FedEx Corporation (03/07/2020)

We invested 6% of the fund's capital into Fedex in March at USD118.36.

We simplistically think of Fedex as an asset heavy service network that becomes increasingly valuable and entrenched as its volumes grow. The network is skewed towards business to business deliveries, while maintaining a meaningful exposure to business to consumer activities. The network is focussed in North America, with a significant presence in Asia and expanding interests in Europe. We hold management in high regard.

The business is exposed to trade and the macro environment. Despite this external volatility, we consider that Fedex has generated attractive returns on capital over time; they have tended to invest aggressively ahead of growth, but then they have consistently delivered adequate returns from this investment. We think of Fedex as a high quality business that operates in cyclical areas.

Over the last two years there have been a number of issues weighing on Fedex. Global trade tensions disrupted their activities, their acquisition of TNT Express NV has taken longer and been more difficult to integrate than expected, Fedex have increased their North American deliveries from 5 to 6 and now often 7 days a week, adding network capacity when volumes have been softer than anticipated, Amazon has aggressively built out its last mile delivery infrastructure to such a degree that Fedex stepped away from servicing them in 2019 and now the economic dislocations of COVID-19 has added to this mix.

When we think about this list of concerns, we focus on Amazon's activities in last mile delivery. Aside from this concern, we consider the other points to be either inherent in the nature of the business or the expected results of management's decisions. These decisions would have immediate negative impacts on earnings, but they are initiatives designed to strengthen the business longer term.

The TNT acquisition was always going to be complex, but it provides Fedex with a dense, domestic European focused delivery network that is difficult to replicate. Increasing delivery days in North America expands the capacity of the network and improves its service levels ahead of volumes, and walking away from Amazon's business aligns Fedex with retailers outside of Amazon's environment and eliminates the risk of Amazon pulling increasing amounts of their delivery volumes in house. We regard these initiatives as positive – they are intentional, the earnings impacts are expected. We view this as a completely different dynamic to management being blindsided and then trying to manage problems within a business.

With regard to Amazon's expansion into last mile delivery, our view is that Amazon's internal growth is forcing them to expand in this direction. Amazon's volumes are large, highly seasonal and growing at 20% plus. UPS, Fedex and the US Postal Service don't have either the labour or physical capacity to adequately service these seasonal and growing peaks.

In 2019, Fedex stepped away from servicing Amazon, aligning itself with retailers outside of Amazon's environment. They are capable in managing and are actively pursuing volumes in non-standardised packages (think packages that are either too heavy or too large to be processed through an automated package sorting facility). Our view with regard to the Amazon risk, is that there is enough room for both of them in last mile delivery. The space is a lot larger than business to consumer online fulfillment. We expect that Fedex will continue to find profitable opportunities despite Amazon's involvement.

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