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The Battle for Value, 2016: FedEx Corp. versus United Parcel Service, Inc.

Teaching Note

Synopsis and Objectives

Set in April 2016, this case invites students to assess FedEx Corp.'s and United Parcel Service, Inc.'s (UPS's) financial performance. The two firms have competed for dominance of the package-delivery industry. This case is intended for use in an introductory discussion of corporate value creation. It requires few numerical computations from the student; rather, the tasks for the student are to interpret the results and to reflect upon their implications. The contrasting record of the two firms affords a platform to:

- Assess and compare the financial performance and health of two organizations. The case provides historical financial, market, and economic profit analysis for both firms. The case provides a stark contrast between backward-looking financial performance and forward-looking market expectations of performance.
- Motivate definitions of corporate excellence, with particular emphasis on comparing operational and financial excellence.
- Evaluate the financial implications of competition and corporate transformation.

Suggested Questions for Advance Assignment to Students

1. Describe the competition in the overnight package-delivery industry, and the strategies by which those two firms are meeting the competition. What are the enabling and inhibiting factors facing the two firms as they pursue their goals? Do you think that either firm can attain a sustainable competitive advantage in this business?
2. How are FedEx and UPS performing financially? Which firm is doing better? Prepare to discuss the insights you derived from the two firms' financial statements, financial ratios, economic profit, and stock-price performance.
3. If you had to identify one of those companies as excellent, which company would you choose? On what basis did you make your decision?

This teaching note was prepared by Michael J. Schill, Professor of Business Administration. It draws heavily from Robert F. Bruner and Sean Carr, "The Battle for Value, 2004: FedEx Corp. vs. United Parcel Service, Inc. (TN)," UVA-F-1484TN (Charlottesville, VA: Darden Business Publishing, 2005).

Hypothetical Teaching Outline

1. *What is going on in the package-delivery industry?*

This questions sets the stage for the class discussion. Students are likely to discuss the boon to the package-delivery industry caused by the rise of e-commerce and the threat of entry by online retailers. In addition, they are likely to talk about the competition between FedEx and UPS.

2. *Do you see this market as highly competitive? Why or why not? How are the two firms competing? What are the competitive prospects for the foreseeable future?*

Most students argue that this is a highly competitive market with intense warfare in virtually all functional areas of the two firms. The lines of competition include "tit-for-tat" entries across many products, services, and geographies. Case Exhibit 4 provides a particularly good example of the competition and the difficulty in differentiation across the two companies. There is much for the students to articulate as examples of competition. One might expect that the basis of competition will continue to be cost efficiency, service, and product and geographic reach.

Other students will maintain that this market is not highly competitive. Their view may center on the oligopolistic nature of the industry, with two main players that appear to demonstrate some level of cooperation. The financial performance provides some support for that view, with relatively high returns (e.g., the historical return on assets [ROA] and return on equity [ROE] figures for UPS).

3. *If you had to vote for one of these two firms to enter the pantheon of excellent companies, which one would you choose?*

Take a vote of the class and tally the votes on the board. Follow up with a detailed review of the rationale by a sampling of students who support each side. This discussion allows the instructor to compare and contrast operational performance metrics with those of financial performance metrics, and to take a deep dive into various forms and varieties of financial metrics. **Exhibits TN1**, **TN2**, and **TN3** provide a summary of some of these measures. Some observations are likely to include:

- UPS is larger across most dimensions.
- UPS has experienced higher margins, asset turnover, and returns. The 2015 ROE figure is astronomical at 194%.
- UPS has generated larger economic profit over recent years.
- FedEx seems to be achieving higher recent growth, both domestically and internationally.
- FedEx has generated larger stock returns over recent years.

A number of follow-up questions emerge from this conversation.

1. Are the operational metrics related to the financial metrics? For example, how is the superior-ranked UPS brand score related to the financial metrics, or how is the superior-ranked FedEx employee satisfaction score related to the financial metrics?
2. How is it that UPS has managed to achieve such an impressive ROE figure? A powerful way to explore this question is to decompose the ROE into three components: Margin (Net profit / Revenue), Turnover (Revenue / Total assets), and Leverage (Total assets / Book equity). By comparing each of these elements across the two firms, one notices that UPS has been superior across all three dimensions, but it is the leverage ratio that is particularly higher for UPS. One can

discuss with students what it takes to have a high leverage ratio. There are two things that may emerge: (1) leverage creates financial risk by magnifying operating returns and as such requires a higher risk-adjusted benchmark, and (2) there is a difference between book values and market values. If one substitutes in the market value of equity, the difference is much less stark. With its recent initial public equity offering, one can discuss why UPS's book equity value might be abnormally low.

3. What is economic profit and what does it measure? For students who have not been exposed to this financial performance measure (or any other), the instructor can use this opportunity to explore the intuition of the metric.

4. What does stock performance tell us? How can FedEx's stock-price performance be superior when UPS's financial ratios are so much better? This question affords a discussion about the difference between backward-looking financial ratios and forward-looking stock-price performance.

5. How do investors justify a higher PE ratio for FedEx? Students are likely to suggest that FedEx's more substantive growth prospects are what justifies the higher PE ratio.

6. What are the relative strengths and weaknesses of the various financial measures? **Table TN1** provides a summary of such a discussion.

7. What do we learn from the perspective of the research analysts?

Table TN1. The strengths and weaknesses of various financial measures.

	Strengths	**Weaknesses**
1. Direct inspection of the financial statements	• Reveals trends • Allows for comparison of absolute sizes	• Does not permit a ready assessment of efficiency • Biased by size differences • Book, not market values • Influenced by GAAP choices • Backward, not forward looking
2. Financial ratios	• Adjusts for size differences (a relative, not absolute, measure) • Provides comparative measures of efficiency and growth	• Based on book, not market, values • Influenced by GAAP choices
3. Earnings per share (EPS) and price/earnings ratios	• Widely used measures of performance • Linked to market price of stock	• EPS influenced by GAAP choices • EPS is not a cash flow • P/E difficult to interpret • Sensitive to choice of observation period
4. Total returns to investors	• Cash flow based • Market value based • Permits benchmarking versus other investments	• Sensitive to choice of observation period • Needs to be risk adjusted
5. Economic profit (EVA)	• Risk adjusted • Permits benchmarking • Theoretically linked to market values • Logically appealing • Increasingly widely used	• Influenced by GAAP choices • Ignores latent option values

Source: Created by author.

Closing

Summarizing or updating the earlier class vote, the class may close with an epilogue on the performance of the two firms since April 2016.

Exhibit TN4 provides a performance summary for 2016. The exhibit shows that in 2016, UPS's performance continued to be better than FedEx's across many dimensions (e.g., profit margin, asset turnover, ROA, ROE); however, the stock returns for FedEx continued to be higher (26% for FedEx versus 23% for UPS). Some justification for this is found in the relative improvement in financial performance. The ROA for FedEx went up to 4.0% while the ROA for UPS went down to 8.5%. One can note that the ROE for UPS went way up to 847%. Students can identify that the cause for this extraordinary ROE is again due to leverage, as the book value of equity for UPS was reduced through equity buybacks to just $405 million. FedEx also continued to outpace UPS on revenue growth (6% for FedEx versus 4% for UPS). These changes in performance could explain the updated expectation for the two companies contained in FedEx's outperformance in the public equity market.

Exhibit TN1

The Battle for Value, 2016: FedEx Corp. versus United Parcel Service, Inc.

Business Comparison, FedEx versus UPS

	UPS	FedEx
Financial measures		
Financial data (2015, millions of dollars)		
Revenue	58,363	47,453
Operating profit	7,668	1,867
Net profit	4,844	1,050
Total assets	38,311	37,069
Market capitalization	85,260	42,075
Revenue growth (2010 to 2015 CAGR)	18%	37%
% revenue international	22%	28%
Operating margin (2015)	13%	4%
Asset turnover (2015)	1.5	1.3
Return on assets (2015)	14%	3%
Return on equity (2015)	194%	7%
Economic profit (2010 to 2015)	$11,492	$1,671
Price to earnings ratio (2015)	22.0	37.9
Cumulative annual return (2012 to 2015)	43%	65%
Operating measures		
2015 daily packages delivered (millions)	18	11
Employees (thousands)	440	325
Jets	650	647
Brand rank	#29	#86
Employee satisfaction	#24	#12
		*Great place to work award
Customer satisfaction score	82	82

Source: Author analysis.

Exhibit TN2

The Battle for Value, 2016: FedEx Corp. versus United Parcel Service, Inc.

2011 and 2015 Financial Performance Comparison, FedEx versus UPS

	2011		2015	
	UPS	**FedEx**	**UPS**	**FedEx**
Revenue	53,105	39,304	58,363	47,453
Operating income (EBIT)	6,080	2,378	7,668	1,867
Interest expense	348	86	341	235
Net income	3,804	1,452	4,844	1,050
Capital expenditures	2,005	3,434	2,379	4,347
Cash and marketable securities	4,275	2,328	4,726	3,763
Accounts receivable	6,246	4,581	7,134	5,719
Total current assets	12,284	8,285	13,208	10,941
Net prop., plant, and equip.	17,621	15,543	18,352	20,875
Total assets	34,077	27,385	38,311	37,069
Current liabilities	6,514	4,882	10,696	5,957
Total debt	11,128	1,685	14,334	7,268
Total stockholders' equity	7,108	15,220	2,491	14,993
	UPS	**FedEx**	**UPS**	**FedEx**
Growth				
Revenue growth	7.2%	13.16%	0.2%	4.14%
Total asset growth	1.4%	9.97%	8.1%	12.09%
Operating income growth	7.8%	19.02%	54.3%	-51.06%
Net income growth	14.0%	22.64%	59.8%	-54.82%
Asset Efficiency Ratios				
Working capital turnover	9.2	11.55	23.2	9.52
PPE turnover	3.0	2.53	3.2	2.27
Capital expenditure %	3.8%	8.7%	4.1%	9.2%
Total asset turnover	1.6	1.44	1.5	1.28
Liquidity and Leverage Ratios				
Current ratio	1.9	1.70	1.2	1.84
Cash ratio	0.7	0.48	0.4	0.63
Total debt/equity ratio	1.6	0.1	5.8	0.5
Times interest earned	17.5	27.7	22.5	7.9
Profitability Ratios				
Operating margin	11%	6.05%	13%	3.93%
Net profit margin	7%	3.69%	8%	2.21%
Return on assets	12%	5.62%	14%	3.47%
Return on equity	54%	9.54%	194%	7.00%
Economic profit (millions)	$2,189	$74	$3,255	($661)

Data sources: Capital IQ, Morningstar, and company annual reports.

Exhibit TN3

The Battle for Value, 2016: FedEx Corp. versus United Parcel Service, Inc.

Analysis of Geographic Distribution

	FedEx			UPS		
	2011	2015	Growth	2011	2015	Growth
Revenue						
Domestic	27,461	34,216	24.60%	39,347	45,309	15.15%
International	11,843	13,237	11.77%	13,758	13,054	-5.12%
	39,304	47,453		53,105	58,363	
International proportion	30.1%	27.9%		25.9%	22.4%	

Data source: Company annual reports.

Exhibit TN4

The Battle for Value, 2016: FedEx Corp. versus United Parcel Service, Inc.

2016 Financial and Market Performance

FedEx	**2015**	**2016**
Revenue	47,453	50,365
Net income	1,050	1,820
Total assets	37,069	45,959
Shareholders' equity	14,993	13,784
Revenue growth		6%
Profit margin	2.2%	3.6%
Asset turnover	1.3	1.1
Return on assets	2.8%	4.0%
Return on equity	7.0%	13.2%
Stock price, Dec. 31 close	148.99	186.2
Dividends declared in $ per share	0.8	1.45
EPS	3.70	4.25
Price/earnings	37.9	43.8
Annual return		26%

UPS	**2015**	**2016**
Revenue	58,363	60,906
Net income	4,844	3,431
Total assets	38,311	40,377
Shareholders' equity	2,491	405
Revenue growth		4%
Profit margin	8.3%	5.6%
Asset turnover	1.5	1.5
Return on assets	12.6%	8.5%
Return on equity	194%	847%
Stock price, Dec. 31 close	96.23	114.64
Dividends declared in $ per share	2.92	3.32
EPS	5.38	5.75
Price/earnings	22.0	19.9
Annual return		23%

Data sources: Google Finance and Value Line.