United Parcel Service

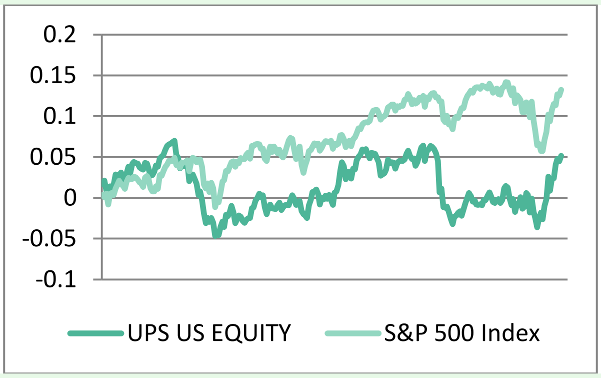
Target Price: 118.04 USD (+12.52%)

2nd November 2014

NUS INVESTMENT SOCIETY

Last Closed Price:	104.91 USD
12M Target:	118.04 USD
Upside Potential:	12.52%
GICS Sector:	Industrial
GICS Sub-Industry:	Air Freight & Logistics
Bloomberg Ticker	UPS US Equity

1Y Price v. Relative Index



Company Description

United Parcel Service, Inc.(UPS) delivers packages and documents throughout the United States and in other countries and territories. The Company also provides global supply chain services and less-than-truckload transportation, primarily in the U.S. UPS's business consists of integrated air and ground pick-up and delivery network

Key Financials

Market Capitalization (mil)	91,889.25
Shares Outstanding (mil)	706.36
A.D. Value Traded (mil USD)	3.13
Free Float (%)	99.95
Dividend Yield (%)	2.51
Beta	0.95
P/E (ttm)	21.95

(USD mil)	FY11A	FY12A	FY13A	FY14A
P/E (x)	19.14	16.26	23.16	-
P/B (x)	10.02	15.10	14.98	-
ROE (%)	50.67	13.81	78.58	-
12m Gross Div	2.08	2.28	2.48	-
Div Yield (%)	2.84	3.09	2.36	-
D/E	156.56	272.58	168.17	-
EBITDA	7862	3201	8901	-
EPS (USD)	3.82	4.54	4.54	-

Key Executives

Chairman/ CEO	D. Scott Davis
CIO/ Senior VP	David A. Barnes
COO/ Senior VP	David P. Abney
CFO/ Senior BP	Kurt P. Kuehn

Research Analyst:

Lester Koh **lesterkoh92@gmail.com**

Toh Zhen Zhou **zhen.zhou@hotmail.com**

Riding on the e-Commerce wave and Emerging Market

UPS' main revenue contribution still comes from U.S. Domestic Package which goes to show there are much more room for growth when UPS manage to capture more market share in the emerging market. Right now, majority of its revenue within the international package segment comes from Europe. Coupled with the rising middle income and the boom of e-Commerce in the recent years, UPS is well positioned in the industry to capture. As of 2013, E-Commerce sales increased by 17%, contributing about 5.8% to overall retail sales, up 0.6% from 5.2%.

Dimension Based Pricing

UPS's shift towards a dimension based pricing strategy should help in improving margins. Currently, margins have been falling due to a growing number of light-weight yet heavy packages. The current pricing system which is based on weight leads to lower revenues per unit space due to lesser packages carried per vehicle or aircraft. By switching to Dimension Based Pricing, UPS should be able to improve its margins. We expect that this strategy, which will be implemented from December 29, 2014 onwards, will result in a 20-35% increase in the pricing of such light-weight yet bulky packages. We believe that the increase in B2C volume and the expansion of online shopping would provide UPS with some leverage to increase rates with a relatively low risk of shippers shifting to competitors.

Falling Oil Prices and Recovering U.S. Economy

The continual falling oil prices has been beneficial to UPS lowering their costs significantly especially in the case of air freight costs. The improving U.S. market after numerous years of quantitative easing from the Feds has led to a slight improvement in the labour market indicating the Feds confidence in the U.S. market. Furthermore with the Feds stopping QE, it signifies largely the recovery of U.S. economy and since UPS' primary revenue driver is in the U.S Domestic market, its ability to capture this recovery in economy is higher.

Valuation & Risks

We use DCF based valuation to arrive at our 12M target price of US$118.04 indicating an upside potential of 12.52%. Pegging the projection growth to the growth in e-Commerce as well as the falling oil prices.

Key investment risks include the nature of air freight and packaging industry which is essentially the same between competitors. The susceptibility to lose market share to competitors is high. However, given UPS' relatively higher margin compared to its peers prove to be a key indicator that management has been able to maintain competitive edge over its main competitors through its complex and wide range of services.

Figure 1. Revenue by Division

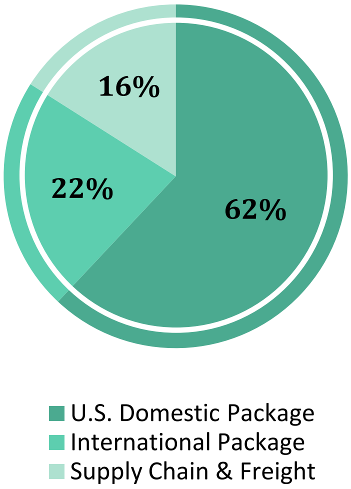
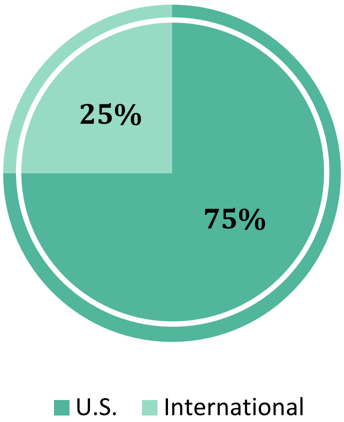


Figure 2: FY13 Revenue by Geography



Source: UPS Annual Report 2013

Company Overview

United Parcel Service, Inc (UPS) is the colossus among global shipping companies; leading the industry with a market capitalization of US$9 billion. UPS was founded in 1907 as a private messenger and delivery service in Seattle, Washington. Through its many years of prudent growth and expansion, it now derives its revenue from 3 main segments, as seen in Figure 1, namely, U.S. Domestic Package, International Package and Supply Chain and Freight.

UPS is currently the world's largest package delivery company by revenue and market share. Being a global leader in logistics, and UPS has highly customizable supply chain control and visibility. Clients use UPS for their broad array of services offered through their integrated ground, air and ocean network.

UPS aims to continue growing the company by riding on a few macro trends in recent years.

1. Expansion of Global Trade
2. Emerging Market Growth
3. Increased expertise in integrated carrier space
4. Logistics Outsourcing
5. Retail e-Commerce Growth

The most prominent of catalyst that can provide huge growth potential for a mature company like UPS is the rising middle income in emerging markets coupled with proliferation of e-Commerce usage. As show on the left in, Figure 2, revenue by geography suggests that there are much more room to grow for revenue driven by other countries. Hence, given UPS' branding, market position and leveraging on its network of transport assets, UPS is in a good position to capture the growth in emerging market and retail e-Commerce.

Industry & Competitive Analysis

Figure 3: Market Share of Key Competitors

Market Share	
UPS	**46%**
Fedex	**32%**
USPS	**15%**
Others	**7%**

Source: Bloomberg

Moderated GDP Growth forecasts: demand for shipping is generally correlated with overall consumer demand and an economy's GDP growth. In general, we expect the global economy to grow, driven mainly by high growth in Japan driven by the countries' fiscal stimulus. From the emerging markets, we expect India to continue growing while we expect a slight decrease in China's growth. Although the Feds is ending quantitative easing, they promised a low interest rate environment for near future, hence, we can expect the general U.S. economy to gain some more momentum and hence, increased consumer demand.

UPS is currently maintaining its lead in the market with the largest market share as shown on the left in Figure 3 and this is important because in the business of logistics and global package delivery, this translates to the fact that UPS has built an strong network of customers and clients who are willing to frequent their services due to their elaborate network.

Not only does UPS lead in market share, it also leads the industry with highest margins amongst its close competitors.

Figure 4: Key Statistics of UPS against Industry Average

Key Statistics	UPS	Industry Average
Net Income Margin	9.4%	6.2%
Operating Margin	10.6%	8.3%
ROE	79%	24.4%
Debt/Equity	1.8	0.6

As shown above in Figure 4 which compares UPS margins and ROE with the industry average, UPS commands and extremely strong margin. However, it has a much higher debt to equity ratio than its competitors. This may seem to be a concern at first glance.

But this should not be a key concern because UPS has a strong track record of sound financial management currently holding USD 5 billion worth of cash and cash equivalents. On top of that, UPS has a steady cash flow generation from its operation, yielding about 7billion in 2011 to 7.3 billion in 2013 while free cash flow has been steadily increasing from about 5 billion in 2011 to 5.2 billion in 2013.

Even if we take into account UPS' closest competitor, Fedex, we see that Fedex pales in comparison to its free cash flow generation ability as well as its consistency in dividend payout.

Another key strength that UPS has is that no one client contributes to more than 5% of their revenue. The largest revenue driver is by Amazon which still only contributes to 2.91% of UPS' revenue. Hence, any shifts in clients to its competitors will not have a huge impact on UPS' revenue.

Investment Thesis

Growing U.S E-Commerce Industry:
The U.S E-Commerce industry is one of the main drivers of volumes at UPS's U.S Domestic Package Segment. As of 2014, E-Commerce sales increased by 16%, increasing its contribution to overall retail sales. This can be attributed to the increase in smart phones, tablets and personal computers, as well as increased internet penetration. UPS' Package Volume is influenced by e-commerce sales considering that many online retailers such as Amazon employ the company's services in order to deliver their products in a timely manner. Figure 5 shows the strength on the growth of internet retailing.

Figure 5: Growth in Internet Retailing

Internet Retailing Trends					
Internet Retailing	2009	2010	2011	2012	2013
%Growth YoY	4.9%	15.4%	15.6%	16.0%	15.9%

Source: Euromonitor

We estimate that the US e-commerce market will grow more than 10% per year through 2018, before slightly tapering off. We feel that despite an already high internet penetration of 85%, there is still potential for existing internet users to shift towards E-Commerce from traditional retail purchases, especially in terms of ordering frequency and value. We therefore believe that UPS's US Domestic Package segment should continue to grow in the next few years. We estimate a growth of 10% in U.S e-commerce sales volumes which would gradually taper off in the next few years given the channel's maturity and high internet penetration rates in the U.S.

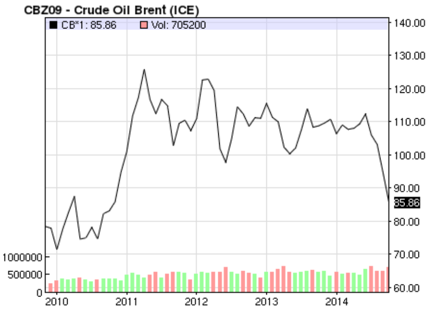
Dimension Based Pricing

UPS's shift towards a dimension based pricing strategy should help in improving margins. Currently, margins have been falling due to a growing number of light-weight yet heavy packages. The current pricing system which is based on weight leads to lower revenues per unit space due to lesser packages carried per vehicle or aircraft. By switching to Dimension Based Pricing, UPS should be able to improve its margins. We expect that this strategy, which will be implemented from December 29, 2014 onwards, will result in a 20-35% increase in the pricing of such light-weight yet bulky packages. We believe that the increase in B2C volume and the expansion of online shopping would provide UPS with some leverage to increase rates with a relatively low risk of shippers shifting to competitors.

Falling Oil Prices and Recovering U.S. Economy

Changing fuel and energy costs have a significant impact on UPS cost because they require large quantities of fuel for their aircraft and delivery vehicles. Hence, falling oil prices, as shown in Figure 6, will likely benefit UPS significantly and thus, improving margins.

Figure 6: 5 Years Crude Oil Prices



Source: Nasdaq.com

Low oil prices will likely stay around for some time as OPEC seeks to drive out competitors in shale gas as well as other geo-political reasons. Not only does oil price directly improves UPS margins, low oil prices will likely stimulate demand in the economy as many companies will start to enjoy lower cost of production. Citigroup has estimated that savings will climb to 1.1 trillion annually, leaving extra cash to companies and consumers to spend and bolster growth. Coupled with the recovering U.S economy indicated by lowest jobless claims in years, UPS is in a great position as a market leader to capture an upward swing in U.S. economy as well as lower cost of transport.

Valuation & Key Investment Risks

We use DCF based valuation to arrive at our 12M target price of US$118.04 indicating an upside potential of 12.52%.

Our DCF based valuation assumes a WACC of 8.2% and a terminal growth rate of 2.5%. A sensitivity analysis is shown in Table 7 on these 2 items on the final valuation are conducted and reflected below:

Sensitivity Analysis						
		WACC				
Terminal Growth Rate		6.00%	7.00%	8.00%	9.00%	10.00%
	1.00%	144.25	120.70	104.39	92.58	83.72
	1.50%	155.97	128.11	109.39	96.09	86.28
	2.00%	170.63	137.01	115.21	100.11	89.17
	2.50%	189.48	147.89	122.10	104.75	92.43
	3.00%	214.60	161.49	130.36	110.16	96.17

The nature of air freight and packaging industry is that the services amongst the major competitors are essentially the same between competitors. The susceptibility to lose market share to competitors is high. However, given UPS' relatively higher margin compared to its peers prove to be a key indicator that management has been able to maintain competitive edge over its main competitors through its complex and wide range of services.

Exposure to emerging markets is also another key risks that we have to take into account. Granted that UPS wants to expand their networks and business in these emerging markets to eventually catalyze its growth, however, there are inherent risks in expanding to more emerging markets. As emerging markets start to drive UPS' revenue more, earnings of UPS is likely to be more volatile than before as emerging markets are more prone to geo-political crisis.
