

EXPEDITORS INTERNATIONAL OF WASHINGTON INC  
Form 8-K  
May 18, 2004

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 8-K**

**CURRENT REPORT**

**Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**Date of Report: May 17, 2004**

(Date of earliest event reported)

**EXPEDITORS INTERNATIONAL OF WASHINGTON, INC.**

(Exact name of registrant as specified in its charter)

**Washington**

(State or other jurisdiction of  
incorporation or organization)

**000-13468**

(Commission File No.)

**91-1069248**

(IRS Employer Identification  
Number)

**1015 Third Avenue, 12<sup>th</sup> Floor, Seattle, Washington**

(Address of principal executive offices)

**98104**

(Zip Code)

**(206) 674-3400**

(Registrant's telephone number, including area code)

**N/A**

(Former name or former address, if changed since last report)



*Item 9. Regulation FD Disclosure.*

The following information is included in this document as a result of Expeditors' policy regarding public disclosure of corporate information. Answers to additional inquiries, if any, that comply with this policy are scheduled to become available on or about June 21, 2004.

SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS UNDER SECURITIES LITIGATION REFORM ACT OF 1995; CERTAIN CAUTIONARY STATEMENTS

Certain portions of this document including the answers to questions 1, 2, 4, 5, 6, 7, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19, 20, 23, 26, 27, 30, 31, 32, 33 and 34, contain forward-looking statements which are based on certain assumptions and expectations of future events that are subject to risks and uncertainties. Actual future results and trends may differ materially from historical results or those projected in any forward-looking statements depending on a variety of factors including, but not limited to, changes in customer demand for Expeditors' services caused by a general economic slow-down, inventory build-up, decreased consumer confidence, volatility in equity markets, energy prices, political changes, or the unpredictable acts of competitors.

**RESPONSES TO SELECTED QUESTIONS REGARDING FIRST QUARTER 2004 RESULTS**

1. *We're shareholders in Expeditors and we wonder if you could disclose what percentage of business is contractual/fixed versus spot market based? By contractual/fixed, we mean Expeditors agrees to provide certain volume capacity at a certain price (or tight range volume and prices). By spot market, we mean a customer comes to you and says "I need this amount of capacity next week and am willing to pay the going market rate. What we are trying to get at is how spikes in carrier pricing up/down can hurt/help Expeditors within those contractual/fixed business arrangements. Is there much flexibility in those contractual/fixed arrangements? What is the typical length of a contractual/fixed arrangement? When carriers do jack up rates to take advantage of a demand/supply imbalance, how quickly can you pass that on to your customers? What would prevent price hikes by carriers always being passed straight through and immediately to customers? Any related commentary on these issues would be appreciated. Thank you.*

**We took one look at this question and knew immediately that it established some sort of new record. Regular readers know that this is not good. In addition to being hopelessly compound and running some 161 words prior to editing, your question contains a large number of "slashed words" in a rather short amount of space. Where else but this question have contractual/fixed, up/down, hurt/help and demand/supply all occupied the same paragraph? While it is unique and therefore a record, this is writing that needs some immediate attention/therapy/help.**

*We can't offer a direct answer to your question for the simple reason that we don't track our revenues and our costs by whether or not they are spot or contractual/fixed. We understand what you're asking, but the data is not available to us in a format that allows us to supply a quantitative answer.*

*If we had to supply a qualitative answer, we would guess that the bulk of our unregulated transportation business would not fit nicely into either classification. In the real world there is a vast middle ground between true spot quotes and contractual pricing arrangements. This is a middle ground occupied by predictable pricing over an indeterminate term without either party truly being bound to anything more than a mutually beneficial business relationship.*

*We will offer the following additional observations on the main focus of your questions:*

Where we do have agreements, certainly no two are the same. Nothing is ever fixed in stone nor runs forever.

Factors that are taken into consideration in connection with the nature and timing of rate changes primarily center around the size and rationale proposed by the underlying carriers and the timing of that last rate change.

2. *Based on comments in your March 8-K, it sounds as if cash bonus compensation for employees would be reduced simply because new accounting rules require the expensing of options - even though expensing has no impact on cash flow. If this occurs, how much will it hurt Expeditors' ability to retain employees? Under this scenario, what things can and would Expeditors do to attract, retain and motivate employees?*

Those who have followed Expeditors for any time at all will recognize that in large part our response to this question needs to begin with the observation that we don't make the rules, we just try to follow them.

Whenever GAAP is modified to require expensing of stock options, this non-cash expense (this time it was your observation not ours) will certainly be considered as an operating expense and it is a fact that operating expenses reduce bonus compensation at Expeditors. We have never made a distinction between cash and non-cash operating expenses and we are not about to start now.

It is unlikely that we will modify our incentive compensation plans to compensate, no pun intended, for this non-cash operating expense. Changing how we compute the bonus would be an egregious example of management stacking the deck to feather their own nest at the expense of the shareholders. It is just not us to change the bonus rules to eliminate the impact of a potential GAAP rule change.

While nobody likes the concept of reduced incentive compensation, we are secure that we will weather this storm because we have the foundation of a great compensation system at Expeditors. Once you have a good foundation in place, it is possible to adapt to changes as they occur. Even if options are expensed, our compensation system should be sufficiently sound to motivate employees to continue to strive to provide shareholders with growth.

There is no cap or limit on how big the branch bonus can become at Expeditors. Our employees know that as they build a bigger and more profitable branch or region, they will generate more incentive compensation regardless of the impact of non-cash GAAP changes. It may require some patience, but we're confident in the commitment of our employees.

We don't want to repeat the arguments we have made in the past with respect to stock options. Suffice it to say that we believe that options are an important part of what made Expeditors what it is today. Therefore, we will continue to award employee stock options as long as our shareholders continue to approve the annual grant. Will the expensing of options cause a reduction in the number of options awarded in any given year? The answer is very likely yes and this of course will slow the dilution of existing shareholders.

No doubt this is good news to those who oppose options but believe fractional interests in corporate jets are a justifiable use of corporate funds. Let's just say we disagree about the options and the jets and move on.

3. *Would you compare net airfreight revenue per transaction in the first quarter of 2004 relative to the same quarter of 2003? While this obviously varies across lanes, we are trying to get a general perspective of the change in relative profitability per transaction compared with last year.*

Net airfreight revenue per transaction was actually fairly comparable when the first quarter of 2004 is contrasted with the same period of 2003. Increases in the overall tonnage handled was the primary reason for the jump in the first quarter 2004 airfreight net revenue.

4. *What would be your expectations for eastbound Trans-pacific ocean freight rate increases in May 2004 compared to last year. On the airfreight side, can you give us some idea of how much airfreight rates have increased year over year in the first quarter of 2004?*

We expect that ocean freight rates will tend to rise, but we aren't in a position at this time to try to quantify what level of change is likely. As for airfreight rates, they have definitely risen on a year-over-year basis, but here the amount of the change depends upon that specific origin. For example, rates out of Shanghai have seen increases that are well into double digits.

5. *Do you believe the change in tariff regulations starting in 2005 for the garment industry will have any impact on U.S. import volumes in 2004? With the inability to borrow from next year's quota, does this have the potential to limit the flow of goods entering the US as we move into later 2004? It would seem that this change encourages importers to ship product earlier in 2004. Would you agree?*

The change you reference is the abolition of U.S. textile import quotas as a result of the WTO. If the consequences of this change were as you predict, we would all need to go out right now and do our holiday shopping plus it would no doubt be wise to purchase some spare underwear.

From a common sense look at the world, it seems to us that the demand for new clothing garments, of whatever kind, is not going to be affected by whether or not there is a quota system in place and there is certainly not enough time to re-establish large scale production of clothing in the U.S. Plus an election year is a bad time for the first U.S. underwear shortage. Something else is going to happen in our opinion.

The concept of quotas will not exist in 2005. The inability to borrow quota from next year will no doubt cause imports from individual countries to close. As these quota closures occur, production will most likely shift to other locations where quotas remain open, as demand for new clothing will continue unabated. This means that textile importers will need to be very comfortable that their logistics providers have sufficient cargo lift in the countries that are considered to be second and third tier manufacturing locations. Fortunately, our global network has just these sort of logistic capabilities.

6. *I am curious regarding the ocean port infrastructure in China (the PRC). We all continue to see the headlines of the massive infrastructure development in the PRC. In reality, are port capacity and port expansion plans adequate to meet the demands across the various regions? Are any regions in the PRC better or worse off relative to the respective demands in the regions? If a bottleneck on transpacific ocean trade were to develop, would it be at West Coast ports or in the PRC?*

As you note, there is a tremendous amount of infrastructure development going on in the PRC. We're almost certain that we are not the ones to comment on whether or not port capacity and expansion plans are adequate to meet the demands across various regions. We are freight forwarders not planners or pundits. We take the infrastructure as it comes. Our goal is make sure that our customers don't need to worry about whatever infrastructure there may be in the PRC, or anywhere else.

As for bottlenecks, we think that it is unlikely that the PRC will allow factories to spring up in areas that are so remote as to not be able to deliver the goods to market, nor do we believe that our customers would elect to source production in places you can't get to from here. While there may be some challenges, we hardly see this developing as an overwhelming trend.

7. *When considered as a whole for Expeditors, how does the profitability of US export forwarding business compare with import business?*

**From a total profit contribution standpoint, U.S. import business adds much more to our bottom line than does U.S. export activity. From an operating margin standpoint (operating income as a percentage of net revenue), U.S. exports have slightly higher operating margins, provided that you buy into the assumptions that are required to allocate common costs among products.**

8. *Please describe Expeditors airfreight and ocean freight year over year volumes during March 2004 vs. the two previous months?*

**The March 2004 airfreight tonnage was higher on a year-over-year basis than were the year-over-year tonnage increases noted for the first two months on the same basis. That is not to say that we were in any way disappointed with January and February of 2004. For the overall quarter, airfreight tonnage globally was up nearly 23% in the first three months of 2004.**



9. *The most recently reported international ATA figures point towards significant volume acceleration in the Pacific (Asia) to U.S. trade lane. Has Expeditors witnessed a significant pickup in airfreight volumes within this trade through March and April 2004?*

**Yes.**

10. *Our sense from speaking with industry insiders is that 2004 should prove another difficult year versus 2003 for forwarder gross yields due to (1) accelerating import/export volumes into recovering domestic and global economies and (2) continued material rate increases put in place by underlying transportation providers. Is our assumption we could witness continued year over year pressure on airfreight and ocean freight gross yields going forward fair??*

**The answer is yes, but we want to add a bit of explanation. We would expect ocean freight yields to be under some pressure in 2004 when compared with 2003. As to our airfreight yields, they were stable during the first quarter of 2004, but is really too early for us to make a call on the last part of this year.**

11. *We've heard incremental comments regarding Expeditors' introduction of a dedicated domestic U.S. freight forwarding network and that the company is currently testing this product in various cities. If so, which cities are currently involved in these tests and what is the time frame for a larger roll out of this product? Will Expeditors use third party trucking capacity as well as third party airfreight capacity? Will Expeditors' product be similar to XXX's domestic forwarding network? How will you differentiate your product from current domestic forwarding products in the market place? Finally, if a larger roll out is anticipated, will Expeditors staff a separate domestic sales force?*

**Currently we are operational in all major gateways and many other branches. Since we have no intention of buying airplanes or trucks, we will use third party asset based providers in the same manner that we use these folks for international air and ocean freight. Our intention in providing the domestic service is to focus on the time-definite market as a natural adjunct to the international air and ocean programs we have operated for years now.**

**As to whether it will look like a competitor's service offering, we have to say that we honestly hope not. We say this not to take a cheap shot or to in any way imply that there aren't some great domestic networks out there. However from where we sit, our competitors seem to have a structured domestic product that stands separate and apart from their international offerings. This works great for them, but this is not the vision that we have.**

**To be uniquely Expeditors, we believe that North American transportation needs to be integrated seamlessly into our existing branch model. It will not be a separate identity, but rather we will build this as an additional product offering within each North American branch.**

With respect to the sales force, there will be domestic product managers and domestic product specialists who spend a lot of their time focusing on the domestic product. These folks will train our existing sales staff as to how to sell this service. They will also be responsible for teaching operations staff in how to deliver it.

12. *I recently read an article in Forbes Magazine, that issued a vague warning about Expeditors. I am not sure I understand the accounting concepts used to make the point, so I thought I'd just ask whether you saw the article and if so ask what you think about it?*

We will assume that you are referring to the *Point of View* column written by Dr. Stephen Hanke entitled "Where's the Cash" which appeared in the April 12, 2004 issue of *FORBES* magazine. Your question is not the only inquiry we received about this article. Several employees, wondering if they were working for the next WorldCom, forwarded the article for comment and one other shareholder asked for comments during the question and answer portion of our May 5, 2004 annual shareholder's meeting.

We want to use this forum to provide a response to Dr. Hanke. At the outset, we want to emphasize the word *response* as opposed to *rebuttal*. While the difference between these two words can be quite subtle, we wouldn't want anyone to be confused and think that we are trying to publicly pick a fight with Dr. Hanke. That's the kind of thing that could prompt another call from the Wall Street Journal and in general divert our attention away from managing this business.

Having decided to respond without wanting to be disputatious, we still can't seem to shake the vague fear that something bad is going to come of all this. Perhaps it is the adage attributed to Mark Twain to never pick a fight with someone who buys ink by the barrel that keeps nagging at us.

When we learned that Dr. Hanke is a Professor of Applied Economics at Johns Hopkins University we wondered if we had gotten under his skin inadvertently. After all, we have previously defined an economist as someone who would marry Cindy Crawford for her money. Frankly, the economist comment was a joke and we meant nothing personal.

While we have no idea what applied economics might involve, we are freight forwarders after all and are prone to quoting Ricky Ricardo the Cuban bandleader as opposed to David Ricardo the classical economist, we agree with Dr. Hanke to the extent that he posits that somewhere in the earnings process cash flow and earnings ought to approximate one another. In fact, we agree with almost everything Dr. Hanke says right up to his last two sentences.

Regular readers know that we share Dr. Hanke's scorn for the concept of EBITDA. We trash EBITDA whenever the opportunity avails itself. So how could a professor who hates EBITDA end his article trashing Expeditors? This thought has bothered us ever since we first read the Hanke commentary.

We don't want to put words in Dr. Hanke's mouth so at this point we want to urge the reader to pull away from this SEC filing and read the original text. When we click on [http://www.forbes.com/forbes/2004/0412/230\\_print.html](http://www.forbes.com/forbes/2004/0412/230_print.html) the article appears for free on our computer screen. Assuming this works for you, take a moment and read what Dr. Hanke wrote. Remember it is all good except for the ending where he lost it for a moment or two.

That Dr. Hanke might not choose to invest in Expeditors, for whatever reason, is certainly his prerogative. Inferring that Expeditors is somehow in the same league as Enron, WorldCom or Adelphia is just plain wrong and we think embarrassingly so. Let us demonstrate why.

We are now going to descend into the bowels of accountancy and likely wallow around a little bit in some relevant accounting information. Just so Dr. Hanke understands that we have a sense of humor we note that accountants are a group that understand they have absolutely no chance of dating someone like Cindy Crawford, let alone marrying her. Instead they focus on figures that can be manipulated with some probability of success.

As you read, Dr. Hanke starts by trashing EBITDA as any sort of meaningful measure of corporate performance and then goes a round or two with Warren Buffet's definition of *intrinsic value* as a foundation for the point that businesses really need to be able to validate

their earnings with some measure of cash flow in order for investors to be comfortable that stated GAAP earnings are real. While we don't always agree with Warren Buffet, we agree that cash earnings less cash expenses approximate real cash profits. We also agree that the value of a business is nothing more than the discounted present value of future cash flows. The practical problem is that this is easier to state than it is to calculate and this accounts for why Mr. Buffet never displays his intrinsic value calculations in public.

Dr. Hanke then gives a number of very sound examples of why a GAAP Statement of Profit and Loss can obfuscate very convincingly, if not totally obliterate, a company's underlying cash flow distress. Here again we agree.

The article next introduces the reader to the concept of free cash flow as a proxy for extractable cash which in itself is the basis of an intrinsic value calculation. This can be found in published financial statements according to Dr. Hanke by deducting *maintenance level capital expenditures* from the figure published for cash flow from operations.

We think this a sound and very useful concept. In fact, at Expeditors we say "It's not real until it is cash." Our district managers certainly understand this concept as uncollected accounts receivable of a certain age are automatically reserved (expensed) against their branch operating income. When incentive compensation in the form of a branch bonus calculated as a percentage of operating income provides the vast majority of management compensation, our employees are keenly focused on the merits of turning the working capital assets into cash. All in all, we've always thought of Expeditors as a virtual free cash flow machine and should have been the sort of company Dr. Hanke could point to with pride. So what happened?

Creating a snappy ending for an article is probably difficult. Having written nearly a page of theory, somebody decided that Dr. Hanke should end his article with real world examples of companies at the extremes of cash flow. In other words a couple of stellar companies and a couple of companies that are close to going broke on paper profits. So Dr. Hanke informs us that he requested Mr. Michael Ozanian, a distinguished Forbes reporter who appears on our television every Saturday morning as a talking head for a Fox News business show, to scroll through a financial database and extract companies based on screening parameters intended to extract the real world examples.

The positive screen was designed to isolate companies where free cash flow per share grew faster than reported earnings per share over the past three years. Mr. Ozanian found two and one just happens to be a darn good customer of Expeditors. It's nice to have customers who are recognized as superior performers.

Dr. Hanke also requested that Mr. Ozanian look for companies that had recorded double-digit earnings growth in their most recently available fiscal year and who had declining free cash flow year over year. Dr. Hanke also wanted companies whose earnings per share exceeds free cash flow per share. The end result of this screen was that based upon 2002, Expeditors and one other company were identified by Mr. Ozanian's computer as deserving of Dr. Hanke's disapproval.

So what happened and if Expeditors is a cash flow performer, how did our company end up on the fake profits list? The answer lies in the screening method but we really don't have enough information to lay the error at the feet of Dr. Hanke, Mr. Ozanian or both. If the theory is bad, we can put the doctor in the barrel, but if the execution was flawed we need to look to the TV star/reporter.

We are reminded of a lesson in critical thinking given by one of our high school math teachers who set out to share with the class a short cut for solving mathematical problems. This teacher put the following fraction on the chalkboard and asked the class to quickly reduce this fraction to its lowest form:

16

64

Before any student could respond, even the smart ones who might grow up to be applied economists, the teacher drew a single diagonal line through both sixes in the fraction in the manner shown below. Chalk flew and when he was done the board looked like this:

The class was electric with amazement. We had each been through countless hours of public school mathematics without ever learning this valuable technique. As the class settled down, the teacher added quietly that the one drawback with this technique was that it only worked with the fraction of 16 over 64. In other words in most cases, the use of this short-cut technique of reducing a fraction with the same number in the numerator as in the denominator would produce incorrect results. He then cautioned the class to be

certain before relying on shortcuts or abbreviated steps that we better understand just how universally the short cut could be applied.

Dr. Hanke set out a short cut in his article. Much like taking the sixes out of 16/64, the free cash flow short cut advocated in the article is not universal. The article says to subtract *maintenance level capital expenditures* from the figure published for cash flow from operations to arrive at free cash flow and that absent any clear-cut information about which plant and equipment outlays expanded the business and which merely kept existing business alive, assume that all fell into the latter category. In the hands of Mr. Ozanian, this short cut lead to linking Expeditors with some of the major corporate frauds of the past decade merely by mindlessly assuming that all of Expeditors' capital expenditures were made to keep the business alive.

We firmly believe that Expeditors has outstanding fundamentals. However, you don't need to take our word for it. Since one of our objections to the Hanke screen is the fact that it focuses on just one year, we thought it might be instructive to compare GAAP cash flow from operations with our cash generation and consumption over several years. The result of this effort is the table below.

Table I

| (in \$ 000 s)                                   | 1996     | 1997     | 1998     | 1999     | 2000     | 2001     | 2002     | 2003     | Total     |
|---|----------|----------|----------|----------|----------|----------|----------|----------|-----------|
| Cash flow from operations                       | 24,167   | 59,804   | 53,238   | 53,311   | 154,458  | 167,614  | 116,493  | 114,335  | 743,420   |
| Capital expenditures                            | (20,824) | (36,007) | (52,455) | (26,582) | (25,582) | (37,382) | (81,427) | (20,745) | (301,004) |
| Free cash flow per Hanke                        | 3,343    | 23,797   | 783      | 26,729   | 128,876  | 130,232  | 35,066   | 93,590   | 442,416   |
| <b>Other stuff that affects cash flow:</b>      |          |          |          |          |          |          |          |          |           |
| Decrease (Increase) in short term investments   | 87       | (13)     | (121)    | (750)    | (818)    | 1,698    | (31)     | (5)      | 47        |
| Acquisitions, net of cash                       |          | (7,076)  |          |          |          |          |          |          | (7,076)   |
| Cash paid for note, secured by real estate      |          |          |          |          |          | (10,208) | (4,262)  |          | (14,470)  |
| Cash held in escrow for real estate acquisition |          |          |          |          |          |          | (31,250) |          | (31,250)  |
| Other   | (3,058)  | (825)    | (93)     | (4,381)  | (3,081)  |          |          |          |           |