Apple Inc AAPL |

Analyst Research Analyst Report Archive Top Rated Stocks in Sector

Apple is driving software and services innovation to capture premium pricing on hardware.

by
Brian Colello, CPA

Authors can be reached at Analyst Feedback

Morningstar's Editorial Policies

Analyst Note

Apple's Watch Could Be an Appealing Accessory to Highly Satisfied iPhone Customers
by Brian Colello, CPA, 03/09/2015

Discuss

See what other investors are saying about AAPL

Analyst Note 03/09/2015

Apple's product launch event centered around the company's new Watch and touted innovations in both hardware (new MacBook) and services (Apple Pay, ResearchKit), but offered few surprises from already-speculated features and pricing, in our view. We think the most important takeaway from the event is Apple's 99% customer satisfaction rate for the iPhone 6 and 6 Plus, as the iPhone remains the far more important, and lucrative, device in Apple's expanding product portfolio. We continue to view Apple Watch as a product category that will drive incremental revenue for Apple, but more important, will offer especially strong stickiness to the iOS ecosystem that will enable Apple to make repeat sales of high-margin iPhones to these customers over time. We will incorporate Apple's Watch pricing, product segmentation and launch timing into our valuation model, but we do not anticipate a change to our $120 fair value estimate or our narrow moat rating for Apple at this time.

Given our view of the Apple Watch as an accessory, rather than a stand-alone device, for the foreseeable future, we're encouraged by the firm's previously announced pricing on the Watch Sport at $349 for the 38-millimeter version ($49 more for the 42-millimeter device). Pricing of the regular Watch, with a steel case and sapphire screen, of $549 (38-millimeter) and an effective price of $699 and up for any non-Sport band, could still be palatable to early adopters (versus the gold Watch Edition starting at $10,000) while being lucrative for Apple as the various bands appear to be high-margin add-ons to the device. Apple touted several new apps that will be available for the device, and we anticipate robust innovation and developer support in the years ahead in order to appeal to a broad audience.

Investment Thesis 01/28/2015

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 sterling brand, strong 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 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 many attributes around the iOS platform that may make current iOS users more reluctant to stray outside the Apple ecosystem for future purchases. In our view, much of Apple's exponential growth in recent years has stemmed not from the firm's economic 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. Yet we still foresee 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 we're seeing less and less meaningful hardware

Morningstar's Take AAPL

Analyst

Price 03-17-2015	**Fair Value Estimate**	**Uncertainty**
127.04 USD	120 USD	High
Consider Buy	**Consider Sell**	**Economic Moat**
72 USD	186 USD	Narrow
Morningstar Credit Rating		**Stewardship Rating**
AA-		Standard

Bulls Say

- Smartphones should continue to grow as a piece of the total handset pie. This bodes well for future iPhone sales.
- Apple's iPhone and iOS operating system have consistently been rated at the head of the pack in terms of customer loyalty, engagement and security, which bodes well for the firm's ability to retain customers in the long-term.
- For each iOS device purchased, customers may be less likely to switch to another provider and more likely to buy repeat Apple products, which we view as a good sign for long-term hardware and iTunes revenue.

Bears Say

- Apple's recent decisions to maintain a premium pricing strategy may help fend off gross margin compression but could limit unit sales growth as devices may be unaffordable for many emerging market customers.
- Apple has a host of large tech rivals, many of which are willing to sell devices at bare-bones prices in order to earn income elsewhere.
- Apple's less-than-stellar launches of Apple Maps and iOS 8.0.1 were near-misses that frustrated many users for short periods of time, but any other buggy software launches could diminish Apple's reputation for building products that "just work."

Competitors AAPL

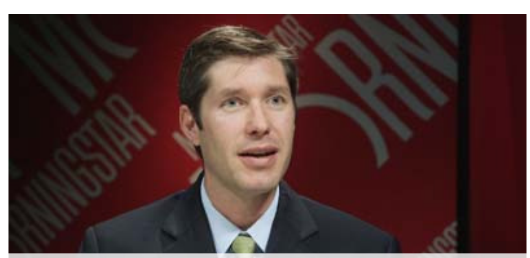
More...

Name	Price	% Chg	TTM Sales $ mil
Apple Inc	**$127.04**	**1.67**	**199,800**
Samsung Electronics Co Ltd	$1,200.00	0.00	188,510
Sony Corp ADR	$26.75	3.60	65,892
Sony Corp	$26.62	4.68	65,892
Panasonic Corp ADR	$12.83	1.09	64,006
Panasonic Corp	$12.69	0.83	64,006

Compare These Stocks

Video Reports AAPL

More...



Pick and Choose in the Overheated Tech Sector differentiation (screen size and quality, etc.). We view Apple as well positioned to develop and expand enough services to enhance the user experience, in order to build switching costs that will help the firm retain customers and generate significant repeat purchases will be critical for future iPhone growth in the years ahead.

Economic Moat 01/28/2015

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. Although Google's Android was able to develop a similar network and applications developers focused on building products for both of these operating systems, Microsoft has been unable to build out a similarly robust developer network thus far, and we think Apple's early advantage in third-party apps will help fend off any potential competitors looking to build the next great mobile ecosystem.

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. New services like Apple CarPlay and Apple Pay also aid the firm's efforts not only to improve the entire iOS ecosystem and the overall user experience, but also to build switching costs that give users more and more reasons not to depart the platform. Furthermore, in hardware, 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 Apple Watch or other gadgets tied to iOS via HomeKit, 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. Other hardware vendors, such as Samsung, are emulating this model by bundling devices together. However, Samsung doesn't control the operating system (Android) used to run these products, and the company has had several false starts in trying to build its own operating system, Tizen.

Looking at other sources of economic moat, Apple holds intangible assets associated with patents for its hardware and software designs. However, both the value of such assets and the sustainable competitive advantage stemming from these assets remain cloudy. Regarding Apple's sterling brand equity, we view brands within technology differently than, say, consumer luxury goods. We doubt that Apple can charge double the price for a product that has the exact same hardware and software specifications as an unbranded product. However, we think that Apple benefits from intangible assets, or a brand, in terms of the (mostly) positive user experiences that customers capture from the firm's integrated hardware, software and services. This brand equity may encourage customers to go with Apple for their first smartwatch instead of a host of other offerings. Similarly, Apple might be the world's most trusted consumer technology firm in terms of delivering flawlessly working products in existing, and even new, product categories. However, we still think tech brands are relatively fleeting, as technological inferiority can supersede years of brand equity at any given time. As an example, Nokia was long considered a top-10 brand, but its failure to stay on the technological forefront overtook 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. Network effects may be forming around Apple's apps developers, as a more robust apps store is likely helping Apple attract new customers. However, these same developers likely build for Android as well, so we think that developers will flock to the ecosystem that offers the most attractive return on investment. Along these lines, Apple Pay may ultimately develop a network effect between merchants, credit card networks, and users, but we would also anticipate that some other service (PayPal, Google, Softcard) could come close to replicating this service and provide customers with a non-iOS alternative. 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.

Valuation 01/28/2015

We are raising our fair value estimate for Apple to $120 per share from $100, as we are substantially more optimistic about near-term iPhone growth in light of the firm's spectacular iPhone 6 and 6 Plus launch in late 2014. Our fair value estimate implies fiscal 2015 (ending September 2015) price/earnings of 15 times (and only 11 times after excluding Apple's cash balance on hand). Given Apple's strong start to fiscal 2015, we project 25% revenue growth for the year, up from our prior projection of 11%, as iPhone sales, especially in China, have been remarkable. We project iPhone revenue growth of 39% in fiscal 2015 and 9% Mac growth, offset by a 16% decline in iPad revenue as Apple's tablet sales slow in the face of longer replacement cycles and cannibalization from the iPhone and Mac. Longer term, Apple should still attract late smartphone adopters in developed markets and new customers in emerging markets (especially China). As more consumers are previous smartphone owners, rather than first-time buyers, 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. We model 8% iPhone revenue growth in fiscal 2016, but low single digit growth thereafter, as Apple may face pricing pressure and a less favorable mix shift toward lower end devices that mostly offsets any additional premium smartphone growth. Longer-term, we model low single digit iPad revenue growth; we anticipate a refresh cycle at some point, but similar to the iPhone, we anticipate that low-priced tablet competition may limit future unit sales growth, iPad pricing, or both. We model 5% long-term Mac revenue growth, as Apple continues to gain share in the PC market. We model $6.5 billion in revenue from Apple Watch in fiscal 2015 and assume that revenue reaches the $15 billion range in the long-run. Based on Apple's premium pricing strategy and iPhone increasing as a mix of Apple's total revenue, we now model minimal corporate gross margin compression from Apple's 39% reported in fiscal 2015. In turn, operating margins hover in the mid- to high-20% range. Our fair value uncertainty rating for Apple remains high, given short product life cycles and intense competition within Apple's key end markets.

Risk 01/28/2015

Apple faces several key risks as competitors attack the firm from all angles. Smartphone and tablet competition is rising, both from upstart Chinese OEMs on the low- and mid-range, and tech titans like Samsung, Lenovo and Huawei all have the size and scale to build large smartphone portfolios to suit customers at every price point. As a premium phone supplier, Apple also runs the risk that wireless carriers could reduce or eliminate the subsidies that have made iPhones more affordable to many customers. Finally, some competitors like Xiaomi and Amazon are more than willing to sell hardware at close to cost in order to drive other revenue streams. If any of these devices offer a similar user experience to iOS products, Apple may be unable to capture an adequate premium on future hardware sales. All the while, the low end of the smartphone market (where Apple does not participate) will likely be the faster growing portion of the smartphone market for years to come.

Apple also must continually innovate on the hardware front, and the company's upcoming Watch will need to match the immense pre-launch hype for the device. Any severe slip up could be damaging to Apple's brand and customer loyalty. Apple must also deliver immaculate software and services in order to generate premiums on hardware sales, but slip-ups like the early launch of Apple Maps and a failed iOS 8.0.1 release show the difficulty in flawlessly staying on the cutting edge. Further, Apple still relies on a robust app-developer base and strong partnerships with third parties, yet these companies will likely focus on the operating system that provides the best return on investment and could turn their attention to Android if Apple's iOS user base were to slip. If Apple were to falter and its exceptional brand be diminished as customers departed iOS in droves, we're not even sure that Apple's mighty cash cushion could help the firm buy its way out of any problem.

Management 01/28/2015

We view Apple as a good steward of shareholder capital. 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. Arthur Levinson, former chairman and CEO of Genentech, is chairman of Apple's board of directors.

We're comfortable with Apple's level of technological innovation over the past couple of years after Jobs' passing. Much of this innovation has come from new software and services within iOS like Apple Pay, rather than brand-new smash-hit products. That said, we still have high hopes that the Apple Watch will deliver incremental earnings growth to Apple, and the firm's ability to execute and deliver another premium product will likely be viewed by many as a sign that Tim Cook's Apple can, or cannot, deliver successful new products over time.

Although Apple maintains sterling brand recognition and has hundreds of millions of loyal followers, the company has made a couple of missteps under Cook that, some skeptics would argue, would have never happened under Steve Jobs. Apple executed poorly when it decided to part ways with Google Maps in iOS 6 and launch Apple Maps with a variety of bugs and errors, leading to a formal apology. Also, Apple was relatively slow to recognize demand for larger-screen iPhones, and although the firm rectified this issue with its iPhone 6 product lineup, Samsung and other Android-based competitors had a two-year head start and were able to steal away some iOS customers who sought out a larger-screen device.

More recently, Apple launched an iOS 8.0.1 update that was quickly recalled after it rendered some users' phones useless. Further, several prominent tech analysts and developers have questioned Apple's cadence of updating iOS and OS X annually without fully fixing the bugs and problems with current software versions. These type of missteps could potentially leave the door open for any frustrated customers to try another platform like Android or Windows. At the very least, Apple may find it more difficult to quickly push its iOS user base onto the latest version of its operating system in future releases, which we see as a key positive differentiator for Apple over Android as apps developers don't need to build and test their apps for a wide variety of operating system versions.

On the bright side, while many may have questioned Apple's management team about its decision to initially price the iPhone 5c at $549, rather than at lower prices that more directly addresses emerging market demand, we tend to approve of Apple's decisions to maintain its premium pricing position. We also applaud Cook's decision to initiate dividend and stock buyback programs, as well as take on debt in order to fund such programs. We recognize that many high-profile investors have called for larger buyback programs, but we think that Apple's current plan of $90 billion is satisfactory as long as buybacks (and the debt issuances needed to fund these buybacks) are made in a prudent manner. In retrospect, the misstep may have come from not front-loading the buyback program in 2013, when both Apple's share price and interest rates were lower than today. Either way, we anticipate that Apple will expand upon its buyback program in April 2015, given the firm's strong cash generation in recent quarters.

Perhaps more importantly, we think Apple's frugality in terms of acquisitions is quite admirable. 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 and Nest, appears to have served investors quite well in recent years. Even Apple's $3.0 billion acquisition of Beats Music and Beats Electronics represented only a tiny portion of the firm's total cash balance, and we suspect that solid revenue growth and gross margins on headphone hardware sales may have justified the valuation. Apple has also done a good job of attracting top-notch talent to the company, such as former Burberry CEO Angela Ahrendts to run Apple's retail and online stores, Paul Deneve, the former CEO of Yves Saint Laurent, and Kevin Lynch, former CTO of Adobe. We are comfortable that these hires have strengthened Apple's bench in the unlikely event of Cook departing the company, and each hire likely has aided in Apple's efforts to build and deliver Apple Watch, and perhaps future products as well. All the while, Apple's ongoing operations continue to generate operating margins and cash flow well above its peers in various hardware industries, which bodes well for future free cash flow for investors.

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.