If you ever find yourself up in Anchorage, make a right turn off Minnesota Drive onto Northern Lights Boulevard as you leave downtown. The road dips and twists for two miles, skirting Lake Hood and cutting through the woodsy Earthquake Park. Just past a hiking trail, you suddenly come upon a parking area that overlooks one of the most majestic sights in all America: Cook Inlet, with the Chugach Mountains off to your right, dwarfing the city, and the Talkeetna Range straight across the inlet, past Point MacKenzie. On a clear day you can easily make out the snowy 20,320-foot peak of Mount McKinley looming in the distance.

You’d think you had landed in paradise. And as far as FedEx is concerned, you’d be right. For just across the road lies FedEx’s Anchorage hub, which has become a heaven on earth for the $25 billion transportation giant. As the market for FedEx’s signature product, overnight express delivery in the U.S., has flattened, Anchorage has come to represent a big part of the company’s future. That’s because it is the gateway to FedEx’s booming business with China, which is up 50% (by volume) over last year. Revenue for FedEx’s international priority unit, of which China is a key part, soared 25% in the most recent quarter and now accounts for one-fifth of the

Take one eerily prescient CEO. Stir in some savvy acquisitions. Execute like no one else. Result: returns that soar above the pack.

BY MATTHEW BOYLE

Why FedEx Is Flying High

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company’s overall sales. Watching as a FedEx ground crew scurries toward an M D-11 cargo plane from Hong Kong, one of five Asian flights arriving on this brisk October afternoon, senior manager Dale Shaw, 35, flashes a boyish grin. “This hub is where the action is,” he says.

Asia is one reason FedEx’s earnings per share more than doubled in the last quarter, compared with the same period last year. Over the past five years the stock price has doubled too, while the stock of rival UPS has risen only 15% and the S&P 500 has fallen 20%. That’s even more remarkable when you consider that the company’s core business is stagnating, thanks to the growing popularity of e-mail and a shift to cheaper ground shipping. No wonder FedEx has such a stellar reputation: It has ranked in the top ten overall on FORTUNE’s Most Admired Companies list for the past three years. Former FedEx CEO Jim Barksdale, who sits on the board, says of his association with the company, “I don’t think there’s anything else I’m more proud of.” That’s quite a compliment coming from the former CEO of Netscape.

How has FedEx stayed on top? Through a combination of smart strategy, savvy acquisitions, and really good execution. The aggressive move into Asia is a prime example. FedEx has also enjoyed excellent results from its foray into less-than-truckload freight hauling—a little-known business in which it wasn’t even involved six years ago. Founder and CEO Fred Smith, 60, built it by buying two regional freight haulers. Revenues for the LTL business, known as FedEx Freight, grew 27% in the past quarter, compared with the same period last year.

Not every acquisition has produced such gratifying returns. Integrating FedEx’s latest purchase, Kinko’s copy centers, is proving tougher than expected. And the future holds plenty of challenges, in Asia and elsewhere. But most company observers point to Smith’s record. “His batting average,” says supply-chain consultant Jim Tompkins, “is better than almost everyone else’s.”

A decisive former U.S. Marine, Smith famously cooked up the idea for overnight express delivery as a Yale undergrad and then built a business around it in 1971, when he was just 27. His prescience soon became legendary. David Cunningham, who now runs the company’s Asia-Pacific operation, remembers a day in 1984 when he and some other Memphis employees sat listening to Smith talk about the future. UPS had just entered the domestic overnight market, worrying Cunningham and his colleagues. Smith said to forget about the U.S. for a moment and consider Asia—and not just Japan, which was fascinating everyone at the time. Smith argued that the rest of the region, in particular China, would forever alter the world economic landscape. “He laid out this picture for us, and I said, ‘Wow, I never thought about it that way,‘” recalls Cunningham.

In 1989, Smith was ready to pounce. He paid $895 million to acquire Flying Tigers, which owned not only planes but the rights to major Asian air routes. Industry analysts sniffed that FedEx had overpaid for Flying Tigers because its air routes didn’t seem that valuable at the time. “Everyone wondered what the heck they were doing,” recalls Bob Novack, associate professor of supply-chain management at Penn State.

That same year Smith made his second bold move: opening the hub in Anchorage. Why there? Because from the seemingly remote Alaskan city, it takes less than ten hours to reach 90% of the industrialized world. (And unlike other, wimpy airports, Anchorage’s never—and we mean never—closes because of snow, even when 28 inches are dumped on it in one day, as happened in 2002.) That makes Anchorage a remarkably efficient location to sort shipments. (FedEx’s facility can handle as many as 13,400 pieces an hour, compared with 5,000 for UPS’s hub there.) And the shorter flights mean that planes can carry less fuel—and since fuel is extremely heavy, less fuel means more freight.

FedEx is now the player to beat in the Asian cargo scene. It operates 622 flights weekly to and from Asian markets—more than anyone else—including service to 224 Chinese cities. That translates to 39% of the U.S.-China express market, according to SJ Consulting, compared with 29% for No. 2 DHL (part of Deutsche Post). “We knew [the Asia business] would take off, but frankly I don’t think anyone could have predicted the level of explosive growth we are seeing now,” Smith says. The Anchorage hub handles 400 cargo flights a month. That’s still small potatoes compared with FedEx’s superhub in Memphis, which handles 200 flights a day. But the company’s yields (revenues per package) on international priority express are five times those of its domestic express envelopes.

The fact that FedEx owns and operates its own fleet of cargo planes gives it a clear leg up on
DHL, which has to buy cargo space in the belly of passenger planes and is therefore vulnerable to capacity crunches. If FedEx’s Dale Shaw faces a spike in traffic from Asia—like when iPods pour in from Pudong—he can call the Global Operations Control Center in Memphis (a.k.a. the Bunker) and ask for an additional plane. (UPS has that advantage too; it entered the Asian market later but already has a 28% share of U.S.-China cargo.)

Down the road FedEx may have an edge on both DHL and UPS. Those companies rely on state-owned Chinese parcel carrier Sinotrans for local pickup and delivery, and that could pose a problem if both squabble for preferred treatment. FedEx, by contrast, inked an exclusive relationship with Beijing-based Da Tian in 1999—the first joint venture in the transportation sector done with a Chinese firm rather than the government.

While the Asian business has a certain global glamour, FedEx is also getting a boost from one that doesn’t: less-than-truckload (LTL) freight hauling in the U.S. Unless you’re a devotee of logistics seminars, you might not know much about LTL, which involves moving such items as 500-pound industrial pumps that are too big to be sent via regular ground service but too small to fill an entire truck. At the moment, though, the business is wildly lucrative. That’s largely because we’re in what FedEx’s in-house economist Gene Huang calls an “industrial up cycle”: Companies are rebuilding inventories to fill supply gaps and buying new equipment and machinery to meet demand.

Just as he did in Asia, Fred Smith saw an opportunity in the highly fragmented freight industry and went after it. FedEx cobbled its LTL business together by acquiring Viking Freight (part of Caliber System) in 1998 and American Freightways in 2001. By layering FedEx’s global network, technological prowess, and money-back guarantee on top of these solid regional freight carriers, Smith has built an operation that’s clearly bigger than the sum of its parts. In the process he has boosted revenues, yields, and profit margins beyond those of most LTL competitors. Although it accounts for only 11% of FedEx’s total revenue, FedEx Freight is growing faster than any other unit. In its most recent quarter, volume increased 14%, to 64,000 shipments a day, and operating margins were 12.8%, the unit’s best ever.

While the “up cycle” benefits all LTL carriers, none can match the resources of FedEx Freight. For example, FedEx has begun outfitting its loading-dock forklifts with wireless scales, which weigh pallets and transmit that data to dock managers instantly. Competitors must move pallets one by one to a separate weighing area, which eats precious time. And last year FedEx Freight joined the company’s other divisions in implementing a money-back guarantee, becoming the first LTL carrier to do so. “FedEx brought certainty to an industry that had never had it,” says freight boss Doug Duncan. FedEx also provides superior tracking technology. That’s why chipmaker Broadcom recently switched over to FedEx’s LTL service, says Tom Porter, Broadcom’s senior director of worldwide corporate services.

But the best thing about the LTL market for FedEx is that for once it doesn’t have to compete against UPS, which dominates the U.S. ground parcel market (75% share, vs. 16% for FedEx, according to SJ Consulting) and is nipping at FedEx’s heels in the U.S. express business (32% vs. 37%). What can Brown do for you in LTL? Not much. “We don’t need LTL,” says a UPS spokesman, adding that UPS concentrates on shipments under 1,000 pounds and forwards anything bigger to its supply chain services subsidiary.
FedEx Freight was a natural extension of Fred Smith’s transportation empire. Copy chain Kinko’s was not so obvious a fit. But after UPS bought Mail Boxes Etc. in 2001, Smith decided that FedEx needed a greater retail presence to attract customers, whether they’re college kids, mom-and-pop businesses, or mammoth multinationals. With 1,231 retail locations and $2 billion in sales, Kinko’s, acquired last February for $2.4 billion, provides that reach. It also provides convenience. Now not only can customers ship their résumés from the same place they had them copied, but a new service allows them to zap stuff from their own laptop to Kinko’s, where it’s printed, bound, and shipped in one easy transaction.

FedEx is pouring more than $20 million into a rebranding campaign, and it has sent Kinko’s employees to more than 700,000 total hours of training on how to handle air and express shipping. FedEx Kinko’s president, Gary Kusin, also wants to beef up copying, document production, and other services for large companies, a market that Xerox and Pitney Bowes currently dominate. Kusin hopes that business will grow from 20% of his sales to as much as 50% in three years.

That’s easier said than done, especially because the copying business does not play to FedEx’s strength. “Every time you move away from the core, the odds of success go down,” says Bain & Co. senior partner David Harding, co-author of Mastering the Merger. “It’s unclear what FedEx brings to the table here.” Indeed, FedEx Kinko’s revenue and profits disappointed analysts in the company’s most recent quarter. Kusin admits that he underestimated the time and effort involved in training, which pulled many employees out of stores. “We hadn’t thought that one through,” he says. Right now analysts are taking a wait-and-see approach. “I’m neither impressed nor disappointed,” says Morgan Stanley analyst James Valentine.

He feels more positive about the future of FedEx’s LTL business. There’s still work to be done there, as freight boss Duncan acknowledges. FedEx Freight could improve its coordination with FedEx’s international network, for example. But analysts say that FedEx Freight is well positioned because of the breadth of services it can offer: A large customer like Hewlett-Packard can, for example, buy air, ground, and freight service through one sales team. Furthermore, FedEx’s drivers are not unionized, whereas most drivers at freight competitors are. That should mean further market share gains down the road.

FedEx’s international priority business has the brightest future. Massive delays in U.S. seaports, which have been forcing companies to send more cargo by air, are unlikely to ease anytime soon. And various analysts project that the U.S.-China air cargo market will grow 10% to 25% a year over the next decade, compared with just 6% for the overall market. To handle the new traffic, FedEx will take delivery in 2008 of three Airbus A380s, massive birds with roughly double the cargo space of an MD-11. FedEx also plans to open a hub on the Chinese mainland in the next few years, either in Shanghai or Guangzhou. “We’re going to pour hundreds of millions of dollars” into China, Smith says.

Things could still go wrong for FedEx. Competition, always fierce, is getting more so; DHL has entered the U.S. market, and UPS is coming on strong in Asia. (A recent agreement between the U.S. and China will add 39 new cargo flights between the two nations this year and next—and the U.S. has said that UPS will get 12 of them, the same number FedEx will get.) A hard landing for the Chinese economy could crimp FedEx’s Asian growth. And, of course, Fred Smith won’t be around forever.

But when he does retire, Smith will be leaving behind a core team that has been with him for more than two decades, absorbing every detail about how he runs FedEx. And that’s a good thing. “When you work for Fred,” says Barksdale, “you either become like him—or you leave.”