

# FedEx Q1 FY09 Earnings Call Transcript – Sept. 18, 2008

## FedEx Q1 FY09 Earnings Call

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### Operator

Good day, everyone, and welcome to the FedEx Corporation first-quarter earnings conference call. Today's call is being recorded. At this time I will turn the call over to Mr. Mickey Foster. Please go ahead.

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### A. Mickey Foster

*VP – Investor Relations, FedEx Corp.*

Good morning, and welcome to the FedEx Corporation first-quarter earnings conference call. I'm Mickey Foster, head of Investor Relations at FedEx Corporation. The earnings release and a 25 page stat book are on our Web site at fedex.com. This call is being broadcast from our website, and the replay and podcast download will be available for approximately 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, and a follow-up, so we can accommodate all those who would like to participate.

I would like 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 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.

To the extent we disclose any non-GAAP financial measures on this call, please refer to the Investor Relations portion of our Web site at fedex.com for a reconciliation of such measures to the most directly comparable GAAP measures.

Joining us on the call today are Fred Smith, Chairman, President and CEO; Alan Graf, Executive Vice President and CFO; Mike Glenn, Executive Vice President, Market Development and Corporate Communications; Chris Richards, Executive Vice President, General Counsel and Secretary; Rob Carter, Executive Vice President of FedEx Information Services and CIO; Dave Bronczek, President and CEO of FedEx Express; Dave Rebolz, President and CEO of FedEx Ground; and Doug Duncan, President and CEO of FedEx Freight.

And now our Chairman, Fred Smith, will share his views on the quarter followed by Alan Graf. After Alan we will have questions and answers.

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### Frederick W. Smith

*Chairman, President & CEO, FedEx Corp.*

Thank you, Mickey. Good morning, ladies and gentlemen. Thank you for joining our conference call highlighting FedEx's financial performance during the first quarter of the fiscal year '09. As everyone now knows, global economic conditions are challenging. FedEx is taking strong, proactive actions to manage through this difficult cycle, however. We're committed to implementing strategies that will improve profits by reducing expenses, enhancing the customer experience, gaining market share and ensuring the long-term success of our company.

As I recently shared with FedEx team members and shareowners around the world, I'm confident we will weather the current storm successfully and emerge even stronger, just as we did in 1979, 1990-'91, after the dot com meltdown of 2000 and after 9/11.

FedEx has all the ingredients for profitable long-term financial performance. We have a strong and sound business strategy. We have precise planning. We have outstanding execution and, most important of all, we have a great team committed to making every customer experience outstanding.

We're especially reminded of our team members' dedication to serving our customers and those in need during the recent storms that struck the southeastern United States. In close cooperation with the American Red Cross a total of 80,000 family packs and food gifts were sorted, packed by volunteers and loaded aboard two donated FedEx aircraft for special delivery. Eighty skids of aid were airlifted to Memphis and trucked to Baton Rouge and Hattiesburg following hurricane Gustav. I want to thank the team for this and many other outstanding efforts in response to the recent hurricanes.

As FedEx faces today's especially tough economic challenges, we'll continue to hold the line on costs across all segments. This includes lowering variable incentive compensation, controlling discretionary spending and limiting staff. We intend to continue to increase productivity through innovation and reengineering. As one direct result, for example, jet fuel consumption is down more than 5% for the quarter. We aim to continue to lower our overhead cost and achieve greater efficiencies through more collaborative management.

During the first fiscal quarter we were able to lower our capital spending forecast for fiscal 2009 by \$400 million from about \$3 billion to \$2.6 billion. Should the

economic downturn become more pronounced, we stand ready to take additional actions to control costs. I want to emphasize, however, that we will not compromise our outstanding service levels or customer experience or take actions that will negatively impact our long-term future.

In this regard we'll not sacrifice opportunities to make investments with high returns such as the substantially more fuel-efficient Boeing 757's which are now entering our fleet, and the Boeing 777 long-range aircraft that we will begin to get next year. The 757 provides 20% more capacity per flight while improving fuel efficiency by 36% compared to the aircraft it replaces. Similarly, the 777 Freighter provides greater payload, range capacity while using 18% less fuel than current long-range aircraft in the FedEx international fleet.

We'll continue to invest in long-term strategic projects that expand and improve our global networks to better serve our customers. In this regard, since January, FedEx Freight has cut transit times in more than 2,800 service lanes in the United States, extending its leadership in the next- and second-day LTL Freight market.

Also in calendar 2008 FedEx Ground has improved transit times by one or more days between more than 41 million ZIP code pairs. FedEx Ground provides the fastest ground service to more businesses in the United States.

In October, FedEx Express will launch FedEx Express Nacional, a domestic next-business-day service across Mexico, one of the fastest growing markets in the express industry and a key part of FedEx International's growth and profitability. This is the first FedEx domestic service in Latin America and follows recent domestic offerings in China, India and the United Kingdom.

Earlier this month FedEx Express launched a new Airbus A310 flight to Vietnam to meet that country's increasing demand for reliable time-definite express services. In addition, FedEx Express upgraded our next-business-day delivery service from Europe to major U.S. East Coast cities. Customers who had two-business-day service now can reach more than 3,500 ZIP codes on the East Coast overnight from virtually anywhere in Western Europe.

FedEx offers the broadest coverage for next-day business service from Europe to the eastern United States now. In short, we believe we have the people, the plan and the resolve that will put FedEx in an excellent position to take full advantage of global economic conditions as they improve. And now Alan Graf, our Chief Financial Officer, will make some comments.

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**Alan B. Graf, Jr.**

*Executive Vice President & CFO, FedEx Corp.*

Thank you, Fred, and good morning, everyone. Earlier this morning we reported earnings of \$1.23 per share for the first quarter ended August 31, as we pre-announced last week, compared to \$1.58 per share a year ago. Our overall revenues increased 8% to \$9.97 billion, led by higher fuel surcharges, 4% higher FedEx Ground average daily volumes and 4% higher FedEx Freight average daily shipments. For the first quarter our results were negatively impacted by the continued weak U.S. economy, which is of course being affected by ongoing high fuel prices; a significant contraction in consumer spending; and a very tough pricing environment.

Looking at our segments and starting with Express, FedEx Express segment revenues increased 9% in first quarter, primarily due to yield increases driven by increases in fuel surcharges. These yield increases were partially offset by decreased volumes in U.S. domestic package and freight services as the weak U.S. economy and persistently higher fuel prices and the related impact on our fuel surcharges have reduced demand for these services and pressured base yields. Price per gallon of jet fuel in the first quarter of fiscal '09 increased 77% versus last year's first-quarter average.

U.S. domestic express yields increased 13%, although base yields, excluding the fuel surcharge, increased less than 1%. Package volumes declined 5%. International Priority revenues increased 12% with yields up 14%. Fuel surcharge and exchange-rate benefits provided 13 of the 14 percentage point increase in yield. International Priority volumes were flat due to a softening in all major regions of the global economy, most notably Asia-Pacific and U.S. outbound.

Cost containment activities combined with lower variable incentive compensation partially mitigated the negative impact of these factors on our operating results. Key cost containment activities during the quarter included: reductions in flight and labor hours; reductions in fuel consumption and maintenance costs; and freezes in hiring for most open positions. In addition, we continue to exercise stringent control over discretionary spending such as travel, entertainment and professional fees.

FedEx Express will increase shipping rates by an average of 6.9% for U.S. and U.S. export services effective January 5, 2009. The rate increase will be partially offset by adjusting the fuel price at which the fuel surcharge begins, reducing the fuel surcharge by two percentage points.

Now turning to Ground. FedEx Ground's segment revenues increased 9% during the first quarter due to yield and volume growth, partially offset by one fewer operating day. Average daily volumes at FedEx Ground increased 4% due to the continued growth of our FedEx Home Delivery service and increased commercial business resulting with market share gains. FedEx Ground's segment operating income was modestly higher as revenue growth and lower other operating expenses offset higher fuel prices and a competitive pricing environment.

At Ground fuel costs increased 118% primarily due to a significant increase in the average price per gallon of diesel fuel. Rent expense increased 19% due to higher spending on facilities associated with our continuing multiyear capacity expansion plan. Purchased transportation costs increased 13%; a result of higher rates paid to our independent contractors and increased fuel supplement costs. Ground continues to improve its already high service levels and speed up significant numbers of lanes as we continue to invest in the customer experience.

Looking at our Freight segment: FedEx Freight's segment revenues increased 10% during the first quarter due to higher less than truckload yields and shipment growth, again partially offset by one fewer operating day. Less-than-truckload yield increased 5% due to higher fuel surcharges despite the 25% rate reduction implemented in July 2007. In a very tough pricing environment, base yields declined.

Fuel costs at Freight increased 58% due to an increase in the average price per gallon of diesel fuel. During the first quarter average daily less-than-truckload shipments increased 4%, resulting from market share gains despite the weak U.S. economy and, again, a competitive pricing environment. FedEx Freight's segment operating income and operating margin decreased due to the fuel surcharge rate reduction implemented in July 2007 and, as I mentioned earlier, higher purchased transportation costs.

Now let's discuss guidance for a moment. We expect our results throughout the remainder of fiscal 2009 to continue to be constrained as we expect no improvement in the U.S. economy in the near-term and a continued slowdown in the global economy. We expect earnings to be \$1.40 to \$1.60 per diluted share in the second quarter compared to \$1.54 a year ago. For the full year we are reaffirming our earnings estimate of \$4.75 to \$5.25 per diluted share, which reflects weaker global macroeconomic conditions.

Home price declines, lower construction starts, deteriorating credit market conditions and the lingering impact of Hurricane Ike will restrain the U.S. economy and a rising U.S. dollar, until at least very recently, may negatively impact exports. This

guidance incorporates oil prices of approximately \$95 per barrel and the related impact on fuel surcharges which, of course, are reducing demand for our services and adversely affecting base rates across the company's transportation segments.

We will continue to have cost management initiatives in place across all segments, including controlling discretionary spending and severely restricting staffing. CapEx has been reduced to \$2.6 billion, as Fred mentioned, and we will continue to balance deferring capital while continuing to invest strategically in growing service lines, expanding our global networks and broadening our service offerings to position us for strong growth and better economic times.

We will not compromise our outstanding service levels or take actions that negatively impact the customer experience in exchange for short-term expense and capital reductions. Our balance sheet remains strong, we have plenty of liquidity, and we will be cash flow positive for fiscal '09. And now let me open the call to questions.

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## Operator

Thank you. (Operator Instructions). And our first question comes from Art Hatfield with Morgan Keegan, please go ahead.

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## Art Hatfield *Analyst, Morgan Keegan*

Morning. I guess this is more for Mr. Smith, but kind of a broader thought process. When we think about the global economic situation, and I hear what you're saying regarding guidance, Alan, are you guys saying that you're seeing the U.S. being more stable and then you're seeing the rest of the world slow down as maybe a lag to where the U.S. is now? And if so, what kind of time lag have you seen in that slowdown with the rest of the world? And what would be your expectations, if you even have any, with regards to growth as the U.S. comes out how far the rest of the world would lag behind the U.S.?

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

Art, good morning. I'm going to comment about the broader issues you raise and then ask Mike Glenn to comment about our specific economic forecast.

About a year ago this time, as I recall, I gave an interview to the *Financial Times*, and the focus of the interview was, has the world disconnected from the U.S. economy? At the time there was a theory out

there that the growth in Euroland and in Asia centered around China was no longer directly related to the United States to the extent that it had been. And my response to that question was that that was nonsense; that the rest of the world would definitely follow the United States if our economy went south.

And, of course, I take no pride in the fact that the forecast I gave was correct, and the world has slowed down, particularly in Europe. Asia is still growing because of the emerging China economy, the intra-Asia market in particular, and of course we're very happy that this December we open up our major new Asia-Pacific hub in Guangzhou, which we're going to show all of you that can come at the Investors and Lenders meeting. And China still continues to grow, but at a lower rate.

So the world is in the midst of a slowdown, which was led by the United States. We obviously have gone into a new realm on all this — these credit problems. But people sometimes forget there's the industrial economy, and there's the symbol economy or the financial sector, and the two, while they're highly related in many ways, they also beat to a different drummer in many respects, as well. So with that, I'll ask Mike Glenn to give our forecast.

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**T. Michael Glenn**

*Executive Vice President, Market Development & Corporate Communications, FedEx Corp.*

Good morning, Art. We actually have taken our GDP forecast on a quarter-over-quarter basis downward in the third calendar quarter of '08 and the fourth calendar '08 and are now looking at a GDP forecast for calendar '08 of 1.9%. And we expect to see similar economic conditions throughout calendar, excuse me, that was calendar '08, and we expect to see a similar economic forecasts through calendar of '09.

So certainly continued below trend economic activity as it relates to GDP here in the U.S., and it's difficult at this point to really see how the international economies are going to respond to that. So as Alan mentioned, we're not expecting any increase in global economic activity in the near term, we actually see more pressure there and certainly more of the same here in the U.S..

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**Art Hatfield**

*Analyst, Morgan Keegan*

If I can ask just a quick follow-up. Is there anything outside of FedEx that you're optimistic about?

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**Frederick W. Smith**

*Chairman, President & CEO, FedEx Corp.*

I think the Redskins are going to do great this year.

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**Art Hatfield**

*Analyst, Morgan Keegan*

Very fair. Very fair. Thank you.

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**Operator**

Thank you. And our next question comes from Donald Broughton with Avondale Partners, please go ahead.

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**Donald Broughton**

*Analyst, A.G. Edwards*

Good morning, gentlemen. If you could lay out for me maybe your top three, top five cost-saving projects and kind of help us walk through how much they're affecting margin on — and what the nominal dollar savings are. And explain to us how you're managing those so that you don't inhibit your future growth prospects when the cycle does turn back in your favor.

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**Alan B. Graf, Jr.**

*Executive Vice President & CFO, FedEx Corp.*

Donald, good morning, it's Alan. I'm probably not the most popular guy inside FedEx Corporation these days, but I can tell you that we have a great team of cost managers. All of our teammates have been educated on the situation, where we are, high fuel prices — I notice that oil is back up over \$100 this morning, weakening economic environment and that we need to stay very focused on our service levels, but also we need to stay very focused on our costs.

So we've got a lot of levers that we've pulled. I think we've talked to you several times about our incentive compensation programs, which have been very significantly curtailed. We are not replacing any staff at all unless it's an operational or sales necessity. We are managing our hours and our flight hours down significantly; Fred mentioned 5% less fuel consumption year over year at Express. And so it's completely across the board and I'm very proud of what we've been able to do. I think we're doing very well in a very bad environment and we will continue to do that. But there is no one thing; it is everything that we're doing.

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**Operator**

Thank you. And our next question comes from Peter Jacobs with Wells Fargo, please go ahead.

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**Peter Jacobs**  
*Analyst, Wells Fargo*

Thank you, and good morning gentlemen. I have a two-part question. Could you kind of break out the International Priority business growth in Asia? Because I'm trying to understand kind of the dynamics globally when I look at the zero growth that you saw in that business, but what particularly what were you seeing in Asia? And then kind of related to that, could you talk about the competitive environment that you're seeing in Asia and China now and how you'd put that in context with the growth rates that you're seeing there?

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**David J. Bronczek**  
*President & CEO, FedEx Express*

Okay, thank you, Peter. This is it Dave Bronczek. I'll answer the first part, and maybe my colleague, Mike Glenn, can help me with the second. But, in the Asia market, of course the electronic business has been soft; I think that's no surprise to anyone.

I should put a little color around the fact that on the flat volume growth, and obviously the yield growth that was mentioned before at 12%, we had one less operating day around the world. And in China, because of how the days fell, we had two less operating days. That coupled with the fact we had two less days on top of that because of typhoons there. So that's slowed down some of the growth there.

The good news is on our domestic Chinese front the volumes have been growing very nicely there along with the rest of the domestic international businesses around the world. So, you have to put a little bit of that into context of what's happened in the way the days have fallen this quarter for China.

I want — one more thing before maybe Mike adds some more color to it. Don't forget that the Olympics — their Paralympics are going on now, of course. The Olympics at the end of the first quarter also slowed some of the shipping and some of the volume down.

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**T. Michael Glenn**  
*Executive Vice President, Market Development & Corporate Communications, FedEx Corp.*

This is Mike Glenn. The competitive situation in China really resembles the competitive situation on a global basis. Our two primary competitors, UPS and DHL, are very active, as we are, but we have a very differentiated value proposition with the number of flights in and out of China, China and the continued expansion of our domestic service. So, we feel quite

good about where we sit and the value proposition that we offer in the market, but it is a competitive market.

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**Peter Jacobs**  
*Analyst, Wells Fargo*

Okay, thanks. And just a follow-up. If you kind of had to kind of normalize for the lost days, both from the typhoon and the two — one or two less operating days, if you had to kind of notionally adjust that, what do you think your International Priority volume growth might have been? Are we talking still low single digits or do you think it could have been plus 5%?

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**David J. Bronczek**  
*President & CEO, FedEx Express*

There's no question that we would have had volume growth higher than what we have shown, probably low single digits would be correct. We had IP mix in there, as well. We had some shifting of our volume to IPFS, which you probably have seen, grew 14%. So not unlike the United States, people have mode shifted a little bit as well.

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**Operator**

And our next question comes from David Ross with Stifel Nicolaus, please go ahead.

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**David Ross**  
*Analyst, Stifel Nicolaus*

Good morning, gentlemen. A question on the Freight side, if you could talk a little bit about volume trends for the quarter. The other LTLs were saying that June was particularly strong and July was pretty good, but that August fell off significantly. Could you talk about what you're seeing on that side and how September has been to-date?

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**Douglas G. Duncan**  
*President & CEO, FedEx Freight*

David, this is Doug. Actually our volume, if you look at our shipment growth, June and August were very similar. July was unusually strong. But to come out with 4% volume growth in a declining LTL market, we're pretty pleased with those volumes. September kind of began to echo August, but now with the softness due to the hurricanes and the shutdowns in Texas and Ohio, it's hard to get a good read on that at the moment.

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**David Ross**  
*Analyst, Stifel Nicolaus*

Okay, and also the shipment growth was very good. Most of the other LTLs are also reporting increased average weight per shipment as maybe some truckload overflow freight has gone into their networks, plus customers are downsizing multiple shipments into fewer shipments and larger weights. Are you seeing a significant increase in average shipment size or is there other things like length of haul impacting your mix?

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**Douglas G. Duncan**  
*President & CEO, FedEx Freight*

We don't really divert our assets to truckload usage. We're actually growing on our LTL market, which is what the fleet is for. So you won't find the truckload mix inside of our company the way you do at some of the others. So that 1% weight per shipment increase that we showed is a real increase in shipment size.

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**Operator**

Thank you. And our next question comes from Gary Chase with Lehman Brothers, please go ahead.

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**Gary Chase**  
*Analyst, Lehman Brothers*

Good morning, guys. I wondered if you could elaborate a little bit on — you've been talking a bit about IP growth, it was flat in the quarter. As you look forward and you think about the guidance, should we be thinking that the thought process around volume there is similar, flattish results through the remainder of the year? Do you think it will be down or back into positive territory looking forward?

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

Gary, this is Alan. I think Dave alluded to it a little bit. We're, frankly, expecting very similar IP results on a year-over-year basis the next couple of quarters, which is flat to perhaps down a bit. We will see some International Express Freight and International Priority Freight Service and our distribution services probably take some of that as people down-gauge a bit. But we'll be very close to flat or maybe down a bit, but we still believe that, because we have such an outstanding service, that we won't see anything like what we've seen in the domestic express.

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**Gary Chase**  
*Analyst, Lehman Brothers*

And Alan, historically you've talked to the growth in international and the incremental margins there; it's been one of the big stories behind the Express margin gains looking backward. How should we think about that in an environment where we're flattish? How are you managing that? And if it does turn a little bit negative, should we think the incremental margin is just as powerful to the downside or can you mitigate it?

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

We can mitigate that, and that's in our outlook for the year. And again, if it's the next couple of quarters I'm talking about, that's a short-term phenomenon. Over the long run it's still the driver of our value proposition. We have by far the best networks out there and we're going to continue to invest in them, expanding them. We just put in the East Coast Special, which Dave can talk about a little bit, which there's been very high demand for.

And so while we may see a little bit because of the economy here in the next couple of quarters, in the long run it's still going to be the driving factor for our value proposition. Dave?

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**David J. Bronczek**  
*President & CEO, FedEx Express*

Well, Alan, Fred already commented on it, but we're actually adding capacity where we think we have some incremental opportunities. The European late-night sorts back into the East Coast, we're reviewing other opportunities there, as well. Vietnam, Mexico, Canada, we're adding flights, upgrading flights into Canada, as well.

We're — one of the things that Alan pointed out that I mentioned earlier, that some of our traffic that you would see in our IP volume growth have just shifted to our International Economy and our IPFS service. So we're growing very healthy in both of those areas there. And as soon as the economy turns a little bit around, we're expecting a nice bounce back there.

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**Operator**

Thank you. And our next question comes from Jon Langenfeld with Robert W. Baird, please go ahead.

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**Jon Langenfeld**

*Analyst, Robert W. Baird*

Good morning. On the fuel side, are there any parts of the Company where fuel is actually a negative outside of the demand, I'm thinking more on the expense side, given how fast fuel surcharges come down? Or was it pretty much a positive across-the-board — year-over-year?

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**Alan B. Graf, Jr.**

*Executive Vice President & CFO, FedEx Corp.*

Well, the biggest factor is, of course, Express where we're about 295 million gallons a quarter of jet fuel and it dwarfs fuel everywhere else. And that was a positive year-over-year for us in the first quarter because of the decline towards the end of the first quarter. It will also be a positive assuming, as I said, fuel barrel prices stay the same here in the second quarter. In the long run it all evens out; and so positive in the first and second quarter and then we'll see about the second half.

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**Jon Langenfeld**

*Analyst, Robert W. Baird*

Fair enough. And on the pricing side, can you just comment how that looks in the domestic express side and how you would compare that to maybe previous cycles?

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**T. Michael Glenn**

*Executive Vice President, Market Development & Corporate Communications, FedEx Corp.*

This is Mike Glenn. If you look at the second calendar quarter year-over-year change in the average revenue per package for our primary competitor excluding the fuel surcharge, you actually see a decline of approximately 5% to 6% in the express segment and a slight increase of less than 1.5% on the ground segment. This compares to FedEx's fiscal Q1 year-over-year increase in average revenue per package, again excluding the fuel surcharge of almost 1% in the Express segment and over 2% in the Ground segment.

Therefore, even with the difference in timing, it would appear that they're taking a more aggressive pricing stance than FedEx. However, we continue to take volume and revenue market share in the Express and Ground segments and are confident that our revenue management strategy is working and certainly yielding the proper balance between volume and revenue growth. So we'll continue along our path.

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**Jon Langenfeld**

*Analyst, Robert W. Baird*

Thank you.

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**Operator**

And our next question comes from Tom Wadewitz with JPMorgan, please go ahead.

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**Tom Wadewitz**

*Analyst, J.P. Morgan*

Yes, good morning. Alan, I wanted to ask you one question on the guidance, and then I have a follow-up on margin side. Is there — I think the second-quarter guidance looks a little better than what the Street was expecting and you're keeping the full year range. Do you think that, I guess that the second quarter just maybe looks a little better due to the fuel benefit, or do you think there is maybe some conservatism in your full year number and perhaps just related to lack of visibility on volumes?

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**Alan B. Graf, Jr.**

*Executive Vice President & CFO, FedEx Corp.*

Tom, I've got to tell you, obviously I've missed three quarterly ranges in a row, so my previous track record has been destroyed by the volatility of fuel and the economic environment changes which are happening so rapidly. So, I have less and less confidence over the very short-term about these ranges. I'm still very positive about where I know we're going to be in the long run.

What we're saying in the guidance is that we're doing a little bit better in the first and second quarter because of the decline in fuel, but we see a continuing weakening global economy. And so the fact is that we probably see a little bit weaker overall revenue now than we did three months ago. And so that's why we've kept the year the same.

And, we'll see you again when we talk again in three months about where everything is going because it's very difficult to judge. We've talked to a lot of our customers. We — they tell us what their plans are. We feel pretty comfortable about the second quarter, after that it's a little hazy for us.

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**Tom Wadewitz**

*Analyst, J.P. Morgan*

Right. Fair enough. It certainly doesn't make any sense to be a hero on the guidance in this type of environment. On the Ground margin, the deterioration in the Ground margin was pretty moderate compared

to pressure on the Ground margin that was a lot more significant the last few quarters. Is this just kind of a one-time thing where you had less legal costs in the quarter, or are the cost measures in Ground sustainable and we probably see a little better Ground performance the next couple quarters than we had seen the prior couple quarters?

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**David F. Rebholz**

*President & CEO, FedEx Ground*

Well, this is Dave Rebholz. Alan made a mention earlier that fuel certainly impacted us, and frankly in a direct sense our surcharges did not cover off our costs but it's diminimus compared to Express.

Having said that, purchased trans was a key driver for us. And really when you look at purchased transportation, between the volume increases, the rate we pay and the increased fuel associated with that purchased trans, which is a function of growth, is really the big highlight in the numbers. And associated with that are some of the costs associated with the expansion of our multi-work area or the rate we're paying contractors, which is now up to roughly 60% are multi-work area contractors.

In terms of cost controls and other cost aspects, we feel very confident. And to your point about legal, the first quarter of last year had some unusual and significant legal expenses that we accrued, and that did not occur in this quarter as we're managing those costs as well. So I'm fairly confident going forward on the cost-containment. It comes again back to this whole economic environment that we're dealing with and the growth opportunities that may or may not exist.

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**Operator**

Thank you. And our next question comes from Ken Hoexter with Merrill Lynch, please go ahead.

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**Ken Hoexter**

*Analyst, Merrill Lynch*

Hi. Alan, can I just get a clarification? You keep mentioning that if fuel stays where it is. What number did you throw into those estimates? But my question really is kind of on the domestic international saw phenomenal strength. Can you comment on — is that just acquisition related or are you really seeing that level of growth in China and other places?

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**Alan B. Graf, Jr.**

*Executive Vice President & CFO, FedEx Corp.*

We sort of kind of factored in there for the second quarter a \$95 per barrel price; it's anybody's guess where it's going to be — bouncing around again today as it always does. And as far as our international domestic businesses, yes, they're growing. China is improving a lot. Now it's not as fast as we would like, and the yields aren't quite as good as we would like, but it's certainly improving although albeit a little bit slower rate. And in FedEx UK our service levels are unbelievable. That team is doing a great job. That was a great acquisition. We're excited about that. So that's a very strong point for us.

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**Ken Hoexter**

*Analyst, Merrill Lynch*

If I can just have a follow-up, then, on price. Do you find yourself in this environment using core prices? It sounded like you said before if you ex out all the fuel, pure pricing maybe in some of those categories would have been up 1%. Is there any area where you find you're getting more aggressive on price? Because, I remember you used to say that we'd look to use it on IP, we've got margins where we want, we're willing to use price more aggressively to get the volumes. In the downturn have you felt yourself moving toward that level yet?

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**Alan B. Graf, Jr.**

*Executive Vice President & CFO, FedEx Corp.*

Well, I'll give you just a brief answer, and then let Mike Glenn give you a little bit more color. As you look at International Priority, I mean the yields were up substantially, and some of that was fuel surcharge but an awful lot of that was also exchange rate and base rates. So that's a terrific story. It's a little tougher in the U.S. on ground and domestic express and I'll let Mike speak to that.

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**T. Michael Glenn**

*Executive Vice President, Market Development & Corporate Communications, FedEx Corp.*

Well, we certainly have a very disciplined revenue management process, which involves input from the finance organization as well as the operating companies. And certainly when there's an opportunity to benefit the company's bottom line we will take a more aggressive stance on individual opportunities, as we've talked about in the past. So, we just have to look at those on a case-by-case basis and, again, look at where it will benefit FedEx Corporation.

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**Operator**

Thank you. And our next question comes from Justin Yagerman with Wachovia Capital Markets, please go ahead.

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**Justin Yagerman**

*Analyst, Wachovia Capital Markets*

Hey, good morning, gentlemen. How are you? I wanted to ask a question on — I guess on the launch of FedEx Nacional in Mexico, I thought that that was an interesting timing. Are you guys seeing more near-sourcing opportunities that's driving that decision to enter the Mexico market? Are customers leading you there because manufacturing has gotten a little bit cheaper there with the transport costs of bringing things in from further away? Can you talk a little bit about that initiative and why the timing is now and that market?

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**David J. Bronczek**

*President & CEO, FedEx Express*

Yeah, this is Dave Bronczek. You're correct, and we're seeing a lot of companies asking us to consolidate their domestic shipping along with their cross border shipping. Juarez, Mexico into El Paso, Texas has been spectacularly successful for us, along with other border crossings from Mexico to the United States. There's a very nice opportunity for us to continue to grow very much like Canada. In fact, it's growing faster than Canada at the moment.

So there's a — we would have probably gotten into this market a little bit earlier if we could have. The timing is just that this all worked out for us right now. So we're very optimistic for the Mexican market, bundling our opportunities there into the United States and Canada.

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**Justin Yagerman**

*Analyst, Wachovia Capital Markets*

Okay, and then just a follow-up. I'm kind of curious as to the rationale behind lowering the fuel surcharge on FedEx Express when looking at the — the rate increase was obviously hefty and I'd be curious to get a sense of what you guys think retention will be like on that rate increase and how much of your customer base it's applied to. But then also, given the volatility that we've seen in fuel, why you would take away some of the fuel surcharge recovery there is something I was a little curious about in this environment.

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**T. Michael Glenn**

*Executive Vice President, Market Development & Corporate Communications, FedEx Corp.*

Yeah, this is Mike Glenn. The January 2009 Express rate increase announced today is consistent with our January 2008 rate increase and, like last year's, partially offset by the 2% reduction in the fuel surcharge. When the fuel surcharge was put in place, obviously average barrel prices were substantially lower than they are today, so we think it's important to, over time, reset that fuel surcharge more consistent with average barrel prices that we're seeing in today's environment. So, this is a trend that we have been following the last several years and anticipate continuing to do so in the future.

Regarding what percentage of the business is actually affected by the rate increase, over 75% of the Express revenue base will see the increase in the January timeframe with other customers being impacted throughout the year based upon contract anniversary dates. And we have a very high retention rate for our rate increases at Express and Ground, somewhere in the neighborhood of 70%.

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**Operator**

Thank you. And our next question comes from William Greene with Morgan Stanley, please go ahead.

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**Bill Greene**

*Analyst, Morgan Stanley*

Yeah, hey Mike, can I ask you to just follow up a little bit on the pricing comment you just made? Why are we being challenged on base rates now given what fuel's done if you have such high retention on big list rate increases?

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**T. Michael Glenn**

*Executive Vice President, Market Development & Corporate Communications, FedEx Corp.*

You're going to have to repeat the question. I'm not sure I understood what you were...

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**Bill Greene**

*Analyst, Morgan Stanley*

You just said that you have a strong history of pushing through these rate increases and a retention of roughly 70%. And yet the base rate increases that have been referenced in the press release today are much lower. And Alan sort of talked about yield increases of more like 1% ex-fuel surcharge. So I'm not clear kind of how — why you're feeling pressure on base rates, but you've got such high retention in list rate increases.

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**Alan B. Graf, Jr.**

*Executive Vice President & CFO, FedEx Corp.*

Hey Bill, it's Alan. Let me just say this. You've got to look hard at our mix. When we talk about a 5% decline, look hard at box and you'll see some of that. We're giving you overall yield numbers, not individual ones, that's part of it. And secondarily, Mike's talking about historically, he's not talking about the current environment that we're in. So let me let Mike talk about that.

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**T. Michael Glenn**

*Executive Vice President, Market Development & Corporate Communications, FedEx Corp.*

I think Alan's points are right. Customer mix is an important issue when you're seeing economic conditions like they are today. You see a down trade from overnight to deferred, deferred to Ground and all of that has a big impact on the rate environment and the volume mix as well. So all those factors come into play, but we've been able to retain a high degree of the rate increase in the past. We're comfortable with the amount of the rate increase that we've announced, again partially offset by a 2% reduction in the fuel surcharge.

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**Bill Greene**

*Analyst, Morgan Stanley*

Okay. So then if I look at the express business and we think about how it evolves during an economic cycle, do you think of it as leading or lagging? And if we think about this downturn, given what you've done on ground and how much you've improved the service there, is it possible that the rebound in express would be more muted going forward?

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**T. Michael Glenn**

*Executive Vice President, Market Development & Corporate Communications, FedEx Corp.*

Well, it's very difficult to project what the rebound is going to be. I clearly believe that some customers will see that ground is a viable alternative for their supply chains going forward. So it's quite possible that we will not see the rebound that we've seen in years past. But our value proposition in the domestic express and global express market is outstanding and where customers need that type of service we feel comfortable we'll see the impact — the positive impact when the economic situation improves.

But again, a lot of this has been related to — a lot of the volume impact has been related to a decline in

documents in the financial markets and things of that nature. So you really have to take that mix issue into consideration when looking at the business.

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**Operator**

Thank you. And our next question comes from John Mims with BB&T Capital Markets, please go ahead.

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**John Mims**

*Analyst, BB&T Capital Markets*

Thank you. I know you've cut your CapEx budget, but as far as spending priority, are y'all reallocating CapEx from Express to Ground or what projects are getting the highest priority?

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**Alan B. Graf, Jr.**

*Executive Vice President & CFO, FedEx Corp.*

Well clearly, as we said earlier, international expansion at Express is getting a very high priority, as is the continued growth at Ground and Freight. I mean, we are growing those businesses, and it's a significant amount of packages and a significant amount of weight, which requires hubs and terminals and dock doors and everything else. So, we're putting at the highest priority and the highest ROIs for the projects that we can see giving us the nearest term benefit.

Having said that, about half our CapEx in fiscal '09 is aircraft at Express. As we've mentioned many times, the 757 and 777, and Fred had that in his opening comments, are very important pieces of equipment for us going forward and we're not going to back off of those any. So we're at 2.6, which is about 10% lower than last year even though volumes are not that much lower. I think we're doing a very good job of managing our CapEx. And as I said, we will be cash flow positive this year.

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**John Mims**

*Analyst, BB&T Capital Markets*

Great. Thanks for that. And as a follow-up, on those planes, on the 777s, are those — are you replacing existing fleet with those, or is there the risk, if global demand keeps falling off, could you get too much capacity in some of your international lanes in the short-term, or are you pulling older planes out as those come on?

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**David J. Bronczek**

*President & CEO, FedEx Express*

No, the 777s will be international. They're not replacing any planes. International continues to grow. We're confident that we'll need all of those planes and are looking to Boeing for more in the future. But if there's any airplanes that we're looking at shorter term it would be here in the United States that we would be parking, for example.

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**John Mims**  
*Analyst, BB&T Capital Markets*

Great — okay. Thanks a lot.

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**Operator**

Thank you. And our next question comes from David Campbell with Thompson, Davis & Co, please go ahead.

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**David Campbell**  
*Analyst, Thompson Davis*

Thanks. Most of my questions have been answered, but related to China, I see where their imports were down in August from July. Do you think that represents the big slowdown there in that country, and what do you expect — don't you think that can be pulled back up in September/October?

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**David J. Bronczek**  
*President & CEO, FedEx Express*

David, we think it's the Olympics, primarily. There was a lot of controls put in place in customs and at the borders and so forth. So we think the majority of it was the Olympics.

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

David, this is Alan. Having said that, I will tell you that our big, strong, powerful electronics customers are not shipping as much with us this year as last year, nor do we expect them to during the second quarter. And that's simply a fact of life about the U.S. economy right now. So, that's also having an impact on APAC.

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**David Campbell**  
*Analyst, Thompson Davis*

Okay, thank you. I appreciate the help.

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**Operator**

Thank you. And our final question comes from Ed Wolfe with Wolfe Research, please go ahead.

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**Ed Wolfe**  
*Analyst, Wolfe Research*

Thank you, and good morning. It feels like there's been a move consistently now from air to ground because of oil prices and the weak economy. And to come out with a 6.9% Express increase now at this time when you've been talking about pricing being difficult probably I'm guessing will send more people to the ground. Is that the intention longer term?

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

Ed, good morning. Fred Smith. I'm going to take part of this and then Mike Glenn needs to answer the thing with a little more color.

It's very important, as has been said at least twice today, to look at the cohorts in the express business. The biggest decline in the express business percentage-wise is in the documents and packet sector, and that sector, of course, is heavily tied into housing, financial services, mortgage and increasingly over time, just as we're doing ourselves with our terrific FedEx Print Online, a lot of it is being diverted into electronic transmission media.

On the bottom side, the deferred express business is down more than the overnight box business. And my guess is, after many years in this business, when you look at the speed up that we've done in FedEx Ground and the great service that they're doing there, that probably has an affect there. But the interesting thing to me is, despite all of the travail and the economic downturn, the overnight express box business is doing pretty good.

So I think the markets are simply adjusting to the logical need. And as you know, because we've talked about it many times, our goal has been over the last 15 years to take our capacity in the express sector and use it more and more for the inland movement of international packages and that is occurring.

We haven't bought a pound of airlift for domestic express business in many, many years and the express business is continuing to increase. And there again, you've got to be careful about looking at just the overall category because the fastest growing segment in the intercontinental business is the International Priority Freight segment. It's the door-to-door retail freight business, and the door-to-door package business is relatively flat but the door-to-door freight business is growing at double-digits.

So, within these traffic cohorts there are some fairly significant trends there that lead us to believe that the businesses are a bit stronger than just the gross numbers would say. So I hated to be — go into that level of detail, but you really have to answer your question. Mike?

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**T. Michael Glenn**

*Executive Vice President, Market Development & Corporate Communications, FedEx Corp.*

Ed, as you know, this is the fourth straight year that we have taken 2% out of the fuel surcharge and put it into the base rate. So I think it's a mischaracterization to say that it's a 6.9% net rate increase. It is not. As we've done in years past, the 6.9% increase is partially offset by the 2% reduction in the fuel surcharge. So while it is not a straight 4.9% rate increase because the impact on individual customers may vary, it is not a 6.9% increase to customers, again, because that is offset by a 2% net reduction in the fuel surcharge.

So this level of rate increase is certainly consistent with what we've done in years past, and we feel comfortable with the impact it will have in the marketplace. And our desire is to put a customer's traffic in the network that best serves them. That's what we are here to do. We sell solutions to customers. So it doesn't matter to us if it's express, if it's ground, if it's international, if it's freight. Our desire is to put the traffic in the network that's going to provide the best value to the customer to create long-term value in the relationship.

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**Ed Wolfe**

*Analyst, Wolfe Research*

I appreciate the responses. If I could just have a follow-up to each of you because you did two different things. Fred, if international freight is suddenly growing faster than international packages, at some point does that lead you to change your thought process maybe in combining ground and air at some point to deliver that through the ground network?

And separately, Mike, just as a follow-up, the 4.9% net, that's a good point — net we're talking 4.9%, not 6.9%. But that's similar to last year and Alan said earlier you're getting less than 1% net of fuel right now. So it's hard to push that through; people are taking other options and slowing down the freight it feels like. It just feels like in this economy that maybe that pushes more towards ground. Do you think that I'm right thinking that way or not?

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**T. Michael Glenn**

*Executive Vice President, Market Development & Corporate Communications, FedEx Corp.*

Ed, it's very difficult to make that statement simply because the individual needs of specific customers differ greatly, and in some cases you are absolutely correct that we can meet the needs of a customer's supply chain by pushing more business into the ground. That is — we would do that no matter what the rate increase is. As you know, we've made substantial improvements in speeding up the network in ground where now 80% of the packages are delivered in three days or less.

So, clearly there is more opportunity to take domestic express volume and put it into the ground network to meet those customers. Having said that, we're pleased with the impact that has on FedEx's bottom line and the ability to manage that mix to meet the needs of FedEx and its shareholders. So, I wouldn't get too hung up on the rate increase, the magnitude of the rate increase, whether it's 400 basis points higher than it should be or not, that's a matter of opinion. It's consistent with what we've done in the past and we're very comfortable with our position.

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**Frederick W. Smith**

*Chairman, President & CEO, FedEx Corp.*

On the broader question about the international freight business, this is really the fruits of many years of labor here at FedEx. We have over the past decade been building out the intercontinental express network. So as Alan mentioned a few moments ago, it is by far the biggest — and that's, quite frankly, why we can mitigate cost on the downside if we need to.

We have so many flights, so many sections that we have greater scale and the ability to fine tune that. Taking a section out on the weekend or taking a section out on Friday or whatever the case may be, making another stop on the weekend and so forth. So we have a lot of flexibility to right size the intercontinental network that we didn't a few years ago.

But what we've also done is to build out our product portfolio so that we have door-to-door express freight service, IPFS; International Priority distribution service where you have an aggregate shipment that crosses a border, it's cleared as one shipment and then it explodes into smaller shipments, either freight or packages. And over the last couple of years we have vigorously rolled out the International Economy Freight Service, IEF, and International Economy Distribution service, IED. We may change that, that's explosive device — but not the same, not the same.

But in any case, those products have been growing very rapidly because as the price of fuel has gone up

— and I've made this comment before on these calls — as the price of fuel has gone up it's actually playing into our hands because these major consolidations by air, depending on the value per pound or the urgency of the piece of the shipment in some cases are going back into the water, and the door-to-door express freight shipments are more and more going in our network. And that's why it's growing so strong, it's a double-digit growth rate during the quarter.

Now those shipments obviously are built around our air system and around the airports and so forth. So there are significant differences in the type of equipment, the times of pickup and delivery, the routes and on and on and down the line between the express freight business and the FedEx Freight organization under Doug Duncan. So, at the moment we think that we're correctly organized.

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**Operator**

Thank you. And that concludes today's question-and-answer session. I would like to turn the conference back over to Mr. Mickey Foster for any additional or closing remarks.

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**A. Mickey Foster**

*VP – Investor Relations, FedEx Corp.*

Thank you for your participation on our first-quarter earnings release conference call. And please feel free to call anyone on the Investor Relations team if you have additional questions. Thank you.

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**Operator**

And ladies and gentlemen, that does conclude today's conference. Thank you for your participation. You may now disconnect.