

Deutsche Bank Markets Research

North America

United States

TMT

IT Hardware and Supply Chain

Industry

Scribner's Slice of Apple

Date

21 January 2018

Periodical

A weekly take on Apple news

For the week ending January 19, 2018

Apple’s plans to invest $350B in the U.S. over the next 5 years was one of the main news stories this week. In addition, in an Interview with ABC News, Tim Cook apologized that the company was not more forthcoming about performance throttling of older iPhones suggesting a future software update will give users the option to disable the feature. In other Apple news, C1Q-18 iPhone production schedules could be cut by 15-30%, Ireland will begin collecting back taxes from Apple, additional governments are investigating Apple’s slowing of older iPhones, contractor manufacturers have shipped HomePods to Apple, iOS share of C4Q-17 device activations increased modestly, and in-app tipping will be restored in WeChat.

iPhone suppliers cutting C1Q-18 production due to low order visibility

iPhone component suppliers are reportedly anticipating 15-30% lower-than- expected order volumes in C1Q-18 due to seasonality and weaker C4Q-17 iPhone 8 and iPhone 8 Plus sales, according to Digitimes. Supply chain sources suggest the upcoming Lunar New Year holidays and poor iPhone 8, iPhone 8 Plus, and iPhone X order visibility, are leading suppliers to temporarily stop February production.

[(http://www.digitimes.com/news/a20180117PD206.html)](http://www.digitimes.com/news/a20180117PD206.html))

Repatriation of overseas cash expected to contribute to $350B U.S. investment Apple has disclosed plans to invest $350B in the U.S. economy over the next ﬁve years, including new and existing capex, spending with domestic suppliers

and manufacturers, and taxes on repatriation of overseas proﬁts. The company expects to pay $38B in repatriation tax payments to the U.S. based on its cash reserves held overseas. In addition, Apple announced plans to spend $30B in capital expenditures in the U.S. over a ﬁve-year period to build a new campus and hire over 20,000 employees to staﬀ the new and current campuses. Apple is also increasing its investment in its Advanced Manufacturing Fund to $5B from $1B, which will support U.S. manufacturing. (ht[tps://www](http://www.apple.com/newsroom/2018/01/apple-accelerates-us-investment-).apple[.com/newsroom/2018/01/apple-accelerates-us-investment-](http://www.apple.com/newsroom/2018/01/apple-accelerates-us-investment-) and-job-creation/)

Collection for Irish back taxes to go into escrow fund starting C2Q-18

In a presentation to members of the European Parliament, Irish Prime Minister Leo Varadkar noted that the country is not a tax haven, according to RTE, while the country's Finance Minister indicated it will begin collecting back taxes from Apple by the end of March 2018. The 13B Euros that Apple reportedly owes will

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Companies featured

Apple Inc. (AAPL.OQ),USD179.10 Hold

2017A 2018E 2019E

|  |  |  |  |
| --- | --- | --- | --- |
| EPS (USD) | 9.21 | 10.45 | 9.70 |
| P/E (x) | 14.9 | 17.1 | 18.5 |
| EV/EBITDA (x) | 7.9 | 9.4 | 10.2 |
| *Source: Deutsche Bank* |  |  |  |

*Our price target is based on shares trading at 16x our FY-19E EPS. Upside risks include stronger-than-expected smartphone sales and share gains, signiﬁcantly higher margins, and a faster ramp of new product categories including Watch and Apple Pay. Downside risks include slower smartphone sales, market share losses in smartphones, and weaker growth in Services sales.*

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Distributed on: 21/01/2018 17:03:08 GMT

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be placed in an escrow account and are not expected to be fully collected until September. As we have written in previous Slices, Apple and Ireland are currently appealing the European Commission's August 2016 ruling that Ireland illegally provided Apple with 13B Euros in tax beneﬁts. (ht[tps://www.rte.ie/news/2018/0117/933878-taoiseach\_europarl/)](http://www.rte.ie/news/2018/0117/933878-taoiseach_europarl/)) (ht[tps://www.rte.ie/news/2018/0118/934185-apple-tax/)](http://www.rte.ie/news/2018/0118/934185-apple-tax/))

Upcoming iOS release to allow users to disable performance-slowing feature

In an interview with ABC news, Apple CEO Tim Cook indicated that a February iOS beta release will allow iPhone users to disable the performance-limiting battery management feature disclosed by Apple in December. The feature was included in software updates for older iPhone models, and was found to slow performance by up to 50%. According to 9to5 Mac, a February beta release suggests a public iOS version could be released in March.

(https://9to5mac.com/2018/01/17/turn-oﬀ-iphone-battery-performance- throttling/#more-516081)

[(http://abcnews.go.com/Business/apple-make-350b-contribution-us-econom](http://abcnews.go.com/Business/apple-make-350b-contribution-us-economy-)y[-](http://abcnews.go.com/Business/apple-make-350b-contribution-us-economy-) years/story?id=52405662)

Additional government regulators investigate iPhone slowdown

The Shanghai Consumer Council has sent a letter of inquiry to Apple, demanding information regarding the deliberate slowing of older iPhones, according to Xinhuanet. Separately, Reuters reported that South Korea's Citizens United for Consumer Sovereignty has ﬁled a criminal complaint against Apple, in addition to the group's civil suit ﬁled last week. Also, the Italian government is reportedly investigating Apple and Samsung for "planned obsolescence," according to the Verge. As we noted in Slices last week, Apple's disclosure that it limited the performance of older iPhones to prevent shutdowns has led to a wave of class action lawsuits in the U.S. and around the world. [(http://www.xinhuanet.com/english/2018-01/16/c\_136897717.htm)](http://www.xinhuanet.com/english/2018-01/16/c_136897717.htm)) (https://ca.reuters.com/article/businessNews/idCAKBN1F80AG-OCABS) (ht[tps://www](http://www.theverge.com/2018/1/18/16906658/apple-samsung-investigation-).thev[erge.com/2018/1/18/16906658/apple-samsung-in](http://www.theverge.com/2018/1/18/16906658/apple-samsung-investigation-)v[estigation-](http://www.theverge.com/2018/1/18/16906658/apple-samsung-investigation-) italian-antitrust-planned-obsolescence-software-slowdown)

HomePod supplier reportedly ships 1M devices

Taiwanese manufacturer Inventec has reportedly shipped 1M HomePod speakers to Apple, according to the Taipei Times. Inventec and Hon Hai are expected to evenly split production of an expected 10-12M HomePod units this year. Industry sources suggest the release of HomePod was delayed due to software and hardware integration issues but that the device is expected to be available commercially soon. [(http://www.taipeitimes.com/News/biz/archives/2018/01/16/2003685829)](http://www.taipeitimes.com/News/biz/archives/2018/01/16/2003685829))

Modest increase in iOS share of device activations in C4Q-17 vs. C4Q-16 According to research by Consumer Intelligence Research Partners (CIRP), iOS devices accounted for 39% of total device activations in the U.S. in C4Q-17

compared to 34% share in C4Q-16. The report credits the launch of the iPhone 8, 8 Plus, and X, and the lack of new Android devices, with the gain. Android devices accounted for 60% of activations in the quarter led by Samsung with 32% share and LG with 13% share. [(http://ﬁles.constantcontact.com/150f9af2201/15e86e35-7f2a-4626-a51e-](http://ﬁles.constantcontact.com/150f9af2201/15e86e35-7f2a-4626-a51e-) f40e787ecﬀc.pdf)

In-app tipping to resume in WeChat

Apple and Tencent have reportedly resolved their disagreement over in-app tipping in Tencent’s WeChat messaging app, according to the Wall Street Journal. Last year, Apple sought to receive a 30% commission from tipping in Chinese social networking apps, as it viewed tips as a form of in-app purchases. In response, Tencent disabled tipping in WeChat as the company does not generate revenue from tipping and oﬀers the service to increase engagement. While the terms of Apple and Tencent's agreement have not been disclosed, WeChat has indicated it will be re-enabling in-app tipping soon. (ht[tps://www.wsj.com/articles/apple-and-tencent-reach-deal-to-let](http://www.wsj.com/articles/apple-and-tencent-reach-deal-to-let-wechat-)-w[echat](http://www.wsj.com/articles/apple-and-tencent-reach-deal-to-let-wechat-)- users-dole-out-tips-1516018849) (ht[tps://www.macrumors.com/2018/01/15/w](http://www.macrumors.com/2018/01/15/wechat-tips-apple-tencent-deal/))echat[-tips-apple-tencent-deal/)](http://www.macrumors.com/2018/01/15/wechat-tips-apple-tencent-deal/))

Apple Investment Thesis

Outlook

Apple has a dominant position in smartphones and tablets where its products represent the gold standard in both categories. These segments continue to oﬀer good growth opportunities, particularly smartphones, allowing Apple to outgrow overall IT spending. Despite healthy growth, slowing smartphone and tablet sales, as well as Apple’s already signiﬁcant revenue levels suggest growth will be more diﬃcult going forward. With puts and takes currently balanced, in our view, we consider shares as fairly valued and rate Apple a Hold.

## Valuation

Apple has traded at an average forward P/E of 13x since 2010 with a range of 9x to 16x. We believe shares should trade in line with these historical multiples and, because of its large market cap (3-4% of the S&P 500), should trade at a modest discount to the market. Our price target is based on shares trading at 16x our FY-19E EPS.

## Risks

Company-speciﬁc positive risks to Apple include stronger-than-expected smartphone sales and share gains, signiﬁcantly higher margins, and a faster ramp of new product categories including Watch and Apple Pay. Negative risks include slower smartphone sales, market share losses in smartphones, and weaker growth in Services sales.