Welcome, Bob!

Log Ou

Open an IRA in 15 minutes or ...

susan G. komen.

ONE IN EIGHT WOMEN BE DIAGNOSED WITH BREAST CANCER IN HER LIFETI
AT SUSAN G. KOMEN, WE'RE ON A MISSION TO END BREAST CANCER FOREV
LEARN MORE AT KOMEN.ORG

Membership | Home | Portfolio | Stocks | Bonds | Funds | ETFs | CEF | Markets | T

Nasdaq	S&P 500	DJIA	Gold	L
3669.27 -15.17(-0.41%)	1685.39 -8.77(-0.52%)	15337.66 -113.35(-0.73%)	1340.50 6.50(0.49%)	1

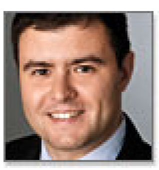
Apple Inc AAPL

Add to Portfolio | Get E-mail Alerts | Print This Page | PDF Report | Data Question

Quote | Chart | **Stock Analysis** | Performance | Key Ratios | Financials | Valuation | Insiders | Shareholders | Transcri

Analyst Research | Analyst Report Archive | Top Rated Stocks in Sector

Apple will have to fend off increased competition from Android in the years ahead.



by
Brian Colello, CPA

Authors can be reached at Analyst Feedback

Morningstar's Editorial Policies

Analyst Note

Our Thesis for Apple Remains Intact as Carl Icahn Discloses Big Stake, Pushes for Buybacks
by Brian Colello, CPA, 08/14/13

Discuss

See what other investors are saying about AAPL

Analyst Note 08/14/13

We are maintaining our $600 fair value estimate and narrow moat rating for Apple after the stock received a $15-per-share boost on Tuesday afternoon following the disclosure by investor Carl Icahn that he has a large position in the stock, which the *Wall Street Journal* believes is roughly $1 billion, and had a recent discussion with Apple CEO Tim Cook about further share repurchases. The news does not change our underlying thesis about Apple, although it clearly added to recent positive momentum around the stock that began with strong June quarterly results and likely continued after reports suggest that new iPhones will be introduced on Sept. 10.

The only fundamental news item, in our view, revolves around Icahn's discussion with Apple's management team about further share repurchases. Apple is currently authorized to buy back $60 billion in stock

AdChoices

Earn 0.85

Morningstar's

Analyst

Price 08-14-2013
498.5 USD

Site Directory | Site Map | Our Products

Corrections Help Advertising Opportunities Licensing Opportunities Glossary RSS Mobile Portfolio Affiliate C

International Sites: Australia Canada China France Germany Hong Kong Italy The Netherlands Norway Spain U.K. Switz

Stocks by: Name | Ticker | Star Rating | Market Cap | Stock Type | Sector | Industry
Mutual Funds by: Star Rating | Investment Style | Total Assets | Category | Top Holdings | Top Sectors | Symbol / Ticker | Name
ETFs by: Star Rating | Category | Total Assets | Symbol / Ticker | Name **Articles by:** Title | Date | Author | Collection | Interest | Pop
Investment Categories by: Topic | Sector | Key Indicators | User Interest | Market Cap | Industry
Premium Stocks by: Name | Ticker | Star Rating | Market Cap | Stock Type | Sector | Industry
Premium Mutual Funds by: Star Rating | Investment Style | Total Assets | Category | Top Holdings | Top Sectors | Symbol / Ticker | Na
Premium ETFs by: Star Rating | Category | Total Assets | Symbol / Ticker | Name **Popular Articles by:** Title | Date | Author | Collectic
Popular Investment Categories by: Topic | Sector | Key Indicators | User Interest | Market Cap | Industry

Independent. Insightful. Trusted. Morningstar provides stock market analysis; equity, mutual fund, and ETF research, ratings, and picks; portfolio plan research. Our reliable data and analysis can help both experienced enthusiasts and newcomers.

© Copyright 2013 Morningstar, Inc. All rights reserved. Please read our Terms of Use and Privacy Policy. Dow Jones Industrial Average, S&P 5(Barometer) quotes are real-time. Russell 2000 quote is 10 minutes delayed.

through the end of calendar 2015, and we think the company made a shrewd round of purchases totaling $16 billion in the June quarter as part of this program. In order to fund future purchases and not drain the firm's U.S. cash balance, Apple will likely need to take on additional debt, since the majority of the firm's cash is held overseas and is unavailable for dividends or buybacks without paying roughly 35% in additional taxes. Apple's initial venture into the debt market with the issuance of $17 billion of bonds (which in turn funded the $16 billion buyback in the June quarter) was done at extremely favorable interest rates. With the rise in 10-year Treasury yields to 2.7% since that time, as well as the fact that bond investors already have the ability to own Apple debt today, we anticipate that it will be a bit more costly for Apple to issue a second round of debt to fund further buybacks. Similarly, a new round of buybacks would still be a good use of capital, in our view, but not nearly as attractive as it would have been just a few months earlier when Apple was trading below $400. Other than encouragement to pull the trigger on further buybacks, we tend to think that Icahn's investment would be one of his more passive ones in terms of owning a cheap stock, rather than an aggressive, corporate raider-type move to shake up the board or split up the company.

Investment Thesis 04/12/13

We believe Apple's strength lies in its experience and expertise in integrating hardware, software, services, and third-party applications into differentiated devices that allow Apple to capture a premium on hardware sales. Although Apple has a robust product pipeline and ample opportunity to gain share in its various end markets, short product life cycles and intense competition will prevent the firm from

Consider Buy 360.00 USD

Co 93

Stewardship Rating
Standard

Bulls Say

- Gartner expects the sr from 2011 to 2014, so growth even if it only
- The iPad has been App which is a tremendous iPod and iPhone.
- For each iOS device pu switch to another prov product, which could b soft PC environment.

Bears Say

- Few firms have been a the handset market, a competition typically le historically prevented marketplace.
- Apple faces a strong, v the premium smartpho smartphone industry a firms in the future.

resting on its laurels or carving out a wide economic moat, in our opinion.

We believe Apple has developed a narrow economic moat, thanks to switching costs related to a variety of attributes around the iOS platform that may make current iOS users more reluctant to stray outside the Apple ecosystem for future purchases. However, much of Apple's exponential growth in recent years has stemmed not from the firm's moat, but from the achievement of building the first truly revolutionary smartphone, the iPhone, that integrated hardware and software, as well as a robust apps store and ecosystem that attracted new users to platform. Apple's first-mover advantage may be diminishing, and "easy growth" coming from early smartphone adopters may be winding down as the smartphone market moves up the adoption curve and competition ramps up from Samsung and others. Yet we still foresee future iPhone growth, coming from both attracting new customers to iOS (mostly in emerging markets, although we still see U.S. growth as well) and retaining Apple's existing premium iPhone customers, where we think the company's moat will play an increasingly important role.

Ultimately, we think future smartphone and tablet competition will stem from software and services, as hardware is already approaching commoditization, similar to the PC market today. Even after the firm's first-mover advantage in the development of iOS and a solid third-party apps store, ongoing enhancements such as FaceTime, iCloud, and Siri have helped differentiate Apple from Google's Android platform thus far, and we expect many more software differentiators in the future. Even if Samsung were to catch up to Siri with its S-Voice service today, Apple's integration of Siri with third-party apps (such as gathering restaurant reviews from Yelp) may make for a more robust service that could become a clear iOS differentiator. We also view iCloud as especially important in terms of switching costs; customers who own an iPhone and other iOS products (perhaps an iPad or Mac) may become more reluctant to buy a new device that doesn't sync with the rest of the ecosystem. Rumors of an Apple iWatch may evolve into another product that could be extremely important in terms of keeping current iOS users invested in Apple's products into the future. Although iCloud and iOS won't provide Apple users with insurmountable switching costs, especially if the company's products are perceived to be stale or boring, the firm has done a much better job than predecessors (BlackBerry comes to mind) that failed to lock in customers when they were king of the hill. Apple's recent growth may have come from new users in the early phase of smartphone market adoption, but the company's ability to generate repeat purchases will be critical for future iPhone growth in the years ahead.

Regardless, Apple will have to continually develop superior products on all fronts (hardware, software, services, and third-party apps) while fending off many strong rivals in end markets highlighted by short product life cycles and intense competition. In hardware, Samsung's popular Galaxy smartphones and Note phablets (phone/tablets) offer larger screen sizes that have resonated with consumers, but a larger iPhone could someday negate Samsung's advantage. In terms of pricing, we expect Apple to remain a premium supplier of devices and addressing lower price points with older iPhone models, essentially ignoring very low-end smartphone buyers ($300 and below) in emerging markets. In services, as Apple's Maps fiasco

- Apple may have lost m
  passing of cofounder S

Competitors AAPL

Name
Apple Inc
Samsung Electronics Co Ltd
Panasonic Corporation ADR
Sony Corporation ADR
Royal Philips NV
Royal Philips NV ADR

Compare These Stocks

Video Reports AA

may show, it's unlikely that any single firm can provide first-class solutions in all aspects of the smartphone experience, so we expect Apple to continue to partner with key third parties like Facebook and others, to offer iOS users a superior experience. Finally, in software, we expect iOS to remain one of the two predominant ecosystems, fending off threats from Microsoft and BlackBerry while battling head-to-head against Android. Despite Apple's nice revenue streams from iTunes, Apple's current and future profitability won't come from add-on purchases, but rather from the premium captured on the sale of its hardware, even though Android-based rivals will likely compete on price. In order to justify and maintain this hardware premium over Android devices, however, Apple's products will have to be thought of as best-in-class (either in perception or reality) based on all of these hardware, software, and services aspects, and the company can afford very few missteps along the way.

Economic Moat 04/12/13

We believe Apple has a narrow economic moat based on modest, but not insurmountable, customer switching costs. We don't believe these switching costs are critical factors in attracting new iOS customers, especially in emerging markets, but that such switching costs will allow Apple to build a loyal iOS user base that may be less likely to flee to other operating systems for future device purchases in the long term. As the smartphone market matures and a greater proportion of purchases come from previous smartphone owners, we foresee these switching costs as extremely important differentiators in favor of Apple. That said, given the short product life cycles of two to four years for most of its devices, we still think competing products will have plenty of chances to lure iOS customers away from Apple's platform and overcome these switching costs, especially if Apple were to stumble in any given product refresh cycle. This prevents us from assigning the company a wide economic moat.

Inherently, we believe there are minimal switching costs associated with smartphones, as all of these devices can perform most necessary functions--place calls, send texts, browse the web, and so on. However, we believe Apple has done a much better job at trying to develop switching costs than its handset predecessors (such as Motorola and BlackBerry) that failed to lock in customers when they were on top. Apple's speedy initial development of a robust third-party application ecosystem attracted early smartphone buyers and provided a difficult barrier to entry for other smartphone OS platforms. However, as Android was able to develop a similar network and applications developers focused on building products for both of these operating systems, we don't believe Apple's early advantage in third-party apps will be sustainable. Along these lines, we see Apple's improved integration with third-party apps (such as camera integration with Facebook and Twitter, or Siri pulling information from Yelp or ESPN) as a potentially strong iOS differentiator in the next couple of years. Although Apple may have a meaningful head start in these types of ventures, we anticipate that similar partnerships between Android and third-party developers may emerge that will eventually replicate this integration, and we therefore do not consider it to be a future source of economic moat.

In our opinion, Apple's switching costs stem from its iOS operating system and appear to be increasing, thanks to its iCloud offering. Apple iOS users who purchase movies, TV shows, and applications from the iTunes store are unable to port these media to Android or other portable devices (music is transferrable). iCloud adds another layer of switching costs by synchronizing media, photos, notes, and other items across all Apple devices. We believe an owner of an iOS device (say, an iPad) is less likely to switch from an iPhone to an Android phone if it means that he or she will be unable to sync or access a portion of their content. Additional Apple devices, such as the Mac and potentially an iWatch, could raise these switching costs even further. By comparison, no other former handset leader (Nokia, Motorola, BlackBerry) offered secondary devices that partnered with their phones, giving Apple a unique edge that handset makers such as Samsung are only now starting to emulate. Along these lines, the iPad Mini, sold at lower price points and, presumably, lower margins, may modestly eat into Apple's tablet profitability but could be the right move if it gains further lock-in from price-conscious consumers who would otherwise buy Amazon's and Google's cheaper tablets. Another encouraging but perhaps fleeting factor is that customers have willingly accepted iCloud and the coinciding switching costs because it offers users a better product experience, rather than other instances of high switching costs where customers begrudgingly accept these lock-in costs because of existing infrastructure or a lack of suitable alternatives.

Looking at other sources of economic moat, Apple's litigation victory over Samsung indicates that the firm has intangible assets associated with intellectual property for some of its hardware and software designs. However, both the value of such assets and the sustainable competitive advantage stemming from these assets remain cloudy. Apple also has a strong brand reputation, but given the short product life cycles, we believe tech brands are fleeting. Nokia was long considered a top 10 brand, but its failure to stay on the technological forefront superseded its brand recognition. Apple is trying to improve the network effects of its devices with functions like iMessage and FaceTime. However, BlackBerry's demise proves that even highly popular smartphone-centric networks like Blackberry Messenger can be broken if other smartphone features (or lack thereof) drive customers to flee. Finally, Apple may have some cost advantages associated with its supply chain, such as squeezing suppliers or making massive purchases of flash memory and other key components. However, we believe these advantages are predicated on the enormous forecast volume of Apple's products, and we suspect these advantages would evaporate if Apple's device production were to shrink. Along these lines, we don't view Apple's cash cushion as a source of economic moat. Its cash balance may help Apple buy innovative startups and potential threats, but it won't be able to bail out the firm if the masses no longer want to buy Apple's products.

Valuation 04/12/13

Our fair value estimate for Apple is $600 per share, which implies fiscal 2013 (ending September 2013) price/earnings of 14 times, and only 11 times after excluding $145 per share of cash on hand as of December 2012. We project revenue growth of 16%

in fiscal 2013, thanks to the success of the iPhone 5, iPad and iPad Mini, and a variety of Mac computers. However, we project slower revenue growth in 2014 and beyond, as iPhone and iPad unit sales increases are mostly offset by pricing declines and an unfavorable mix toward lower-priced models. We currently model 10% revenue growth in fiscal 2014 and midsingle-digit growth thereafter.

We still project healthy long-term iPhone unit growth, as in the near term, Apple should still attract late smartphone adopters in developed markets and new customers in emerging markets, especially once the firm eventually strikes a partnership with China Mobile. Longer-term, as more and more consumers are previous smartphone owners, we think Apple has a good chance to retain a sizable portion of its iOS user base today, and perhaps gain further share at the high end of the market. However, the next big wave of smartphone adoption will likely come from low-end phones sold in emerging markets, and we don't foresee Apple being a major player in the low end. We also foresee a less favorable mix shift toward older, lower-priced iPhones that may weigh on gross margins.

We project robust long-term iPad revenue growth, as this device both displaces PCs and is purchased as a third device alongside PCs and phones. However, a mix shift toward lower-priced iPad Minis will partially offset this strong unit sales growth. We assume Apple's line of Mac PCs will see minimal revenue growth, as Macs gain share in the large but slow-growth (at best) PC market. We also do not make any profitability assumptions for an Apple TV or iWatch, but recognize that future innovations may provide upside to our valuation.

We anticipate that Apple's gross margins peaked at 44% in fiscal 2012, but fall to 38% in fiscal 2013 and down to the mid-30% range in the long term. In turn, operating margins of 35% in fiscal 2012 will fall to the mid-20% range five years out. Our fair value uncertainty rating for Apple is high.

Risk 04/12/13

We believe a large, well-diversified company like Apple faces several risks. Smartphone and tablet competition is rising, as Samsung, in particular, has developed compelling iPhone alternatives in the premium smartphone space. Meanwhile, we anticipate that a greater portion of smartphone sales come from low-end devices in emerging markets where Apple does not participate. If these devices turn out to offer only a slightly worse user experience than iOS products, Apple may be unable to capture an adequate premium on future hardware sales.

Despite its intentions to control as much of the user experience as possible for its products, Apple still relies on a robust app developer base and strong partnerships with third parties. Its decision to use an in-house mapping solution (and subsequent apology) may have diminished Apple's reputation and its customers' user experience, at least in the near term, and switching costs around other iOS products might not be enough to retain unsatisfied customers. We think it is unlikely that a further split from Google involving search is next, as we believe Apple's and Google's map differences pertained to specific creative user interface differences around mapping features, whereas search has a much simpler user interface (i.e., typing in the search bar).

If Apple were to falter and its exceptional brand be diminished as customers departed iOS in droves, we don't think Apple could use its cash to buy its way out of any problem. As a premium phone supplier, Apple also runs the risk that wireless carriers could reduce or eliminate the subsidies that they provide their customers on the iPhone, in turn raising customers' up-front costs and perhaps making other smartphones appear to be better alternatives. Finally, Apple lost cofounder and visionary Steve Jobs in October 2011, and while we believe CEO Tim Cook is a more-than-capable leader, Apple runs the risk that its unique culture and sense of innovation may diminish over time.

Management 04/12/13

We view Apple as a good steward of shareholder capital. Arthur Levinson, former chairman and CEO of Genentech, is chairman of Apple's board of directors. Tim Cook became CEO in August 2011 after cofounder, longtime CEO, and visionary Steve Jobs stepped down from the CEO role before passing away in October 2011. Cook was considered to be Jobs' right-hand man and served in various operations roles with Apple before becoming COO in 2005. We believe Jobs' passing was a blow to the firm, as he was a one-of-a-kind leader and creative mind.

Although Tim Cook was a highly effective COO, one could question his leadership in the top spot thus far. Apple's formal apology after parting ways with Google Maps in iOS 6 and launching Apple Maps with a variety of bugs and errors may have put management in the spotlight. Given Cook's reputation as an operations guru, we're also modestly concerned with Apple's inability to build enough supply of a host of new products (especially iMacs) in the December 2012 quarter, potentially leaving revenue on the table. Also, Apple recently hinted that a 4" screen is an adequate screen size for a smartphone, yet Samsung has done quite well in recent quarters with its much larger Galaxy S III (4.8" screen) and Note II (5.5") products, and we fear that Apple may miss out on part of the premium smartphone market if it fails to build a larger-screen iPhone. Finally, Apple's capital allocation has come under question. Although we applauded Cook's decision to initiate a dividend and stock buyback plan in early 2012, we recognize that may investors may be impatient and hope the firm distributes more of its $137 billion cash hoard (as of December) to shareholders.

Nonetheless, Apple continues to generate operating margins and cash flow well above its peers in various hardware industries. We also appreciate that Apple's frugality may be frustrating to some investors regarding capital allocation, but is quite admirable in terms of acquisitions. Apple's strategy of focusing on smaller tuck-in deals and developing products in-house, rather than splashy but questionable deals like Microsoft's purchase of Skype or Google's foray into hardware by acquiring Motorola Mobility, appears to have served investors quite well in recent years.

Overview

Profile:

Apple designs consumer electronic devices, including PCs (Mac), tablets (iPad), phones (iPhone), and portable music players (iPod). Apple's products run internally developed software, and this integration of hardware and software often allows the firm to maintain premium pricing for its devices. Apple's products are distributed online as well as through company-owned stores and third-party retailers.

S&P 500 index data: S&P 500 Copyright @ 2013

All data from Morningstar except U.S. intraday real-time exchange quotes, which are provided by BATS when available. End-of-day quotes for Nasdaq, NYSE, and Amex securities will appear 15 minutes after close. Graph times are Eastern Standard. @ Copyright 2013 Morningstar, Inc.