Apple Inc AAPL

Apple appears likely to retain its vast iOS customer base over time

by
Brian Colello, CPA

Sector Director

Authors can be reached at Analyst Feedback

Morningstar's Editorial Policies

Analyst Note 05/01/2018

Apple reported solid fiscal second-quarter results and provided investors with a decent third-quarter forecast that was not as bad as we feared. Although the iPhone X "super cycle" did not transpire over the past six months, iPhone unit sales held up well while higher average selling prices, or ASPs, per device continued to contribute to robust revenue growth. We were also impressed with growth seen in Other Products and Services, especially as we continue to believe that sales of add-on hardware and services should continue to drive switching costs that will help Apple make repeat, high-margin iPhone sales to its customers over time. Meanwhile, the company authorized another $100 billion of share repurchases while boosting its quarterly dividend by 16% to $0.73 per share, taking advantage of changes in U.S. corporate tax policies. We plan to modestly raise our fair value estimate for narrow-moat Apple to $175 per share from $170 but continue to view shares as fairly valued.

Apple sold 52.2 million iPhones in the September quarter, up 3% year over year. However, iPhone revenue rose 14% year over year, thanks to an 11% increase in ASPs driven by sales of the higher-priced iPhone X. Apple noted that the X was its highest selling model in each of its 13 weeks in the March quarter (as opposed to the iPhone 8 or 8 Plus), which we again view as an encouraging sign regarding Apple's ability to maintain premium pricing. Other Products revenue rose 38% year over year thanks to Apple Watch and Airpods, which we think is an underrated, innovative hit for Apple. Services revenue rose 31% year over year, accelerating from 18% year-over-year growth in the December quarter, with particular strength in iCloud storage and Apple Music.

Investment Thesis 02/02/2018

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 many 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 app store and ecosystem that attracted new users to platform. Apple's first-mover advantage and "easy growth" from new smartphone adopters is over, but the company appears likely to retain its existing premium customer base and could still attract some switchers from Android over time.

Morningstar's Take AAPL

Analyst

Price 05-03-2018	**Fair Value Estimate**	**Uncertainty**
176.89 USD	175 USD	High
Consider Buy	**Consider Sell**	**Economic Moat**
105 USD	271.25 USD	Narrow
Stewardship Rating		
Standard		

Bulls Say

- Between first-time smartphone buyers, users switching from Android, and repeat sales to current customers, Apple has plenty of opportunity to reap the rewards of its iPhone business.
- 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 long-term customer retention.
- We think Apple is still innovating with introductions of Apple Pay, Apple Watch, Apple TV, and AirPods; each of these could drive incremental revenue, but more crucially help to retain iPhone users over time.

Bears Say

- Apple's 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 customers.
- If Apple were to ever launch a buggy software update or subpar services, it could diminish the firm's reputation for building products that "just work."
- Apple is believed to be behind firms like Google and Amazon in artificial intelligence, or AI, development, which could be problematic as tech firms look to integrate AI in order to deliver premium services to customers.

Competitors AAPL

More...

Name	Price	% Chg	TTM Sales $ mil
Apple Inc	**$176.89**	**0.18**	**239,176**
Samsung Electronics Co Ltd	$2,210.00	-3.07	210,871
Sony Corp ADR	$47.10	0.94	77,252
Sony Corp	$45.18	-2.31	77,252
Panasonic Corp	$14.70	0.81	71,223
Panasonic Corp ADR	$14.50	-0.72	71,223

Ultimately, we think future smartphone competition will stem from software and services, as we're seeing less and less meaningful hardware differentiation. 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. We consider almost all other products and services that Apple offers (Apple Watch, iCloud, HomePod, AirPods, Apple Pay) as not only incremental revenue and earnings drivers for the firm, but as (more importantly) improving the iOS ecosystem that will enable Apple to sell future iPhones at premium prices to a loyal customer base.

Economic Moat 02/02/2018

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 see minimal switching costs associated with smartphones, as all of these devices can perform most necessary functions--place calls, send texts, browse the web, run apps, 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), which failed to lock in customers when they were on top. In our opinion, Apple's switching costs stem from its iOS operating system and appear to be increasing, thanks to iCloud, Apple Pay and other native services.

Furthermore, in hardware, we believe an owner of multiple Apple devices (say, an iPhone and Apple Watch) 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, iPad, Apple Watch, AirPods, and Apple TV, as well as other gadgets to potentially tie 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 still trying to emulate this business 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 wearable device, instead of similar offerings from a host of other competitors. 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 brand recognition failed to make up for its lack of technological innovation in the smartphone space. In other words, new customers might give Apple's products the benefit of the doubt and trialability based on brand, but such an advantage might not be sustainable forever.

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) could come close to replicating this service and provide customers with a non-iOS alternative. In short, the network effects created by these services (with perhaps the largest and most important being the iOS apps community) might not be strong enough to ensure excess ROICs for Apple if other aspects of the phone (hardware, operating system, services, for example) become inferior to other offerings.

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 05/01/2018

We are raising our fair value estimate for Apple to $175 per share from $170, mostly due to modestly higher near-term and long-term free cash flow assumptions. This new fair value estimate implies fiscal 2018 (ending September 2018) price/earnings of 15 times (and only 12 times after excluding Apple's net cash balance on hand). Apple earned 6% revenue growth in fiscal 2017, thanks to a nice bounce back in iPhone 7 revenue plus solid growth in Mac, Services and Other Products revenue. We foresee a big year for Apple in fiscal 2018 with 13% revenue growth, driven by healthy sales of the iPhone X at substantially higher average selling prices than prior generation iPhones. We also foresee strong revenue growth from Other Products, including the Apple Watch and AirPods, while we anticipate that services revenue will now grow in excess of 20% in fiscal 2018, up from our prior forecast for a midteens pace. We're forecasting a slowdown in revenue in fiscal 2019 and fiscal 2020 as customers pause their spending (similar to the iPhone 6s in fiscal 2016 after a monster iPhone 6 launch in fiscal 2015) but model midcycle mid-single-digit revenue growth for Apple thereafter. Based on Apple's premium pricing strategy and services becoming a slightly bigger part of Apple's revenue mix, we model gross margins remaining roughly flattish in the 38%-39% range over the next five years. We expect Apple to aggressively spend on research and development in order to fund new product categories (perhaps an Apple car), so that operating margins deteriorate slightly from 27% in fiscal 2017 to 25% in the long run.

Risk 02/02/2018

Apple faces several key risks as competitors attack the firm from all angles. Smartphone and tablet competition is intense, both from upstart Chinese OEMs on the low and midrange, and tech titans like Samsung and Huawei, which all have the size and scale to build large smartphone portfolios to suit customers at every price point. As a premium phone supplier, Apple runs the risk that, as wireless carriers in the U.S. strive to reduce phone subsidies and two-year contracts, customers may hold on to their phones longer, in turn weighing on future sales. 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 were to offer a similar user experience to iOS products, Apple could fail 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 probably be the faster-growing portion of the smartphone market for years to come.

In addition to continual innovation on the hardware front, Apple must also deliver immaculate software and services in order to generate premiums on hardware sales. Recent mistakes like the early launch of Apple Maps, various software bugs, and the firm's PR snafu around throttling down older devices to protect battery life all show the difficulty in flawlessly staying on the cutting edge. Any severe slip-up could be damaging to Apple's brand and customer loyalty. Further, Apple still relies on a robust app developer base and strong partnerships with third parties, yet these companies are likely to 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 were to be diminished as customers departed iOS in droves, we're not sure that its mighty cash cushion could help the firm buy its way out of any problem.

Management 05/01/2018

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' death 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. Jeff Williams serves as COO of Apple and would be our best bet to replace Cook as CEO.

We're comfortable with Apple's level of technological innovation over the past couple of years. Much of this innovation has come from new software and services within iOS like Apple Pay, as well as under-the-hood improvements in semiconductors, rather than brand-new life-altering devices. That said, we still have high hopes that products like the Apple Watch, AppleTV, AirPods and HomePod will deliver incremental earnings growth to Apple, and the firm's ability to execute and deliver additional premium products will likely be viewed by many as a sign that Cook's Apple can, or cannot, deliver successful new products over time. Although the Apple Watch has not sold at similar volumes to the iPad or iPhone, we're not concerned about this relatively slower start, as both the iPod and iPhone had similarly tepid launches, at least in terms of unit sales. We think the firm still has room to go in areas like voice recognition and artificial intelligence to stay ahead of other tech titans like Google, Facebook, Amazon and Microsoft, but we would not declare Apple as dead in these areas just yet.

Although Apple maintains sterling brand recognition and has 1.3 billion active devices (as of December 2017), it has made a couple of missteps under Cook that, some skeptics would argue, would have never happened under 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. More recently, Apple is being investigated by the U.S. government as the firm purposefully slowed down iOS on older devices. While the firm claims that it was to protect the user from sudden phone shutdowns, many fear that Apple was implementing planned obsolescence of their devices, in order to get customers to upgrade.

In terms of capital allocation, we applaud Cook's decision to initiate dividend and stock buyback programs, as well as take on debt in order to fund such programs when most of its cash was trapped overseas. We think Apple's recent plan of $300 billion in capital distributions (to be completed in the June 2018 quarter) was more than sufficient to appease investors. We like the firm's expansion of this program by another $100 billion in buybacks, along with the company's healthy dividend raises in recent years.

Perhaps more important, 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.

Apple has also done a good job of attracting topnotch talent to the company, such as former Burberry CEO Angela Ahrendts to run Apple's retail and online stores. 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 the 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 a wide variety of consumer electronic devices, including smartphones (iPhone), tablets (iPad), PCs (Mac), smartwatches (Watch), and TV boxes (Apple TV), among others. The iPhone makes up the majority of Apple's total revenue. In addition, Apple offers its customers a variety of services such as Apple Music, iCloud, AppleCare and Apple Pay, among others. Apple's products run internally developed software and semiconductors, and the firm is well known for its integration of hardware, software and services. Apple's products are distributed online as well as through company-owned stores and third-party retailers. The company generates about 40% of its revenue from the Americas, with the remainder earned internationally.