FedEx Q2 FY14 Earnings Call

A. Mickey Foster
VP - Investor Relations, FedEx Corp.

Good morning and welcome to FedEx Corporation's second-quarter earnings conference call. The earnings release and our 31 page stat book are on our website at FedEx.com. This call is being broadcast from our website and the replay and podcast will be available for about 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 in order to allow us to accommodate all those who would like to participate.

If you are listening to the call through our live webcast feel free to submit your question via email or as a message on stocktwits.com. For email, please include your full name and contact information with your question and send it to ir@fedex.com address. To send a question via stocktwits.com, please be sure to include $FDX in the message. Preference will be given to inquiries of a long-term strategic nature.

I want 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 website 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; Alan Graf, Executive Vice President and CFO; Mike Glenn, President and CEO of FedEx Services; Chris Richards, Executive Vice President, General Counsel and Secretary; Rob Carter, Executive Vice President, FedEx Information Services and CIO; Dave Bronczek, President and CEO of FedEx Express; Henry Maier, President and CEO of FedEx Ground; and Bill Logue, President and CEO of FedEx Freight. And now our Chairman, Fred Smith, will share his views on the quarter.

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

Thank you, Mickey. Happy Holidays to everyone and welcome to our discussion of results for the second quarter of fiscal 2014. FedEx posted solid second-quarter earnings reflecting improved performance at FedEx Express as the profit improvement initiatives that we introduced more than a year ago continue to gain momentum. We are very pleased with the excellent work by the entire Express team in improving their results.

While a later start to the holiday shipping season contributed to a decline in operating margin at Ground on a quarter-over-quarter basis -- year-to-year basis rather, we expect the full-year operating margin at Ground will be consistent with the FY 2013 margin of nearly 17%. FedEx Freight results were affected by a shift in customer mix and shipment attributes.

Overall we believe our strategy is working well and we are confident we will achieve our goals. We expect revenue and earnings growth to continue into the third quarter and the remainder of 2014 driven by ongoing improvements in the results of all our transport segments. Our balance sheet is strong giving us the flexibility to initiate the significant stock repurchase program announced in October while continuing to execute our strategic growth initiatives. The profit improvement program and the stock repurchase exemplify, I think, our commitment to deliver outstanding value to our shareowners.

I would like to thank our more than 300,000 team members around the world, many working in very challenging weather this very day to deliver the holidays to our customers. The past three Mondays, December 2, 9 and 16, were record days for average daily volume with this past Monday setting a record of more than 22 million packages. Now I will turn the call over to Mike Glenn and following that, Alan Graf. Mike?

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

Thank you, Fred. I will cover economic commentary as well as some commentary on yields per package. The FedEx economic forecast calls for moderate growth in the global economy. We see real GDP, industrial production and consumer spending better sequentially in both calendar 2014 and calendar 2015 in the U.S. and globally. Our U.S. GDP forecast is 2.4% for calendar 2014 and 3% for calendar 2015.

For industrial production we expect growth of 3.1% in calendar 2014 and 3.6% in calendar 2015. Policy risk remained high but improvement is ongoing in Europe and China. We estimate global growth of 2.8% in calendar 2014 and 3.2% for calendar 2015.

Turning to yields, excluding the impact of fuel, year-over-year Express domestic yield per package increased 4.3%. The increase was primarily driven by rate and discount improvements followed by increased weight per package and service mix.

The Ground package yield increased 3% excluding the impact of fuel. The year-over-year increase was driven by rate and discount improvements as well as an increase in extra services charges. Excluding fuel, international export Express package yield increased 3.2% year-over-year primarily due to service mix.

And finally, excluding the impact of fuel, FedEx Freight LTL yield per hundredweight declined about 1% year-over-year. The decrease was driven by changes in shipment attributes and heavier quarter end revenue deferrals due to the timing of Thanksgiving in the month of November. Alan?

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

Thank you, Mike, and good morning everyone. Second-quarter earnings increased to $1.57 per share and operating income increased 15% to $827 million. Yield improvements and cost management at Express were the primary drivers of the profitability improvement. Results also benefited from the favorable comparison to last year's Sandy impacted results, lower pension expense and a modest benefit from the voluntary employee severance program.

During the second quarter the Company repurchased 7.2 million shares of FedEx common stock for a total of 10 million shares repurchased fiscal year to date. The second-quarter share repurchases had no effect on the quarter's earnings per share, but will have an estimated $0.04 per share impact for the full-year.

Express had a wonderful quarter, operating income increased to $326 million, and margin increased to 4.8% despite slightly lower revenue. The profitability improvement was driven by stronger base U.S. and international package yields, lower pension expense and lower net expenses from ongoing cost reduction activities.

International Priority revenue per package increased 3% while average daily volume declined 5%. It's important to note that within the IP category average daily volume for the lower yielding distribution services declined while IP average daily volume, excluding these distribution services, increased 1%. International Economy average daily volume grew 10%.

Fuel cost decreased 8% due to 6% lower jet fuel prices and fewer flight hours. 3% fewer gallons were used year-over-year as we optimized our network and flew more fuel-efficient aircraft. Fuel price did not impact income for the quarter based on a static analysis of the net impact of year-over-year changes in fuel prices compared to changes in fuel surcharges. Express is implementing a 3.9% average list price increase effective in January.

Turning to our Ground segment, revenues increased 10% to $2.9 billion and operating income increased $424 million due to volume and yield growth at Ground and volume growth at SmartPost. Average daily volume at Ground increased 8% from continued growth in our commercial business and Home Delivery service.

The increase in operating income was partially offset by higher network expansion cost as we continue to invest heavily in our growing high-margin Ground and SmartPost businesses. Operating margin declined primarily due to this year's later start of the holiday shipping season, as Fred mentioned, as cyber week occurred in December this year versus November last year.

The seasonal increases in volume, revenue and operating income related to cyber week will be realized in this year's third quarter versus the second quarter last year. Ground and Home Delivery will be implementing a 4.9% average list price increase effective in January. SmartPost rates will also increase.

At Freight revenues increased 4% from higher weight per LTL shipment and higher average daily LTL shipments. Operating income increased slightly as higher revenue from increased demand was partially offset by higher purchased transportation. Weight per shipment increased 2% due to Freight's priority service offerings. Average daily LTL shipments increased 4% as the economy and priority services both grew.

Turning to the outlook, we expect revenue and earnings growth to continue into the third quarter and the remainder of FY 2014 from ongoing improvements in the results of all of our transportation segments. Based on these improvements, plus our to date share repurchase results, we are raising our earnings per share guidance for the full-year to 8% to 14% from the FY 2013 adjusted results. This compares to our previous growth range of 7% to 13%.

This outlook reflects share repurchases made to date but does not include any benefit from additional share repurchases. We plan to continue purchasing shares under the program but have no specific timeframe for completion. We have 32.2 million shares under our current authorizations remaining.

We are continuing to execute on the profit improvement programs we announced in October of 2012. The majority of the benefits from our profit improvement programs will occur in FY 2015 and to a greater extent FY 2016.

In our economic outlook that Mike discussed, coupled with continued execution of our profit improvement programs at Express and earnings growth at Ground and Freight, I see increasing earnings, returns and cash flows over the next several years. I too would like to thank all of our team members for their hard work and dedication during our very busy peak season. They are truly an amazing team.

Lastly, remember that Monday is the last day to ship your presents overnight and have them delivered before Christmas, and Dave can use the business. Now we will open up for questions.

Operator (Operator Instructions)

Art Hatfield
Analyst, Raymond James

Good morning, everyone. Just on the IP category, if you could discuss the reduction in volumes through distribution services. Is that something that you guys are focused on that you want to reduce exposure to? And if so, how could we think about that going forward from kind of a modeling or thinking about volume in that segment on the go forward? Thank you.

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

Art, this is Mike Glenn. We made a specific decision and elected not to participate in some product releases that would have traveled in our distribution services capability. That decision was driven by our revenue management yield improvement programs and that was the primary issue there that affected those volumes in the quarter.

David J. Bronczek
President & CEO, FedEx Express

Art, this is Dave Bronczek. Alan mentioned it and it is a good point. The majority of our IP of course is not the distribution services product and that actually grew 1% all around the world led by the U.S. outbound and Europe. And on top of that, our International Priority yields grew 4%. So we are very pleased with that category.

Operator
Tom Wadewitz, JPMorgan.

Tom Wadewitz
Analyst, JPMorgan Chase & Co.

Good morning. I wanted to ask you a little bit more on the Ground margin commentary both in terms of the second half and I don't if you want to offer any kind of medium-term comment just on how we think about that. But I kind of thought that in Ground margin sometimes when you went through the peak and you had the maximum volume going through that actually made you stretch the network and that was sometimes a little bit of a margin headwind.

But I guess you are characterizing the cyber week timing as being a factor that hurt your margin in the second quarter and maybe helps going forward. So just wondering if you could give a little further perspective on Ground margin near-term. And then, if we think about it, medium-term as being kind of stable in the high teens or however you want to comment on that. Thank you.

Henry J. Maier
President & CEO FedEx Ground

Tom, thanks for the question. This is Henry Maier. So let me give you a little bit of color here as to what is going on. First, I think it is important to realize that not only is e-commerce increasing our volumes during peak, it is making holiday volume spikes peakier. And you need to understand that over a four to six week period of time each year our business typically more than doubles.

And preparing for this phenomenon and ensuring we are able to handle it with the level of reliability and services customers expect is a year-long activity that starts in January of every year. And yes, it means every year that we invest increased operating expense in the second quarter.

This year we had to do some unprecedented things to prepare, which is just another indication of how we are enabling this new e-commerce economy. For example, our network expansion costs increased to ensure we have capacity for the forecasted volume. This is not only a peak phenomenon but it is just building the base capacity we need to handle the growth we see coming year round.

Our purchased transportation costs increase to ensure we have the resources to pick up and deliver all the packages. This happens every year and it includes rental equipment and purchase line-haul transportation.

This year we incurred some increased vehicle maintenance costs in Q2 that we have historically spread out throughout the year. We decided this year in preparation for the peak season, given the fact that it is so compressed as opposed to years past, it made sense to incur these maintenance costs now. And again the focus on that was ensuring outstanding service for our customers during this holiday season.

Now we operate our network seven days a week during peak, allowing our fixed assets to truly sweat and avoiding the cost of carrying capacity the rest of the year when we don't need it. These decisions afford us significant flexibility to manage our network in the busiest time of the year while providing unparalleled service to our customers.

Now all these things that I have mentioned are not atypical to what we do every year; the only thing that is different this year is the timing of cyber Monday, which begins a week that typically reflects some of the busiest volumes we see throughout the year, and the fact that this year peak is compressed into three weeks rather than four.

And we call that the compression of the calendar which, by the way, will be the same next year and then in 2015 we go back to something more normal, which is a four-week period of time. So I hope that answers your question.

Operator
Jack Atkins, Stephens

Jack Atkins

Analyst, Stephens, Inc.

Good morning, guys. Thanks for the time. I think it is pretty clear from your results that you guys are making some significant progress here on your profit improvement plan. But I guess just to kind of step back and kind of see where we are over the course of the last year, of that $1.7 billion that you expect to generate an incremental profit, where are we to date as far as the run rate that you've, as far as costs taken out of the business or incremental profit that is now in the business that wasn't there this time last year?

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

Jack, this is Alan. Let me just say that we are on track to be where we need to be by the end of FY 2016. I think you could see in the Express results that we are making some significant progress. We are also managing the business as we go. As I mentioned in the last call, the five buckets that we talked about back in October of 2012 are likely going to change but we are still committed to the number.

We are managing very aggressively the trade down in international. We were glad to see our peer IP grow and our yields go up this quarter. That is a very good sign. We are not going to give you benchmark measurements on where we are until we get further into the program. We are only two quarters in, but we are on track to be there by the end of 2016.

Operator
Scott Schneeberger, Oppenheimer

Scott Schneeberger
Analyst, Oppenheimer & Co.

Thanks. Good morning. I know it is early in both, but on One Rate and Delivery Manager, would love to get any commentary on how those are progressing, any quantification would be great. Thanks.

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

This is Mike Glenn. We are very pleased with the response to Delivery Manager, of course it is a key enabler to e-commerce this time of year by allowing consignees to really take control of the shipment, to manage the signature requirements, to redirect that to a hold location or schedule a future delivery.

So it is a big bonus to have that active and up and running during the peak season and it's critical to our e-commerce strategy. I will just say that our registrations are way ahead of expectation and we're pleased with the customer response to the program.

One Rate is still relatively new. Again, we're pleased with the response to that. Customers love the convenience and simplicity of the service and we expect a future positive response as well. So we're very excited about both of those opportunities and both of them play a part in e-commerce, which is especially important this time of year.

Operator

Ken Hoexter, Merrill Lynch.

Ken Hoexter
Analyst, BofA Merrill Lynch

Great, good morning. SmartPost only was up in the upper single-digits for I guess its second non-double-digit growth in the past 19 quarters. Is there a change here and did this impact the margins at Ground? Can you talk a little bit about that as well?

Henry J. Maier
President & CEO FedEx Ground

Thanks, Ken, this is Henry Maier. Volume at SmartPost was affected by the calendar and the later start to the holiday's shipping season. The yield was impacted by lower fuel in the quarter. Everything else was in line with what we historically see. Once again, it was all about the calendar.

Operator
Justin Yagerman, Deutsche Bank.

Justin Yagerman
Analyst, Deutsche Bank

Good morning, guys. I had one follow-up on Tom's question and then I had a question for you on International Economy. Just if you guys could quantify any numbers around that cyber week shift in Ground it would be helpful. And then similar to the question Ken just asked on SmartPost, I was curious on International Economy. Since this is a newer segment and it obviously ties in with the whole program you guys have on using third-party line haul.

We had I think a 15% growth rate last quarter, we had a 10% growth rate in volume this quarter. How should we be thinking about growth in that product going forward and your capabilities in terms of offloading to that third-party line haul network?

Henry J. Maier
President & CEO FedEx Ground

Justin, this is Henry Maier. More than a quarter of the volume that we see in peak comes in cyber week. And if you think about it, that volume in revenue and profit was all shifted to the third quarter.

David J. Bronczek
President & CEO, FedEx Express

This is Dave Bronczek. On the IE question, we've had double-digit growth in IE for many, many quarters now. But don't forget the IP product, the pure IP product is still the dominant product that we have, it's over 70% of all of our international packages around the world. So IE, yes, it's going into other networks, it's in a network that makes us more money, but the IP is really the key going forward.

Operator
Ben Hartford, Baird.

Ben Hartford

Analyst, Robert W. Baird & Co.

Good morning, guys. Alan, can you provide some perspective of the 32 million share repurchase authorization was incremental relative to the last quarter? Can you just give us some perspective in terms of how you're thinking about prior comments regarding the dividend and try to take the dividend yield up to a 1%-ish type yield versus thinking about buy backs on a shorter and intermediate term basis? Can you provide some perspective on that capital allocation strategy?

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

Well, I thought we were very aggressive in the second quarter, accumulating 7.2 million shares in that quarter alone. We don't have a specific time-frame for completion, but we will continue to be buying shares. And as for our dividend policy, of course that's a Board decision. Our Board generally takes that decision up in the June meeting, which has been what we've done for several years and my expectation is that's when we will address it again.

Operator
Chris Wetherbee, Citi.

Christian Wetherbee
Analyst, Citigroup

Thanks, good morning. Can you talk a little bit about capacity in the international lanes, sort of where you stand and any -- is there further progress or need to move towards third-party capacity, particularly on the trans-Pacific route? You're sort of where you need to be I guess relative to what the volume flows are right now. Is there any more to do in the short term?

David J. Bronczek
President & CEO, FedEx Express

Yes, we're very pleased with where our capacity is right now. The customers are as well. We've mentioned in several quarters now and in the past that we've made some trans-Pacific adjustments. And going forward we'll see how things go, but right now we're very pleased with where our network is.

Operator
Scott Group, Wolfe Research.

Scott Group
Analyst, Wolfe Research

Thanks. Good morning, guys, how's it going? So my question is on the Express side and kind of following-up on Justin's question a little bit. How much of the economy business or how much of the overall business has been moved at this point out of FedEx aircraft onto third-party aircraft? And where do you think that can go? And then just along those lines, when we look at CapEx for the year, I know you kept the guidance unchanged. But you're kind of below the run rate of $4 billion, do you think that there's any flexibility to cut that $4 billion down a little bit?

David J. Bronczek
President & CEO, FedEx Express

This is Dave Bronczek. I'll answer the first part of the question, then I'll turn it over to Alan. Our customers sit down with us all the time and they kind of tell us what kind of services they're looking for from Express. And we balanced our network right now to achieve those goals for our customers and for ourselves.

And so yes, we have opportunities to move more IP; we have opportunities -- more IE as well. As you know, the global marketplace for underbellies around the world keeps increasing. So we see that there's really no end in sight for what our customers want from us. And we of course have a great product offering in our FTN ocean business and that keeps growing. We do a tremendous amount of business in FTN now as well.

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

Scott, this is Alan. On your first question that Dave just addressed, let me just say that we are continuing very hard to continue to work on our international networks. And that, as you know, we taken down two trans-Pac flights since the announcement of our profit improvement program, going from ten to eight.

Recall that we retired a lot of airplanes early and accelerated depreciation on a lot of others and we are in a process. And we are managing our customers' needs with our continuing to get to the right place on our networks and that's going to continue all the way through 2014 and all the way through most of 2015 before we're going to probably be exactly where we need to be. But having said that, it's an integral part of our profit improvement program.

Now as to CapEx, I'm very happy with where we are in our CapEx, we've got a very strong balance sheet. It's very important that we do the two things that we are mostly doing with our capital. One is the fleet modernization has to continue at Express, it's an integral part of our profit improvement program. We're seeing significant benefits and you saw those in the second quarter, particularly in fuel burn and maintenance. That's going to continue as we continue to add the 767's and 757's.

And the other big piece of this is we have got to continue to expand the Ground network. And we are in the process of building three to five major hubs over the next several years. These are going to have very high ROIC. We are going to continue to grow Ground at a nice growth rate and maintain those high teens margins and that is an important part for what we are doing as well.

So we are as steely eyed as ever on CapEx, but we are intentionally spending a little bit higher than our 6% to 8% range right now in order to get the benefits to the bottom line.

Operator
Allison Landry, Credit Suisse.

Allison Landry
Analyst, Credit Suisse

Thanks, good morning. I wanted to ask a question on LTL. If you exclude the impact of weight per shipment and the shorter length of haul, what would the core pricing run rate look like just within the context of some of your peers' reporting numbers in the roughly 3% range?

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

Clearly, customer mix impacts that. What you typically see is smaller customers tend to have lighter weight shipments and shorter length of haul. And we have been very successful diversifying our customer base for LTL. So it certainly had an impact and it certainly has a drag on yield per hundredweight when you do see the change in mix of traffic.

Now we also had some stronger growth in other customer segments, stronger than anticipated, which provides an opportunity for some yield management activities which we have initiated and will be conducting going forward. So we think we have got a good handle on yield per hundredweight and where the levers are and we will be managing that along with the FedEx Freight operating company going forward to continue to improve our margins.

William J. Logue
President & CEO, FedEx Freight

Allison, this is Bill, let me jump in on that. Again as Mike said, we are really pleased with our volume across all the segments and particularly the priority and economy mix we saw very good growth in both, so we are excited about that. And also the year-over-year fuel surcharge came down, so that kind of leaves a big impact as well on the yield. So look at that and then, again, as Mike said, we are very focused on our yield management process so we are in a good position.

Operator
William Greene, Morgan Stanley.

Bill Greene
Analyst, Morgan Stanley

Good morning. Fred or Mike, can I ask you to comment a little bit on the evolution of the e-commerce space? There's lots of time some discussions about what Amazon is doing and could they ever sort of become a transportation company themselves with some of the logistics efforts they're trying? You don't have to speak to Amazon but how do you see that space evolving? Do players in that world become a competitor to you? How do you make sure you are kind of guarding against that kind of outcome? Thank you.

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

This is Fred Smith. I am going to make a couple of comments and then I am going to ask Mike to amplify on this and maybe some of my other partners can jump in here too, Henry or whomever, because this is a big subject. And quite frankly I don't think I have seen more mythology in the press about anything than I have about the e-commerce space over the last year or so.

The first thing I would say to you is there are two enormous transportation networks that are built around moving light packages and freight and they are FedEx and UPS. The size and scale of these operations are so big that it's almost amusing some of the comments about delivering items by drones. And we have a drone expert on the staff, it is Rob Carter, our CIO. He actually owns a drone and he reported that it can operate about eight minutes and carry four Budweiser beers at his farm.

Now that is not to belittle UAS technology because we've got a lot of studies underway in that area ourselves. But at the end of the day the inner-city transportation networks of FedEx and UPS and, to a lesser degree, the Postal Service which is designed around delivering very lightweight items.

All you have to do is look in your neighborhood with the small jeeps that drive down the road and the right-hand drive and so forth. That network is designed to move very lightweight things and publications and correspondence or letters.

Now the whole issue about e-commerce at the end of the day is it is very expensive to deliver things to residences. Not every residence gets a package every day and it is quite unlikely that every residence will start getting an item every day.

So in certain situations an Amazon.com or some very large e-tailer, they can unquestionably do local deliveries should they choose to do so. And I think in the case of some of them they use various local delivery options today. But for the vast majority of products moved, it is almost certain that -- if they are going to be delivered, be moved by one of those three large networks and then some of the smaller regional players as far as the eye can see. Mike, do you want to amplify on that?

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

Yes, I would say the important point to understand here is e-commerce has a very long runway both domestically and internationally and FedEx is well poised to benefit from both of those. Clearly e-commerce is growing at a multiple of overall retail sales, but having said that, based upon the Forrester Research, it will be 2017 before online sales represent a total of 10% of all revenue.

So, we are still at the tip of the iceberg here in terms of e-commerce and its potential. I think another issue that is a big driver is mobile devices now account for about 11% of online transactions. Free shipping is part of about 50% of the transactions. SmartPost is particularly poised to take advantage of that.

So there are a tremendous amount of emerging trends in e-commerce before you even get to looking at how big-box retailers are starting to respond at picking at the store level to facilitate efficient next day delivery on a cost-effective basis which FedEx is well positioned to take advantage of.

So I would say even though there is a tremendous amount of talk about e-commerce we are still in very much the early stage development of this channel and we sit right in the sweet spot of it. We talked about Delivery Manager earlier in the call about enabling our consignees to really take control of the transaction. Our retail network enables people to get their packages when they want to and we have got other technology out there that we are working on to further facilitate this.

So FedEx is extremely well positioned with our broad portfolio. But I think the important point here is that we are, again, very early in the overall stage of this channel. And again, I would just refer you back to that Forrester Research which states that it will be 2017 before we reach the 10% point of all retail sales being generated online. So a lot of runway here and we are well positioned to take advantage of it.

David J. Bronczek
President & CEO, FedEx Express

I will just jump in from Express' point of view, obviously the globalization of e-commerce in our global powerhouse network around the world with over 200 countries and all these customers and they are all global reaching now. This is a synchronization around the world that is an art form and we have been doing it successfully for decades now.

Operator
Brandon Oglenski, Barclays.

Brandon Oglenski
Analyst, Barclays Capital

Good morning, everyone. I want to come back to the discussion around capital priorities, especially in light of the share repurchase announcement back in October. Alan or Fred, is that really a change in strategic direction for the Company? And I know you have a lot of aircraft renewals to go the next couple of years, but when you look out beyond fiscal 2016 and you think about CapEx relative to revenue, should we be thinking longer-term that is going to trend closer to that 6% range rather than the 8% you are running today?

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

Hard to say. We will have to see what the opportunities look like there in terms of Ground's growth rate and how far along we have come on the Express profit improvement program. But certainly we probably will be high for the next couple of years. And if we have the ability to move a couple of things around, one or two planes comes in May instead of June, it can change these numbers.

But I think at least through fiscal 2016 we are going to be probably about where we are and then we will see how well we have done with our profit improvement program and how well we have improved our returns, which I think we will be successful at. So as long as we can see that modernizing the fleet and Ground growth continue to improve our returns we are going to keep investing in them.

Operator
Helane Becker, Cowen.

Helane Becker
Analyst, Cowen & Co.

Thanks very much, operator. Hi, gentlemen, thanks for the time. Alan, I think this might be for you. You mentioned that you are continuing to expand the Ground operations and you were building I think you mentioned three to five hubs over the next couple of years. I am just wondering, are you comfortable that you are able to expand these operations fast enough and that you are ahead of the changes that are taking place in delivery requirements or are you still kind of chasing change? Thank you.

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

Helane, I will start and I will turn it over to Henry. One of the great things about our Company is our operations and engineering group and OR groups are brilliant in determining where the forecasted future traffic flows are going to be, where hubs need to be and how much capacity we need to have.

And even though we have significantly stepped up our investment and we will continue to do that in

Ground to keep up with its growth, it is going to remain tight and it is going to remain tight by design. We will be able to handle those 50% increases that Henry talked about for the three to four-week periods of peak, but the rest of the year it should be running fairly close to full and I will let Henry give you some more information about that.

Henry J. Maier
President & CEO FedEx Ground

This is Henry Maier. We manage between 150 and 200 real estate projects a year typically. We take a five to seven year view of the marketplace when we plan these facilities. We are very careful not to add capacity we don't need 11 months out of the year. And at peak and month of December we plan to add operating expense as best we can to handle the volume surges so we can dismantle it when the volume leaves. And that is essentially the way we have run the Company for the past 20 some years and it has worked out very well for us.

Now sometimes we might get a little bit ahead, sometimes we might get a little bit behind. But, as Alan said, we are a highly engineered and highly automated operation and we have incredible flexibility to be able to flex up or down in the short-term to handle customers volume as it comes. So I think you should be confident going forward that we have a good plan to handle anything that happens in this business.

Operator
David Ross, Stifel.

David Ross
Analyst, Stifel Nicolaus

Good morning, everyone. Bill, can you talk about the reacceleration in FedEx Freight shipment volumes? Was that driven by bundling, increased sales force size? What was going on there to kind of show the best growth rate you guys have had there in a couple years?

William J. Logue
President & CEO, FedEx Freight

David, obviously we are very pleased with the volume growth and, as I said earlier, it is across all segments, the small, medium and large customers in focusing on Priority Economy volume coming out of both segments was really showing the value prop is kicking in. We went through a couple of quarters there that we had some volume challenge the last two quarters.

So the team really responded well, went out there and brought in some excellent volume for us. And as we go forward, as I have always said, our goal is double-digit margins and to get there we need really good balance on both volume and yield. That is our focus going forward.

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

David, it is Mike Glenn. We have terrific collaboration between the Freight operating company and our sales team. And let me remind you that the entire FedEx sales team in the U.S. sells our complete portfolio of services. And that is a strategic advantage for us and allows us to target and provide coverage for customers that are not typically seen by an individual when dealing with LTL transactions.

And again, combined with the power of the bundle and the terrific collaboration that we have with the operating company has really been a plus. We've also had enhancement to our automation systems which has made it much easier for our customers to do business with us and the outstanding service levels that the Freight team is providing really gives us an industry-leading value proposition.

Operator
Thomas Kim, Goldman Sachs.

Thomas Kim
Analyst, Goldman Sachs

Thanks. I have a couple of questions with regard to Express. First off, can you give us a guide as to the airfreight demand outlook by region based on your forward bookings and on your discussions with your customers? And I also would just like to follow up with regard to one of the earlier questions with regard to third-party capacity utilization. Can you give us a sense of what percentage of your IE is going on your planes versus third-party capacity just in terms of the relative context let's say at the beginning of the year versus where you think it might be at the end of let's say next year? Thanks.

David J. Bronczek
President & CEO, FedEx Express

This is Dave Bronczek. I can tell you that -- and I mentioned this before -- the U.S. international, as was reported this quarter, was up, Europe was up, Asia was off a little bit because of the distribution services primarily in the release of some of the product launches. Other than that though they were up in Asia and clearly across the world. So where our volumes and our yields and our network capacity sits, we were very pleased with where we were and we are this quarter as well.

In terms of third-party distribution, we are using FTN which is a sister company inside of Express very much now. And we are using it for some of the launches, quite frankly, as well. And we just have a lot of opportunity around the world to continue to move lower yielding traffic into the right networks to make us more money.

Operator
Jay Van Sciver, Hedgeye.

Jay Van Sciver
Analyst, Hedgeye

Good morning. Looking at the intercompany charges line for the different segments, why is Express seeing its cost decline relative to sales while Ground and Freight have seen probably less progress there or slight increases? And should we expect that shared overhead to be down in the second half of fiscal 2014 and into 2015?

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

Obviously that is one of the big places that we are working and it is part of the profit improvement programs to get our overhead down, not just in Services but at every operating company, and I think we are doing a very good job of that.

Our intersegment charges are very complicated. Some are directly based on revenue which would explain a little bit of why Ground is getting a little bit more and Express is getting a little bit less. Others are directly charged and others are just using basic good old cost accounting to arrive at what the appropriate ones are.

I can tell you that one of the good things about our Company is the great debates we have on this subject. And we have the right amount of tension in there and I think it makes us focus to keep them all as low as possible in total.

Operator
Jeff Kauffman, Buckingham Research.

Jeff Kauffman
Analyst, Buckingham Research

Thank you very much. Congratulations on the quarter. Alan, I want to focus a little bit on the capital for the Ground fleet and the air fleet. You mentioned you are taking capacity down and I know we have got fewer trans-Pacs, we are bring on new aircraft. Two questions.

One, what are we doing with the MD-11's that we might not be using in some of those markets? It doesn't look like you are planning on taking those planes out of the system just based on what you have in the release.

And number two, could you talk a little bit about your thoughts on alternative fuels, particularly as it pertains to the domestic delivery fleet?

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

Well, let me direct the fleet MD-11 question to Dave and then we will talk about who is going to answer the alternative fuels, but there is a lot of work going on in that regard. Dave?

David J. Bronczek
President & CEO, FedEx Express

Thanks, Jeff. We are obviously putting our 777's high reliability, low fuel, better operating cost airplanes, the 777's, in our international network, bringing back the MD-11's into our U.S. network, they're replacing the older MD-10's, some of our older planes. Some of those MD-11's are on lease as well. So we are going to be continuing to cycle this through our global network, but where the global service improvements and cost improvements are coming from, the 777's are going there, the MD-11's are coming back here.

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

Jeff, over time we are going to be an all twin operator, so that is longer-term and I'm not going to give you any specific time frames on that but that is where we are headed. And I'm going to ask my boss to talk about alternative fuels.

Frederick W. Smith

Chairman, President & CEO, FedEx Corp.

Regarding alternative fuels, we have efforts underway in all of the operating companies. In FedEx Freight they are the lead on natural gas powered vehicles. We are operating two test LNG over the road rigs and two compressed natural gas over the road tractors. They are performing very well as I understand it.

We have lots of focus on fuel improvement at FedEx Freight with aerodynamics and in FedEx Express, because they tend to use the lighter, smaller pickup and delivery vehicles, they are the lead company on electrification. We have about -- I think almost 500, maybe more, of all electrics and hybrids. And Ground has pioneered a lot of things, hydraulic vehicles and so forth.

On the specific question of biofuels, our aviation department has a lot of work underway in advanced projects of all types including autonomous aircraft, as I mentioned, or augmented aircraft, which is what I think is going to happen, just improved assistance for the flight crews. I think it is going to be a long time before you are going to see a lot of autonomous airplanes operating.

And there is no question that you can produce biofuels. FedEx Freight is buying biodiesel and FedEx Express is involved in a number of things with biojet. The problem with all of them is that while they are technically drop-in fuels and interchangeable with petroleum, they simply have not been produced at scale at a cost competitive price. But we are pretty confident that that will happen over time using a number of feedstocks.

The one contract that FedEx Freight has for instance is for biodiesel made of wood chips I believe, produced at a refinery in Columbus, Mississippi. So we have got a lot of work there, but at present there is no large-scale biofuels that are available to us. But I suspect that will probably change as you get into the 2020's, a lot of work going on and a lot of progress.

Henry J. Maier
President & CEO FedEx Ground

Jeff, this is Henry Maier. With respect to Ground CapEx, 90% of our capital expense in FY 2014 is to expand capacity. And included in that are expenditures for the new hubs Alan mentioned, building expansions and relocations, material handling and rolling stock.

Operator
David Vernon, Bernstein Research.

David Vernon
Analyst, Bernstein Research

Hey, thanks for taking the question. Just wanted to ask you, maybe Dave or Fred, on the international network strategy, some of the other investments that you guys have lined up in hub capacity in Osaka and Shanghai and get a sense for how those investments play into the sort of future development of the international network. Are you guys changing that thought process around those investments given the changes in market conditions? If you could comment on that I would appreciate it. Thanks.

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

This is Fred Smith. Let me make a couple of comments here because I want to make sure there is no confusion on the part of the investors. And then I will ask Dave to specifically talk about Osaka and Shanghai.

Regarding the network of FedEx Express, the current system of eight trans-Pacific flights and seven trans-Atlantic flights, and of course we have some Asia to Europe operations as well, in all likelihood that is not going to materially change for some period of time. That network is designed to offer competitively superior cut-off times and transit times and it is performing very, very well.

And the facilities, which Dave will talk about, are an integral part to speed up those processes and make them more automated and more efficient and to handle the volumes that sometimes have been inefficiently handled just because facilities are very difficult to put together in certain parts of the world. And the two you mentioned are going to be huge improvements.

So what you can anticipate, based on what the customers are telling us, is probably relatively slow growth in the IP sector with customers opting to take a day or two longer in transit in the International Economy sector. And both priority and economy have three flavors. There is the door-to-door package IP and IE, door-to-door freight IPF and IEF.

And then we offer a distribution service in both categories which is a large shipment that clears the border on a single clearance document and then it is exploded and goes to many different destinations and that can be either packages or freight. Sometimes that lexicon, those terminologies get misunderstood.

So that is why it is important, and Dave and Alan have both mentioned this to you, that IP, which is the real key product line, is actually growing and the yields are going up. The IPD, it is hard to make money with that product.

So I think what you are going to see is not very much change in the near-term in the backbone network and a lot of growth in the economy traffic which lends itself to being put in underbelly, which is going to grow next year, according to the last report I saw -- the capacity is going to grow about 5%. The 787, the 777-9, the A350's, there is going to be a tremendous amount of that underbelly capacity out there which is very attractive in terms of cost per pound and we are very effectively utilizing that and Dave's plans are to do even more of that.

So I didn't want anybody to be confused about those terms and about the backbone priority network which is working very well, it is going to work even better here with a couple things that Dave is going to tell you about.

David J. Bronczek
President & CEO, FedEx Express

Thanks, Fred. That is exactly right. Osaka opens in April, we are really excited about it. It lets us flex up and flex down off of our main backbone network without adding to that network with change of gauges, flights from Asia, feeding Asia into the rest of the world over Osaka. It is going to be terrific.

So as the volumes grow we just add change of gauge in Asia. Or if they decline we can flex down as well. So it is a terrific flex up and down. Shanghai is -- I was just out there recently -- a new facility, it is tremendously automated, very efficient, right in the heart of a lot of our business opportunities in China. So we are very excited about both of those hubs that are opening here shortly.

Operator
Keith Schoonmaker, Morningstar.

Keith Schoonmaker
Analyst, Morningstar

Thanks. I'm asking about longer-term use of railroad. And I believe you have recently mentioned using rail for about 17% of Freight line haul. Do you envision this increasing through the next couple of years? And maybe even beyond the Freight segment, are you connecting anything through Trade Networks using rail? And maybe even stretching it a bit more, does rail make sense for SmartPost line haul at some point?

William J. Logue
President & CEO, FedEx Freight

Keith, this is Bill Logue. Yes, on the Freight side over the past three years, as you have noticed, we have grown our rail usage substantially particularly on our economy offering, so that's worked out very well for us. We continue to look at lanes and adjustments, we made some this past July.

And again, going forward we will continue to look at our network. You saw some of our PT growth, purchased trans growth this year. And again, that was due to our rail increases coming off of July. And again, we will tweak and adjust our network as we see appropriate for the most efficient way to run our business.

Henry J. Maier
President & CEO FedEx Ground

Keith, this is Henry Maier. We use a little bit of rail throughout the year. In the month of December our rail usage jumps up, in fact I think this month it is about 7% of the miles that we run. That would include Ground and SmartPost. We use it where it makes sense. We won't use it where it degrades our service, so that is how we think about this in our network.

Operator
Anthony Gallo, Wells Fargo.

Anthony Gallo
Analyst, Wells Fargo

Good morning. Thank you. If I look at FedEx Express on the expense side excluding fuel, you did a nice job year-over-year, but you are still up a fair amount versus fiscal 2Q 2012. And part of that looks like it is in SG&A despite the fact that you have made some changes there, you're using more purchased transportation as the mix changes. How much of that was pension year-over-year and how much of that is pension versus say fiscal 2012?

David J. Bronczek
President & CEO, FedEx Express

This is Dave. On the purchased transportation, remember a lot of FTN expenses are in the purchased transportation and the revenues are up in there too and we made that change last year.

In terms of our overall expenses, as you can see, they are actually performing very well. Pension should have been a positive for us in the quarter.

Operator

Thank you. That does conclude our question-and-answer session. I would now like to turn the conference back over to Mickey Foster for any additional or closing remarks.

A. Mickey Foster
VP - Investor Relations, FedEx Corp.

Thank you for participating in the FedEx Corporation's second-quarter earnings release conference call. Feel free to call anyone on the Investor Relations team if you have any additional questions about FedEx. Thank you very much.