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March 5, 2009

Industry View
Attractive

Freight Transportation

More Bearish Parcel Data; Consensus Still Too High

Growing evidence of significant earnings pressures on the parcel carriers. We maintain parcel consensus is just too high. Trends in air cargo, standard mail, and industrial production are bearish for parcel earnings, we believe. While the exit of DHL from the US market is helpful, it cannot offset the effects of a global economic slowdown or pension-related cost headwinds. As a result, we are cutting EPS for FDX and UPS today (see table to right). Our new F09 estimate for FDX is slightly below the bottom of the company's guidance, but we believe FDX will lower guidance for F4Q09 (ending May), when the company reports earnings on March 19. We expect UPS to report 1Q earnings that are at or near the low end of its guidance range of \$0.52/share.

The Air Transport Association (ATA) reported that US air cargo collapsed in January, as ton-miles fell 21% Y/Y, which is worse than December's drop of 17%. Pacific traffic was worst, falling a significant 32%, where FDX is a bigger player than UPS. Atlantic and Lat Am markets fared only slightly better with RTMs down 18% and 22% Y/Y, respectively. Domestic volumes fell 17%. We don't expect parcel volumes to be as bad as air cargo trends, as lighter-weight, shorter-haul packages could account for some of the ton-mile decline. However, mix shifts will likely negatively impact package yields in 1H09. This is consistent with UPS's 4Q08 trend that showed package volume down 4.4%, but total air weight per package down 10% and ground down 5%.

Macro factors suggest downside risks to parcel volumes. It's important to remember that we have little data on the parcel carriers for the recessions of the early 1980s, as UPS wasn't public and FDX was solely an air express carrier. As such, we need to use broad macro factors to assess likely volume trends. Standard mail and US industrial production (IP), both of which are decent barometers for the economic activity that drives parcel volumes, have been very weak. The magnitude of the decline in both suggests investors should brace for a potentially significant shortfall in parcel volumes and weight in 1H09.

Change to MS Parcel Estimates

	New Estimate	Previous Estimate	Factset Consensus	Variance
UPS				
1Q09	\$0.51	\$0.55	\$0.57	-10.0%
2009	\$2.45	\$2.65	\$2.87	-14.6%
2010	\$2.65	\$2.85	\$3.38	-21.6%
2011	\$3.42	\$3.57	\$3.84	-11.1%
2012	\$4.25			

	New Estimate	Previous Estimate	Factset Consensus	Variance
FDX				
3Q09	\$0.33	\$0.44	\$0.51	-35.0%
F2009	\$3.43	\$3.70	\$4.08	-15.9%
F2010	\$2.75	\$3.60	\$4.45	-38.1%
F2011	\$5.39	\$5.40	\$5.20	3.7%
F2012	\$7.32	\$7.00		

Source: Factset, Morgan Stanley Estimates

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Consensus for FDX and UPS Still Too High

We have been arguing for some time that the global slowdown will have a significantly negative impact on earnings and returns at FedEx and UPS. Despite a consensus view that suggests earnings will fall modestly in calendar 2009 (see table below) we are much more bearish in our outlook. It is difficult for us to understand how in a period when rail volumes are falling 15%+, truck tonnage is down by over 10%, the Morgan Stanley Truckload Freight Index is at all-time lows, US Industrial Production is falling 10%+ Y/Y, and US air cargo ton-miles are down over 20%, the parcel carriers will feel relatively modest pain from the downturn. In fact, we simply disagree and believe that the coming months will see significant downward revisions to estimates. Also, we expect that pension headwinds will cause even greater pressure on earnings in F2010 at FDX, in particular. Therefore, we continue to recommend that investors sell parcel stocks on strength and avoid the group until estimates are closer to the economic reality.

Exhibit 1

Consensus Estimates Are Too Optimistic

EPS Growth	Morgan Stanley		Consensus		MS vs. Cons.
	EPS Est.	Growth	EPS Est.	Growth	
UPS					
2008	\$3.50		\$3.50		
2009	\$2.45	-29.9%	\$2.87	-17.9%	-12.0%
2010	\$2.65	8.0%	\$3.38	17.6%	-9.6%
FedEx					
F2008	\$5.83		\$5.83		
F2009	\$3.43	-41.2%	\$4.08	-30.1%	-11.1%
F2010	\$2.75	-19.8%	\$4.45	9.1%	-28.9%

Source: Company data, Factset, Morgan Stanley Research

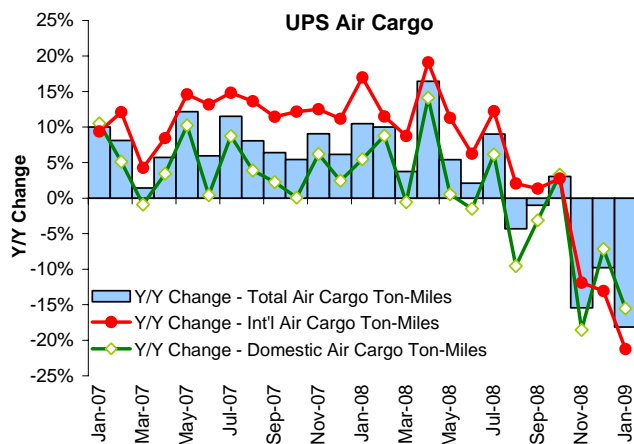
Air cargo ton-miles are bearish for parcel trends. The Air Transport Association (ATA) reported that US air cargo collapsed in January, as ton-miles fell 21% Y/Y, which is worse than December's drop of 17%. Both international and domestic ton-mile trends were poor. In the Pacific region, traffic as measured by ton-miles was the worst of any region, falling by a significant 32% (see Exhibits 5-9). FedEx is a bigger player in this market than UPS. Volumes at the carriers fell by 31% and 24% Y/Y, respectively. The Atlantic and Latin American markets fared only slightly better, as ton-miles fell 18% and 22% Y/Y, respectively. Over 50% of UPS Int'l revenue is Europe-related (much more than FDX), but both carriers are similarly sized in air cargo to Latin America. FedEx fared better

than UPS to Europe, realizing only an 8% Y/Y decline in air ton-miles, while UPS volumes fell 16%. Overall US Domestic ton-miles fell 17%; while UPS and FedEx reported Domestic ton-mile declines of 15.5% and 13.4%, respectively.

Despite these worrying declines, we should remember that package volumes will not be as bad as the ton-miles suggest. Reported package data does not account for average package weight or distance shipped, both of which are captured in a ton-mile metric. That said, the negative mix shifts will have a material impact on reported package yields, as lighter-weight, shorter-distance packages generate a lower revenue per package. We should also be aware that changes in ton-mile data can mask other changes in business mix, such as the percentage of freight on a jet that is "priority." If shippers choose to shift heavy air freight to surface transport options, it can have a material impact on ton-miles, but a smaller impact on revenue. As such, we think it important to use the ton-mile data as a directional indicator, but not necessarily as a predictor of absolute margin level.

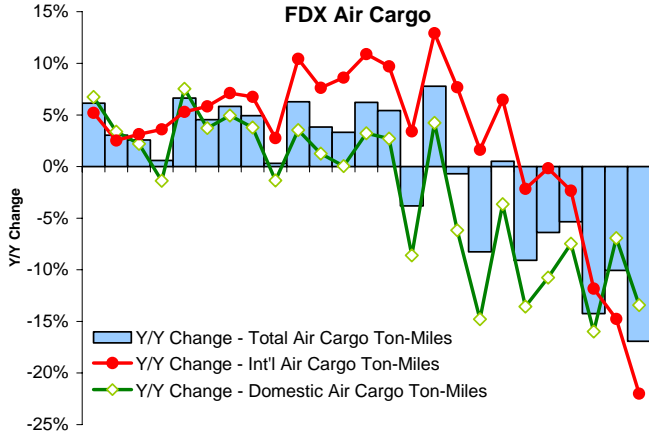
Exhibit 2

Year-over-year Change in UPS Air Cargo RTMs



Source: Air Transport Association, Morgan Stanley Research

Exhibit 3
Year-over-year Change in FDX Air Cargo RTMs

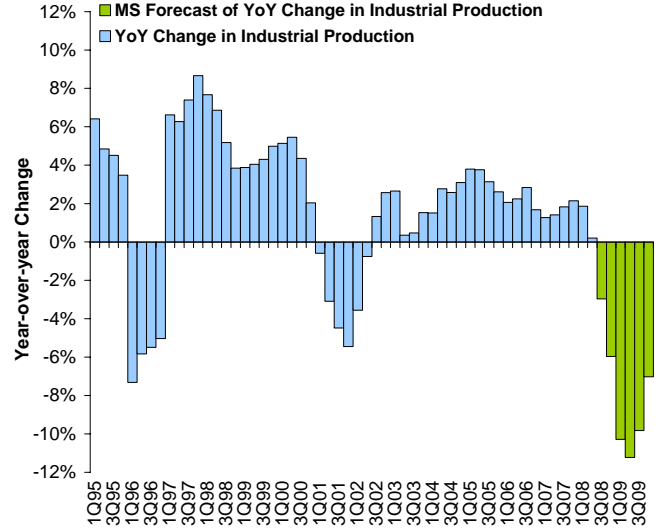


Source: Air Transport Association, Morgan Stanley Research

USPS sees a collapse in standard mail. FedEx and UPS compete in no way with USPS in the standard mail category; however, standard mail is a good barometer for economic activity, in our view. The volume of USPS standard mail in the December quarter fell 11%, which is a significant fall-off relative to historical trends. Typically, standard mail is up or down a few percent, as it is generally considered a base load type of mail, representing investment in future sales for shippers. Direct mails and circulars are good examples of what moves via standard mail. The fact that standard mail is off so much suggests retailers of all sorts are very bearish on their ability to use direct advertising to drive future sales in this economic environment. While not directly related to parcel volumes, the read-across for business-to-consumer and even business-to-business shipping can't be good. We also believe the large deviation from historical norms underscores the need to avoid historical benchmarking biases when forecasting parcel volumes in this environment.

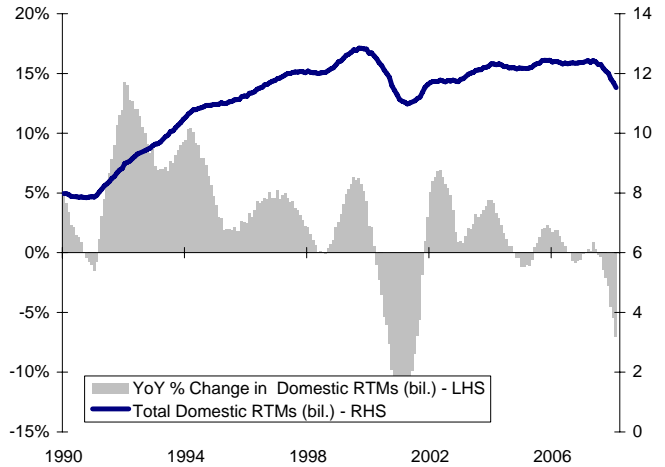
Industrial production remains severely depressed. As shown in Exhibit 4, US industrial production is down sharply Y/Y. Both FDX and UPS have long indicated that IP is one of the single best coincident drivers to domestic parcel volumes. The magnitude of the decline in IP suggests to us that parcel volumes and weight will also be severely depressed for the next couple of quarters.

Exhibit 4
IPI Facing Greater Year-Over-Year Declines



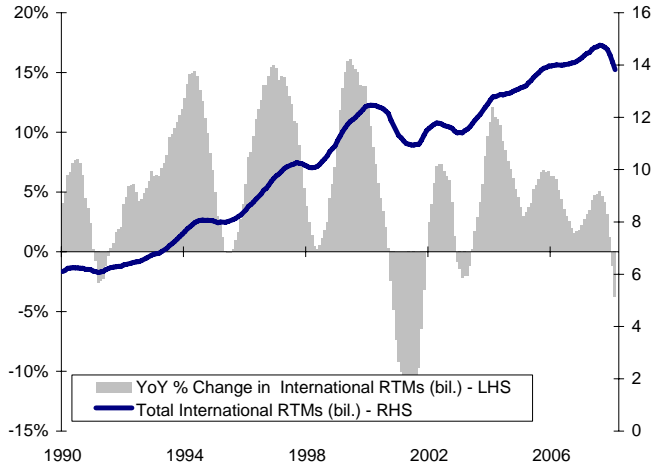
Source: Morgan Stanley Economists, Morgan Stanley Research

Exhibit 5
Domestic Air Cargo – Revenue Ton-Miles



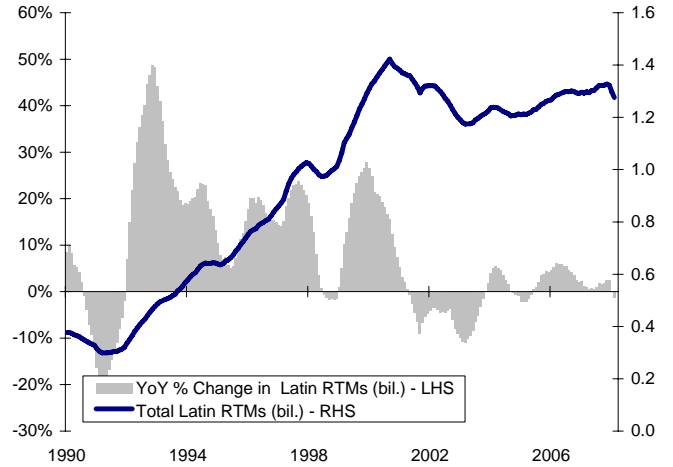
Source: Air Transport Association, Morgan Stanley Research

Exhibit 6
International Air Cargo – Revenue Ton-Miles



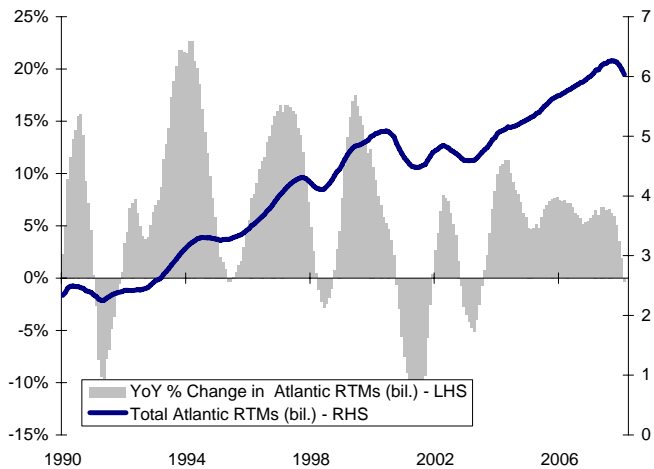
Source: Air Transport Association, Morgan Stanley Research

Exhibit 8
Latin America Air Cargo – Revenue Ton-Miles



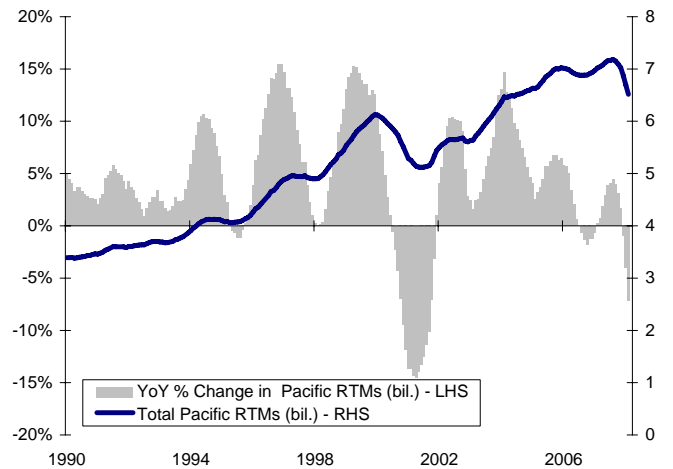
Source: Air Transport Association, Morgan Stanley Research

Exhibit 7
Atlantic Air Cargo – Revenue Ton-Miles



Source: Air Transport Association, Morgan Stanley Research

Exhibit 9
Pacific Rim Air Cargo – Revenue Ton-Miles



Source: Air Transport Association, Morgan Stanley Research

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(as of February 28, 2009)

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	Count	% of Total	Count	% of Total IBC	% of Rating Category
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Total	2,257		571		

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Industry Coverage:Freight Transportation

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Canadian National Railway Co. (CNI.N)	E (10/31/2008)	\$32.05
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