Mu Capital Group

FedEx Corporation

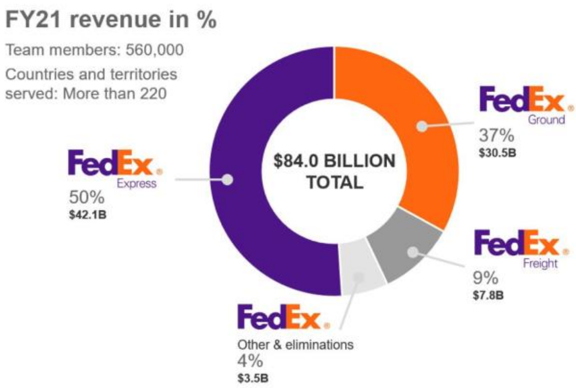
FedEx is a mature company operating in a sector supported by various secular trends. We believe FedEx is a great value play in times of record high valuation, inflationary environment and rising interest rate. We recommend a buy on the stock, with a price target of $317

Company Overview

FedEx corporation is a holding company focusing on the transportation of parcels in the US and around the world. The company was founded in 1971 and is now worth $60bn, with over $80 bn in sales. It is the market leader in express delivery and is one of the largest companies in its' sector alongside UPS, DHL and USPS.

FedEx is divided in 4 different segments:

- FedEx Express: The global network responsible for providing time-sensitive and air-ground express service.
- FedEx Ground: Renders reliable B2B delivery or convenient residential services. Although FedEx serves customers & businesses across the globe transcending geographical barriers, FedEx Ground is exclusively for North America.
- FedEx Freight: Provides an array of LTL (less-than-truckload) choices to address customer needs. This is interesting as freight is usually associated with large items and more quantities of an item, or multiple items, but LTL is a shipping service by land, sea or air for relatively small loads or quantities of freight.
- FedEx Services: Uses technology to address customer needs



FedEx uses its wholly owned subsidiaries to provide a portfolio of transportation, e-commerce, and business services. The company operates independent networks, each focused on its own respective markets, enhancing the service quality and reliability from each business unit. However, these networks interreact to build a holistic approach to compete in a dynamic and ever-changing market.

1/10/21

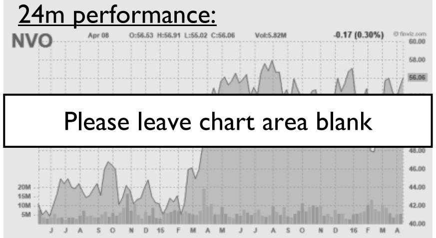
FDX

Price ([date])	[$220.00]
Market Cap (bn)	[$58.5]
EV (bn)	[$87.7]
Beta (5Y monthly)	[1.23]

Parcel Delivery

Price Target	[$317]
% Upside	[44%]

24m performance:



Market Data:	
52- Week Range	[219-319]
Shares Out. (m)	[265]
P/E (ttm)	[12]x
PEG (5-yr expected)	[1.14]
EPS (ttm)	[18.84]
EPS growth	[N/A]%
Div./Yield	[$2.8]/[1.28]%
Payout ratio	[15]%

Profitability:	
Profit margin	[5.9]%
Op margin	[9.06]%
ROA (ttm)	[6.14]%
ROE (ttm)	[5.88]%

Financial Data:	
Revenue (bn)	[86.6]
Revenue growth	[14]%
EBITDA (bn)	[11.7]
EBITDA growth	[NA]%
EBITDA margin	[NA]%

Leverage:	
Net debt (bn)	[29.8]
Total debt/equity	[1.5]x
Current ratio	[1.51]
Cash ratio	[NA]

While 70% of FedEx revenue comes from the US, FedEx is expanding internationally, obseved through FedEx Express growth. In 2016 FedEx acquired TNT Express, which rapidly accelerates their European expansion, substantially enhancing their global footprint through TNT Express's lower-cost road networks in Europe, the Middle East and Asia. The latter benefits the company as it further expands their capabilities and solutions for our customers. The completion of the physical network integration of TNT Express is expected to occur in 2022.

INVESTMENT RATIONALE

The company reported revenue beat but earning miss during their latest earning call (Sep 21). This was mainly due to a rise in labour, rental and gas costs. We see these rising costs as driven by macroeconomic factors, mainly due to policies implemented from governmental institutions. YE guidance was also cut following the miss, a disappointment for many investors, leading the stock to plunge 12%. Nevertheless, the broader market was down that day, exacerbating the sell-off. Investors mainly focused on the short-term headwinds, while neglecting the long-term value story we focus on. Indeed, the revenue beat indicates that the underlying demand remains strong, supported by secular growth E-commerce. This unjustified negative sentiment offers a great buying opportunity. Additionally, the 12x P/E multiple is low compared to i) the market's 33x P/E ii) to peers and iii) FedEx historical valuation (14x P/E), which suggest the company is undervalued. This investment presents lower downside risk and reduces our risk of multiple compression in an environment of increasing yields. Despite the earnings miss, FedEx remains a market leader in an attractive sector. The company also pays a healthy dividend of 1.5%, with a low payout ratio of 15%, which indicates there is room for dividend growth as well as capital appreciation – increasing returns. All these positives are summarised by Wall Street consensus on FedEx, with a 40% upside on average, and with the lowest target price above current levels.

MARKET POSITION

FedEx operates in a highly fragmented market, with smaller players competing for national markets (Royal Mail, USPS, La poste…).

FedEx dominates the US market with UPS and USPS, all with revenues around $80bn. They each offer more or less the same services but specialise in different areas. While FedEx is mostly recognized for its time sensitive international delivery, UPS is widely known for its domestic ground package delivery. FedEx is colloquially known as an airline that owns trucks, whereas UPS, a trucking company that owns airplanes. In an increasing globalised world and with economies emerging from lockdown, this can be a key driver for FedEx. Nevertheless, UPS has been slightly more successful in its ability to expand margins due to better operational efficiency and focus on lower cost ground delivery.

MANAGEMENT

FedEx has 7 corporate managers, 6 international leaders and an additional 3 members for each of the segments mentioned previously. This enables each party to focus on improving efficiency in their division. There are two notable figures in this management:

FedEx particularity is that its founder, Frederick W. Smith is still CEO. Considering the company was founded in 1971 and is a multibillion-dollar company, this is relatively rare occurrence. This is positive as the founder's vision is still implemented and the CEO's interest is aligned with shareholders (as he owns 5% company). Nevertheless, this might give him extra power on the company, limiting innovation and meritocracy within FedEx.

Raj Subramaniam is President and Chief Operating Officer and is another asset for FedEx as he has more than 30 years of industry experience at FedEx. He is responsible for several recent transformational initiatives, including revitalizing the company's operating strategy, profitably growing the e-commerce business, and harnessing the power of global supply chain data to drive the company's digital transformation.

INTEGRITY AND ESG ANALYSIS

Similarly to many companies nowadays, FedEx says it's a pioneer in ESG matters - but we do not totally agree with that. Firstly, independently on the ESG score, which is usually relative to competitors in the same sector, the parcel delivery service is a polluting business. Additionally, unlike UPS, FedEx doesn't have a unionised workforce, which signals management disproportionate power over their labour force. Finally, the management's lack of diversity is also disappointing, as out of 30 leadership roles, 2 are from ethnic minorities and 6 are women.

On a more positive note, the company is aiming to go carbon neutral by 2040, by using only electric vehicles, improving efficiency of jet fuel and investing in carbon capturing technologies. This is 10 years ahead of competitors, and particularly encouraging. Furthermore, FedEx has been vital in test and vaccine distributions during covid, enabling the US governments to limit the spread of the virus. Overall, we see the company as average from an ESG perspective

KEY RISKS

We have identified several risks with FedEx. Firstly, the high debt level, with a debt to equity at 80%, could pose a threat to shareholders returns. In an environment of rising yields where refinancing this debt will become more expensive, this is particularly worrisome. FedEx desire to reduce its debt should be prioritised. Most of the debt is long-term, which is reassuring. Compared to peers though, FedEx is less exposed to this risk as UPS and DHL both have higher D/E ratios (200% and 100% respectively). Additionally, the company will face supply chain congestion ahead of peak season. Further increases in costs due to wage pressure and labour market constraints will hamper the company's ability to meet rising demand. The latter coupled with the company's low margin business, could have detrimental effect in the next few quarters and see several earnings miss as margins compress further. Indeed, the company has trouble passing down costs to consumers fast enough. Finally, E-commerce growth is decelerating as Covid tailwinds start to fade. Nevertheless, we see most of these risks dissipating in the long-term.

OPPORTUNITIES FOR GROWTH

Analyst expect the synergies from the TNT integration to materialise YE22. FedEx had trouble with the integration of the TNT network, which has disappointed investors in the past few years. Patient investors should soon be rewarded as this will relief supply chain congestion and contribute to the company's goal of expanding margins. Secondly, FedEx should enjoy a boost in demand from economies reopening as B2B activity picks up. Finally, the E-Commerce secular growth story is here to remain, supporting demand in the long term and benefiting FedEx business mode. Overall, the company's long term prospects are mainly positive, and the recent sell off and particularly cheap valuation offers a good opportunity for buy and hold value investors.

FINANCIAL EVALUATION

FedEx's beta of 1.27 reflects the extra volatility associated with the stock against the broader market. In the last quarter, the stock has fallen nearly 30%, including a 12% fall in the week after FedEx's quarterly report, which did not meet analyst expectations. However, we see this as a market overreaction, which provides an opportunity to purchase the stock at a significant discount. The company cited rise in costs due to constrained labour markets creating an estimated $450 million in additional YoY costs. However, revenue growth still beat expectations.

Moving onto key indicators, the company revenues have steadily grown revenue in the past few years, leading the firm to beat earnings four quarters in a row before last quarter. FY2021 numbers were particularly impressive, with tailwinds from the pandemic helping the company post a record historical revenue growth of 21.06%.

Looking at past performance, profitability ratios indicate strong management, with return of equity strong particularly in FY2021 at 22%. The growth of ROE of 19% from FY2019 to FY2021 illustrates an increase in management effectiveness via leveraging company assets to create profits. 5% growth in profit margin & profitability from FY2019 to FY2021 shows FedEx's ability to generate profit and create growth opportunities in the long run. Asset Turnover is consistently over 100% bar 2020, reflecting the efficiency of revenue creation through its assets.

The company liquidity and debt ratios reflect the institutional 'too big to fail' nature of the company. The illiquid nature of the company has remained relatively constant, hence is of little concern. The debt to equity ratio was lowered significantly towards the end of FY 2021, with FedEx reducing outstanding debt by over $2bn through debt refinancing. Whilst long term debt at $20 billion is still significant at around one quarter of revenue, it is in line with competitors and is certainly manageable. The $6.8bn held in cash & cash equivalents combined with a practically constant current ratio of around 1.5 shows that the company has the capability to pay for short-term obligations that were otherwise unexpected. Whilst the company does have high debt levels, the coverage ratios are still healthy, ensuring the company will remain stable in the future with a strong balance sheet.

The comparative analysis was conducted with only two other companies - UPS and DHL. The analysis showed that FedEx valued cheaply versus peers from our comparative template. Historically, FedEx has traded at a discount to UPS, its main competitor. However, this difference deviates from historical norms, in particular on the P/BV metric, suggesting we would be buying real and not inflated assets. Even if we take out the P/BV metric of our analysis, we reach a 30% upside. The company is trading at 12x Trailing P/E well below the historical average of the company, which stands around 14x.

Looking towards valuation, a PEG ratio of 1.14 is attractive against the broader market. However, the financial and comparative analysis, combined with historical valuations of FedEx indicate that the stock presents a great opportunity for a discount bargain. As mentioned previously, the P/E ratio of 12.68 is much lower than the industry and historic average of FedEx. Through our comparative analysis, our implied price of FedEx is $317.60, in line with the typical average and median analyst expectations. From a quantitative point of view, the company is healthy and appears to be mature. This seems like a value stock that would be a great addition to the portfolio on a valuation basis.

Shareholder Structure

75% of the company is owned by institutions, and almost 8% by insiders (including 5% by the CEO). The Vanguard Group is the largest shareholder with around 6.5%, followed by Primecap advisors, at 5.2%. The company is largely held by institutions and is part of the S&P500, which should limit downside risk.