Engineered Income Investing

by Richard Berger

Latest Getting Started Tools

FDX:

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Engineered Income Investing: Exclusive Premium Research

Steering a company forward is very much analgous to steering a big rig. You must constantly be aware of what is happening around you and anticipate changes so as to control you own course and arrive safely at your goal. FedEx (FDX) has been having some trouble doing this of late. Today I'll consider the outlook going forward for this popular dividend income target.

FedEx (FDX)

Market Price: $156.51

Dividend: $2.60 (1.66%) Ex-Dividend ~3/6/20

YDP Fair Value: $157.58 (1.65% recent yield average)

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P/S Fair Value: $224.30

P/OpCashFlow FV: $173.70

Prior Results:

The original FDX position was opened as a DOPA play on 11/27/18 with ex-div pending for $0.65 at 12/7/18, about 2 weeks forward. Did a buy-write with market leg of $224.69 and covered calls for 12/21//18 $205.00 @ $21.18 premium for a net debit of $203.50 and net Arbitrage premium of $1.50. Shares plunged to close 12/7/18 at $201.39. Therefore, there was no call away, we captured the $0.65 dividend and the new total net adjusted basis break-even became $202.85. Did a series of aggressive rolls for damage control to the current position of running covered call contracts for 128 day remaining 4/17/20 $175.00. Total net premiums to date after the original b/w added $18.20 and $3.25 of dividends have been harvested, further reducing our breakeven by another $21.45 to a net $182.05. Shares are trading currently at $157.00, leaving us $25.00 underwater at this time.

Current Outlook:

FedEx continues to see strong competitive pressures in its core ground and air shipping business. Office supplies and services also will continue to see headwinds from direct retail competition and continued migration to electronic office records and internet business to business. Against this difficult outlook we see shinking margins as fedex eliminates prime time holiday season home delivery premium surcharges and cuts margins to respond to competitive pressure. The company also has stopped providing deep discount shipping rates to Amazon. The effect of this was the trigger of the early December 2018 plunge as market fears of the break of relationship between FedEx and Amazon caused investors to shun FDX shares. Prices did not begin to stabilize and recover until after Christmas 2018, and after rising to April 2019 highs of about $199, have been in a declining channel trend, now shifting to consolidation at the $150 to $158 price levels. Current analyst sentiment leans from a neutral to modestly bullish outlook.

Dividend Review:

The company has a good dividend history, reaching Dividend Achiever status (10+ years of rising dividends). However, the company has now gone 7 quarters

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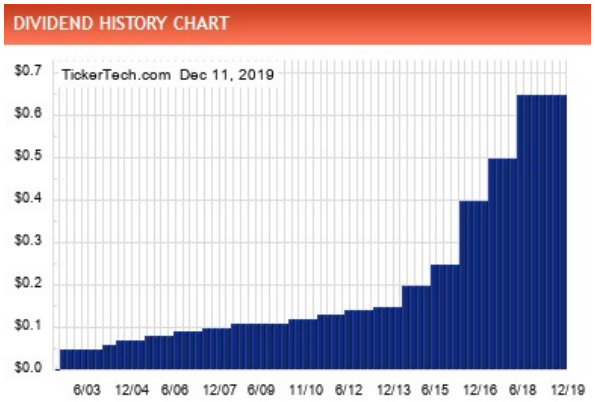
without a dividend increase and appears likely about to lose that status. Also of note is just 10 years ago, FDX failed to makes it yearly dividend increase during the 2008/9 financial crisis. These brief interruptions for good cause do show responsible management actions in shepherding cash flow during difficult times. However, they do also indicate that management is not primarily focused on maintaining a strong safe dividend as a top priority.



Although the company has outperformed the S&P500 for most of its history, total net return has been negative for the past 5 years.

	FDX	SPY
Start date:	01/02/2015	01/02/2015
End date:	12/10/2019	12/10/2019
Start price/share:	$172.45	$205.43
End price/share:	$157.00	$313.53
Starting shares:	57.99	48.68
Ending shares:	60.95	53.47
Dividends reinvested/share:	$9.35	$22.70
Total return:	-4.30%	67.65%
Average Annual Total Return:	-0.89%	11.03%
Starting investment:	$10,000.00	$10,000.00
Ending investment:	$9,568.01	$16,767.29
Years:	4.94	4.94

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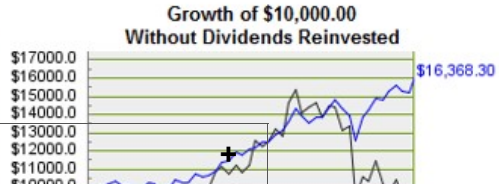
Dividends collected/share:	$9.35	$22.70



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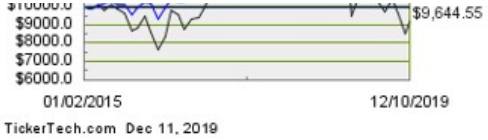
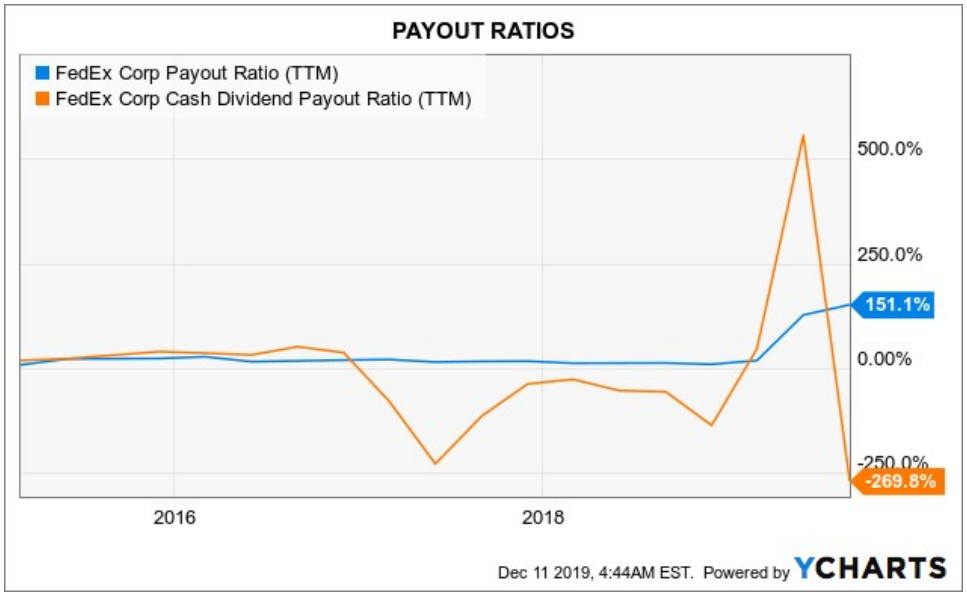
Total return:	-3.54%	63.67%
Average Annual Total Return:	-0.73%	10.49%
Starting investment:	$10,000.00	$10,000.00
Ending investment:	$9,644.55	$16,368.30
Years:	4.94	4.94



Chad Brand took a recent walk through the FedEx dividend and share buyback programs along with contrasting them to cash flows. He points out that FDX has only generated $1.6 billion in FCF (free cash flow) over the past 6 fiscal years, while expending $14.1 billion on dividend distributions and share buy-back programs. The clear conclusion is that these are being funded largely from taking on debt. This, coupled with negative total net return for the past 5 years leads me to label FedEx as a yield trap, attempting to prop up share price with unsustainable distributions and buybacks. Dividend growth investors should beware.

Payout Ratios confirm the past 5 years are not sustainable, first with cash payout ratio going negative and now earnings payout also far in excess of 100%.



A look at key financial metrics on a per share basis reveals declining per share free cash flow and earnings for the past 3 years even as revenues have more than doubled. Funds From Operations have been gyrating widely and are misleading even at that. With debt sharply rising and cash flow minimal and falling, along

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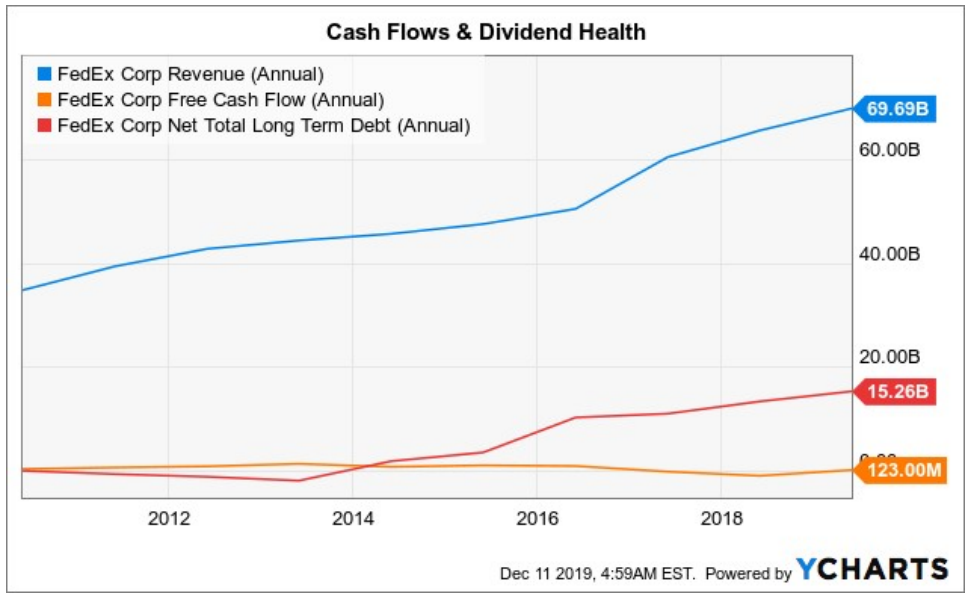
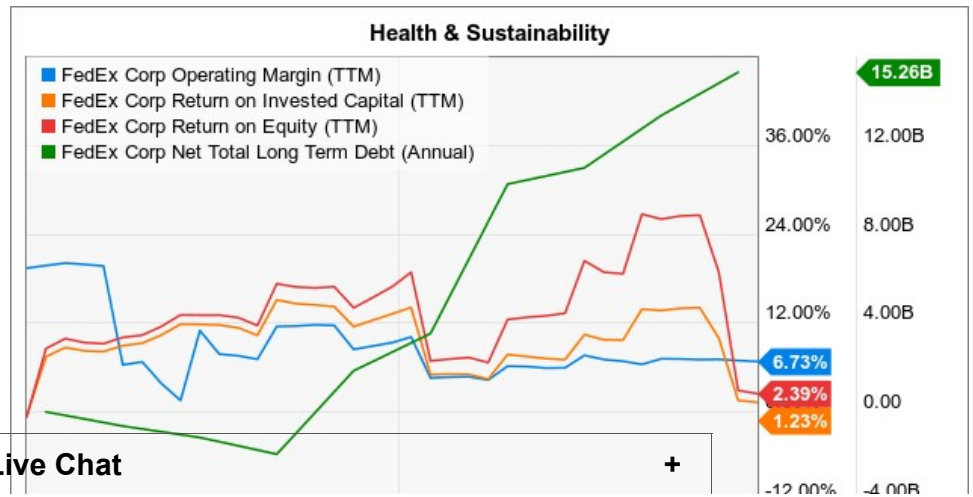
with declining earnings, the increased revenues are not reaching the bottom line, squandered on debt to engineer false looking shareholder metrics, not to invest in future growth.

Over the past 10 years, debt had piled on to a prior clean balance sheet, while FCF is up only modestly and earnings are in decline.



and ROE are ROI are in free fall, along with declining Operating margins. This over the same period that debt is climbing. These are not good signs.



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In summary, we have a company that is not growing its bottom line cash flow and is borrowing to engineer the look of shareholder returns as more attractive than company operating performance suggests. The changing face of the competitive environment along with FedEx diversification into office services/shipping centers, anchored by the acquistion of Kinkos, has diverted funds and attention from the core shipping business, tying up large amounts of capital.

The picture is not all bleak. I have often spoken of the Nexus, where e-commerce and traditional retail meet. With a global footprint of shipping/delivery-pickup points, along with last mile services to home and office, FedEx is in strong position to occupy a key place in the Nexus.

Furthermore, a paradigm shift to automated drone last mile and robotic transfer stations should begin to offer opportunites for FedEx to slash labor costs. To do so will require significant new capital investment in these new technologies. Given the swollen and growing debt of the company, I expect divestiture of the FedEx Kinko centers and other non core business will be needed in the immediate future to free up capital and redirect employment of credit. Management still can turn things around if they are willing to take these needed steps to return to core business based on a platform grounded in new technology and designed to meet customer needs at the Nexus.

An additional opportunity exists for FedEx to lead in a new niche. With more and more international e-consumer sales and a changing tax situation and outlook for internet sales, the use of duty free facilities for pickup of international packages could become a major service segment globally. FedEx is already established with a presence at many major international airports with their air transport and transfer station facilities. Adding Duty-free shop presence would be very easy for the company with these contacts and facilities already in place. This new service would enable someone that is planning international travel in the near future to then make international internet purchases and have them delivered to the FedEx duty free station at the airport the buyer will be transiting anyway. This allows avoidance of taxes and import duty. An added bonus is the security of the entire delivery chain. As an expat living in Brazil, I know how expensive import duties

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are (100% of cost, plus shipping frees, and a bit more added for administrative fees; Bringing the total fees to more than 100% of the purchase price.) The paperwork can be difficult and confusing for imports also and the last mile local in-country mail delivery fraught with peril from loss, theft, fraud, and damage. There is a huge potential untapped market for this service and FedEx holds a good position to fill it, charging premium rates for such a service while still saving the customer money on the net cost to them. In 2018, Amazon (AMZN) generated $65 billion in international revenues, much of it from retail sales. Just 20% of this from Duty-free center services would mean $13 billion in new high margin revenue to FedEx. A 50% figure (near $30 billion) is quite realistic even.

Current management will need to show a clear plan and path for the future. This will be critical within the next few quarters. Demonstrated proof of success implementation will need to begin not far thereafter. Hopefully, a strong activist investor will step in to guide and monitor such efforts in the near future now that share price has begun to stabilize and recover within the range of fair values for the company as it currently is positioned.

Having looked at this need for a turn-around and the some of the opportunities to drive one, let's look at valuation.

Fair Value Analysis & Appraisal:

Historically, FedEx has been driven as a growth business with a foundation anchored on safe dividends with strong compound growth. This has changed in the past 18 months to a look of slow to no growth and a dividend that is no longer growing and does not even look sustainable at current distributions. Thus, we have departed what used to be a strong income stock valuation, well suited for YDP evaluation, to a more complex scene.

YDP fair value for the current $2.60 of annual dividend distributions at the 5 year historical average yield 0.61% is $426.23. Let me assure you that such a valuation is not even available as a dream, let alone reality. A valuation based on a more realistic yield rate of 1.65% such as has been the ball park trend since it became apparent that growth is stalled and dividends are at risk, provides a YDP valuation at a more realistic $157.58. Given the lack of current long term dividend sustainability, that figure should be considered the high-side limit to values presently.

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Traditional valuation metrics based on financial ratios showed many well correlated indicators in the past until mid 2017. These include Price/OpCashFlow, Price/Sales, and to a lesser extent, P/E. Correlation of these valuations to actual market prices has deteriorated for each of these factors post 2017, with P/E becoming completely delinked from as a value indicator. P/OpCashFlow , and to a slightly lesser degree P/S also, remain useful valuation tools. Currently, these provide valuation of $173.70 and $224.30, respectively. The lower, at $173.70 is in fairly good agreement with my current YDP view. Therefore, I suggest the $175.00 valuation with moderate confidence at this time and a lot of downside risk going forward. For instance, a 25% dividend cut would be expected to reduce valuation to $118.00 per share.

Technical Chart Notes:

The current key pattern of note on the technical chart is the development of a sideways consolidation trend in the higher half of the declining channel for the past 2 months. This appears to be an early signal of a technical bottom formation with support at the $151 level.

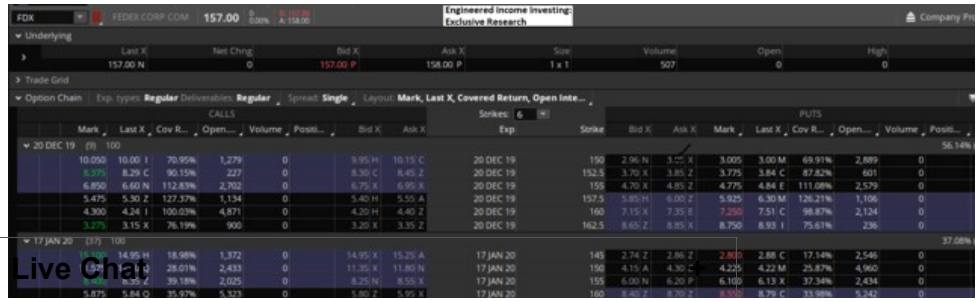
Covered Option Writing Opportunities:

With shares trading near fair value and in a consolidation trend with significant downside exposure risk, you may wish to consider the short term cash secured puts for the 37 day 1/17/20 $145.00 @ $2.80 premium. This provides a 19.42% annualized yield rate on net covering cash of $142.20 and $14.80 in downside protection for just the 37 day contract exposure.

For those like me, in major damage control mode, consider agressive long term forward rolls to decrease your net break-even point as deeply and rapidly as possible. I am entering an order this morning to take me from current 128 day covered calls for 4/17/20 $175.00 strike for a forward diagonal downward roll to the covered calls using the 12/17/21 $155.00 with a net $22.65 credit premium on the roll of a net 609 days. I have chosen this course to reduce my break-even (with dividend harvests) to below current market and with a long term turn-around situation having time to play out going forward.

Those holding a current position in FDX shares but no option contracts may wish to consider writing covered calls using the 37 day 1/17/20 $165.00 @ $3.85 premium (or a higher strike at your net breakeven point if higher and the yield is attractive). Yield rate on this contract would be 24.8%. Combined with the 1.66% dividend rate, total yearly rate is then 26.46%.

Next ex-div is ~ 3/6/20, thus too early for a new DOPA play to be considered.



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Closing Thoughts:

I will be traveling at the end of the week and spending 12/15 to 1/7/20 in Colombia, then on to the States. I should have a very good internet connection while traveling and expect to be able to stay up to date with research and everyone with no problems.

As always, I am available to answer any questions or discuss anything you wish. Please do not hesitate to reach out to me in chat or via email to do so.

Richard

Disclosure: I am/we are long FDX. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

Comments (1)

webicknell
Marketplace
I have a 12/20 $135 FDX Put ($1.36 Prem) and now also a Jan 17 $135 ($1.05 Prem). As you can see, it is not my intention to own the stock, but if I get the shares, they will be below the current 52 week Low

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