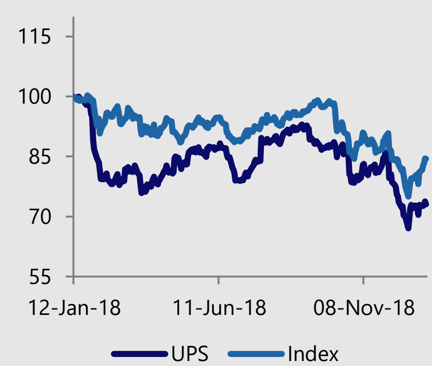
RESEARCH REPORT

January 14, 2019

Ticker	UPS
Market Cap. (MM)	$84,106
P/E LTM	15.7x
EV/EBITDA LTM	10.3x

52 Week Performance



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United Parcel Service Inc.

Still Delivering the Package?

Background

The QUIC Industrials sector has owned shares in the United Parcel Service Inc. (NYSE:UPS) since early 2018. However, the most recent holiday season has driven the company's share price down by 20%, prompting the IND team to revisit our holding.

Summary

In determining the future prospects for UPS, this memo will:

- Revisit our original theses and the company's fundamentals
- Analyze the short-term challenges driving down the share price
- Discuss UPS' near-term plans and initiatives for the future
- Conduct a deep-dive into the long-term Amazon threat

In the short-term, the recent challenges facing UPS seem manageable and pose an insignificant risk to the fundamental factors that have historically made UPS a good company. Over the next few years, UPS should continue to enjoy high returns on capital and strong FCF generation. However, Amazon is emerging as a significant competitor in the U.S. shipping space – one which will gradually erode UPS' economic moat, wide margins, and strong returns in the long-run. Thus, the Industrials team has decided not to buy more shares in UPS, opting to hold our current position in the meantime. While the ultimate goal will be to exit the name, the Industrials' team will wait for a more favourable exit price.

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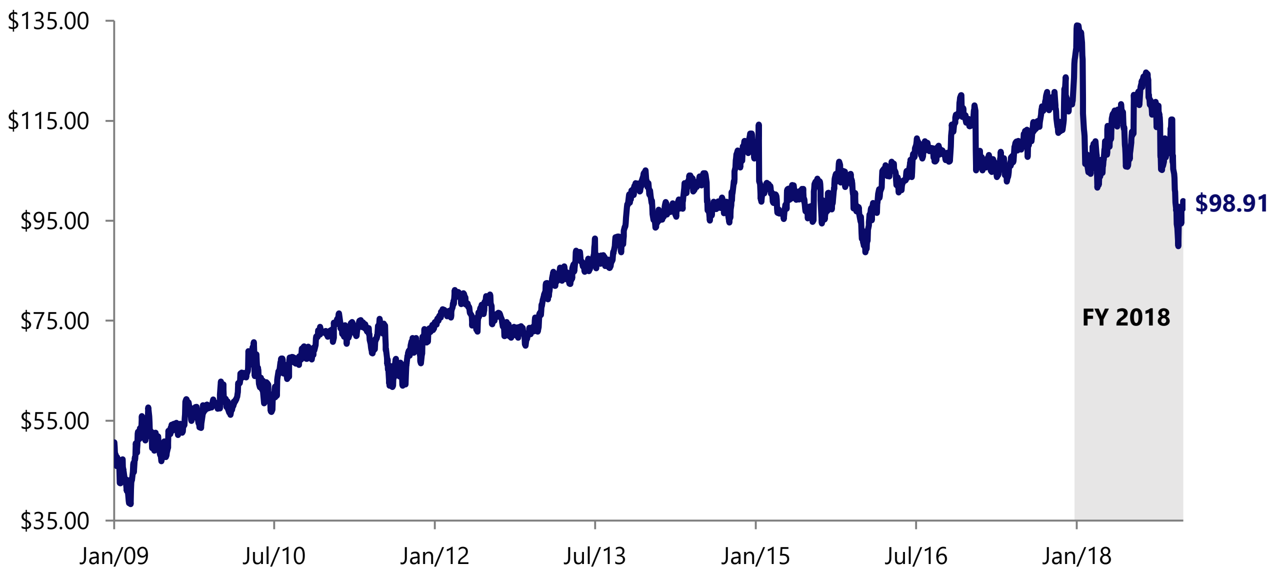
Introduction

On the surface, UPS has been performing successfully. Although 2018 financial results have not yet been reported, projected annual revenue growth is approximately 9.4% while estimated EPS is expected to surpass 20% growth YoY. Despite predicted financial performance, UPS stock has sold off over 20% over the course of the 2018 holiday season, despite robust consumer spending from a macroeconomic view. The QUIC Industrials team was intrigued by the seemingly counterintuitive sell-off and set out to evaluate whether our original theses for the business still hold. In 2017, QUIC was debating purchasing a stake in UPS and FedEx as we sought exposure to the U.S. shipping market in our memo entitled, “Shipping Wars”. The research report into shipping led to the decision to purchase a stake into UPS, as it was deemed a less capital-intensive businesses with greater potential for margin expansion. However, the memo noted that UPS’ “single network” operational model led to an inherent inability to handle surges in capacity, while yielding low margins on consumer customer purchases. In 2018, healthy macroeconomic factors including robust wage growth, low unemployment rates and growing e-commerce platforms led to a surge in UPS’ consumer segment, driving down margins and unveiling a fundamental flaw in its business to investors.

The result was a sell-off that shaved over $20 billion of equity value. The shipping industry is seeing a growing concentration of its revenue originate from low-margin consumer sources rather than businesses. In this report, the QUIC Industrials team attempts to summarize the key challenges in UPS’ business that led to the recent negative investor sentiment. We then move on to re-assess our original opinion of the stock and its economic moats alongside our long-term, quality-focused investment strategy.

EXHIBIT I

Trailing 10-Year Share Price Performance



Source(s): Capital IQ

Have the Fundamentals Changed?

Background

The Industrials team entered a large position in UPS in January 2019 after doing a deep dive into the parcel shipping market. The rationale was two-fold: (1) the U.S. parcel carriers (FedEx and UPS) offered strong fundamentals and business characteristics, (2) between the two, the Industrials team believed UPS had a better outlook. Before diving into the short-term developments that caused share prices to decline in 2018, the Industrials team revisited each of the original theses to determine if industry fundamentals have changed over the past year.

Barriers to Entry

The Industrials team believes that the U.S. parcel carriers still boast an impressive economic moat from scale. UPS and FedEX are able to reach millions of addresses spanning in every country in the world, including every listed address in North America and Europe. Its virtually impossible for a new entrant to overcome this economic moat due to the scale of the duopoly's operations. In order to provide these services, a parcel carrier requires an extremely large network with "hub-and-spoke operations" in every region in which they operate. This means thousands of distribution centers, local facilities, and transportation assets (airplanes, trucks, drivers, pilots etc.) around the world. Thus, no other player has managed to enter the market on a national scale to date, and the risk of new entrants remains low. However, Amazon poses a significant threat to this moat in the medium to long-term, as discussed on Page 13 of the memo.

Pricing Power

Due to enormous barriers to entry, FedEx and UPS are able to operate as a duopoly in the U.S., with smaller players only able to capture share in niche segments and geographies. Pricing between UPS and FedEx has historically remained rational, with both companies avoiding a price war in most segments and reaping the benefits of duopolistic industry structure. Both companies have demanded mid-to-high single digit pricing increase over the past 15 years. Most recently, UPS announced a 4.9% pricing increase for 2019.

We believe the moat around UPS remains stable, and pricing will continue to be a bright spot for consistent revenue growth in the face of rising costs and the shift to B2C. The importance of pricing to the future success of UPS is discussed on Page 12 of the report.

EXHIBIT II

UPS & FedEx Pricing Increases

Source(s): Lojistics Annual Carrier General Price Increase Report

Have the Fundamentals Changed?

Strong Returns, FCF Generation

After establishing the attractiveness of the parcel shipping industry, the Industrials team deemed UPS more attractive than FedEx due to its ability to generate higher returns on capital. This was largely due to UPS' single integrated network structure (as opposed to FedEx separate ground and express networks), which drives higher margins from operations while simultaneously being less capital intensive. UPS' ROIC has been an average 18% since 2001, double FedEx's 9%. UPS returns remained high this year, with a ROIC of 25% on a TTM basis.

Higher returns and lower capital intensity have historically allowed UPS to return more capital to shareholders than FedEx. Despite only being 1.5x larger, the company has issued 5x the dividends and repurchases since 2000. Thus, UPS not only generates higher returns because of lower capital intensity, but its also able to return more of the value generated to shareholders. While this trend continued this year, the $4.5bn+ returned to shareholders represented a decline from last year's $5.0bn+, likely due to plans to increase capital spending in the coming years.

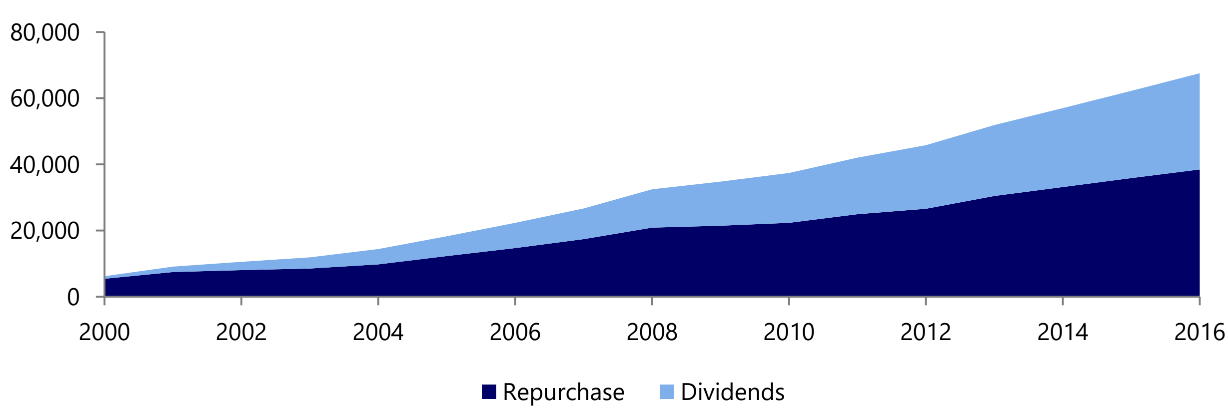
So What Happened?

While UPS' more efficient network and lower capital intensity are generally positive characteristics, 2018 showed that they come at a price. The next section of the memo will discuss how UPS network sacrifices flexibility for the sake of efficiency. This can become problematic when there's a surge in demand, particularly around the holiday season, as UPS becomes unable to handle the higher capacity and resorts to outsourcing (which increases cost). We see this as a potential flaw in the business model overlooked in our original report. While there seems to be no immediate threat to pricing power for now, the potential for further margin decline could hurt FCF generation and returns in the future.

As discussed over the next few pages, this lack of flexibility is one of the major factors driving margin pressure. We believe (1) lower margin outlook, and (2) "the Amazon threat" were responsible for driving share price declines in 2018. We see (1) as a short-term threat while (2) represents an ongoing concern for UPS that warrants a deeper dive.

EXHIBIT III

UPS Cumulative Capital Returned to Shareholders ($MM)



Source(s): Bloomberg

The Shipping Paradox

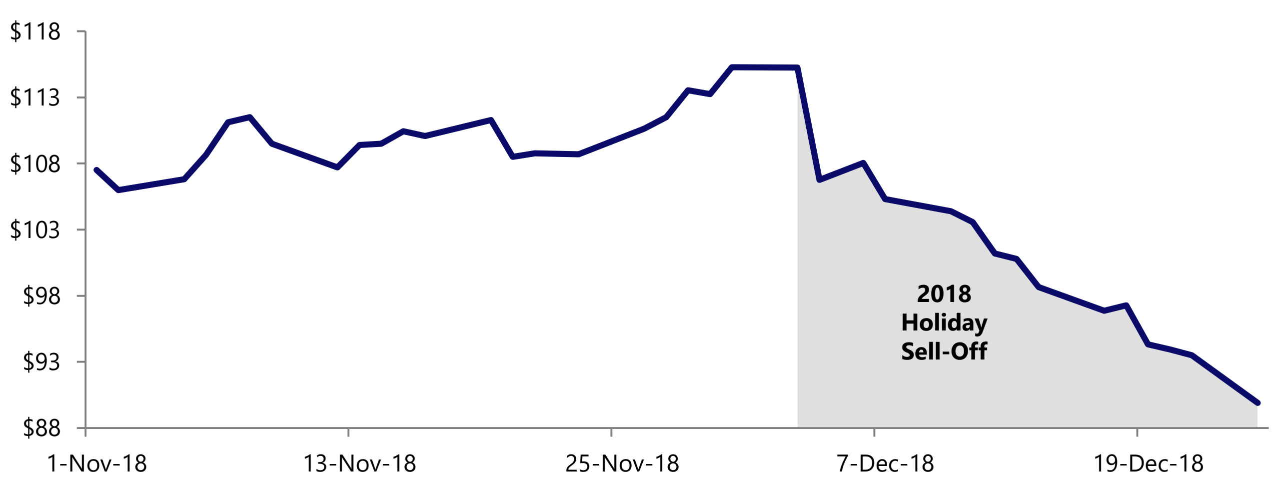
The 2018 Christmas season brought record consumer sales driven by increasingly efficient e-commerce platforms. According to Shopify, the United States saw a 16.6% annual increase in online consumer sales. With such success in the consumer shopping markets, it seems almost paradoxical that a market-leading shipping company can lose over 22% of its equity value during of the most lucrative holiday shopping seasons of the decade. However, the reason for UPS' poor performance during the season is rooted in two fundamental factors of its business model.

I. B2C Presses Down On Margins

In QUIC's 2017 memo entitled "Shipping Wars", Business To Consumer (B2C) demand was projected to surpass that of Business To Business (B2B) by 2018. The proportion of UPS' B2C revenue increased from 55% to 63% during December of 2018, qualifying as the largest swing in 10 years. While the proportion of revenue for UPS may seem trivial when revenue is increasing, it actually has a significant impact on the company's profitability. B2C orders have significantly lower shipment density, averaging 1.2 packages per stop compared with 4.0 packages per stop for B2B. Lower shipment density places downward pressure on margins and hinders efficiency. Moreover, a focus on B2C limits pricing power, as consumers are more sensitive to price changes than businesses. The seasonality of macro consumer demand for products and services is also more cyclical than that of businesses. The upward pressure on cost decreased margins during the 2018 holiday season, even after being offset by pricing increases. The net result was UPS being unable to return the expected amount of its revenue growth to its bottom line. A graphical depiction of the historical relationship between the proportion of B2C in UPS' revenue stream and its EBIT margin is displayed in Exhibit III. After running a regression analysis, we have determined that the correlation between B2C revenue makeup and EBIT margin is approximately -49%.

EXHIBIT IV

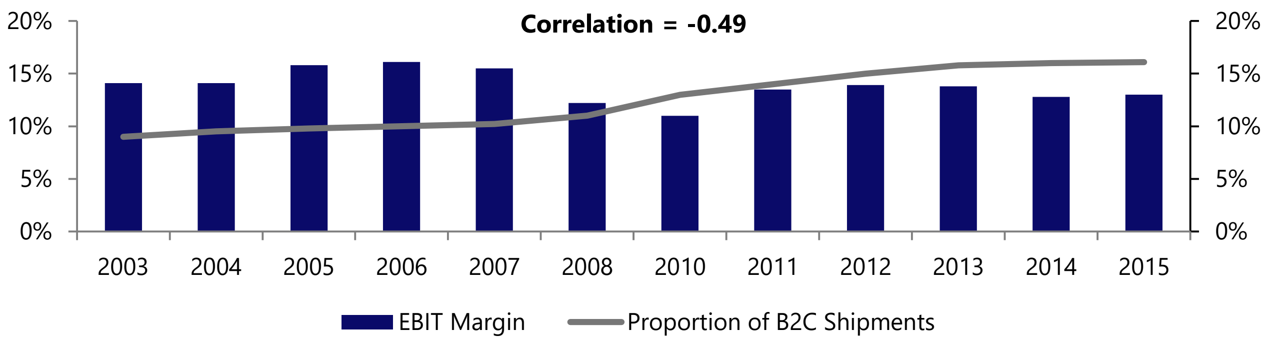
UPS 2018 Christmas Season Share Pricing



Source(s): Capital IQ

EXHIBIT V

UPS B2C Shipment Proportion vs EBIT Margin



Source(s): BMO Capital Markets

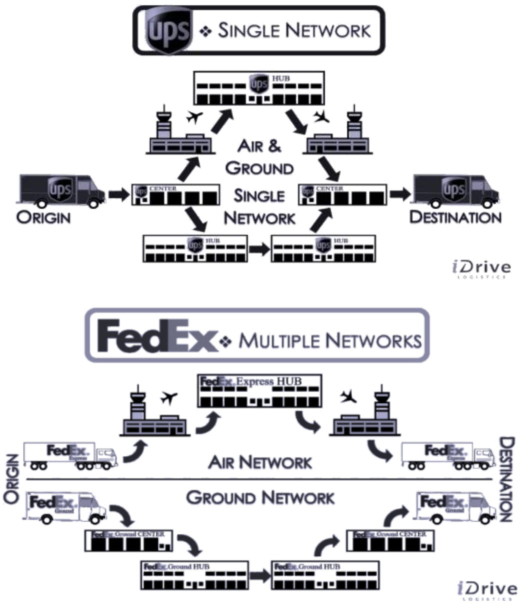
The Shipping Paradox (Cont'd)

II. Single Shipping Network Model

In "Shipping Wars", we noted that UPS and FedEx differ fundamentally on the structure of their networks. UPS operates a single, integrated network, in which each UPS truck or plane can handle shipments from both ground and express services. In contrast, FedEx operates multiple, separate networks in its air and ground operations. While the QUIC team argued that UPS' approach was more cost efficient due to its ability to increase shipment density, we also noted that the structure is not nearly as conducive to capacity expansion as FedEx's multichannel model. While this downside seemed inconsequential at the time, it turned out to be a key driver of UPS' inability to adapt to the surge in B2C demand. A single channel network funnels land, air, and freight packages into one hub before sending them to regional shipping centers. During surges in volume, the hub can easily become overwhelmed. FedEx's multichannel model keeps the air, land, and freight channels completely separate, preventing any one point along the delivery chain from having a significant volume imbalance. During the 2018 holiday season's volume surge, UPS' single network model was overwhelmed with overcapacity, further pushing down margins and the brand's goodwill with the growing consumer market.

EXHIBIT VI

UPS & FedEx Operational Models



Source(s): iDrive Logistics

The Shipping Paradox (Cont'd)

II. Single Shipping Network Model (Cont'd)

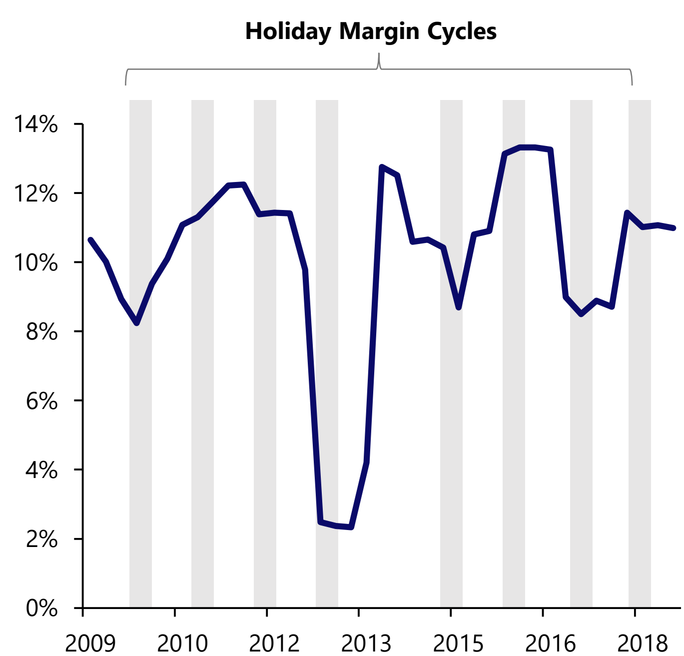
Pick-up and delivery operations, also known as the "Last-Mile", account for approximately 50% of costs. When over-capacity, UPS resorts to outsourcing the Last Mile to the United States Parcel Service (USPS). During the holiday season, UPS was forced to pay a surge in outsourcing fees to resolve its overcapacity. In the weeks leading up to the season, USPS announced its intention to raise its fees after historically pricing below marginal cost, augmenting investor uncertainty in the viability of UPS' dependency on outsourcing to complete the Last Mile. The announcement bolstered investor sensitivity during the holiday's capacity crisis, contributing to the season's sell-off.

Holiday Margin Cycle Analysis

As shown in the following exhibit, UPS' inability to handle surges in demand has essentially made its margins dependent on its proportion of B2C revenue, which usually surges during holiday seasons. During each holiday season, UPS sees the same capacity issues and downward margin pressure arise. The cycle analysis below offers evidence that the stock's holiday crash of 2018 is indicative of an inherent problem of the shift to B2C. These issues must be addressed to unhinge the business from dependence on seasonal consumer spending cycles. In addition to margin cyclicality, growing emphasis on the B2C revenue segment is producing a net effect of downward margin pressure. The trend is summarized in Exhibits VI to IX.

EXHIBIT VII

Cycle Analysis of UPS EBIT Margin

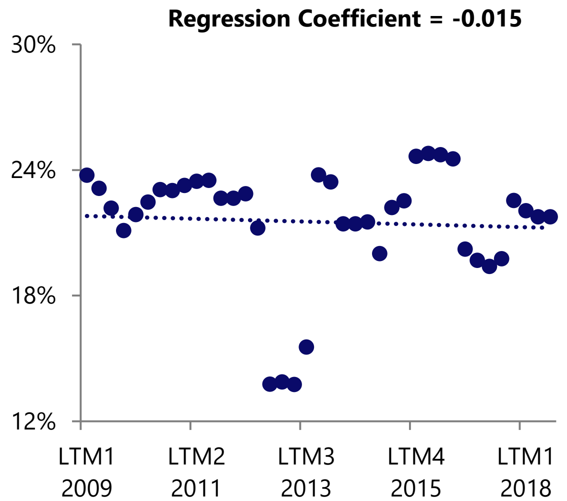


Holiday Season	EBIT Margin Change (QoQ)
2009	(8%)
2010	2%
2011	(7%)
2012	(75%)
2013	nmf
2014	(2%)
2015	21%
2016	(32%)
2017	(7%)
2018	(9%)
Average	**(13%)**

Source(s): Capital IQ

EXHIBIT VIII

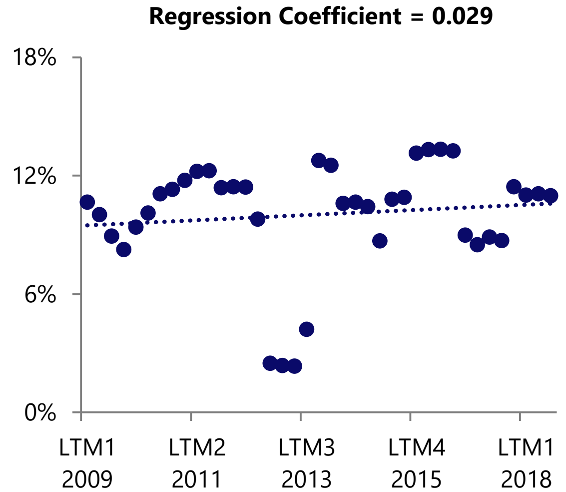
Historical Gross Margin Performance



Source(s): Capital IQ

EXHIBIT IX

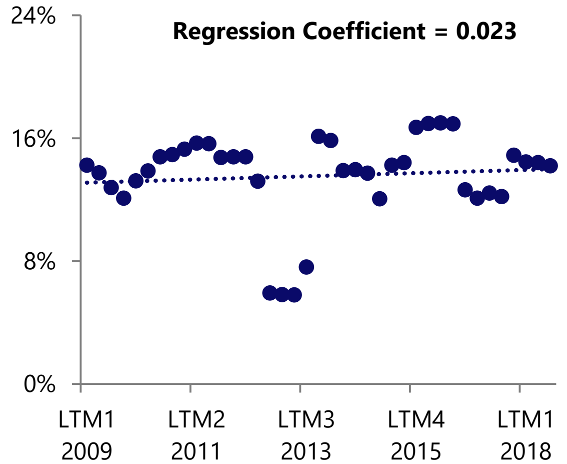
Historical EBIT Margin Performance



Source(s): Capital IQ

EXHIBIT X

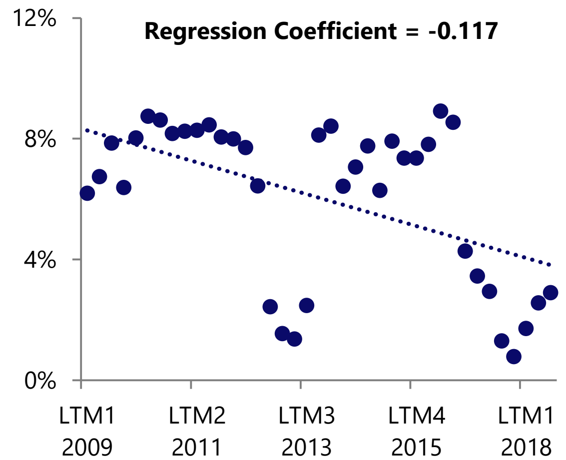
Historical EBITDA Margin Performance



Source(s): Capital IQ

EXHIBIT XI

Historical LFCF Margin Performance



Source(s): Capital IQ

Moving Forward: UPS's Transformation Plan

In light of the challenges that UPS is facing, what are they doing to address their problems? This can be partially answered by UPS' transformation plan, which was unveiled in Q4-18 and is aimed at improving margins and generating higher quality revenue.

UPS's transformation program leverages their scale to ensure profitable growth, and focuses on four strategic imperatives: (1) expansion of high-growth international markets, (2) expansion of both B2B & B2C e-commerce sales, (3) further penetration of the profitable healthcare logistics market, and (4) enhancing services for small & medium businesses.

Renewed Focus on Healthcare Logistics

The IND team looks favourably upon UPS's initiative to further penetrate the healthcare and life sciences segment. UPS serves big-name customers in the pharmaceutical and medical device market, offering highly specialized services such as temperature-controlled, time-sensitive shipping and expertise in compliance with regulations. Business is booming healthcare, driven by aging baby boomers and demand for home health services, but as firms go global in search of new markets they run into supply chain challenges. It makes sense for shipping giants like UPS to step in, as they have already have a global logistics infrastructure in place. Clients are willing to pay a premium for these niche services, resulting in higher margins. Additionally, healthcare is not as cyclical as e-commerce, providing stable returns.

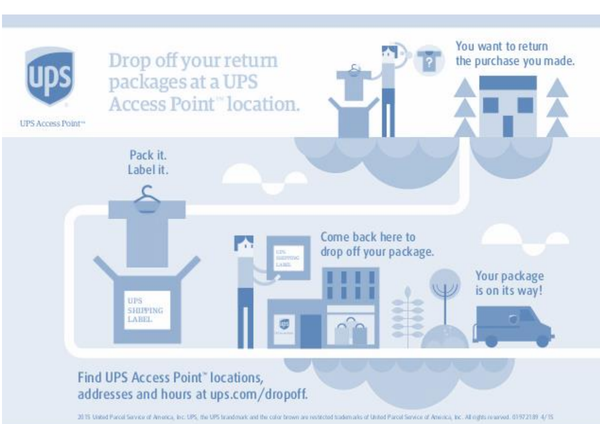
Higher Revenue Quality (B2C, SMB)

Although B2C shipments have been growing rapidly due to the popularity of e-commerce, UPS will be focusing on increasing higher-margin sales, such as B2B shipments. They will also be repositioning their SMB strategies to help increase this segments' usage of UPS services. SMB shipping makes up 30% of U.S. volume. Their business results in higher margins as they lack the bargaining power of huge companies such as Amazon while having higher willingness to pay than consumers.

To combat margin compression in B2C operations, UPS is continuing to expand its network of Access Points. This allows online shoppers to pick up purchases from a convenient location, thereby eliminating the need for UPS to deliver packages to residential homes and reducing costs (fuel expenses and time).

EXHIBIT XII

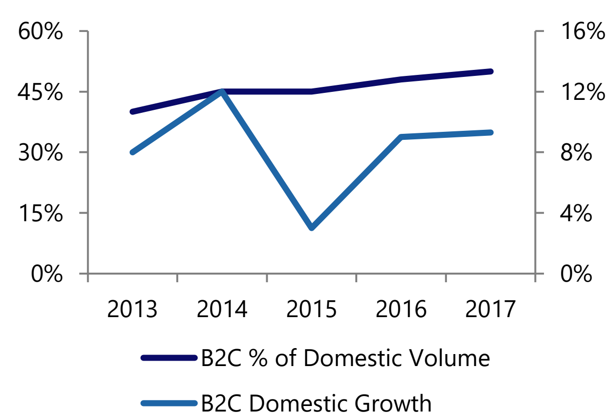
UPS Access Points



Source(s): Google Images

EXHIBIT XIII

B2C Domestic Volume % (LHS) & Growth (RHS)



Source(s): Company Filings

UPS's Transformation Plan (Cont'd)

Every minute that a UPS truck driver saves every day leads to savings of $14.5 million per year. Additionally, UPS will not need to worry about making repeated delivery attempts; undelivered packages occupy non-revenue generating space, which is a cost to the company.

Investing In Capacity and Technology

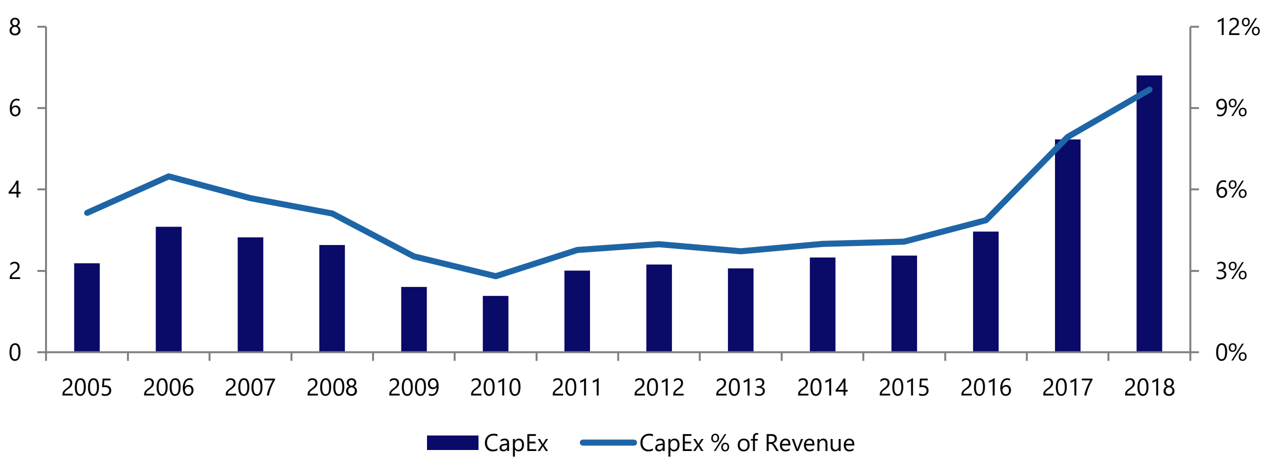
As previously stated, UPS's single shipping model can easily be overwhelmed with overcapacity. Their transformation strategy includes heavy investments in several areas such as automatization and capacity. New facilities, aircraft and fleet assets are coming online at record levels during the next four years. In 2019 and 2020 UPS will be adding 350,000-400,000 pieces per hour of sortation capacity in the U.S. each year, seven times more than the capacity added in 2017. Higher capacity cargo jets have been added to the UPS fleet and the company has in the last two years significantly expanded international capacity.

UPS also recently opened a new Super Hub in Atlanta, part of an expanded network of regional hubs designed to improve efficiency and service levels. These new high-speed Super Hubs reduce time-in-transit within the company's hub-and-spoke network, which is greatly needed as shipping volumes soar. Other UPS initiatives include electrifying its fleet of trucks and introducing B2B innovations for SMBs such as a Shopify checkout app, new fulfillment options and shipping integration solutions.

That being said, the IND team is concerned that this new capacity will be devoted to the large volume of low margin B2C shipments. It remains to be seen whether or not UPS will actually be successful in increasing revenue quality through these initiatives. However, given the lack of an immediate threat and management's strong track record of efficient capital allocation, the Industrials team believes these initiatives will bear fruit. In the meanwhile, its reasonable to assume that margin pressure and higher capital intensity will take their toll on returns in the short-term. With ROIC consistently in the ~20% range, UPS has room to course correct in this space.

EXHIBIT XIV

UPS Capex ($MM) (LHS) vs Capex as a Percent of Revenue (RHS)



Source(s): Company Filings

Is UPS Going to Course Correct?

What does the future look like for UPS? While some macro factors are out of the company's control (e.g. trade wars may potentially eat into international shipping volumes), we are cognizant of the fact that shipping carriers are cyclical businesses where higher B2C volumes at the end of the year are inevitable. Combined with the shift to B2C, battling margin pressure will be an ongoing concern for UPS. While we believe their initiatives are on the right track, two other factors will be crucial to the company's success.

Sustainable Price Increases

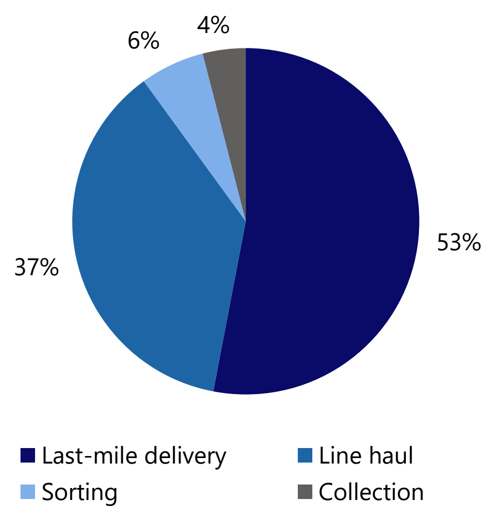
Raising prices is the only way forward for UPS, at least in the short-term. This will allow them to continue funneling capital into critical capacity and technology investments while combating margin compression. A more significant price hike for both carriers in the near future would boost margins, while giving customers no other alternative to take. USPS is raising their prices in 2019 between 9%-12%. This is a double edged sword as it gives UPS and FedEx the flexibility to raise their prices as well, but hurts them on outsourced last-mile delivery costs. That being said, the Industrials team will be carefully watching pricing trends in 2019.

Delivery Density and Consolidation

Continuing to identify opportunities for delivery consolidation should offset the margin-compressing process of delivering one package to one house at a time. For example, if UPS determines that one of their deliveries and a delivery made by USPS are bound for the same destination on the same date, UPS will re-direct the USPS delivery into its network, resulting in higher profit per piece as they drop two packages at one stop. UPS should also focus on expanding their "Synchronized Delivery Solutions" where they create synthetic density by speeding up or slowing down package deliveries so multiple packages are delivered to the same residential area at the same time. Strategies centering around these two initiatives - price increases and delivery consolidation - should serve UPS well and are viewed favourably by the IND team.

EXHIBIT XV

Share of Delivery Costs, By Part of Journey



Source(s): Business Insider Intelligence

Wait … What About Amazon?

Up until this point, this memo has discussed industry dynamics and UPS' position today, focusing on developments in 2018. While we believe the fundamental characteristics that make UPS a good company are safe in the near-term, there's plenty of talk about Amazon being the industry's biggest threat in the long-term. UPS' short-term challenges are manageable, but it's not yet clear how the "Amazon Boogeyman" – a coin termed by Industrials in 2017 – will affect UPS's business model.

Our team conducted a deep dive into the Amazon issue and found that the boogeyman is not entirely fictional and provides plenty of reason for concern. The key insights are discussed in the next section of the memo.

Revisiting "The Amazon Boogeyman"

Amazon (NASDAQ:AMZN) building its end-to-end delivery network, from the purchase of items on its website to delivery to its customers is old news. Since 2014, the e-commerce giant has been spending heavily on airplanes (leases 40 Boeing 767s), truck trailers (owns 1000) and fulfillment, sorting and distribution centers in a variety of major metropolitan areas across the world (operates 328 centers in the US, and 708 worldwide with 55 future facilities). This massive investment has given rise to speculations that Amazon is planning to eventually take on its delivery partners FedEx (NYSE:FDX) and UPS.

However, the prevailing view among the parcel industry executives, at least publicly, is that any such speculations demonstrates a misunderstanding of the scales and complexity involved in running a global transportation network. The founder and CEO of FedEx, Fred Smith, stated: "Amazon is a retailer; we are a transportation company." In other words, FedEx and UPS do not believe that Amazon, a company whose revenue is three times higher than theirs, is growing at 30% annually and who has tamed its investors to forego any expectations for short-term profit, would ever make that investment.

History

The decision to build out Amazon's delivery network was made in 2014 following the so-called '2013 Christmas Fiasco'. A few weeks earlier, on December 24, 2013, UPS announced that its network was overloaded and that it would fail to deliver many of its packages on time for Christmas. Amazon was then forced to issue cancellations and refunds to a large number of angry customers—all of which made "Earth's most customer-centric company" very unhappy.

What Amazon realized in the days post the "Christmas Fiasco" is that UPS/FedEx are not ready for the age of e-commerce. Their infrastructure is not oriented around home-delivery and their technology is dated.

Amazon then decided that it was no longer willing to be fully dependent on FedEx and UPS to deliver its packages. Publicly, it announced that it would build a fully integrated delivery network to "supplement our existing partners."

Building Capacity

In 2015 it launched Amazon Flex, an Uber-like crowdsourced delivery service, now available in more than 50 US markets, which utilizes approximately 100,000 drivers. It also began rolling out its fleet of trailer trucks, which now number in the thousands. In 2016, on top of leasing 40 airplanes, it made a move into global freight shipping (a $350B dollar industry) by registering Amazon China as an ocean freight forwarder. Amazon explained this move as a step to achieve more control over shipping costs, but according to a Bloomberg report, Amazon's real goal is to disintermediate DHL, UPS and FedEx, and allow sellers on its platform to book cargo space directly with Amazon through a 'one click-ship platform for seamless international trade and shipping'.

Furthermore, in Amazon's 2016 annual report, management clearly stated for the first time that "our current and potential competitors include … companies that provide fulfilment and logistics services for themselves or for third parties".

At the beginning of 2017, Amazon announced a $1.5B investment in a Kentucky based airport to serve as the new cargo hub for its aircraft fleet, which is eventually planned to support 100 Prime aircraft and 2,700 employees. Throughout the year it continued to experiment with delivery drones, self-driving cars and other forms of delivery automation, and rolled out a mobile app called Relay, which allows it to harness tens of thousands of independent truck drivers to overcome the increasing shortage of driver supply across the trucking industry.

Revisiting "The Amazon Boogeyman"

Then, late in the year, Amazon was rumoured to potentially make a bid for XPO Logistics—a $15 billion trucking company that specializes in less than a truckload (LTL) logistics and Last Mile delivery of bulky items such as furniture.

Leaving Little Doubt

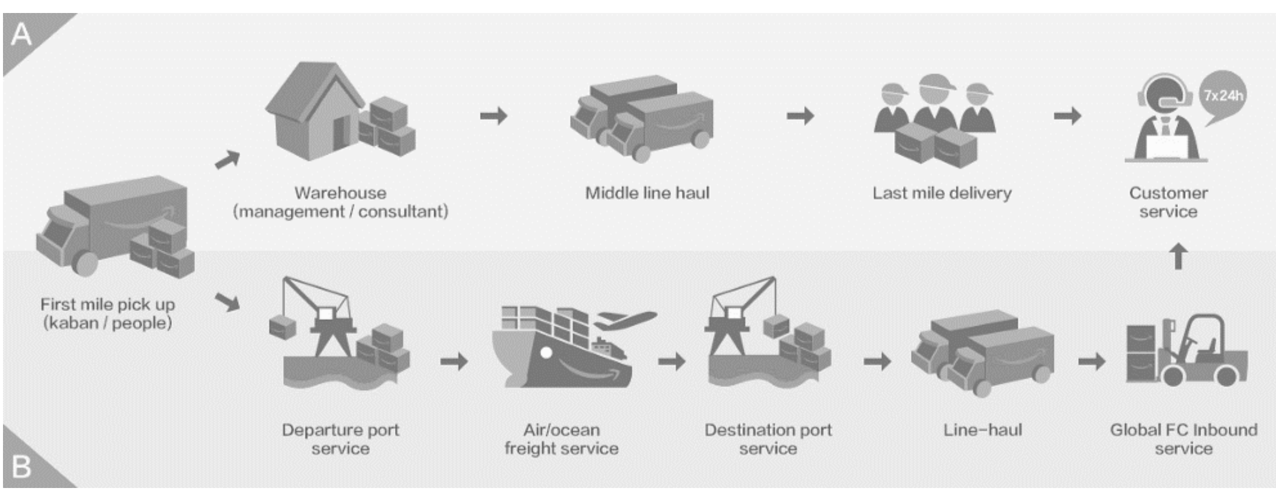
As the first step, Amazon recently announced that they are now testing, and planning to expand, Seller Flex, a new service that allows Amazon sellers to grant Amazon full control of their shipping logistics. Already today, Amazon drivers deliver packages for Amazon's sellers, but up until now, this service has been provided only to sellers who ship from Amazon's fulfilment centres. Under Project Seller Flex, Amazon would now oversee pickup of packages directly from the seller's warehouses, and determine how these packages would be delivered—a task that was previously left to the seller, who often contracted with FedEx and UPS.

Once Seller Flex has been implemented, the way to disintermediate FedEx and UPS becomes rather simple. In February 2018, the Wall Street Journal announced that Amazon is preparing to launch a delivery service for businesses named "Ship with Amazon (SWA)." The service will use third-party couriers to transport packages from the sellers' warehouses to Amazon's distribution centers, and from there use the Amazon Logistics fleet for the final mile delivery. Ship with Amazon allows the retail giant to completely cut out FedEx and UPS from the delivery of its sellers' packages. It also means that Amazon could soon skip its distribution centers, and deliver directly from its sellers' facilities to customer homes.

As the news about Amazon's latest moves hit Wall Street, UPS and FedEx's stocks immediately changed direction and dropped 25% and 16% respectively between January and March.

EXHIBIT XVI

Amazon's End-to-End Logistics Solutions



Source(s): Amazon China

Revisiting "The Amazon Boogeyman"

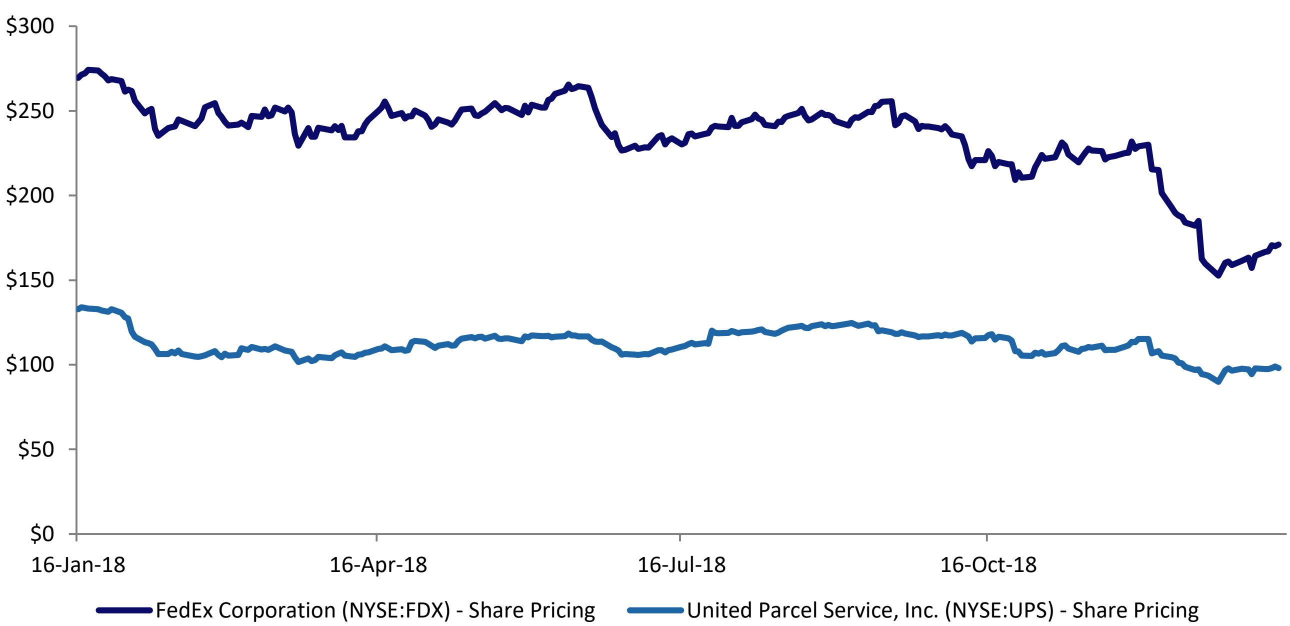
Amazon's Incentives

Amazon's shipping costs are steadily rising in correlation to its massive growth, and have almost doubled between 2015 ($11.5B) to 2017 ($21.7B). It would be a mistake to assume that Amazon would not turn a loss by "cutting out the middleman" and insourcing delivery operations. Yet, Amazon can indeed save billions by insourcing its own delivery system, primarily by leveraging three key strategies.

First, as FedEx's Fred Smith noted above, "Amazon is a retailer; we are a transportation company". Amazon, therefore, does not need to present a profit on its delivery operation, can simply skim the 11% EBIT line that UPS and FedEx generated in 2016. According to analysts, this would translate into $1 billion in annual savings for Amazon. Second, unlike UPS, Amazon has managed to keep the labour unions out the door, and thus has lower labour costs. In the absence of a strong union, Amazon is free to leverage programs like Amazon Flex, which Amazon pays crowdsourced delivery drivers $18-$25 per hour, all inclusive, compared with UPS employees who are paid up to $35 along with benefits. Third, and most important, is the technology opportunity. UPS and FedEx still all use legacy technology systems and practices. For examples, most delivery drivers are still required by their employers to carry old handheld GPS devices, which cost $2,000 to $3,000, instead of using a mobile app to complete delivery tasks. Such opportunities present major savings for Amazon, who is developing its software infrastructure from scratch.

EXHIBIT XVII

NYSE:UPS & NYSE:FDX Share Price Trailing 1 Year



Source(s): Capital IQ

Revisiting "The Amazon Boogeyman"

Despite these massive savings opportunities, it would be naive to assume that Amazon will cut out FedEx and UPS overnight, as it still heavily relies on their capacity. Instead, Amazon is playing a long-term strategic game to increasingly squeeze margins out of FedEx and UPS, and slowly take over some of the more profitable pieces of their business. Perhaps the best example of this is the 'pockets of density' strategy:

As a retailer, Amazon is especially popular among middle to upper-class populations who tend to reside in metropolitan areas. FedEx and UPS love those metropolitan areas since they are denser and hence more profitable: for the same hourly cost of driver and vehicle, UPS delivers many more packages in the city than in suburban or rural areas. Large apartment buildings are especially attractive since they allow delivery companies to drop multiple packages in one stop but charge separately for each package.

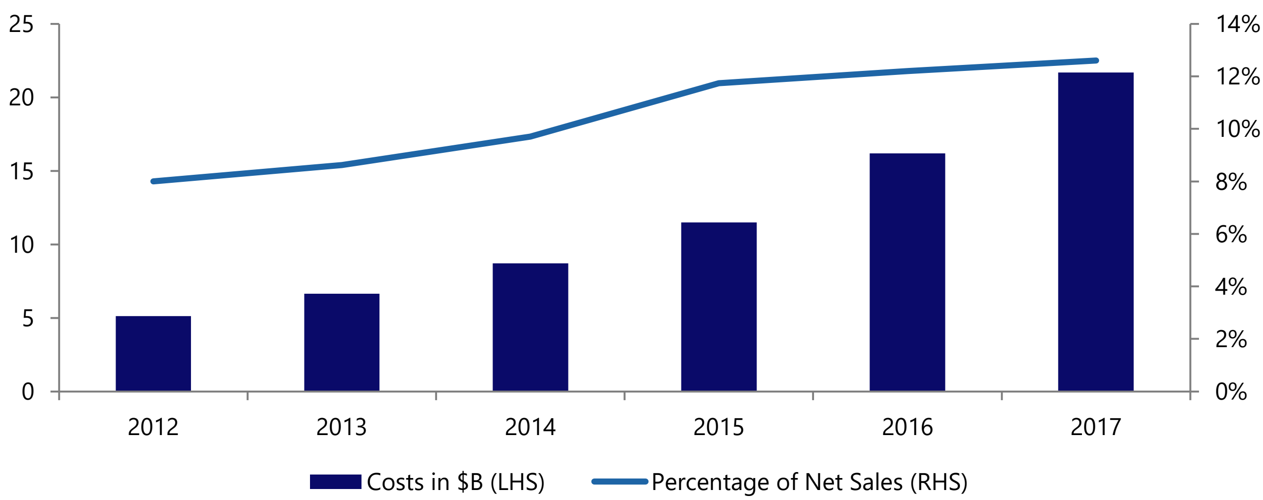
It should come as no surprise, therefore, that when Amazon began building its internal delivery network, it initially focused on these "pockets of density" who presented an immediate cost-saving opportunity.

To illustrate, assume that Amazon ships 20 packages to one block of buildings and that it takes a driver exactly one hour to deliver them all. Now assume that UPS charges $4 per every package it delivers. If shipping with UPS, Amazon would pay 20 X $4 = $80 for that 1 hour. But by insourcing the delivery, Amazon can now pay its Flex driver $18 for that same 1 hour. Big savings.

Once Amazon has sent out a delivery driver with its own packages, there is nothing preventing Amazon from allowing other sellers to add their packages to their vehicle. This is not only attractive to Amazon as a new revenue stream, but also as a strategy to subsidize the delivery cost of its own packages: the more packages delivered to the same building block or neighbourhood, the higher the delivery density, and the less it costs Amazon to deliver each package.

EXHIBIT XVIII

Amazon's Logistic Shipment Costs



Source(s): Company Filings

"The Amazon Boogeyman"

Lastly, the most overlooked piece in this puzzle – and likely the most important one to Amazon – is customer experience.

There is an abundant amount of data showing that online shoppers reward retailers who guarantee on-time delivery, provide accurate transit times and remove unnecessary friction for the customer when receiving a package. The more Amazon owns the distribution of its packages, the more it can control the factors that make or break a relationship with a customer. This was the core reason behind Amazon's decision in early 2014 to launch Amazon Logistics and reduce its reliance on UPS and FedEx.

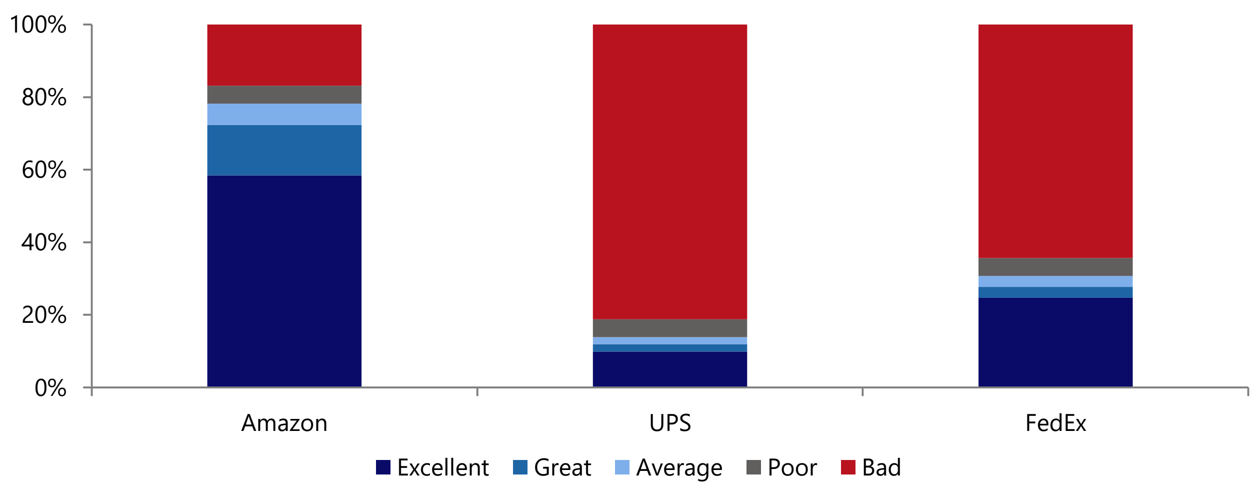
How do FedEx and UPS fare when it comes to customer experience?

Google the words "UPS (or FedEx) Customer Reviews" and you will find thousands of complaints from angry customers. Sure, customers are ungrateful, and often unaware of the massive operation required to ship a package across the country in 2–3 days. But truth be told, for the most part, both FedEx and UPS have justifiably earned this image: poor communications with end-customers; lack of price transparency; frequent rate increases; poor digital user interfaces and frequent delivery delays especially during the holiday season—are all prime contributors to this negative brand perception.

Unlike FedEx and UPS, Amazon does not treat 'delivery' as merely the act of bringing a package to the customer doorstep; rather, Amazon sees 'delivery' as "the new moment of truth": the moment when the customer "meets" Amazon in real life, interacts with its product, and continues to develop deep customer loyalty. This completes a 'customer journey loop' in which a great delivery experience reinforces the purchase decision and leads to increased future engagement. In essence, Amazon sees delivery as the physical extension of its online shopping experience and treats it as such—with the utmost importance. And just like Alexa, Dash Buttons, Prime Video and Amazon Music—it is a novel innovation that further drivers sales on its platform and customer lifetime value.

EXHIBIT XIX

Customer Satisfaction Ratings for Amazon, UPS and FedEx



Source(s): Consumer Affairs, Trust Pilot

Revisiting "The Amazon Boogeyman"

A New Dawn for Shipping

UPS, FedEx and their regional competitors should all take a closer look at the current competitive landscape. The world is changing rapidly and they need to constantly be thinking about keeping up with the likes of Amazon. What used to be considered the world's most advanced delivery networks are now increasingly becoming a commodity, while value continues to shift to smarter and more flexible technology infrastructures.

Moreover, Amazon—which still calls itself "a partner" of these delivery companies (10% of revenue for UPS)—is playing a long-term strategic game in which it is developing a full-fledged delivery network under UPS and FedEx's nose, and will ultimately emerge as a direct competitor.

Conclusion

Portfolio Implications

This memo covered many different topics, making one thing clear – UPS no longer plays in the same industry it dominated 10 years ago. E-commerce has made lower-margin B2C shipping the new reality, holiday capacity is a constant issue due to an inflexible network, and Amazon keeps investors up at night. While we think the fundamental traits that make UPS a great company – a scale-based economic moat, high pricing power, strong returns, and a focus on returning shareholder to capital – are safe in the near-term, Amazon could fundamentally change the picture in the future, potentially in as little as 5 years.

Valuation Commentary

While we think the short-term challenges facing UPS are manageable, the long-term threat of Amazon is likely to continue plaguing the stock price, particularly as the Boogeyman continues to make increasingly public moves. Due to this negative sentiment, the Industrials team has decided to hold our current UPS shares rather than taking advantage of the recent sell-off and increasing our position. That being said, we believe the market has overreacted to a certain degree, making an immediate divestment unwise. As shown on the next page, UPS would be trading close to $150 if trading at its average historical multiples – a 50% premium to its current trading price, even during a year which saw record earnings.

Thus, the Industrials team will wait for a better time to exit the UPS name. The share price, currently at 5-year lows, is often lowest after Q4 results (see Page 8) due to the cocktail of investor worries that arise after the holiday season. While Amazon will continue to put pressure on the share price, we believe UPS will see short-term wins in 2019 which should increase consumer confidence in UPS.

Historical Multiples

EXHIBIT XX

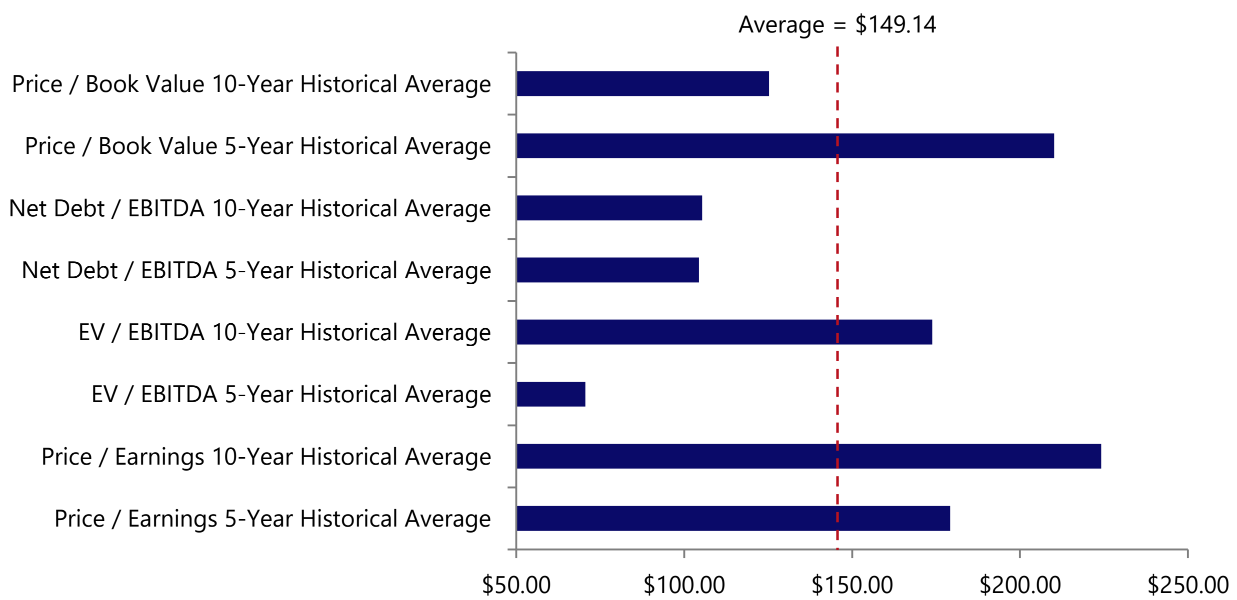
Historical Multiples Implied Share Prices

Metric	Multiple	Implied Share Price	Implied Return
Price / Earnings 5-Year Historical Average	23.9x	$179.18	83.01%
Price / Earnings 10-Year Historical Average	29.9x	$224.17	128.95%
EV / EBITDA 5-Year Historical Average	12.3x	$70.61	-27.88%
EV / EBITDA 10-Year Historical Average	12.7x	$173.90	77.61%
Net Debt / EBITDA 5-Year Historical Average	1.3x	$104.42	6.65%
Net Debt / EBITDA 10-Year Historical Average	1.2x	$105.39	7.64%
Price / Book Value 5-Year Historical Average	58.3x	$210.18	114.66%
Price / Book Value 10-Year Historical Average	34.8x	$125.31	27.98%
Average		**$149.14**	**52.33%**

Source(s): Capital IQ

EXHIBIT XXI

Football Field Diagram



Source(s): Capital IQ

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