

SMF Analyst Report
Apple Inc.

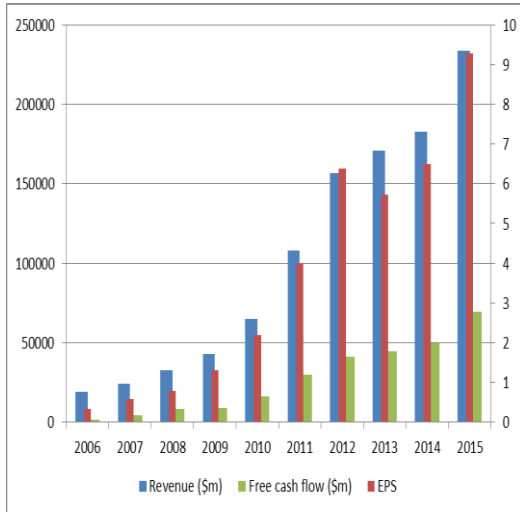
By:

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Analyst Report

Company: Apple Inc.
Date: 4/25/2015
Ticker: AAPL

Industry: IT/ Tech Hardware, Storage & Peripherals
Current Price: \$105
Exchange: NASDAQ
Recommendation: Buy
Target Price: \$137



Highlights

We are issuing a BUY recommendation for Apple Inc, with a target price of \$137. We believe the stock has upside potential primarily reflects AAPL's compelling valuation, favorable view on leasing programs by carriers/AAPL and positive outlook on potential products offerings in 2016 (i.e. new iPhones and TV streaming). The main drivers for revenue growth will be new product launches, growth in emerging markets, and rise in the US market's increasing disposable income.

Solid Revenue Growth and Strong Cash Flow Generation

Apple's tremendous iPhone 6 and 6 Plus enabled the firm to grow fiscal 2015 revenue by 28% or \$51 billion dollars in the latest quarter to over \$233 billion for the year, more than total revenue earned by almost 90% of the Fortune 500. In light of this amazingly high revenue bar, it is projected that Apple's revenue in fiscal 2016 will rise by 5%. Further, strong balance sheet and excess FCF will be employed for dividends and stock repurchases, as well as small bolt-on acquisitions which will enhance the competitive positioning and valuation of the company.

Main Risk Factors

Risk assessment is medium due to the ever-evolving market for consumer-oriented technology products, potential challenges associated with the company's growing size and offerings and possible changes in the pace or success of product innovations following recent management changes.

Market Profile	
52-week Price Range (AAPL)	\$92.00/\$134.54
Average (3m) Volume	39.05 m
Dividend Yield	1.97%
Market Capitalization	\$582.17 b
EPS	\$9.40
P/E	11.17
Beta	1.15
Credit rating	AAA+ (S&P)
Revenue	\$233.7 b

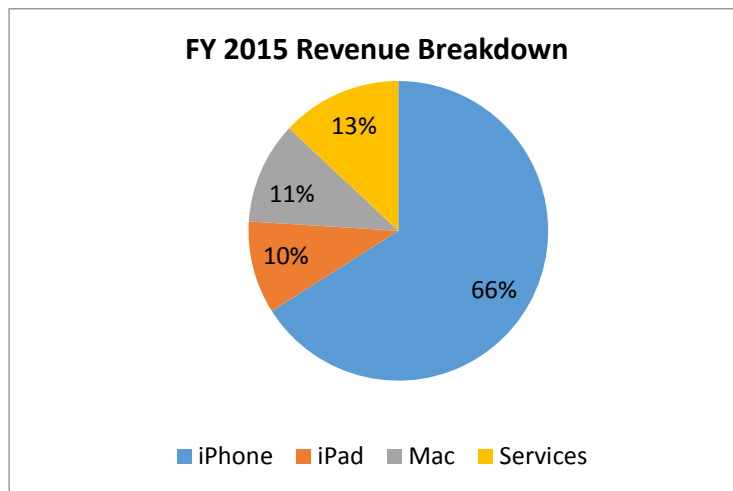


Business Description

Apple Inc. is one of the world's largest makers of PCs and peripheral and consumer products, such as the iPod digital music player, the iPad tablet, the iPhone smartphone, and the "Apple Watch," for sale primarily to the business, creative, education, government, and consumer markets. It also sells operating systems, utilities, languages, developer tools, and database software.

AAPL's iPhone directly accounted for 66% of FY 15 revenues, with over 230 million units sold. AAPL sold over 169 million iPhones in FY 14, contributing 56% of revenues. This was AAPL's fastest-growing segment over the past couple of years, and while we expect the rate of growth to slow as the business becomes larger and more mature, we still see substantial opportunities related to international, enterprise and education markets. We note the fall 2015 introductions of the next generation iPhone 6s and the iPhone 6s Plus devices.

Released in April 2010, the iPad quickly became the best-selling tablet computer by far. Before the iPad, unit sales for similar computing devices were less than 200,000 units, according to market researchers. In FY 10, the first year of availability, AAPL sold over 7 million iPads, accounting for around 8% of total revenues. In FY 15, about 55 million iPads were sold (10% of sales), but showed a decline from the 68 million units shipped (17% of sales) the previous fiscal year. We believe the tablet form factor will remain popular as it launches next generation devices, but we see new entrants diluting AAPL's overall market share over time. Nonetheless, we expect AAPL to continue to dominate in the upper part of this fast-growing computing market. Sales of AAPL's computers, commonly known as Macs, made up 11% of revenues in FY 15 compared to 13% in FY 14. On a unit shipment basis, Macs had grown notably faster than what was reported for the PC industry. Revenue from Services and other hardware products comprised for about 13% of sales in FY 15. This includes revenue from the iTunes Store, the App Store, the Mac App Store, the iBooks Store, AppleCare, licensing and other services. It also includes sales of Apple TV, Apple Watch, Beats products, iPod and Apple-branded and third-party accessories.



Financial Position & Performance

Following ratios and metrics clearly show the company's sound financial strength. Operating profit % is above 30% consistently with double digits revenue growth in every year expect 2014. Recent numbers are as below:

	2012	2013	2014	Q1-2015	Q2-2015	Q3-2015	Q4-2015
Revenue	156.5b	170.9b	182.8b	74.6b	58.0b	49.6b	51.5b
Operating Profit	55.2b	49.0b	52.5b	24.2b	18.3b	14.1b	14.6b
Net Income	41.7b	37.0b	39.5b	18.0b	13.6b	10.7b	11.1b
Revenue Growth %	45%	10%	7%	29.5%	27%	32%	22%
EBITDA%	37%	32%	33%	35.9%	35.8%	34.6%	34.5%
Operating Profit %	35%	28%	28%	32.5%	31.5%	28.4%	28.4%
Net Income Margin	26%	21%	21%	24%	23%	21%	21%
D/E	0	13.7	31.6	29.52	34.01	43.3	54.01
EPS	6.38	5.72	6.5	3.08	2.34	1.86	1.97
PE Ratio	15.11	12.14	15.57	15.33	15.2	14.61	12.45
Current Ratio	1.5	1.68	1.08	1.13	1.16	1.09	1.11
ROE	42.84	30.64	33.61	35.15	38.37	41.15	46.25
ROA	28.54	19.34	18.01	18.26	20.47	20.47	20.45
Dividend Per share	0.38	1.63	1.82	0.47	0.47	0.52	0.52
FCF	42.5b	45.5b	50.1b	30.5b	16.7b	12.9b	9.9b

Although AAPL's sales are affected by broader macroeconomic conditions, the company has generally been less cyclical than peers, given its strong brand, innovative and high quality products, loyal customer base and exposure to fast-growing markets. Considering the maturity of the computer and portable media player markets, it is expected that unit shipments and average selling prices for Macs and iPods to decline. However, with anticipated growth in the smartphone and tablet markets, AAPL will largely sustain notable share in these areas, see increasing shipments of and revenues from iPhones and iPads over the future. iPhones and Mac products offer margins above the level of the company as a whole, and this should support gross margins, as they make up a large percentage of total revenues. The company should benefit from operating leverage as sales increase faster than costs and expenses, supporting the upward trend of operating margins, which have already widened to over 30%. AAPL has a very strong balance sheet, with over \$200 billion in cash and investments, and about \$53 billion in debt as of FY 15 end. AAPL boasts return metrics, such as ROE and ROA, which are relatively higher, compared to other peer.

In their latest earnings report for Q4 2015, Apple Inc highlighted the following positive results which further cement the company's solid financial strength.

- Quarterly earnings & revenue topped expectations, boosted by strong iPhone growth in China.
- EPS \$1.96 vs \$1.88 estimate
- Revenue in greater China rose 99 percent year over year to \$12.52 billion, but was down 5 percent from the previous quarter
- Apple saw its highest-ever rate of users switching from Android devices
- Apple's cash pile also rose to about \$206 billion in the fourth quarter

Industry Outlook & Competitive positioning

Global growth is forecast at 3.3 percent in 2015 and 3.8 percent in 2016, with uneven prospects across the main countries and regions. Growth in emerging market economies is softening, reflecting an adjustment to diminished medium-term growth expectations and lower revenues from commodity exports, as well as country-specific factors. The outlook for advanced economies is showing signs of improvement, owing to the boost to disposable incomes from lower oil prices, continued support from accommodative monetary policy stances, and more moderate fiscal adjustment.

Domestically for the United States growth remains positive. The preponderance of economic data support the case that the U.S. economy is in the middle of what could turn out to be the longest expansion on record. The U.S. economy is believed to be in its midcycle phase and equities are expected to outperform, albeit at a slower pace and with slightly more volatility than in recent.

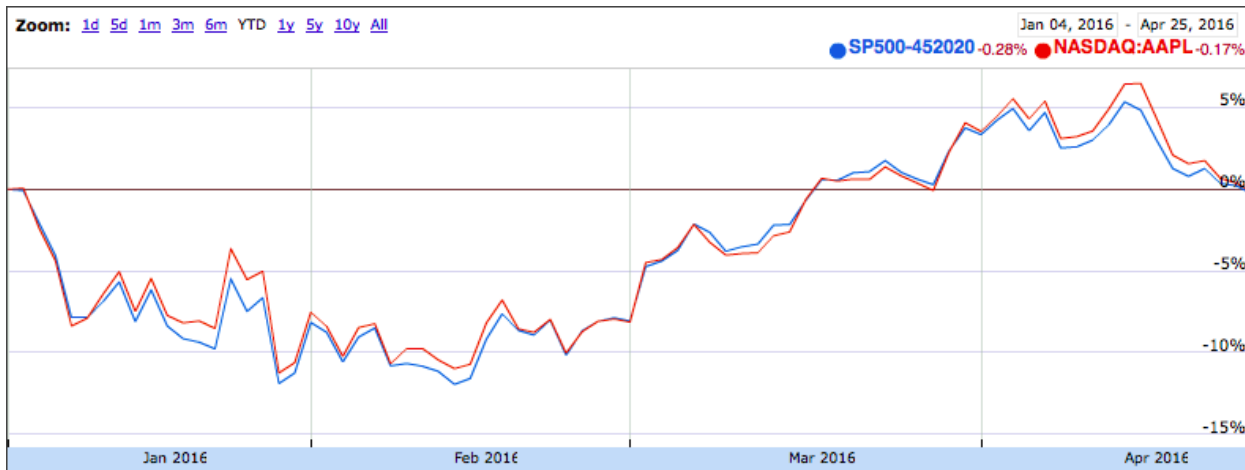
Apple Inc. is in the Technology Hardware, Storage & Peripherals sub-industry within the IT sector. Outlook for the Technology Hardware, Storage & Peripherals sub-industry for the next 12 months is positive. PC sales have begun to stabilize and see less pronounced pressures related to the cannibalization on lower priced tablet devices. Also hardware vendors will continue their efforts to take costs out of their infrastructures as they strive for profitability.

Since mid-2010, PC unit sales suffered from consumers substituting media tablets, which are smaller and less robust than traditional PCs and not generally counted as PCs, for laptop PCs. However, it is now believed that this substitution effect has likely peaked and should no longer act as a headwind to PC sales. Also, the growing popularity of robust mobile computing devices stimulates data traffic to be handled by servers, creating another spur to the industry. Healthy growth for data storage hardware market is seen in the next 12 months driven by content digitization, growing popularity of social networking websites, longer record retention for compliance with government regulations and the increasing prevalence of data mining and related analytics. We foresee growing demand for Internet-based computing solutions because they offer companies opportunities to reduce costs and improve customer service. This will have a positive impact on the industry.

Growing demand for Internet-based computing solutions is foreseen because they offer companies opportunities to reduce costs and improve customer service. Accordingly, servers and data-center computing hardware should benefit from rising demand. However, we also see price competition in servers. We think that hardware vendors have been seeking to offset the negative impact on profits by offering higher-margin services, software, and storage products.

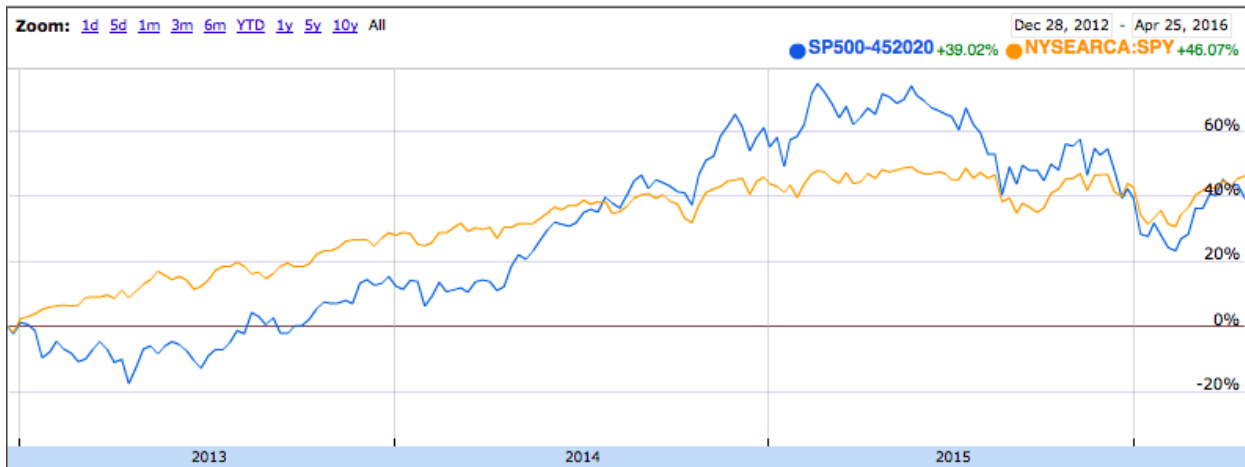
Year-to-date through March 24, 2016, the S&P 1500 Technology Hardware, Storage & Peripherals Index has risen 0.8% compared to a 0.3% decline for the S&P 1500. The S&P 1500 Technology Hardware, Storage & Peripherals Index declined 11.1% in 2015, while the S&P 1500 has fallen 1.0%.

YTD Return Comparison



-0.28%_ S&P 500 Technology Hardware, Storage & Peripherals -0.17%_ Apple

All time Return Comparison



+39.02%_ S&P Technology Hardware, Storage & Peripherals +46.07%_ S&P 500

Apple Inc.'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. Switching cost is not much in the market in which Apple Inc. operates but these 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, these switching costs as extremely important differentiators in favor of Apple. However, even if Apple's switching costs stem from its iOS operating system, 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, an owner of multiple Apple devices 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.

Below is the comparison of Apple Inc. with its peers and the industry. Apple Inc. is comfortably placed both in terms of financial strength and market perception as it can be seen that its results out-perform those of other competitors. Its closest rival Samsung too is not as profitable and it showing negative revenue growth. The amount of disposable FCF Apple Inc. generates is by far the maximum amongst its peers which gives it added strength in the market place and security to the shareholders.

	Apple Inc.	Samsung	HP Inc.	EMC	Industry Avg.*
P/E	12.68	9.76	4.43	18.86	18.46
P/B	5.46	1.02	0.94	2.39	2.33
Dividend Yield	1.70	--	5.88	1.88	3.04
PEG Ratio	0.78	4.39	0.75	1.62	1.63
EPS	9.25	119	2.49	1.20	14.70
Revn Grth	27.86	(9.83)	(0.75)	5.25	(1.65)
NI Grth	35.14	(22.60)	(1.96)	(6.06)	24.88
Operating Margin	30.48	12.14	6.45	16.52	10.11
Debt / Equity	54%	6.7%	93%	34%	NA
Market Cap	651.0b	168.4b	26.5b	48.9b	112.6b
Revenue TTM	233.7b	179.7b	106.0b	24.7b	75.8b
Net Income TTM	53.4b	18.6b	4.6b	2.4b	9.1b
FCF TTM	70.0b	5.8b	3.0b	4.8b	10.0b

*Industry Avg. includes companies listed and Seagate Tech, Sony Corp, Cisco, Ericsson, Blackberry, LG

From a CSR perspective too Apple Inc. is favorably positioned. Following table shows Apple Inc.'s CSR score compared to the industry:

	Apple Inc.	Industry
Governance Disclosure Score	57.14	54.42
ESG Disclosure	45.93	36.02
Social Disclosure Score	19.30	31.63
Environmental Disclosure Score	55.21	36.9

Investment Thesis

We are issuing a BUY recommendation for Apple Inc, with a target price of \$137 because of Apple Inc.'s compelling valuation, favorable view on leasing programs by carriers/Apple Inc. and positive outlook on potential products offerings in calendar-year 2016 (i.e. new iPhones and TV streaming). We note Apple Inc.'s significant market position in key areas, and high customer satisfaction and switching costs. Apple's superior ecosystem and new product launches will be enough to sustain high iPhone customer retention rates. The reserves of free cash flows and strong balance sheet will in the future be employed for dividends and stock repurchases, as well as acquisitions. 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. Further, innovation at Apple lives on with introductions of Apple Pay, Apple Watch, and Apple TV, each of which could drive incremental revenue but, more important, help to retain iPhone users over time. The main drivers for revenue growth will be new product launches, growth in emerging markets, and rise in the US market's increasing disposable income.

Valuation

We used the Discounted Free Cash Flow to Firm (DCF) method in arriving at the intrinsic value per share. The major assumptions of the DCF model are below:

1. Financials

Particulars	2010-2015 Average	Assumption	Remarks
Revenue Growth %	31%	7%	Conservative revenue growth considering substitution effect of PC sales is now over. Organic growth from new markets and loyal customer base. Historic average, in-line with Bloomberg/ Valueline and S&P Netadvantage, and no reason to believe margins will not be maintained at such levels of volumes
Gross Profit %	40%	40%	
Op Profit Margin	31%	30%	
NI Margin	23%	20%	
EBITDA Margin	35%	33%	
FCF %	28%	26%	

2. WACC

Particulars	Rate	Source
10 year Treasury Rate	1.91%	Actual
Beta	1.15	Bloomberg
Market Risk premium	8.7%	
Ke	10.6%	
Pre-tax Cost of Debt	2.46%	Apple Corporate Bond. Issue size \$5.5 billion with maturity in 2023
Eff. Tax Rate	26.00%	Average tax rate
Kd	1.82%	

	W	Cost	W*Cost
Equity	90%	10.6%	9.54%
Debt	10%	1.82%	0.18%
			9.7%

3. Others

EBITDA Exit Multiple = 5.4x

Perpetuity Growth Rate = 2.8%

Intrinsic Value

	Intrinsic Value	Current Value	Upside
Valuation using EBITDA Multiple Method	\$ 137.72	\$ 105.06	31%
Valuation using Terminal Growth Method	\$ 208.62	\$ 105.06	99%

Sensitivity Analysis

Valuation using EBITDA Multiple Method

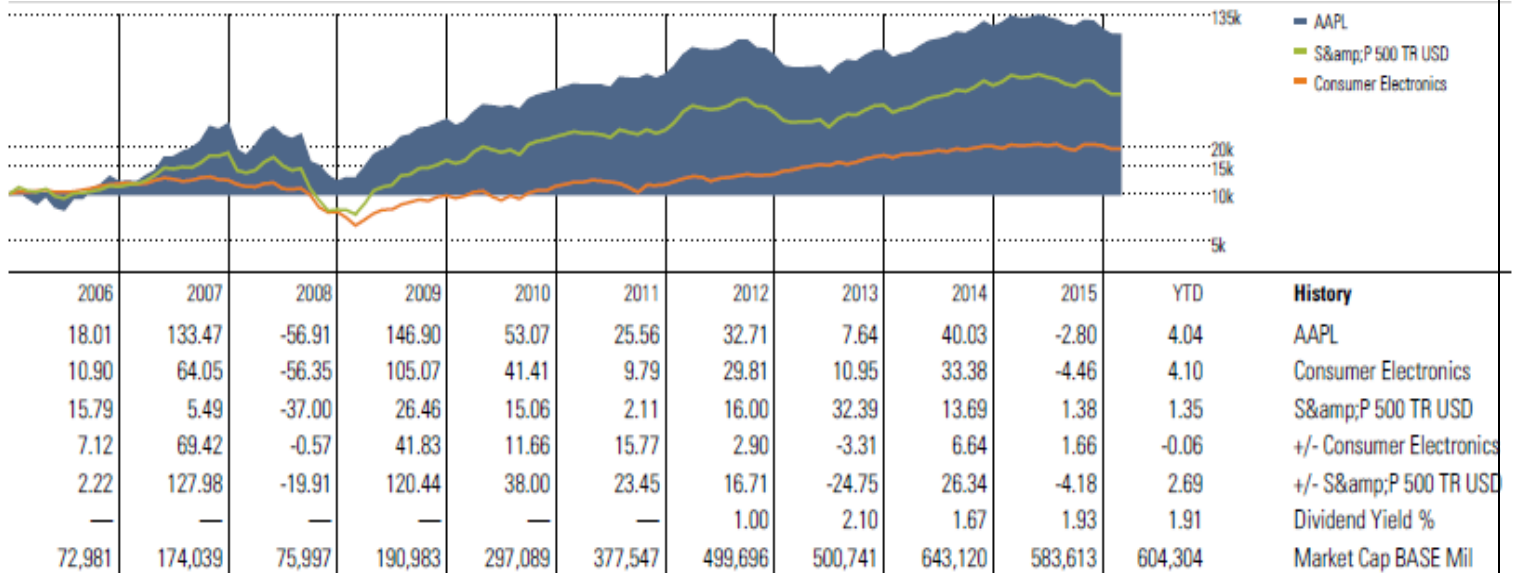
	<u>Value in USD</u>				
	2.4x	3.9x	5.4x	6.9x	8.4x
8.7%	104.82	123.32	141.82	160.33	178.83
9.2%	103.58	121.66	139.75	157.83	175.91
9.7%	102.37	120.05	137.72	155.39	173.07
10.2%	101.19	118.47	135.75	153.02	170.30
10.7%	100.04	116.93	133.82	150.71	167.60

Valuation using Terminal Growth Method

	Value in USD				
	2.3%	2.8%	3.3%	3.8%	4.3%
8.7%	226.23	239.72	255.69	274.88	298.40
9.2%	211.62	222.95	236.20	251.88	270.73
9.7%	198.98	208.62	219.75	232.76	248.15
10.2%	187.96	196.23	205.69	216.62	229.40
10.7%	178.25	185.41	193.53	202.82	213.56

Sensitivity Analysis shows that the stock is currently undervalued under both types of valuation techniques even if we stress the assumptions.

Historic Returns



Investment Risk

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.

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 mistakes like Apple Maps and iOS 8 show that difficulty can

be faced even by company of this stature. Currency fluctuation ie. strong US dollar can also hurt the topline of the company.

Conclusion

The intrinsic value is still above the company's current market value. Therefore, we recommend a 'BUY' for this stock.

Sources:

Bloomberg Terminal

Google Finance

Yahoo Finance

Valueline