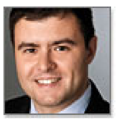
Apple Inc AAPL

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



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Morningstar's Editorial Policies

Investment Thesis 01/28/2014

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, 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 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 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. A partnership with China Mobile, the world's largest wireless carrier, should also give iPhone growth a shot in the arm.

Ultimately, we think future smartphone and tablet competition will stem from software and services, as hardware is already approaching commoditization. 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 01/28/2014

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

Morningstar's Take AAPL

Analyst

Price 02-14-2014 543.86 USD	**Fair Value Estimate** 570 USD	**Uncertainty** High
Consider Buy 342 USD	**Consider Sell** 883.5 USD	**Economic Moat** Narrow
Stewardship Rating Standard		

Bulls Say

- Gartner expects the smartphone market to more than double from 2012 to 2015, providing Apple with avenues for iPhone growth.
- Apple appears poised to generate strong revenue growth from the iPad in the years ahead as tablets cannibalize PCs.
- 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 iPhone, iPad, and Mac sales, as well as an ability to see any new devices like a revised Apple TV or iWatch.

Bears Say

- Apple's recent decisions to maintain a premium pricing strategy may help fend off gross margin compression but may also limit unit sales and market share as the low end of the smartphone space will likely grow faster than the premium market.
- Whereas Apple focuses on a handful of key products, Samsung has emerged as a strong rival by offering highly competitive devices of all sizes and prices at all times of the year.
- Apple may have lost much of its vision and creativity with the passing of cofounder Steve Jobs in October 2011.

Competitors AAPL

More...

Name	Price	% Chg	TTM Sales $ mil
Apple Inc	**$543.86**	**-0.10**	**173,992**
Samsung Electronics Co Ltd	$1,250.00	-1.96	212,032
Panasonic Corporation	$11.39	0.62	71,792
Panasonic Corporation ADR	$11.37	-2.40	71,792
Royal Philips NV	$35.95	0.79	31,928
Royal Philips NV ADR	$35.84	0.08	31,928

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 many other upstart 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. 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, a lack of suitable alternatives, or because their businesses dictate such moves.

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. 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. 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 01/28/2014

We are trimming our fair value estimate for Apple to $570 per share from $600 due to lower near-term revenue projections. Our new fair value estimate implies fiscal 2014 (ending September 2014) price/earnings of 13.5 times, and only 10 times after excluding $157 per share of net cash on hand as of December 2013. We project revenue growth of 6% in fiscal 2014, down from our prior projection of 13%. Apple profited from successful launches of new devices such as the iPhone 5s, but follow-up sales in the March 2014 quarter were below our expectations, which points to even lower revenue growth through the rest of fiscal 2014 as these products age.

Longer term, Apple should still attract late smartphone adopters in developed markets and new customers in emerging markets, especially as Apple's partnership with China Mobile, the world's largest wireless carrier, begins to pay dividends. As more consumers become experienced 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 additional share at the high end of the market. However, although Apple has taken on the strategy of maintaining premium pricing, which may support gross margins in the years ahead, such pricing may weigh on future revenue growth. In turn, we currently model low single-digit iPhone revenue growth in fiscal 2015, and beyond.

We project solid iPad revenue growth in fiscal 2014 and 2015, as this device both displaces PCs and is purchased as a third device alongside PCs and phones, but minimal growth thereafter as Apple maintains premium pricing on these devices but fails to recognize exponential unit growth as in years past. We assume Apple's line of Mac PCs will see modest revenue growth, as Macs gain share in the declining PC industry. 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, as they fell to 38% in fiscal 2013. We project 37.5% gross margins in fiscal 2014, and mid-30% gross margins in the long term, as Apple maintains its focus on premium pricing that helps to stave off meaningful gross margin compression, albeit with relatively slower unit sales growth. In turn, operating margins of 35% in fiscal 2012 should fall to the mid-20% range five years out. Our fair value uncertainty rating for Apple is high.

Risk 01/28/2014

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. Apple also has to square off against several competitors with much different strategies than traditional hardware makers. Apple's devices compete against firms like Amazon (with its Kindle Fire tablet) and Xiaomi, which appear willing to sell hardware at cost, in order to drive other revenue streams.

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, and other similar missteps may cause customers to leave the iOS ecosystem altogether. 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.

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 01/28/2014

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 Apple maintains a sterling brand recognition and has hundreds of millions of loyal followers, the company has made a couple of missteps under Cook that, some 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 and the ouster of VP Scott Forstall. Given Cook's reputation as an operations guru, we were 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 and leading to uncertainty about whether Apple was continuing to run on all cylinders. Also, Apple hinted that it believes 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 smartphones and Galaxy Note phablets (phone/tablets). We fear that Apple may miss out on part of the premium smartphone market if it fails to build a larger-screen iPhone in the near-future, although rumors continue to swirl that an iPhone 6 launch in 2014 may include a larger screen version.

On the other hand, while many may have questioned Apple's management team about its decision to 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 a dividend and stock buyback plan in early 2012, as well as take on debt in order to fund a $60 billion stock buyback program in 2013. We recognize that many high-profile investors have called for an even larger buyback program, but we think that Apple's current plan 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.

Perhaps more importantly, we think Apple's frugality 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 and Nest, appears to have served investors quite well in recent years. Apple has also done a good job of attracting top-notch talent to the company in recent months, such as former Burberry CEO Angela Ahrendts to run Apple's retail and online stores, and Paul Deneve, the former CEO of Yves Saint Laurent. We are comfortable that these hires have strengthened Apple's bench in the unlikely event that Cook were to depart the company. Both hires not only have experience managing luxury brands that sell aspirational goods, but also fuel speculation that an iWatch is on the horizon. 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.