FedEx Corp.

| Overweight Reason for Report: Company Update |

**Fear & Loathing In Las Vegas...Notes From The ISP Expo**

**INVESTMENT CONCLUSION:**

Admittedly the title is a little over the top, but we couldn’t pass up the opportunity to riff Hunter S. Thompson. Ultimately the attitude at the Route Consultant Contractor Expo this weekend was a mixture of love/appreciation towards FedEx and widely held concerns that e-commerce/B2C has made the ISP/contractor business model less profitable and for some, unsustainable. Inflation, fuel and a botched 2021 peak have put many ISPs in a hole, and FedEx Ground has been unresponsive to these challenges. That said, near-term this is likely only a headline risk, as our sense is there is a low probability that this unrest translates into any meaningful level of coordinated work action that disrupts peak operations. Long-term, it's clear that there are structural problems here. We continue to believe the Ground ISP model, which is broken and inefficient, needs an overhaul for FedEx Ground to ultimately achieve the results shareholders expect.

**KEY POINTS:**

**It's a Business Trip...I Swear.** This weekend we attended the Route Consultant Contract Expo & Party, which was held over two days at the Paris hotel in Las Vegas. There were about 4,000 folks in attendance, including roughly 3,500 FedEx Ground contractors/ISPs which equates to about 60% of FedEx Ground’s contractor base. For us this provided an opportunity to speak with a number of ISPs as well as attend two separate keynote addresses and a small group Q&A session by Spencer Patton, CEO of Patton Logistics, one of FedEx Ground’s largest contractors, who has been very vocal in recent weeks about the urgency for FedEx Ground to take meaningful action to shore up its contractor base financially. Mr. Patton also has a number of consulting businesses that serve the Ground contractor base. Notably, John Smith, CEO of FedEx Ground, was not in attendance. Our understanding is that Mr. Smith was invited to speak and address over half of his contractor base, but the invitation went unanswered. He should have attended, if for no other reason to see a performance by the Jabbawockeez.

**The Problem.** To be clear, every contractor experience is different based on mix of freight, contract terms and location, but contractor frustration with FedEx Ground is elevated currently. Our sense, after multiple conversations both at the Expo and with ISPs in recent weeks, is that after seeing strong profitability in 2020 due to additional payments made by FedEx and much higher volume, the margin structure for a Ground ISP/contractor began to come under pressure in 2021 with structural changes made by FedEx to the ISP contract, the roll-out of Sunday delivery (which has much lower package density and creates a number of operational challenges for the ISP as well as additional capital requirements and costs) and an acceleration in...
Express deliveries via Ground, for which the Ground contractor is paid a lower residential delivery settlement vs. a traditional Ground delivery. This is also part of a broader mix shift towards B2C/ecommerce deliveries, which the ISP gets paid less for generally. FedEx Ground has also been making unilateral contractual changes in its favor with as little as 30 days notice, which has frustrated the contractor base. These building structural headwinds were exacerbated by a bungled/botched peak season, where FedEx missed the volume projections that it told its contractors to staff/prepare for. For many contractors, our sense is that the money made in peak season is critical to bridging through to the next peak. With 2021 being a costly one for Ground contractors (poor projections by FedEx which caused overstaffing at the contractor level and unfavorable changes to contract terms related to "Schedule K"), they entered 2022 already behind the proverbial 8-Ball. Matters worsened this Spring with rising fuel prices and inflationary pressures. The way the Ground contractor/ISP contract works, only one-third to a half of the fuel cost is supposed to be offset by the weekly adjusted fuel surcharge. That’s fine if fuel costs stay in a relatively tight band, but when diesel goes up by 40% (as it did from late February to late June), that’s a problem for ISPs. As FedEx Ground has publicly stated in recent weeks, the remedy for this should be for a contractor to ask for a contract renegotiation. However, as one contractor told us, a renegotiation is like a sasquatch…he’s heard of one, but has never seen one. That was our sense broadly, contractors that have asked for a renegotiation have either been told no or the requests have gone unanswered. This has left many contractors feeling upset, and unsure about how to proceed. They appreciate all that FedEx Ground has helped them build over the years, but they are also now facing challenges to their businesses with some contractors telling us that they are just hoping to get to peak and currently running their business on credit cards to survive. Contractors are increasingly looking to exit the business, with the number of ISP businesses for sale up by nearly 65% y/y and asking prices down about 8% as a % of revenue since January 2021, but there are still bidders for these businesses and sellers are still getting about 95% of tier asking price on average. Interestingly, however, increased ISP failures and defaults have caused the Small Business Association to flag loans for ISP routes, which we think is worth watching as it could create less liquidity for new capital to come in to buy these assets.

**The Ask.** Mr. Patton’s two keynote addresses did not feature his initial request from July for a $0.50/stop increase in payments to ISPs and a $0.20 increase in payment per linehaul mile. We are unsure if this is because Mr. Patton is no longer asking for this on behalf of the ISP community or if he feels like a more individual approach is more appropriate given how different the 6,000 ISPs are across the broader FedEx Ground network. That said, Mr. Patton did argue, to strong applause from the ballroom full of ISPs, that FedEx Ground needs to abandon Sunday deliveries. He is also asking for FedEx Ground to be more responsive to contractors in terms of renegotiations and to do a better job training Ground terminal staff, as well as improving technology at Ground terminals so that its daily projections of capacity needs from contractors will be more accurate. While Mr. Patton cannot and did not call for a group boycott or a horizontal work stoppage, he did tell the group that unless FedEx Ground addresses the significant financial challenges facing his business and ISPs broadly, he will not deliver packages on November 25, the day after Thanksgiving. While in the past, he noted that it has been lucrative for ISPs/contractors to take on “contingency” routes/packages at terminals when another contractor/ISP fails (recall that generally there are about 13+ contractors in each of FedEx Ground’s 600+ terminals), this peak season he does not believe that is in the best interest of contractors as it provides a safety net to FedEx Ground and will help the Company avoid addressing these structural problems. Mr. Patton also did not call for contractors to avoid signing “Schedule K”, noting that the 2022 peak season Schedule K isn’t out yet and could be an olive branch from FedEx Ground. Schedule K is a series of daily or weekly volume commitments by the ISP providing FDX a level of guaranteed extra peak season capacity and the ISP with extra bonus payments if additional volume thresholds are met, but penalties if they are not. As we noted above, the 2021 Schedule K was dilutive to many contractors and there are concerns that FedEx Ground could make it even more dilutive in 2022. Layer on top of this the concern that peak demand could be lower this year (it is our sense that several ISPs have been guided by FDX to prepare for a mid-single-digit decline in volume in the 2022 peak period) and there is a lot of apprehension about what lays ahead. Ultimately, if FedEx simply engages in a more constructive dialog with its contractors, we think that alone would go a long way to improving the relationship.

**An Attempt By Contractors To Meet FedEx Ground Halfway.** Beyond the clear asks that Mr. Patton and his fellow contractors have for FedEx Ground, we were encouraged that there is also an attempt to meet the Company halfway via ways to cut costs and drive increased revenue. On the cost side, Mr. Patton announced a fuel savings card, a tire buying program and a series of other measures in an effort to leverage the collective group’s buying power to lower input costs. We find it baffling that FedEx Ground, unlike so many other transportation providers, has not done something like this for its contractors before now. On the revenue front, Mr. Patton announced an annual dividend check for contractors that leverage these buying groups that ranges from $1,000 a year if an ISP leverages two of the five savings programs up to $10,000 if all five are leveraged. In addition, Mr. Patton announced a program to advance ISPs $200,000 immediately against their employee retention tax credit (the average ISP is in line to get an ERTC of about $565,000 in 2023). It seems Mr. Patton, in many ways, is doing FedEx Ground’s job for it by helping the ISPs bridge through peak and into 2023 when hopefully FedEx is willing to meet them in the middle.

**So Where Do We Go From Here?** As we noted at the beginning of the note, we continue to believe that the FedEx Ground model has major issues, given that all of its major stakeholders are unsatisfied, and is inefficient with waste and
capital inefficiency throughout. It's hard for us to see how exactly we can bridge back to 11%-12% margins at Ground over time (vs. 8% in FY22), much less long-term margin improvement, without a rethink of how the FedEx Express and Ground networks, which are currently separate, operate. Clearly changes are in the air, as the Company briefly touched on Network 2.0 at its June analyst day, but what does that look like and how are we going to get there? These are fair questions for investors to ask, but we doubt any substantive answers will be forthcoming in the near/intermediate term. It's clear that Ground contractors are under financial strain and (depending on their contract) their route likely isn't worth as much as it used to be. We sense little appetite from contractors to follow Mr. Patton's lead and park trucks ahead of the most lucrative part of the year for their businesses. They can't afford to do that or risk losing their routes. In addition, lower fuel prices in recent weeks likely also means the wolf isn't quite as close to the door today as it was in July. That said, headline risks remain here and if peak season 2022 mirrors peak season 2021, there will be a much more severe challenge facing these contractors and FedEx Ground in 2023.
APPENDIX A

ANALYST CERTIFICATION

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In general, we have utilized relatively standard valuation metrics within the transportation space to derive our price target for FedEx, including:

- Stock Price / Earnings Per Share (P/E ratios)
- Enterprise Value / EBITDA (EV/EBITDA ratios)

Risks to Achievement of Target Price for FedEx Corp.

- Significant or prolonged economic downturn
- Problems associated with current and future acquisition integration
- Legal challenges to the Company's use of independent contractors
- Increased regulatory environment for global aviation

Ratings Definitions

OVERWEIGHT (O) - The stock's total return is expected to be greater than the total return of the company's industry sector, on a risk-adjusted basis, over the next 12 months. EQUAL-WEIGHT (E) - The stock's total return is expected to be equivalent to the total return of the company's industry sector, on a risk-adjusted basis, over the next 12 months. UNDERWEIGHT (U) - The stock's total return is expected to be less than the total return of the company's industry sector, on a risk-adjusted basis, over the next 12 months. VOLATILE (V) - The stock's price volatility is potentially higher than that of the company's industry sector. The company stock ratings may reflect the analyst's subjective assessment of risk factors that could impact the company's business.

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