September 9, 2020

Apple: What Are Investors Expecting?

Recently, Apple became the first company in history to top US$2 trillion in market capitalization. The S&P 500 has a combined market capitalization of $27 trillion, giving Apple a weight in excess of 7%.

Investors in the stock market are also aware of Apple's share price performance. Since January 2015, Apple's stock has risen from $109 to over $500 today – a return of over 30% per year. Over this period, Apple has added $1.4 trillion to its market capitalization and driven a disproportionate amount of the total stock market return given its large weight in the S&P 500 index.

Looking back to the Apple of 2015, we had a company that just lost its visionary founder and was struggling to diversify its business away from the iPad and Mac where sales were stagnant, if not declining. The company seemed to be reaching saturation in its key iPhone market and faced many strong competitors, including Samsung. Innovation was slowing, which risked elongated refresh cycles, causing the smartphone market to potentially contract. The company was starting to elaborate a strategy where it would shift into the sale of services, such as cloud backup, music streaming and video.

These new markets were risky. Services were an area where Apple was unproven, and the size of the iPhone business meant that very rapid growth was needed to offset any weakness in its traditional markets. In fact, despite the company's success in the service area over the past few years, the thesis of secular stagnation has largely played out. Since 2015, Apple's sales grew from $231 billion to an estimated $273 billion in 2020, representing only a 3.3% compound annual growth rate (CAGR), or less than that of global GDP. The performance of earnings before interest, tax, depreciation and amortization (EBITDA) has been even worse, staying relatively constant at $78 billion. During this time, Apple's iPhone unit sales have declined by almost 20%.

Notwithstanding this "ho-hum" operating performance, Apple's stock has risen almost 400% in the same period making us ask: "What's up with Apple?" Well, it has been the price-to-earnings (P/E) multiple that has expanded to over 30x. Investors have become increasingly excited about the company's service businesses, which today generate about $52 billion of the $274 billion in total revenue. This includes Apple Music, App Store sales, cloud storage of contact info and photos, licencing fees, Apple TV and Apple Care. Apple is an amazing company with great products, a culture of innovation and deep pockets with close to $100 billion in cash. However, given the size of the remaining legacy business, one must understand that the services must sustain extremely high growth rates to justify this type of multiple.

In contrast, Samsung enjoys a cellphone market share of approximately 23% compared to Apple's 15%, is vertically integrated in the manufacture of phones, from chips to the final product, and trades at 10x estimated 2021 net income.

Our portfolios hold Samsung. It is well financed with $94 billion in cash and almost no debt. It also holds significant knowhow in the manufacture of virtually all components for the making of cellphones, computers and other high-tech devices.

We also own three companies each of which derive over 40% of their revenue from Apple products: Skyworks (semiconductors for signal filter and amplification), ams AG (light sensors for facial recognition) and Cirrus Logic (electronics for converting voice to digital and vice versa). We sold prior investments in Apple's manufacturing partner, Pegatron, and its baseband modem supplier, Qualcomm at a profit. We have preferred this strategy of exposure to Apple because, broadly speaking, these companies can supplement their growth by increasing content per phone, and diversifying into new markets such as the Internet of Things.

Ams AG, for instance, has seen average growth rates of over 50% per year over the past three years, due to increasing penetration of their 3D sensors in both the iPhone and Android markets. Skyworks could expect solid double-digit increases in revenue over the next couple of years due to their products which enable 5G network connectivity. Cirrus could also see above market growth due to its expanding lineup into power management and haptics controllers (devices which control vibrations over the phone's surface to give the impression of physical sensations, such as the sensation of touching a real button).

Of note, should Apple trade at the same P/E as Samsung, it would be worth $1.4 trillion less than it is today. This premium is almost equivalent to the value of Amazon or the combined value of Walmart, Johnson & Johnson, Procter & Gamble and JP Morgan.

Investors clearly have great hopes for Apple's ability to innovate and grow, but might this optimism be excessive?