

Apple, Inc. (AAPL)

iPhone Impresses but Questions Persist

■ Estimate Change

■ **Quick Take.** — We expect Apple's many bulls to focus on the company's above consensus iPhone unit shipments (31M vs. 26M) and better gross margin results (36.9% vs. 36.7%). However, we point out that even after adjusting for inventories, Apple's iPad, iPod, and Mac sales all declined y/y such that, despite a 22% y/y increase in iPhone, total Apple units grew only 5% y/y (versus tablet industry units growth of 91% y/y and smartphone industry units growth 67% y/y). Meanwhile, based on guidance, gross margin is expected to decline for the 6th quarter in a row, leading us to model our FY14 GM's well below consensus (36.5% vs. 37.2% consensus). We acknowledge that Apple's upcoming products hold some promise for investors, limiting downside, but in light of the view that smartphone sales are decelerating, we reserve our enthusiasm. On our new estimates, our PT remains \$430.

■ **iPhone Units Surprise But Mix Down.** — Apple reported 31M iPhone unit sales in 3Q13(Jun) (up 22% y/y after adjusting for inventory), easily beating consensus forecasts of 26M and leading us to raise our estimates. While undoubtedly a positive, we suspect that upside was likely driven by strength in low-end iPhone 4/4S, pointing to declining iPhone ASP's as an indication (ASP's have fallen 10% in the 2 quarters since the launch of the iPhone5). This stokes our growing concern that high-end smartphone growth is decelerating, driving a greater proportion of sales to lower-end devices. We add that greater sales of iPhone4/4S now, potentially cannibalizes sales of low-cost iPhone upon its launch in late 4Q13/early 1Q14(Dec) and puts greater onus on new carriers in the success of low-cost iPhone. And with our estimate of low-cost iPhone cost (~\$275 to build, \$350 wholesale price), we suspect new carriers, who have heretofore balked at a subsidy, will have limited interest in low-cost iPhone.

■ **iPad Losing Ground Fast.** — Reported iPad units fell 3% y/y (after adjusting for inventory), in stark contrast to overall industry tablet growth of 91% y/y. Apple rightfully pointed out that 3Q12(Jun) benefited from the launch of the iPad3 Retina (3Q12 indeed grew 44% q/q), skewing the y/y comparison. But in light of Apple's flattish revenue guidance, in which we assume only modest variations in mix, we note that y/y iPad units will decline -7% y/y. Even if Apple were to grow 1Q14(Dec) iPad's by 75%, this implies 6% growth y/y in CY13, well below industry growth of 58.7% (according to IDC). We continue to expect iPad5 and a low-cost iPad Mini to be launched in 2H13.

■ **Is the Eco-System Healthy?** — Apple's iTunes/Software & Services revenue grew 25% y/y, endorsing the strength of Apple's eco-system. (*Continued below...*)

Neutral	2
Price (23 Jul 13)	US\$418.99
Target price	US\$430.00
Expected share price return	2.6%
Expected dividend yield	2.9%
Expected total return	5.5%
Market Cap	US\$393,285M

Price Performance (RIC: AAPL.O, BB: AAPL US)



EPS	Q1	Q2	Q3	Q4	FY	FC Cons
2012A	13.87A	12.30A	9.32A	8.67A	44.15A	44.15A
2013E	13.81A	10.09A	7.47A	7.50E	39.02E	39.31E
Previous	13.81A	10.09A	7.08E	6.46E	37.48E	na
2014E	12.54E	9.72E	8.04E	7.72E	38.02E	43.13E
Previous	11.66E	11.38E	9.40E	7.30E	39.84E	na
2015E	12.93E	9.49E	7.94E	8.05E	38.39E	44.42E
Previous	12.65E	11.52E	9.11E	9.45E	42.81E	na

Source: Company Reports and dataCentral, Citi Research. FC Cons: First Call Consensus.

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AAPL.O: Fiscal year end 30-Sep						Price: US\$418.99; TP: US\$430.00; Market Cap: US\$393,285m; Recomm: Neutral					
Profit & Loss (US\$m)	2011	2012	2013E	2014E	2015E	Valuation ratios	2011	2012	2013E	2014E	2015E
Sales revenue	108,249	156,508	168,993	164,453	167,975	PE (x)	15.1	9.5	10.7	11.0	10.9
Cost of sales	-64,431	-87,846	-105,589	-104,093	-106,917	PB (x)	5.1	3.3	3.1	2.5	2.2
Gross profit	43,818	68,662	63,404	60,360	61,059	EV/EBITDA (x)	9.2	5.0	4.9	4.8	4.3
Gross Margin (%)	40.5	43.9	37.5	36.7	36.3	FCF yield (%)	8.5	10.7	11.0	8.9	8.6
EBITDA (Adj)	35,604	58,518	54,739	51,866	52,852	Dividend yield (%)	0	0.6	2.7	3.1	3.3
EBITDA Margin (Adj) (%)	32.9	37.4	32.4	31.5	31.5	Payout ratio (%)	0	6	29	34	37
Depreciation	-1,814	-3,277	-6,724	-7,500	-8,300	ROE (%)	41.7	42.8	29.6	24.9	21.5
Amortisation	0	0	0	0	0	Cashflow (US\$m)	2011	2012	2013E	2014E	2015E
EBIT (Adj)	33,790	55,241	48,015	44,366	44,552	EBITDA	35,604	58,518	54,739	51,866	52,852
EBIT Margin (Adj) (%)	31.2	35.3	28.4	27.0	26.5	Working capital	5,757	-299	5,252	2,371	1,138
Net interest	415	522	1,243	1,222	1,882	Other	-3,832	-7,363	-6,941	-7,320	-6,762
Associates	0	0	0	0	0	Operating cashflow	37,529	50,856	53,050	46,916	47,229
Non-op/Except	0	0	0	0	0	Capex	-4,260	-8,295	-10,000	-13,000	-14,000
Pre-tax profit	34,205	55,763	49,258	45,588	46,434	Net acq/disposals	-32,464	-38,427	-27,141	9,365	9,352
Tax	-8,283	-14,030	-12,937	-10,941	-11,144	Other	-259	-48	-188	0	0
Extraord./Min.Int./Pref.div.	0	0	0	0	0	Investing cashflow	-36,983	-46,770	-37,329	-3,635	-4,648
Reported net profit	25,922	41,733	36,321	34,647	35,290	Dividends paid	0	-2,488	-10,559	-11,946	-12,884
Net Margin (%)	23.9	26.7	21.5	21.1	21.0	Financing cashflow	1,444	-1,698	-11,635	-11,946	-12,884
Core NPAT	25,922	41,733	36,321	34,647	35,290	Net change in cash	1,990	2,388	4,086	31,335	29,697
Per share data	2011	2012	2013E	2014E	2015E	Free cashflow to s/holders	33,269	42,561	43,050	33,916	33,229
Reported EPS (\$)	27.68	44.15	39.02	38.02	38.39						
Core EPS (\$)	27.68	44.15	39.02	38.02	38.39						
DPS (\$)	0	2.65	11.40	13.11	14.02						
CFPS (\$)	40.07	53.80	56.99	51.48	51.38						
FCFPS (\$)	35.52	45.02	46.24	37.22	36.15						
BVPS (\$)	82.89	126.45	137.17	167.74	193.53						
Wtd avg ord shares (m)	924	935	924	906	914						
Wtd avg diluted shares (m)	937	945	931	911	919						
Growth rates	2011	2012	2013E	2014E	2015E						
Sales revenue (%)	66.0	44.6	8.0	-2.7	2.1						
EBIT (Adj) (%)	83.8	63.5	-13.1	-7.6	0.4						
Core NPAT (%)	85.0	61.0	-13.0	-4.6	1.9						
Core EPS (%)	82.6	59.5	-11.6	-2.6	1.0						
Balance Sheet (US\$m)	2011	2012	2013E	2014E	2015E						
Cash & cash equiv.	25,952	29,129	45,344	77,314	107,659						
Accounts receivables	5,369	10,930	8,897	6,719	7,025						
Inventory	776	791	1,712	1,764	1,852						
Net fixed & other tangibles	11,333	20,930	22,678	28,178	33,878						
Goodwill & intangibles	4,432	5,359	5,875	5,875	5,875						
Financial & other assets	68,509	108,925	119,091	109,091	99,091						
Total assets	116,371	176,064	203,597	228,942	255,380						
Accounts payable	14,632	21,175	15,715	15,243	16,004						
Short-term debt	0	0	0	0	0						
Long-term debt	0	0	16,958	16,958	16,958						
Provisions & other liab	25,124	36,679	44,117	44,834	45,605						
Total liabilities	39,756	57,854	76,790	77,036	78,567						
Shareholders' equity	76,615	118,210	126,807	151,906	176,812						
Minority interests	0	0	0	0	0						
Total equity	76,615	118,210	126,807	151,906	176,812						
Net debt	-25,952	-29,129	-28,386	-60,356	-90,701						
Net debt to equity (%)	-33.9	-24.6	-22.4	-39.7	-51.3						

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For definitions of the items in this table, please click [here](#).

- *(Continued from above...)* However, on a q/q basis, ISS sales fell 3% marking only the 4th q/q decline in ISS sales since iPhone was first introduced (and 2 of those 4 were in the 2008 recession). To be sure, rolling ISS revenues/installed base have risen modestly for the past 2 quarters, leading us to ultimately conclude that the eco-system is indeed healthy, although the anomalous sequential decline in ISS sales bears watching in future quarters.
- **Is Retail Healthy?** — Apple's retail sales/store fell q/q and y/y, raising questions about the overall health in retail. Retail sales/store in 3Q13 fell to their lowest levels since March 2011. We note, however, that March 2013 sales/store were a record, and followed the third strongest sales/store quarter in December 2012, alleviating any concerns. Ultimately, we continue to model healthy levels in Apple's retail sales.

Apple, Inc.

Company description

Apple, Inc. (AAPL), is a leading vendor in "eco-system" based mobile hardware devices globally and one of the largest companies in the world by market capitalization. With the iMac in 1998, iPod in 2001, iPhone in 2007, and iPad in 2010, Apple set itself apart with innovative hardware and has increasingly extended this differentiation into chip design, software (operating system) and applications throughout its entire product offering. Apple derives ~51% of its revenues from iPhone, while iPad represents ~21% and PC another 15% of total sales. iPod sales account for ~9% of revenues and the rest ~4%. The company was founded in 1976 by Steve Jobs and Steve Wozniak, and is headquartered in Cupertino, CA. Apple employs approximately 72,800 on a full-time basis and has an additional 3,300 temporary employees and contractors.

Investment strategy

We rate Apple Neutral. Apple shares have fallen since September 2012 consistent with previous corrections of the company and its peers. While our analysis suggests a potential rebound based on this correction, we also note the company is facing challenges in decelerating demand for high-end smartphones, and from rising competition in the form of Samsung/Android, other ecosystem providers such as Amazon and Microsoft, and low-cost whitebox vendors in emerging markets.

Accordingly, our price target is below consensus, reflecting our perception that risks for Apple (competitive, market, and profit) are increasingly coming into focus. While growth deceleration is a function of the law of large numbers, these exogenous risk factors also play a role, and increasingly so. As a result, we see risk to Apple's share of the smartphone market from low-end smartphones and competition from other ecosystems. The maturation of the mobile market compounds the effect(s) of these competitive threats, resulting in downward pressure on Apple's sales mix and thus their profitability. We see upside to tablet growth, but this also negatively impacts gross margin. We see additional risk to gross margin as competition reduces pricing, accelerates product cadence, and impairs branding. Faster product cadences place growing emphasis on execution, leaving little room for error. In light of these factors, we see caps to Apple's valuation multiples, reflected in our price target.

Valuation

Our target price for Apple is \$430, based on the implied multiples derived from growth and value regressions of a sample of large-cap technology companies. We believe our methodology reflects the multiples investors ascribe to large-cap technology companies. We have found the market is paying an FY2 earnings multiple of $(-1.48) \times (\text{Sales Growth \%}) + 10.79$ and price-to-book multiple of $0.099 \times (\text{ROE}) + 0.346$. For Apple, our CY2015 sales growth estimate of 2.01% yields an implied P/FY2 earnings multiple of 10.76x. We multiply our CY2013 GAAP EPS estimate of \$37.60 by the growth multiple for an implied share price of \$405, to which we add discounted cash per share of \$130, for derived price of \$535. Our FY2015 ROE estimate of 19.96% yields an implied P/BV 2.32x. We multiply our CY2013 tangible BV/share estimate of \$141.29 by the value multiple for an implied share price of \$327. We equally weigh our growth and value implied targets to derive a target of \$431, which we round to \$430.

Risks

Key risks to our investment thesis include:

- 1) Macroeconomic conditions or shifting consumer demand could cause greater-than-expected deceleration or contraction in the handset and smartphone markets. This would negatively impact Apple's prospects for growth, and the shares may fail to achieve our target price as a result.
- 2) Greater-than-expected market share loss in the high-end smartphone and tablet markets. While our thesis contemplates Apple losing share, should Apple fail to maintain its competitive advantage as an ecosystem leader and lose share precipitously, the stock price may fail to achieve our target price.
- 3) Conversely, should Apple recover handset market share with a low-cost iPhone for emerging markets and/or more compelling high-end iPhone for developed markets, the stock price may exceed our target price.
- 4) A significant carrier expansion, particularly in emerging markets like China and India, would improve Apple's market share, and the stock price may exceed our target price as a result.
- 5) Greater-than-expected gross margin erosion: We expect gross margin to be flat to slightly down, as negative impacts from a greater share of iPad sales and rising manufacturing costs are mostly offset by steady but decelerating growth in iPhone sales. However, should i) iPhone sales decelerate more than expected or even decline; ii) iPhone gross margins degrade; iii) iPads grow faster than expected; and/or, iv) manufacturing costs rise faster than expected; there will be a negative impact on gross margin and the stock price may fail to achieve our target price.
- 6) Should carriers reduce subsidies for iPhones, demand for Apple's products may fall. To mitigate this effect, Apple may be forced to lower prices, impacting profitability. The stock price may fail to achieve our target price as a result.
- 7) An extended, or more significant, share price correction. Our thesis rests partly on analysis that Apple's stock has capitulated to an extent similar to previous corrections of the company's shares and those of its peers. Should this correction extend further in time or grow in magnitude, the stock may fail to achieve our target price over the time frame we forecast. Conversely, should Apple shares rebound from this correction, the stock price may exceed our target price.

Appendix A-1

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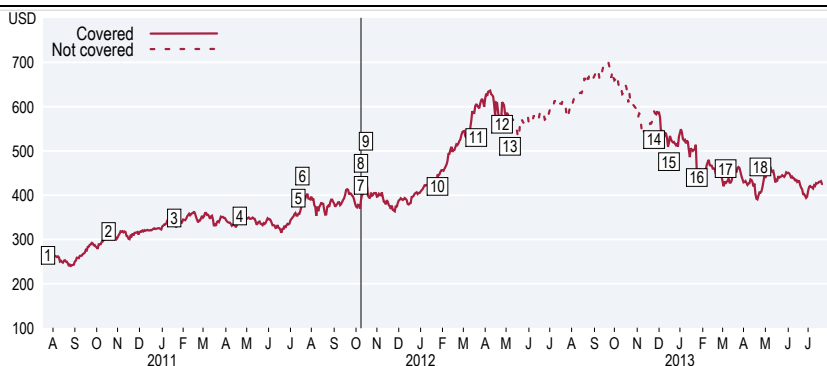
IMPORTANT DISCLOSURES

Apple, Inc. (AAPL)

Ratings and Target Price History Fundamental Research

Analyst: Glen Yeung

Covered since November 25 2012



Date	Rating	Target Price	Closing Price
1 21-Jul-10	1H	*350.00	254.24
2 19-Oct-10	1H	*390.00	309.49
3 19-Jan-11	1H	*415.00	338.84
4 21-Apr-11	1H	*435.00	350.70
5 13-Jul-11	1H	*450.00	358.02
6 19-Jul-11	1H	*480.00	376.85

* Indicates change

Date	Rating	Target Price	Closing Price
7 8-Oct-11	Stock rating system changed		
8 8-Oct-11	*1	480.00	369.80
9 17-Oct-11	1	*500.00	419.99
10 25-Jan-12	1	*600.00	446.66
11 20-Mar-12	1	*700.00	605.96
12 25-Apr-12	1	*720.00	610.00

Date	Rating	Target Price	Closing Price
13 7-May-12	Coverage terminated		
14 25-Nov-12	1	*675.00	571.50
15 16-Dec-12	*2	*575.00	509.79
16 24-Jan-13	2	*500.00	450.50
17 6-Mar-13	2	*480.00	425.66
18 24-Apr-13	2	*430.00	405.46

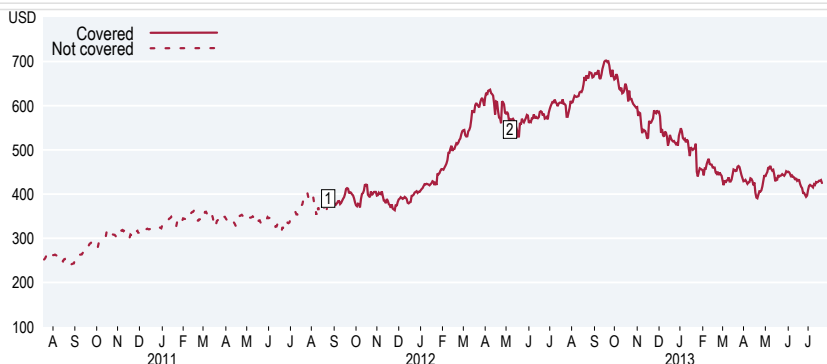
Rating/target price changes above reflect Eastern Standard Time

Apple, Inc. (AAPL)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Glen Yeung

Covered since November 25 2012



Date	Rating	Target Price	Closing Price
1 24-Aug-11	*ADD MP	-	376.18

* Indicates change

Date	Rating	Target Price	Closing Price
2 7-May-12	*REM MP	-	569.48

Rating/target price changes above reflect Eastern Standard Time

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