Case study of fedex and ups

Business

The location could not have been more appropriate. China was shaping up to be the world's most significant market for air cargo, and Yank Yuan's, director general of China's General Administration of Civil Aviation, had just announced that China would be opening up its air cargo market to an even greater degree.

The major global cargo companies had been picking up their level of investment in China and ere poised for growth: Faded Corp… Had Just begun construction of a major regional hub in Gunshot and already had over 200 Chinese cities in its international network, and United Parcel Service of America, Inc. (UPS), was Just completing a new logistics hub In Shanghai and had recently begun domestic Chinese express package services.

The question on the minds of many was which of these two cargo giants was going to make the most of this opportunity.

Spurred in part by entry into the World Trade Organization in 2001 , growth in trade with China had accelerated and the need for cargo shipment and logistics support ad skyrocketed. On June 1 8, 2004, the United States and China reached a landmark air-transportation agreement that quintupled the number of commercial cargo flights between the two countries. The agreement also allowed for the establishment of air- cargo hubs in China and landing rights for commercial airlines at any available airport. The pact represented the most dramatic liberalizing of air traffic in the history of the two nations.

Faded had been quicker to seize the new opportunities this agreement presented.

By year-end 2005, It operated more all-cargo flights to China than any other airline. During 2005, the company launched the express Industry's first direct service to China (from Europe). In January of 2006, Faded announced that it would buy out the remaining 50% of a Chinese joint venture started in 1999 with local carrier Tannin Titian W. Group. Upon closing that deal, Faded would employ more than 6, 000 people in China.

At the announcement of the buyout, Frederick W.

Smith, chair, president, and CEO of Faded, said: " China is changing the world's economic landscape. This strategic investment in the long-term growth of China will broaden This case was prepared by Associate Professor Marc Lipton, Robert F. Burner, and Sean Carr. It was written as a basis for class discussion rather than to illustrate effective or Ineffective handling of an administrative situation. Copyright 0 2009 by the university of Valhalla Darned School Foundation, Charlottesville, VA.

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No part of this publication may be reproduced, stored in a retrieval system, used in a photocopying, recording, or otherwise" without the permission of the Darned School Foundation. -2- UV2561 and deepen our relationship by improving access to important markets, fueling economic development for years to come.

" l While UPS currently lagged behind Faded in the Chinese market, it was still the world's largest package-delivery company and the dominant parcel carrier in the United States. UPS was the first carrier in the industry to offer nonstop service from the United States to China.

It had recently completed a partner buyout of its own, acquiring full control of an express delivery service in China. While not the dominant player in China, it was dominant globally. According to UPS Chief Financial Officer D.

Scott Davis, “ Our industry is critical to international trade, our position in this industry is strong, and we have a track record of delivering exceptional financial results. “ 2 With the continued maturing of the U. S. Package-delivery segment, the international markets” and especially China” became a battleground for the two package-delivery giants.

Faded had virtually invented customer logistical management and was widely perceived as innovative, entrepreneurial, and an operational leader.

Historically, UPS had a reputation for being big, bureaucratic, and an industry follower, but “ Big Brown,” so called for its iconic trucks and uniforms, was aggressively shedding its loading image as it too became an innovator and a tenacious adversary. UPS had recently undergone a major image overhaul and was repositioning itself as a leading provider of logistics and supply-chain management services.

As these two companies positioned themselves to seize the growth opportunities presented by the Chinese market, the central question was which of these companies would best convert these opportunities into wealth for investors. Both companies made financial performance a part of their mission” what Faded called “ superior financial returns” and UPS called long-term competitive returns. “ 3 Since the business models of the two companies had largely converged, with Faded boosting ground capabilities and UPS boosting air capacity, success would hinge on execution, particularly financial execution.

Faded Corporation Faded first took form as Smith’s undergraduate term paper for a Yale University economics class. Smith’s strategy dictated that Faded would purchase the planes that it required to transport packages, unlike other competitors, which used the cargo space available on passenger airlines. In addition to using his own planes, Smith’s eye innovation was a hub-antipode distribution pattern, which permitted cheaper and faster service to more locations than his competitors could offer.

In 1971, Smith invested his $4 million inheritance, and raised $91 million in venture capital to launch the firm” the largest venture-capital start-up at the time. “ Faded Express to Acquire Express Business of Chinese Transportation Company DEW Group,” Faded press release, January 25, 2006. 2 UPS annual report, 2005.

3 UPS and Faded annual reports, 2005. -3- In 1973, on the first night of continuous operation, 389 Faded employees delivered 86 packages overnight to 25 U. S. Cities.

In those early years, Faded, then known as Federal Express Corporation, experienced severe losses, and Smith was nearly ousted from his chair position. By 1976, Faded finally saw a modest profit of $3.

6 million on an average daily volume of 19, 000 packages. Through the rest of the sass, Faded continued to grow, and in 1981, Faded generated more revenue than any other U. S. Air-delivery company. By 1981, competition in the industry had started to rise.

Emery Air Freight began to imitate Feeder's hub system and to acquire airplanes, and UPS Egan to move into the overnight market.

The U. S. Postal Service (USPS) positioned its overnight letter at half the price of Feeder's, but quality problems and Feeder's " absolutely positively overnight" ad campaign quelled that potential threat. In 1983, Faded reached $1 billion in revenues and seemed poised to own the market for express delivery. During the sass, Faded proved itself as an operational leader, even receiving the prestigious Malcolm Baldrics National Quality Award from the President of the United States.

Faded was the first company ever to win in the service category.

Part of this success could be attributed to deregulation and to operational strategy, but credit could also be given to Feeder's philosophy of " People-service-profit," a slogan that reflected its emphasis on customer focus, total quality management, and employee participation. Extensive attitude surveying, a promoters-within policy, effective grievance procedures that sometimes resulted in a chat with Smith himself, and an emphasis on personal responsibility and initiative not only earned Faded a reputation as a great place to work, but also helped to keep the firm largely free of unions.

By the end of 2005, Faded had $20, 404 million in assets and net income of $1, 449 million on revenue of $29, 363 million. The company delivered to 220 countries through an infrastructure consisting of 260, 000 employees, 51 , 500 drop-off locations, 677 aircraft, and 70, 000 vehicles and trailers. The company planned to expand its Indianapolis air hub by more than 30% by 2008.

Feeder's Kink's division was the leading provider of document solutions with 1, 400 locations in 11 countries. Exhibit 1 provides Feeder's financial and analytical ratios.

Founded in 1907, UPS was the largest package-delivery company in the world. Consolidated parcel delivery, both on the ground and through the air, was the company's primary business, although increasingly the company offered more specialized transportation and logistics services. UPS had its roots in Seattle, Washington, where 19-year-old Jim Casey started a bicycle-messenger service called American Messenger Company. After merging with a rival firm, Motorcycle Delivery Company, the company focused on department-store deliveries, and that remained true until the sass.

Renamed United Parcel Service of America, UPS started an air- delivery service in 1929 by putting packages on commercial passenger planes. The company entered its strongest period of growth during the post-World War II economic boom; by 1975, it -4- had reached a milestone when it could promise package delivery to every address in the continental United States. The key to the success of UPS, later headquartered in Atlanta, Georgia, was efficiency. According to Businesslike, " Every route is timed down to the traffic light. Each vehicle was engineered to exacting specifications.

And the drivers endure a daily routine calibrated down to the minute. " 4 But this demand for machinelike precision met with resistance by Pup's heavily unionized labor force. UPS experienced several major strikes resulting from changes in labor practices and driver requirements. In August 1997, the 190, 000 teamsters employed at UPS went on strike for 1 5 days before agreeing to a new five-year contract. For most of the company's history, UPS stock was owned solely by Pup's managers, their families, former employees, or charitable foundations owned by UPS.

In November 1999, UPS initiated a transaction that took the company public and kept voting rights concentrated in a small set of owners. Until that time, the financially and operationally conservative company had been perceived as sluggish. But after going public, UPS initiated an aggressive series of acquisitions, beginning with a Miami-based freight carrier operating in Latin America and a franchise-based chain of stores providing packing, shipping, and mail services with more than 4, 300 domestic and international locations.

More assertive than ever before, the UPS of the new millennium was the product of extensive reengineering efforts and a revalidated business focus. While the company had traditionally been the industry low-cost provider, in recent years the company had been investing heavily in information technology, aircraft, and facilities to purport service innovations, maintain quality, and reduce costs. In early 2003, the company revamped its logo for the first time since 1961 and emphasized its activities in the wider supply-chain industry.

The small-package market in the United States is about a $60 billion market,” said Mike Skew, Pup’s chair and CEO. “ The worldwide supply-chain market is about a $3. 2 trillion market. “ 5 The firm was seeking avenues for growth. The recent acquisition of Menlo, a freight forwarding business, and Commenting on the firm’s 2005 results, SCOFF Scott Davis remarked that “ this was our fastest volume growth in the U.

S. For five years, and we are growing faster than the market. “ 6 By the end of 2005, UPS had $34, 949 million in assets and net income of $3, 870 million on revenue of $42, 581 million.

That year the company delivered 14. 7 million packages to 1.

8 million customers in over 200 countries through an infrastructure consisting of 407, 000 employees, 6, 000 aircraft, and 98, 000 ground fleet vehicles. In addition, UPS managed the supply chain of companies in 186 countries with over 1, 000 facilities. The company plans to invest at least $1 billion to expand its main air hub in Louisville, Kentucky. This would increase 4 Todd Vogel and Chuck Hawkins, “ Can UPS Deliver the Goods in a New World? ” Businesslike Noun 4, 1990). 5 Harry R.

Weber, “ UPS, Faded Rivalry: A Study in Contrasts,” Associated Press Newswire, May 21, 2004. 6 Andrew Ward, “ UPS Quarterly Profit Jumps on International Demand,” Financial Times, January 26, 2006. -5_ capacity by 60% by 2010 and was needed to cope with the surge in parcel volumes generated by increased global trade. 7 Exhibit 2 provides Pup's financial and analytical ratios. Drivers of Success Success in the package-delivery market was driven by a number of factors related to he provision of delivery and logistics services to customers: Customer focus.

Both companies emphasized their focus on the customer.

This meant listening carefully to the customer's needs, providing customized solutions rather than standardized products, and committing to service relationships. Price competition. UPS boldly entered the market by undercutting the price of Feeder's overnight letter by half; however, by the late sass, both firms had settled into a predictable pattern of regular price increases. Costs became a priority.

Cost reduction was achieved through the exploitation of economies of scale, investment in technology, and business-process reengineering, which sought to squeeze unnecessary steps and costs out of the service process.

Information technology. Information management became central to the operations of both UPS and Faded. Every package handled by the two firms was carefully scanned and tracked. UPS, for example, collected data on 97% of packages moving through its U.

S. Systems. Service expansion. Faded and UPS increasingly pecked at each other's service offerings. Faded, armed with volume discounts and superb quality, went after the big clients that had previously used UPS without thought. UPS copied Feeder's customer interfaces and began Saturday pickups and deliveries to match Feeder's schedule.

Logistics services.

The largest innovations entailed offering integrated logistics services to large corporate clients. These services were aimed at providing total inventory control to customers, including purchase orders, receipt of goods, order entry and warehousing, inventory accounting, shipping, and accounts receivable. Virtually all these dimensions of competition required extensive investments. From aircraft to information technology, this was an investment-intensive industry.

The impact of the fierce one-musicianship occurring between Faded and UPS was clearly reflected in their respective investment expenditures.

Between 1992 and 2005, capital expenditures for Faded and UPS rose at an annulled rate of 36. 62% and 39. 29%, respectively. During this period, the two companies matched each other's investments in capital almost exactly. (Exhibit 3 depicts the firms' cumulative capital- investment expenditures.

) 7 " UPS Sets $1 Billion+ Expansion of Global Air Hub; Strong Growth in International and Domestic Express Business Fuels Demand for Additional Hub Capacity," Business Wire, May 17, 2006. -6- International Package-Delivery and the Chinese Market revenues for UPS and Faded.

After making significant investments in developing European delivery capabilities, Faded eventually relinquished its hub in Europe in 1992 by selling its Brussels, Belgium, operation to DEL. Analysts estimated that Faded had lost $1 billion in Europe since its entry there in 1984. Faded would continue to deliver to Europe but relied on local partners.

In 1995, however, Faded expanded its routes in Latin America and the Caribbean, and later introduced Faded Asinine, a next-business-day service between Asian countries and the United States via a hub n Cubic Bay, Philippines.

UPS did not break into the European market in earnest until 1988, with the acquisition of 10 European courier services. To enhance its international delivery systems, UPS created a system that coded and tracked packages and automatically billed customers for customs duties and taxes. In May 1995, it announced that it would spend more than $1 billion to expand its European operations during the next five years. It was growth in China that made international markets the current focus for both firms.

China’s economy was booming, and its trade surplus continued to grow as manufacturing shifted to the country. In the past year, trade with the United States had increased 25% and had doubled since 2002. More important than the surplus was the total value of imports and exports. That total had grown dramatically. By 2005, the total of Chinese imports and exports had reached $1, 422 billion, after growing at a compound rate of 31% a year over the previous three years.

8 According to economic and industry experts, China would become the world’s second-largest economy within 11 years and the largest by 2039. China’s economy is expected to continue its extended cycle of strong growth, thanks to the pivotal role it plays in the lobar supply chain,” said Gene Hung, Faded chief economist and a Shanghai native. “ China’s solid manufacturing base is essential to neighboring Asian economies, which

export key electronic components. Its emerging middle class and growing consumerism will continue to attract capital goods and luxury items from the rest of the world. “ 9 The growth of the Chinese market was going to spur the need for package and logistics services and provide unparalleled opportunities for UPS and Faded.

In 2005, approximately $60 billion of goods entered and left China by air. UPS noted that its Asian export volume, which increased 29% for the year, was driven by export growth from China. Growth would be accelerated from expansion of its international delivery network, including the additional flights to Shanghai that were added in the fourth quarter of 2004 and express air service to Gunshot that began in the second quarter of 2005. Faded was expected to have double-digit revenue growth from international package operations for the next two years as Asian markets flourished and as Faded expanded operations at its hub in Cologne, Germany. 0 8 PRE General Administration of Customs, China’s Customs Statistics. Faded Express to Acquire Express Business of Chinese Transportation Company DEW Group; Strategic Investment Boosts Long-Term Prospects for China and Faded,” Business Wire, January 24, 2006.

10 9 As for express delivery, Morgan Stanley estimated the size of the Chinese market at about $1. 0 billion to $1. 5 billion. While this amount was a fraction of the $50 billion U. S. Market, the Chinese market was growing at more than four times the global rate, with recent annual growth of 30%.

1 Morgan Stanley analyst James Valentine noted that demand for express services was accelerating with the shift to Just-in-time apply chains that

require speedy and reliable shipments. “ As a business economy develops it relies more heavily on moving shipments via parcel rather than the more traditional truck or even railroad, a trend that allows parcels to grow well in excess of the rate of the economy,” he said in a recent report. 12 The Chinese domestic market was also potentially quite attractive.

David Cunningham, president of Faded for Asia- Pacific, noted that heavily populated cities such as Human, a growing city in the inland Huber province, could be a vital part of the company’s future plans. There’s a whole domestic segment out there,” he said of central and western cities. The Chinese domestic air cargo market was currently the world’s second largest, with approximately $2 billion to $4 billion in revenues.

Given the underdeveloped ground transportation infrastructure of much of China, the domestic airfreight market was expected to grow rapidly, anywhere from 10% to 20% per year. 3 The buyout by Faded of its partner in the domestic air business would give Faded substantial presence and control within the domestic market, with service to 80 cities versus 23 for UPS. But it was still the midsection market that would drive short-term performance. “ Longer term, the domestic Chinese market will become increasingly important,” analyst Adam Hallway said, “ but, at the moment, it’s the Chinese export sector and the transpacific and the Asia to Europe trade lanes that are really driving a lot of the increasing demand for freight. 14 Finally, there were substantial opportunities for both firms in the provision of logistical services and support. Logistics could be quite challenging for locations in central and western China.

1 5 Distribution systems were Just beginning to meet the demand. Prolog's, one of the world's largest owners of distribution facilities, was planning to expand in China by nearly 50%. 16 The Prolog's investments added to a wave of international investment in Chinese logistics infrastructure that was needed to support China's pivotal role in the globalization of supply chains. 1 Andrew Ward, " A Dogfight for Courier Service Dominance," Financial Times, February 15, 2006. Ward.

13 B&T Capital Markets Report, January 24, 2006. Wall street -renascent 171, no. 21 (May 22, 2006): 1. 15 B&T Capital Markets Report. 16 " Prolog's Expanding Industrial Portfolio in China; Company Will Build More Than 3 Million Square Feet at New Strategic Locations Over Next 18 Months," PR Newswire, May 15, 2006. 12 -8- Future Prospects It was clear that international markets were going to be the new battleground for Faded and UPS.

As of 2005, both companies had about a third of revenues from international markets (see Exhibit 4). Moreover, within the international market, China would loom large. While the European markets were important, the Asian markets were the places for growth and opportunity. Faded had a Jump on UPS, both in terms of international flights to China and in the Chinese domestic market. Bear Stearns analyst Edward Wolfe had observed a year earlier that UPS had not responded quickly enough to the shift in manufacturing to China and other low-cost countries, leaving it with too much infrastructure and cost in its slow-growing U.

S. Market and too little capacity in the fast-expanding international markets. But UPS was quickly making up for that slow start. 17 Furthermore, UPS had a track record of success in other markets, and many recalled the Faded failure in Europe. Interestingly, over the past few years Feeder's stock price ad outperformed Pup's stock price although UPS had consistently better operating results (Exhibit 5 graphs the two stock prices, and Exhibit 6 presents returns and operating ratios).

In the end, it was not clear which of these fierce competitors was going to best capitalize on the opportunities in China and deliver superior returns to shareholders.