HollAnd
Advisors

Holland Views: Apple Inc – Price: $166; MCap: $785bn

Sticky, Loyal and Rich

We have been refining our Franchise approach to business and stock selection for almost a decade now and have been drawn into some unexpected sectors. Our latest Franchise is one of the largest, most talked about and perhaps most envied companies in the world. This begs the question, aren't we late to the table and what can value we possibly add to the debate?

For some time now, **Apple** has excelled at two of our three franchise hurdles. It <u>generates</u> >>100% RoNTA and it <u>allocates</u> capital wisely (>100% payout). Yet it trades on 11.5x PE.

> *"I did mention one thing at the meeting which I don't think people appreciated at all – 'today's great businesses don't require capital'* "– Buffett on CNBC post the 2017 Berkshire AGM

Why so cheap? Apple's '<u>operate</u>' function – that is, the sustainability of its profits and moat – is for the first time, under much doubt – and for good reason. There are perhaps two ways to consider that issue: to focus on the quantifying near-term iPhone replacement cycles (and prices) **<u>or</u>** to qualitatively assess the long-term moat of the business. We choose the latter.

You will be glad to hear that you won't find us flogging 'proprietary channel checks' or the like in this piece. Rather, we encourage investors to start considering Apple under the lens of our Franchise approach perhaps this offers a new perspective on a maturing giant. We outline why Apple's ubiquitous software acts as a sticky force for customer inertia.

Apple**,** we conclude, is a great company (a Franchise?) – but, at 11.5x PE, is priced just like an OK one. Everyone agrees Apple has had a great past – but we suggest the company and its shares *can* still have a good future. Citing Apple's world-class design innovation, brand or retailing credentials should not be news to anyone. Nor the ginormous returns the company makes: $70bn of EBIT on just c.$12bn of Net Tangible Assets last year! We touch on these of course, but opt mainly to focus on a simple Franchise framework for how to think about this mighty but maturing business.

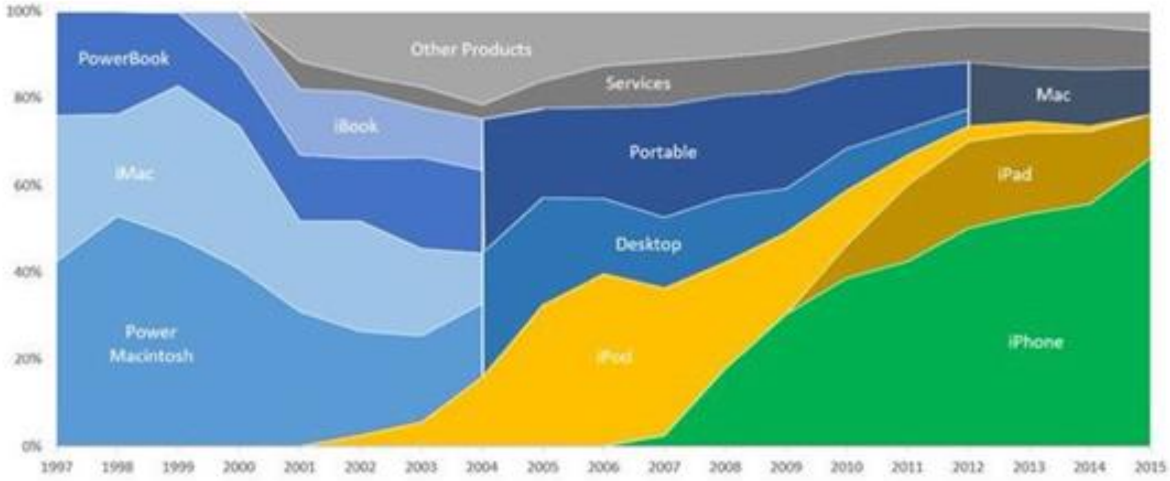
1. **An Installed Base of sticky customers to die for**: aka a cult-like 1.4 billion sticky, loyal and (relatively) rich customers. Customers that have paid top dollar for the product.
2. **Franchise-like behaviour:** Apple we observe is adapting and becoming more Franchise-like in its behaviour. We note its fair approach to customers (recent cheap battery replacement offer) and shareholders alike. ($238bn in buybacks since 2013).
3. **Value:** Our reverse-engineering of today's share price shows margin erosion is already well discounted. Erosion of brand equity is perhaps already priced-in also.

Apple's valuation discounts an eroding hardware business which is likely a prudent assumption. We don't doubt that iPhone upgrades are being delayed and recent higher selling prices look under pressure. That trend may not be your friend in the near term. Even so, especially given the trajectory of Services revenues, we do not think the business is necessarily over-earning. Yes, group profit *growth* will surely slow (as it would for any business this size) commensurate with a mature consumer goods business. But such a business (with such high returns) would still warrant a PE re-rating closer to 14-16x, rather than today's 11.5x (ex-Cash). A re-rating of this nature coupled with prodigious cash generation and buybacks offers attractive IRR for today's buyers of the shares. For those looking for analogies and precedents and tempted to consider Nokia, another comparable we think is Microsoft in 2012.

First a recap – The past isn't a guide to the future but…

One of your authors is a former technology analyst who had a ring-side seat as the rise and collapse of Nokia's handset business unfolded. So we are acutely aware of the often fleeting nature of success in the technology world. That said, we also have seen mature technology businesses like Microsoft written-off prematurely only to see such a business leverage its entrenched position (and formidable cash generation) into new markets.

Fig.1: Never a one-trick pony – Apple Revenues by Device type



Source: Asymco

Apple, by the numbers:

- 1.4 billion active users of its devices. The company has generated $1 trillion in hardware revenues in the last five years.
- Apple is the highest cash generating business in the S&P500 by a very wide margin. Last year, the company generated $77bn in cash from operations (Google and Microsoft generated c.$45bn each), a year when Apple's operating margin was -300bp off its peak.
- Last year the company made a stunning >500% (not a typo) RoNTA such is its capital lightness. This reflects the fact that Apple not only has excellent margins but turns over its assets c.20x times each. In short it doesn't need much capital, thus profits get returned to shareholders.
- That's not to say Apple isn't investing capital at high rates of return (esp. in Data Centres but also retail outlets etc.). Fixed Assets have doubled to $41bn since 2014 alone. The kicker to returns is that Apple has negative working capital as a result of its power over the supply chain and efficient logistics (which used to be managed by CEO Tim Cook).

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

Contact:

Holland Advisors London Limited
2nd Floor Berkeley Square House
London
W1J 6BD

Tel: (0)871 222 5521
Mob: (0)7775 826863
www.hollandadvisors.co.uk

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