS, full stop. The Postal Service essentially got out of the upstream business of doing all the pickup, sortation and line haul over thirty years ago. They instead developed a system which incents first mailers and, more recently, parcel shippers to do all of that and then insert it into the Postal Service in what's called a destination delivery unit (DDU) or a sectional center facility (SCF). That's the next level up. You get a discount if you do that. It's important to realize that if you do not have those sortation capabilities, and in the case of FedEx, we have in the United States, in the express business, Memphis, Indianapolis, Fort Worth Alliance, Greensboro, Newark, Miami, Oakland, very large facilities and in Los Angeles and in Chicago and then Anchorage.

Fred Smith: 00:05:09 There is a tremendous misunderstanding that you cannot be in the business we are in, unless you have that upstream capability. As eCommerce has evolved in the last 15 years or so, specifically with the accelerant that mobile telephony gave to eCommerce back in 2008 and 2009, and you can just see it taking off as smart phones proliferated because that lets you have in your hand an order entry device. You could see the goods, you could see the pricing, you could punch.

Fred Smith: 00:05:50 Of course, Amazon has done a fantastic job making this easy for people and really pioneering the eCommerce business. From our standpoint, however, the only difference in what we've been doing for years, is the same networks, upstream networks and sortation facilities work equally well for B2B. Think a package full of hospital supplies and FedEx Ground going to replenish a Walgreens. Think a Stryker implant that's in our little video that's going for brain surgery at Mayo clinic in our express network. But the networks don't know whether it's B2B or B2C. The only issue in the B2C business is that the items are delivered to residences, and that has a different economic profile than delivery to businesses. Specifically, you'll have more miles between stops, and you will average about 1.1 packages per residential delivery stop, as opposed to over three for a B2B delivery.

Fred Smith: 00:07:08 So as eCommerce has become more and more a factor in all business, B2B and *particularly* B2C, then we have increasingly moved into the residential delivery business. First by setting up FedEx Home Delivery, which was an adjunct of FedEx Ground that was initially only B2B. Then we added FedEx SmartPost, which took advantage of those last mile delivery capabilities of the Postal Service, which is called Parcel Select, and added Zenith. We were inserting into 22,000 small direct delivery units or local Postal Services, lightweight packages for residences for delivery.

Fred Smith: 00:07:59 We have felt for some time that there would come a point where the Postal Service's economics would create a situation where we would be the low cost producer for these short haul packages in our ground business as the Postal Service was disrupted by the diversion of mail to digital transmission. That point is now clearly on the horizon. Last May, we introduced a number of changes to our system: seven day delivery, a separate network for larger packages, which is also growing prolifically for the big retailers like Wayfair, Walmart, Target and so forth And most importantly, we would in-source the packages we had been giving to the Postal Service in their Parcel Select service and have them delivered by our own delivery people.

Fred Smith: 00:09:00 Now in the Express side of the business, the Postal Service also has a system for priority mail, which is more packets, lighter-weight packages, and we are the upstream capability there on a wholesale basis in our FedEx Express units. We fly and drive the traffic airport to airport. They do the pickup and deliveries a little bit differently than the ground package business. But, there again, the Postal Service's economics are such that we are able on a go-forward basis to do these things cheaper than the Postal Service can, and that changes everything.

Fred Smith: 00:09:40 That is why we believe one of our three goals is to be the largest and most successful package delivery company in North America. Those steps that I outlined are integral parts of doing that. I've covered a lot of ground here, but you have to understand the context in which we operate with the Postal Service, and UPS and FedEx being the only upstream networks that have those sortation capabilities. Amazon doesn't have a single hub. The Postal Service virtually has no hubs anymore. It's a two-way race, if you will, between us and UPS as to who's going to dominate that business. Let me be quiet and let Alan jump in here.

Alan Graf: 00:10:29 What's exciting to me mostly is the fact that we figured out how to sweat our assets. Seven days a week, we were doing that during peak for years, and I think it's just a natural extension for us to go ahead and do it. We're open 24/7, 365 days a year. For years, we know we suffered from low ROIC. One of the great big moats around FedEx Corporation is just that. To duplicate what we've put in over the last 40 years just cannot be done. Hubs are vital for long distances because that's where you do the switching, and that's where you get your productivity. As eCommerce moves the packages closer to the customer, either from a warehouse nearby, a fulfillment center nearby or frankly a store, we recognize the fact that we're already there with the assets in place.

Alan Graf: 00:11:24 What do we need to do to figure out how to deliver short haul, zone one packages, for example, for pickups late into the evening, next day, with the system that we have? Well, you don't have really any line haul. You just have the sort. You're already making a sort and you can run a second sort, which is what we're doing at the facilities that we already have.

Alan Graf: 00:11:47 That drives down our costs dramatically, reduces the capital intensity, which we know that we have to do, we will touch on this some more later, and allows us to offer pricing that the Post Office can't offer. The Post Office has no more first-class mail. Their marketing mail declined for the first time in a long time. They're going to lose controllable or uncontrollable billions of dollars this year. They've got \$100 billion of liabilities. That just can't continue. We're going to get our cost below theirs, and the low-cost producer will drive a lot of eCommerce to us.

Alan Graf: 00:12:23 Also, we're now the brand friend. You know the brands that want to have their own websites. I can speak for Nike, for example. If you go on nike.com you're going to only see Nike stuff. You're not up against anybody else. Nike's wholesale people can have a shoe in a store that we can get and deliver for the same day, and there's so many opportunities there. With the growth of eCommerce, it's going to continue with packages becoming closer to the customer than they have been in the history of FedEx. We have the perfect mousetrap to attack that market.

Staley Cates: 00:12:56 So, related to that number with the slides that you guys gave us, on number five, it talks about addressable market, which I thought was really interesting to put it that way. When people have talked eCommerce, sometimes that's been code, mistakenly, for Amazon. This is interesting in how it breaks out non-Amazon versus Amazon on that. Can you talk a little bit more about that on slide five?

Fred Smith: 00:13:18 Well, Amazon has made their intentions clear since the summer of 2018, when they announced that they would buy 20,000 Sprinter vans. And shortly after that, I happened to be at a *Bloomberg* forum in Singapore, and the *Bloomberg* reporter asked me, "Doesn't that concern you?" I said, "No, it doesn't concern me. We're not getting that business anyway." They're just giving it to the Postal Service for Parcel Select, exactly the way we do with FedEx SmartPost and UPS does with SurePost. And in fact, Amazon direct inject FedEx SmartPost and UPS SurePost - we're probably 80% of the entire ground parcel business of the Postal Service. I said, "The Postal Service should be extremely worried about that." Well, the interesting thing to me was those comments which I gave to *Bloomberg* and to *The*

*Economist* had been completely ignored. I'll ask you a question right now to demonstrate how important this is.

- Fred Smith: 00:14:33 What did the Postal Service lose in August?
- Staley Cates: 00:14:37 Oh, boy.
- Fred Smith: 00:14:39 You don't know, right? You're a very sophisticated man in this business, but you don't know that number, right?
- Staley Cates: 00:14:44 I do not.
- Fred Smith: 00:14:46 I'm not being critical, I'm just showing you people don't think about this as it relates to the eCommerce business. The answer to that question is the Postal Service lost, in August alone, \$1.7 billion, and their marketing mail, and as Alan mentioned a moment ago, their first-class mail is all but gone. It's marketing mail and parcels that have kept the lights on there, and marketing mail declined 7.5% in August year-over-year.
- Fred Smith: 00:15:17 So mail *worldwide* is declining by 4 or 5 to 7% compounded annually, and it's been doing that since the start of the century. The vast majority is thrown away. It's marketing materials. When you get to the Generation Z cohort, not only do they throw it away, they find it ecologically offensive that you're burning fossil fuels and cutting trees down to send you a sweepstakes ad.
- Fred Smith: 00:15:55 A lot of people think that the Postal Service "makes money" on packages but loses money on mail. It's one network. It's like saying "I make a lot of money on my first class passengers, but I'm losing a tremendous amount on my economy passengers in this airline, and I'm going to go broke in two years." The Postal Service started FY 19, which ended in September, with a forecast that they would lose \$6.5 billion or \$6.6 billion. On November the 14th or 15th, not long from now, they will announce their results for FY 19, and we estimate the loss will be pretty close to \$10 billion.
- Fred Smith: 00:16:37 This is the organization that facilitated Amazon's eCommerce growth, and at one point, well over 60% of all the deliveries that Amazon made were through the Postal Service. They're very smart people up there. They saw this coming too. That's why they bought the 20,000 Sprinters. But, what they *don't have* are those upstream line hauls and hubs. And I mentioned the express network a minute ago. It's even more profound in the ground business. We just opened last year these massive facilities in Littleton, Connecticut and Allentown, Pennsylvania. These things are irreplaceable. They take years to develop.

They're hundreds of acres. I visited the Rialto hub recently, which is not far from the new one we're building in Chino, California. We have 21,000 trucks dispatched per week from that hub. I mean, the choreography to run this network is just incredible.

Fred Smith: 00:17:41 Even if tomorrow you wanted to start building this network, it's not possible. The moat is too high. That doesn't mean that Amazon is not going to have their own system for the eyeballs and the customers they control and the inventory if they're part of fulfillment by Amazon. They are setting up a network which will be able to move a lot of that stuff to *most* destinations. But where they will run into problems is in the less dense area of the country. Because, unlike FedEx and UPS, which are combining packages from all over the world, much less all over the country, in our delivery vehicles to every potential recipient in the country, they just have the Amazon "universe," if you will.

Fred Smith: 00:18:38 Now, will they try to sell that to other people? Of course they'll try to sell it, but they don't have any sales and marketing capabilities to do it. They have no hubs. Now with our decision to not provide services to Amazon, they have a very significant and, I believe, irresolvable conflict with UPS because are they friend or foe? Well that's not an issue to us. And as you commented, the addressable market that we see is very large, and we think that if we execute our plans as we've outlined, particularly this seven day delivery, which is what the eCommerce merchants want, then we will end up being the leading ground parcel and express parcel company in North America.

Fred Smith: 00:19:33 That's the strategy. It's very straight forward. The demise of the Postal Service has been completely ignored. A lot of people say, "Oh, well a lot of that is just the post-retirement healthcare and the pension. It isn't really a cash expense." Well that's true, but it was the law passed in 2006 that they were required to make those payments, and they simply have ignored it. Now you tell me how they felt free to do that. It *has been* a subsidy provided by the US government for the delivery of parcels, particularly their Parcel Select.

Staley Cates: 00:20:15 What keeps that can from just continually being kicked down the road? Is there a day or reckoning legislatively?

Fred Smith: 00:20:19 No. The day of reckoning is the one thing in business that Alan has constantly reminded me of, is you cannot run out of money. The Postmaster General, Megan Brennan, a very wonderful lady, and we've had very good relations with the Postal Service for years, and I've actually supported postal reform singularly. UPS has fought it tooth and nail. We've supported it. She testified on

May 1, 2019 in Congress that they would run out of cash money. And remember, there's no receivables in the Postal Service. It's a cash business. That they would run out of money in 2024. Our best projections are that, that is more likely 2022 because the insourcing by FedEx and by Amazon has created a much more significant cash drain than she thought would be the case when she made that comment on May 1<sup>st</sup>. So that's not our projection, that's her projection.

- Fred Smith: 00:21:22 We believe that it was overstated. At that point in time, the Postal Service is illiquid. It can't pay its personnel. It can't buy its diesel or gasoline. No later than whenever that cash day is, the Postal Service *must* be reconfigured one way or another. And we have our ideas about that, but as usual, Congress is just pushing this down the road and doesn't pay any attention to it. That's why I asked you the question, "Did you know what they lost in August?"
- Staley Cates: 00:21:56 \$1.7 billion.
- Fred Smith: 00:21:57 But Staley, the key is you haven't seen one word of that in the *Wall Street Journal* or *Bloomberg* or *Business Week*, even though, in November, I gave them that story, which they have completely ignored. In fact, in our analyst call in the last quarter, we put up the chart - I think you just referred to it - which shows the Postal Service's volume going down and Amazon's volume going up.
- Staley Cates: 00:22:25 So that leads to a couple of follow ups.
- Staley Cates: 00:22:26 On that slide, it shows Amazon now doing all this stuff to basically carry up to around half of their own stuff. And the fear that we hear talking to our own investors is what happens when they've hit 100%, and they're trying to go forward? And you just mentioned a minute ago that, yeah, there'll be places they'll try to sell to third parties. I think because of Amazon Web Services (AWS), everybody is so terrified of them as they get into whatever business that is peripherally and then make it core. When we then come back with some of the other stuff you talked about that they'll never be there on low cost. Then the thing that follows that is, well they do a lot of things that lose money because they can. They have a trillion capitalization, and it turns into a worry that they can hurt FedEx, not because it may make cost sense, but just basically because they can afford to for a different goal. Can you talk about some of that?
- Alan Graf: 00:23:25 I'd flip the coin on that one. If you looked at the latest results of Amazon, their shipping costs continue to grow at a much faster



rate than their revenues, as they try to get closer and closer and closer.

- Staley Cates: 00:23:37 It was up what, 46, 47% the other day?
- Alan Graf: 00:23:40 Yes. It's just, I don't know how they can continue to do that... How are they going to get the people and the facilities and the cost to continue to do that and get closer? Their own inventory carrying costs for those skus they've got, it's got to be they dominate the merchandising end of the business because they're losing so much money on the transportation side. Secondly, WWS free ride days are over. Microsoft just got Jedi, that's a \$10 billion contract with the US government. You see some Microsofts in there big time. You see Oracle. Everybody else is coming after that.
- Alan Graf: 00:24:23 I don't know how long that can continue, but all I know is that if our costs were going that direction instead of the other direction, I'd be in a completely different position than I think we are. I know that we're going to continue to drive our costs down, particularly in eCommerce, because we can see it, and we had been doing it. We're going to grow the number of units going through ground very, very quickly here, so the yields are going to be lower. The margins may be a little bit lower, but the absolute cash flow that we're going to generate out of that on much lower capital investment is going to be a great ride for a number of years, as far as I'm concerned.
- Alan Graf: 00:25:00 The interoperability between the companies, we always talk about "why don't you just put them together". If we thought it would make sense and we could prove it to ourselves, we would have done it. The fact of the matter is they don't fit. The reason we have a 28% net one day faster lane delivery in the US today, which a lot of customers buy from us because we have that, is because they are separate. Ground facilities are at a completely different location by design and cheap land, away from high expensive airport land in our networks. But the interoperability to be able to connect and keep a FedEx Express truck and a FedEx Ground truck out of your neighborhood at the same time of day are there for us, and the bigger that we get, the faster we can do more of that.
- Alan Graf: 00:25:45 So there will be some, as we call it, interoperability going forward, and we think that has a tremendous amount of productivity because if we can go from 1.1 to 1.15, and we can reduce the amount of miles because we have so many more packages, then density wins. Because this is really in the eCommerce business if you're trying to make money, it's a

nickels and dimes business, and we have to break it down and look at that down to the last penny.

- Alan Graf: 00:26:09 I'm confident where we're going to be. We're not there at the moment because we're investing to get there. We're putting the technology in there. We're doing the six and seven day to get there. We're expanding our large package capabilities. We have to because it's so much more productive. There doesn't seem to be any marketing rules applied to large packages because we keep raising the price of them, and we keep getting more of them. People want trampolines and mattresses and things like that delivered to their house. For eCommerce, I'm extremely excited about how well positioned we are going forward.
- Fred Smith: 00:26:43 The biggest impediment, in my opinion, to Amazon after the upstream infrastructure that I've described now a couple of times is the inherent channel conflict of the other retailers. There may be small customers and certainly people that are in the Amazon marketplace ecosphere, they'll be perfectly happy to ship with Amazon, but I could sit here all afternoon and read a customer list of people that will never ship with Amazon. I'd also point out, it's been absolutely fascinating to me in terms of urban legends. I mentioned to you a moment ago, the complete disregard by anybody in the popular press of the meltdown of the Postal Service.
- Fred Smith: 00:27:36 Let me give you two more. Beginning in September of 2016, about three years ago, Businessweek published a cover story by a guy named Devin Leonard, who had written a very top line history of the Postal Service. That was his qualification to write this article that was essentially, "Oh, just like Amazon did AWS, somehow they're going to do that in transportation." And the cover of the magazine says, "Will Amazon kill FedEx?"
- Staley Cates: 00:28:09 We got a lot of phone calls after that cover.
- Fred Smith: 00:28:12 Here is the urban legend. Amazon has never been a huge part of our business, although I can tell you that the last couple of percentage points of volume have hugely contributory margins. So, it was painful for us not to renew the Amazon contract, but we felt, for all the reasons we've described, that strategically that was the best decision.
- Fred Smith: 00:28:42 UPS today, 10% of their revenue is from Amazon. It's probably more than that in terms of their volume. There's hardly ever been a word written about Amazon disrupting UPS, and in fact, most recently UPS's common relation to this was, "We have a mutually rewarding relationship with Amazon." Nobody probes that, but

there is just this constant drumbeat, particularly from *Bloomberg*, that since September of 2016 by Mr. Leonard, who by the way, never contacted FedEx, never asked our question and never asked us anything, has been this constant drumbeat that somehow we're going to be disrupted by Amazon. But UPS, which has gotten much more exposure, oh, there's no problem there.

- Staley Cates: 00:29:34 I have found that amazing.
- Fred Smith: 00:29:35 It's beyond comprehension.
- Staley Cates: 00:29:37 That's one of the biggest headscratchers of this conversation.
- Fred Smith: 00:29:39 It's beyond comprehension. I don't know how it's occurred, but that is just the two things that are just bizarre that nobody pays any attention to what's happening with the Postal Service, which is by some analyst *still* is a revitalized Postal Service. It's terminal. It has to be restructured. The Postal Service itself agrees with that and has advanced a postal bill to do that, which as I mentioned we have supported.
- Fred Smith: 00:30:14 The Postal Service has refused, interestingly enough, throughout the summer of 2019 to present to the Congress, including the late chairman Cumming and ranking minority member Mark Meadows of North Carolina. They simply refused to give them their strategic plan, and the reason they won't give them their strategic plan is because there are only three things that you can do to solve the Postal Service's problem. You can shrink the network, which is what they prescribed in Canada and have done in Europe to a great extent.
- Fred Smith: 00:30:53 Number two, you can lower the input cost. That gets extremely dicey because that means reducing labor costs, and there are very powerful unions who resist that and who have an arbitration clause that precludes the arbitrator from considering the Postal Service's financial condition and rewarding whatever decision they might make on a union arbitration with the Postal Service. And I know there's one, but I think there are two underway right at the moment. So, you have to change the input cost or some way, you have to raise prices. There isn't any fourth way.
- Fred Smith: 00:31:39 So this very straightforward analysis is something that's just completely lost on the popular business press or isn't any interest to them. A few analysts talk about it, but I think they underestimate the rapidity of the digital diversion, which is taking away the stop subsidy that has allowed the parcel delivery to take place. It's about five or six times more expensive for the

Postal Service to deliver a parcel than it is to deliver a letter. This is coming, and there's nothing going to stop it, short of a miracle. It has to be restructured. That, again, is why we announced all the things we did in May. It wasn't just off the cuff. We've been working on this thing for *four years*, and we knew this point was coming. That's why we made the announcements, and that's our number one objective is to be the leading parcel company in North America. We have two other objectives, but that's the first one.

Staley Cates: 00:32:46 So now moving to Global instead of just North America. Can you talk a little bit about express and especially about the TNT thing? I think this market is so myopic that we look at TNT as a two-to-three-year investor and think these numbers are huge and extremely meaningful. I think a lot of people don't care because two-to-three years may as well be infinity, but can you just talk about that?

Fred Smith: 00:33:13 I mentioned to you in the United States, the way the marketplace is going to evolve is there's going to be us and UPS, and Amazon is going to do whatever Amazon's going to do within their marketplace ecosphere. The Postal Service is going to be challenged because of the fundamental economics, as I've just explained. I'm for the Postal Service, and we're the only big company that has supported postal reform legislation in Congress. A big part of which is to take that \$100 billion liability and give it to the taxpayer and move the obligation to the Medicare. It's not going to be very popular with a lot of fiscal conservatives, but the reality is the government's already *done* it by allowing the Postal Service not to cover those costs with its shippers and its mailers, which was the law. They just ignored it.

Fred Smith: 00:34:08 On the international side of the house, there are also three entities that are going to be present there. There's us and again, UPS and DHL. DHL and FedEx are about the same size, about \$70 billion this year. The configurations of the company are quite different, and most importantly, DHL tried to become the third player in the North American parcel business and acquired Airborne some years ago, and it was so financially painful that they withdrew. They are exceedingly strong in various parts of the world, particularly the lesser-developed areas like the Middle East and Africa and Latin America and Southeast Asia. They're these protected enclaves, which we've been expanding in very strongly.

Fred Smith: 00:35:01 We are the biggest international export company in the North American market. Our volumes outbound from North America are as much as DHL and UPS combined, but where we were

*substantially* weaker is the second, maybe now the third, largest economy in the world, and that was Europe. And in Europe there was a company as you know, TNT, that got into a position where we could buy it. What we particularly liked about TNT was the road network they had, which was completely unduplicated, and still is, in Europe.

Fred Smith: 00:35:46 Now, TNT is mostly B2B, and they carry parcels and pallets, so it's a bit different, but it fit perfectly our strategy in intercontinental business, which was to put in a network built around our 777 airplanes that we've been bringing in that allowed you to pick up and transport and deliver packages and pallets faster between any two points than has ever been true in history. And that system is built now with one route that will be added when the Charles de Gaulle (CDG) hub expansion is completed in 2021.

Fred Smith: 00:36:26 Our strategy is to have the fastest network with our own aircraft and to use our interline capabilities to move the less time sensitive on a non-asset intensive basis. Both our Intercontinental and our European strategy has been hurt over the last year and a half, primarily because of the great economic slowdown in the goods producing sector.

Fred Smith: 00:36:59 When the President started his trade initiative or trade war, and that was the word he used, and on March 2, 2018 he said, and these are his words, not mine, "Trade wars are good and easy to win." And then he began that summer imposing tariffs on Europe. He threatened tariffs on many things in Europe, and he did put tariffs in on aluminum and steel. I don't think what was recognized was when those tariff bullets, if you will, were fired at China, the ricochets hit Europe and particularly Germany. And, combined with the trade wars and Brexit, Europe's economy has been virtually zero growth from beginning about September or October of last year. The goods-producing sectors in Europe and in the United States and in China have all been in a recession for over a year.

Staley Cates: 00:38:17 Which your guys shouted out really earlier than anybody else on earth.

Fred Smith: 00:38:20 No one believed us. And we have a referendum. We move 15 million things a day. We have a referendum, which was not theoretical, not like the banks, not like the Federal Reserve. We're watching the referendum every day on this sector of the economy. And this very day, I just saw it as I was walking out, Brad Jacobs, the CEO of XPO, that's the exact headline and his quote in an article today is, "The goods-producing industry has been in recession for a year."

Fred Smith: 00:38:53 That's really the primary issue that we have in TNT. We just have not achieved the revenue in the timeframe that we expected to achieve our bottom-line results. Now, we're going to get a lot from the cost savings, which are on the ground, essentially done by the fourth quarter of this fiscal year (next May). On the air side with the completion of the Charles de Gaulle expansion. We're just as enthusiastic about TNT today as we were then.

Fred Smith: 00:39:28 And we went through a hell of a thing with the NotPetya attack, but we tried to make that - with our very terrific IT team, who you know all about, led by Rob Carter, who's one of the most renowned CIOs in the world - into an advantage versus adversity. And we sped up some of our capital investment to modernize these systems. But the biggest issue we have in the international business is the slow growth due to the trade wars, full stop.

Fred Smith: 00:40:01 Now, we're reducing capacity, we're getting it right sized. TNT ground integration is basically done by the fourth quarter of this year. You'll see a lot of the benefits if the macro doesn't deteriorate further, but we will have this massive presence in Europe that's astounding. We have at present, I think 1,000 facilities. It'll go down to about 600. We have 50,000 truck dispatches per week in Europe, 55,000 teammates over there. Our trans-Atlantic system, nobody can match what we can do to and from Europe.

Fred Smith: 00:40:45 So longer term, this is our second major objective, is to be the major global parcel and pallet express company. Let me make one thing clear, and then ask Alan to jump in here. People talk about "the air cargo business", but it's like all markets, there are segments. If you talk about restaurants, how big is the restaurant business? It's irrelevant because there's a lot of difference between Ruth's Chris and McDonald's. They both sell beef, but they sell them to a different segment, different price point, different experience and so forth.

Fred Smith: 00:41:21 When you talk about the air cargo business, 80% of the shipments that are moved by air globally weigh less than 3000 kilos, but they only constitute 20% of the weight. And conversely, 20% of the shipments are these big commodities being moved. Think Apple phones and Samsungs and so forth. These big consolidations that are these lumpy moves, and that's 80% of the weight.

Fred Smith: 00:41:54 So our system is designed to serve the 80/20 portion. It's roughly a hundred-billion-dollar business. And the express carriers, even though it's 20% of the weight, it's about 40% of the revenue. So these numbers, you have to understand them, they're very

discreet segments like McDonald's and Ruth's Chris, but we believe particularly now with the road networks we have in Europe, Southeast Asia, the Middle East and Latin America with TNT, our ability to free flow this 80/20 cohort, the smaller shipments, 3000 kilos and below, either on our own airplanes or putting on these patented pallets that we develop from the underbellies of our passenger partners, United, JL, Emirates and so forth, we believe that we will achieve our second goal of being the dominant worldwide express carrier even though UPS, and, more importantly, DHL had these large bastions in Europe, which we basically matched and exceeded with the pallet and road capabilities of TNT. We're disappointed with our financial results, but we're very happy with the strategic results.

- Staley Cates: 00:43:21 And the \$1.2 billion to \$1.5 billion you've talked about is the synergy part, but that is-
- Fred Smith: 00:43:28 No, some revenue too.
- Staley Cates: 00:43:34 You've talked about the revenue opportunity, especially on Europe-to-Asia routes. You talked about that on the last call. Has that been quantified anywhere, or is there really a way to go at that?
- Alan Graf: 00:43:44 Well, let me add a little bit to what Fred said and try to get us a little bit further down the road. First, you should know that Fred and I had been looking at TNT for damn near 30 years. The first assignment I got as CFO from Fred and the Board of Directors was to go restructure Europe.
- Alan Graf: 00:44:07 I don't ever want to do it again. We were losing \$1 million a calendar day, and this is in '92. So "don't ever forget nothing," which I learned from my boss. "Don't ever forget nothing."
- Alan Graf: 00:44:19 We were anxious to buy TNT. It was expensive when UPS made their offer, which was substantially higher than the one that we ended up making. We talked at length about, "Well let's top them," because we needed it. We decided not to. It was a bridge too far. As Fred said, "When the price got right, the price helped us take the risks that we took."
- Alan Graf: 00:44:40 We knew it would be expensive, and it would take time. I missed it; It took more money and more time, NotPetya notwithstanding-
- Staley Cates: 00:44:47 I was going to say, couldn't have foreseen part of that.

Alan Graf: 00:44:50 Notwithstanding, that really wasn't the biggest issue; It was really hard. As I look back on it with perfect hindsight, we weren't aggressive enough. That's all behind us. We are aggressive full speed right now. As you look forward, which is what I think our job really is to do, we learn from our mistakes. Don't ever forget nothing. We're offering *two full networks* every day. There's still a TNT driver in an orange shirt delivering packages. I never thought that would be the case in calendar year 20. It is, but that's about to end.

Alan Graf: 00:45:25 And we'll get the aviation operability in the year 2021. All those numbers that we've talked about are still true and even bigger, because the business has continued to grow. And despite our follies and foibles and trying to get a TNT label through the FedEx network where it made sense, and how we disappointed customers, they've stayed with us because we've done everything we could for them, and they know where we're headed.

Alan Graf: 00:45:49 So I know what the customers are saying. I know what I'm seeing in terms of what's going to happen on the cost structure, particularly as you go into FY21 over there. And then lastly, I think we've got a lot of really good people who really care. TNT is going to deliver exactly what we said. It's just a little bit too long and a little bit too expensive for what we had hoped.

Staley Cates: 00:46:14 Turning to more overall macro stuff, not just FDX-related, but you guys, as you mentioned before, you have an incredible dashboard of what's going on in different places. Can you talk more about the world economy, world trade situation?

Fred Smith: 00:46:30 Well, it's the same in the goods-producing sectors. I mean they're-

Staley Cates: 00:46:37 You showed the PMI charts in these slides.

Fred Smith: 00:46:41 They're down in all three of the big sectors, Europe, which led the way, and then the United States. And of course, the numbers that they put out in China are very opaque, but they're down there too. I mean, they have admitted that.

Fred Smith: 00:46:54 That's been the result of the friction that's been put into the trade environment by the tariffs and the anti-trade rhetoric, primarily of the Trump administration. So far largely driven by low interest rates, which you'd know more about than I do, it seems to have accomplished the purpose of being a fiscal stimulus for the consumer sector of the economy. The consumer



in the US remains the locomotive that's driving whatever growth there is.

Fred Smith: 00:47:30 Employment remains high and unemployment low, so the real question is going to be, "What happens as we go into 2020"? At the moment, there is no reason to believe it's going to materially change, absent the resolution of these trade disputes because nobody's going to invest with this uncertainty. What people missed was the goods-producing sectors of the economy are quantumly more global than the services sectors are.

Fred Smith: 00:48:03 So imports/exports are 13%, 14%, thereabouts, some place 26% of the total US economy. That's not the way they were accounted for in GDP because imports are reduced, otherwise you'd count them twice at final sale. But they're a huge part of the economy. When you start talking about manufactured goods, it's much higher than 26% or 27%. I mean, you can't make Bombardier business jets for North America, you have to make them for the world. You can't make machinery to make chips *just for* North America, you have to make them for the world. Increasingly, you have to make medical devices and medicines for the world, not for the domestic market.

Fred Smith: 00:48:58 And even automotive, which have brands in Europe and China and the United States, which differ to some degree, in large measure have common suppliers of the components and the parts and pieces that are necessary to make automobiles. So the goods-producing part of the business, which we are tied into, particularly in our express business in our freight business, it has been in a recessionary mode for a year, and absent trade resolutions, and I think in particular, re-embracing open trade.

Fred Smith: 00:49:36 I mean the United States today is overtly protectionist and China's overtly mercantilist, and neither one of them has been shown to be an effective way to increase prosperity. Open markets *have* demonstrated that effect. We've argued long and hard to everybody who will listen, the United States made a mistake walking away from the Trans-Pacific Partnership (TPP) and the agreement that we were working on with the Europeans when the Trump administration took over.

Fred Smith: 00:50:07 Our opinions have been respectfully listened to, but we haven't been successful in changing the course. I hope that at some point these things will be put behind us because absent that, you're not going to see a big macroeconomic growth spurt in my opinion.

Alan Graf: 00:50:26 At issue here is that, by design, we have worked many, many years to be the most exposed company to global trade. All those industries that Fred mentioned to you, the manufacturing thing, they'd source and sell on a global basis. All that stuff is high value. It can't go on a ship. It can't go on deferred forward or anything. It's got to go in 24-to-48 hours. That's what we've built our network for. We don't have enough of that traffic right now. So barring a big reversal, you're going to see us reduce the size of our capacity post peak here, which we can do because we've got a lot of ancient airplanes that we really don't want to be flying around anyway, and we can park them.

Alan Graf: 00:51:07 I think it is important to note that, as Fred has said two or three times, and I think it gets missed, particularly for a long-term investor, that network, except for one or maybe two lanes, is built out *forever*.

Staley Cates: 00:51:21 Yep.

Alan Graf: 00:51:22 We're connected to most of the world in 24-to-48 hours with plenty of capacity right now. What we can't stop doing is building our fleet and getting our fleet modernized. Trimotors don't work. They're hangar queens. They burn too much gas. There are always pilot issues about lights blinking when they shouldn't be. It's just they're old, and so for the next year and a half or two, we feel strongly, despite the fact that we aren't generating enough free cash flow as people would like over the next year or two, that as a result of our re-fleeting, the years beyond that, when we get into FY23 when the re-fleeting is largely over, our capital intensity goes *way* down. At the same time, all this stuff comes back.

Alan Graf: 00:52:07 We see that what's happened to us over the last 12 months reversing in that period of time, and we're on this great upward mobility in terms of free cash flow and return on invested capital (ROIC) with a completely built out global network that no one can touch.

Fred Smith: 00:52:22 That's the third big goal. The first, I mentioned to you to be the most successful North American package company. The second is to be the most successful global express business for packages and pallets. And the third, as Alan mentioned, as we get through 2022, all our A310s and MD-10s, which at one point we had 159 of them. 159 of them. The A310s are economically obsolete, unreliable as Alan mentioned. The MD-10s were very, very old. Some of them built in the early 1970s.

Fred Smith: 00:53:06 So we will have retired those 159 airplanes, and we will need to buy far fewer airplanes per year to, over a longer period of time, replace the MD-11s and to a lesser degree, the A300s.

Alan Graf: 00:53:24 Yeah, our cap ex ought to come down, while revenues and profits are going up post 2022.

Staley Cates: 00:53:29 I totally agree with you, that is unappreciated. I think it's more just because it hadn't happened. It would be such a watershed. It would be such a-

Alan Graf: 00:53:37 We agree.

Staley Cates: 00:53:38 ... go the other way that people ... it is hard. It's there in the footnotes. You show what the airplane commitments are.

Alan Graf: 00:54:47 I have to say, Fred brought it to my attention first about what Trump was saying about trade. Well, I was so euphoric in the fourth quarter of Fiscal 18. We were having the best quarter in the company's history with momentum. Express was at double digit margins on its way into teens. And then the summer came, and we started seeing a little bit of downfall. But the US was still carrying everything, and it wasn't until the fall, basically post our earnings release, that all of a sudden, my lights started flashing on my dashboard. The impact of those tariffs and those threats, everybody got nervous. People locked up. They stopped doing the plans they were doing. They slowed their production lines down. They didn't move their manufacturing, all those things. And that's where we're living in right now.

Alan Graf: 00:54:34 If that's a management error that's fine, but we're fixing that going forward.

Staley Cates: 00:54:39 So we talked a ton about the Postal Service and DHL in the international sense. Anything else about UPS to discuss competitively, or have we covered that?

Alan Graf: 00:54:51 I just want to stress that we have a better mouse trap. We have our independent service provider model, we can sweat our assets, we're a lot faster than they are in many lanes because we're more flexible, we're not as reliable on the rail as they are, although we probably can utilize the rail a little bit more, and we will. We're building on our large package business. We're going to seven days. We know exactly how we're going to seven days, we know exactly what we're going to cover in seven days, and we've got a lot of customers lined up and ready for it because they love it.

Alan Graf: 00:55:21 I mean, out in our neighborhood you see that postal truck out, if you're there on Sundays, driving around, doesn't know where they're going. They got a package. They're not sure which door it is. There's no manifest. It's a beautiful new truck, but I can't imagine how much money they're losing. We will over time make a significant amount of money on six and seven day. We won't just be doing it for the customer, we'll be driving profit there.

Staley Cates: 00:55:48 Can you move into succession plans, all things management? You've had a lot of different announcements at the top. Can you talk about those?

Fred Smith: 00:56:01 Well first of all, it's important that you understand FedEx has today, and has had for its entire history, a very formal succession program for the top leadership of the company. Not just me, but for every one of the top 40 or so senior executives in the company.

Fred Smith: 00:56:24 Our rule is you must have two successors ready to be appointed at any time in the event of your incapacitation or death. That's true of Alan, it's true of our general counsel, it's true of our marketing head, and so forth. We lost two officers last year, David Cunningham, who was the head of express, and David Bronczek.

Fred Smith: 00:56:58 Because of the succession plan that we have, it was Raj Subramaniam who was next person up, and he had taken over from David Cunningham and Don Colleran, our Chief Sales Officer, who like Raj, had lived abroad. And in Raj's case was from abroad. They moved into those positions and we never missed a beat.

Fred Smith: 00:57:26 I recommended to the Board of Directors, and of course our board is composed of independent outside directors, there's not any inside sycophants whatsoever. My recommendation to the board in the event of my death, which I hope is some time off, or incapacitation, is that Raj become the CEO. As Alan will join in saying that, because I know how he feels, that he's one of the most brilliant people you've ever met. He understands the company in great detail. He's been in operational roles. He's been in sales roles. As does Don Colleran, who also has been in sales and operational roles.

Fred Smith: 00:58:11 I would recommend that they make him the CEO, not necessarily the Chairman. We have several people that could perform that role, who are independent directors. That's my recommendation, and I feel confident that that is exactly what the board would do if those circumstances arose.

Alan Graf: 00:58:32 And a lot of people talk about FedEx because of Fred's service to our country and the militaristic approach. We have a lot of things that are militaristic, but one thing that all of us believe, particularly that has been there a long period of time, is that those people that are designated one or two, if they're not leaders, you don't get to be one or two. I mean, that's the number one thing. You've got to be a leader. You have to have *demonstrated* leadership.

Alan Graf: 00:59:00 How can Don Colleran go from sales into ops? Because he was a great sales leader. He knew how the operations works, that's how he sold the business every day. You've known me for a long time, I love operations. I mean, I really care about them, but I enjoy them. And it's fun to watch these networks work. So, it's just fantastic.

Alan Graf: 00:59:22 The other thing is that we have so many good people that we've developed over such a long period of time who have hired so many good people, that it never ceases to amaze me about where the ideas come from. Certainly not from my office.

Fred Smith: 00:59:35 That's true. Me too.

Alan Graf: 00:59:36 I mean, we've got people that bring stuff to me that I would've never thought of in a million years. And then we get it, we hook on it, and we implement it. Raj is a terrific leader, he's razor sharp. He's learning a tremendous amount. He's been my partner for a long period of time. Even when he was working for Mike Glenn, which was four jobs ago, we developed a good relationship. I have total confidence in Raj. He's killing it right now, and he's frustrated. He's taken a lot of it on personally. I said, "Raj, you're not setting tariff rules out there. We've just got deal with them."

Alan Graf: 01:00:10 He's perfectly capable, and he's going to be great in his role as COO. There's no doubt.

Fred Smith: 01:00:16 One other thing it's important that you and the audience for this podcast recognize, the strategy of FedEx is not *my* strategy, it's *our* strategy. We synthesize our strategy at the strategic management committee (SMC) level. The SMC runs the company. Over all the years that I've had this role, I'm fully prepared on something that the SMC members dealing with issues amongst themselves can't decide to call a jump ball, so to speak.

Fred Smith: 01:00:52 I think in all the years I've done it, I've had to do it twice. So the strategy of FedEx that we've articulated, particularly these goals

of being the most successful North American parcel company, the most successful global express company for packages and palettes, and to reduce our capital intensity as soon as the critical parts of the fleet modernization, are completed at the end of FY22, there are others. We want to continue our leadership in the FedEx Freight sector, which includes FedEx Freight Direct, which is over the threshold All our eCommerce customers want us to do it because it's very unsatisfactorily performed today by the other providers, generally with these unkempt, independent contractors that don't arrive on time and so forth. We think that's a real opportunity.

- Fred Smith: 01:01:47 And we want to be very good in our retail business, and we think we have a transformational SameDay Delivery bot, Roxo. Those are important, but those first three are the ones that we are pursuing and which I think are most important in the near term to our shareholders.
- Staley Cates: 01:02:07 Well, this has been incredibly helpful. Exactly what we were hoping for. Thank you both so much, and thanks for decades.
- Fred Smith: 01:02:14 Thank you.
- Alan Graf: 01:02:15 Thank you. We appreciate your support.
- Gwin Myerberg: 01:02:18 Many thanks to Fred Smith and Alan Graf for joining us today. And thank you to all of our listeners for tuning into The Price-to-Value Podcast with Southeastern Asset Management. As Staley noted at the beginning of the episode, you can review the FedEx slide deck and video reference and the conversation on the podcast episode page on our website at [southeasternasset.com/podcasts](https://southeasternasset.com/podcasts).
- Gwin Myerberg: 01:02:39 As always, if you have any questions or would like to share topics that you would like to see us cover in future episodes, please feel free to send us an email at [podcast@SEasset.com](mailto:podcast@SEasset.com).