

Deutsche Bank Markets Research

North America

United States

TMT

IT Hardware and Supply Chain

Industry

Scribner's Slice of Apple

Date

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Periodical

A weekly take on Apple news

For the week ending February 2, 2018

Apple's quarterly results were a key area of focus in Apple-related news this week as investors looked for some clarity on iPhone X demand. While the company's December quarter results beat expectations, March quarter guidance disappointed, underscoring the mix of puts and takes in results. Ahead of earnings, reports of a 50% cut to C1Q-18 iPhone X production surfaced amongst supplier reports of reduced iPhone component orders. Also, T-Mobile and Verizon are oﬀering two-for-one iPhone deals, IDC data showed Apple in ﬁrst place in a declining C4Q-17 smartphone market, and the U.S. government is investigating Apple's deliberate slow-down of older iPhones. In other news, streaming music services including Apple Music will now pay 15.1% of sales in royalties, three upcoming refreshed Macs and an iPad will feature proprietary Apple chips, and Wistron is looking to expand iPhone production in India.

Mixed F1Q-18 results: weak iPhone units balanced by ASP upside, cash return

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Companies featured

Apple Inc. (AAPL.OQ),USD167.78 Hold

2017A 2018E 2019E

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| potential | EPS (USD) | 9.21 | 10.88 | 10.80 |
| Apple's F1Q-18 results were modestly ahead of expectations driven by upside in | P/E (x) | 14.9 | 15.4 | 15.5 |
| iPhone ASPs and Wearables. However, F2Q-18 guidance missed expectations, | EV/EBITDA (x) | 7.9 | 9.1 | 9.6 |
| lending credence to recent reports of cuts to iPhone X production. From our | *Source: Deutsche Bank* |  |  |  |

perspective, the quarter was a mixed bag, with the lower sales outlook and declines in iPhone units oﬀset by higher iPhone ASPs and the potential for signiﬁcant capital returns over time. The quarter had enough of both positives and negatives to keep the bulls and bears ﬁrmly in their own camps for now. (https://research.db.com/Research/Document?rid=9be3a1ba-076a-11e8-987a- e3758a6e3d3d-604&kid=RP0001&documentType=R)

C1Q-18 iPhone orders cut due to weaker demand

Apple has reportedly reduced C1Q-18 iPhone X component orders by between 50 and 60%, due to weaker-than-expected holiday sales in the U.S., Europe, and China, according to The Nikkei and the Wall Street Journal. Both reports suggest iPhone X production has been cut from 40M to 20M units, while production for iPhone 8, 8 Plus, and 7 is expected to remain at 30M units. Separately, Bloomberg reported that iPhone suppliers Broadcom and Qualcomm both commented on pressure from lower-than-expected wireless component orders during their December quarter earnings calls. The article attributed the lower orders to iPhone.

(https://asia.nikkei.com/Business/Companies/Apple-to-halve-iPhone-X- production-volume-in-1Q)

*Our price target is based on shares trading at 14x 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.*

(ht[tps://www.wsj.com/articles/apple-to-curtail-iphone-x-pr](http://www.wsj.com/articles/apple-to-curtail-iphone-x-production-in-the-face-)oduct[ion-in-the-face-](http://www.wsj.com/articles/apple-to-curtail-iphone-x-production-in-the-face-) of-weak-demand-1517312098) (ht[tps://www.bloomberg.com/ne](http://www.bloomberg.com/news/articles/2018-02-01/top-iphone-suppliers-)ws/art[icles/2018-02-01/top-iphone-suppliers-](http://www.bloomberg.com/news/articles/2018-02-01/top-iphone-suppliers-) warn-of-slower-sales-ahead-of-apple-results)

Two U.S. carriers oﬀering buy one get one free iPhone deals

T-Mobile and Verizon are both oﬀering buy one, get one free deals on new iPhones. With the purchase of an iPhone X, 8, or 8 Plus, T-Mobile is oﬀering $700 oﬀ of a second device, in the form of a pre-paid MasterCard. Verizon is oﬀering

$699 in bill credits over a 24-month period for the purchase of an iPhone X, 8, or 8 Plus.

Apple gains share in declining C4Q-17 smartphone market

Global smartphone unit sales fell by 6% Y/Y in C4Q-17 to 403M units, according to preliminary IDC data. Apple moved into ﬁrst place in the market with 19% share, up 100bps Y/Y, displacing Samsung. Samsung was the second largest vendor with 18% share, up 40bps Y/Y. Huawei remained in third place with 10% share, but lost 30bps Y/Y. Xiaomi and OPPO were essentially tied for fourth place with 28.1M and 27.4M units, respectively, and approximately 7% market share each. However, Xiaomi gained 370bps of share Y/Y and was the only top ﬁve vendor to see unit growth shipments in the quarter, while OPPO lost 50bps of share Y/Y. (ht[tps://www.idc.com/getdoc.jsp?containerId=prUS43548018)](http://www.idc.com/getdoc.jsp?containerId=prUS43548018))

U.S. government investigating disclosures around iPhone slow-down

Apple's disclosures regarding software updates that deliberately slowed the performance of older iPhones are being investigated by the U.S. Department of Justice and the Securities and Exchange Commission for potential securities law violations, according to Bloomberg. As we have written in previous Slices, Apple is being investigated by regulators in Shanghai, South Korea, Italy, and France. The company is also facing numerous class action lawsuits in the U.S. and around the world.

(ht[tps://www.bloomberg.com/ne](http://www.bloomberg.com/news/articles/2018-01-30/u-s-said-to-probe-apple-)ws/art[icles/2018-01-30/u-s-said-to-probe-apple-](http://www.bloomberg.com/news/articles/2018-01-30/u-s-said-to-probe-apple-) over-updates-that-slow-older-iphones-jd1yahj7)

Streaming music services to pay higher royalties

Apple Music, along with streaming music peers including Spotify and Amazon, will be required to pay songwriters and music publishers 15.1% of sales, vs. a 10.5% share, following a ruling by the Copyright Royalty Board of the US Library of Congress, as reported by the New York Post. The royalty increase is the result of a lawsuit brought by the National Music Publishers Association and the Nashville Songwriters Association International against Google, Amazon, Apple, Spotify and Pandora.

(https://nypost.com/2018/01/28/copyright-board-boosts-songwriters-streaming- fees/)

Upcoming Macs and iPad to feature proprietary chips

Apple plans to expand its use of proprietary co-processors in Macs and add its AI chip and graphics processing unit (GPU) to a new iPad later this year, according to Bloomberg. Currently, only the MacBook Pro with Touch Bar and the iMac Pro feature Apple's co-processors, or chips that shift certain functions like power management or computer security, from devices' main Intel processor. These new refreshed Macs are expected to include two laptops and a new desktop unit. To

date, Apple has included its proprietary AI chips in Apple Watch and GPUs in iPhone 8 and iPhone X.

(ht[tps://www.bloomberg.com/graphics/2018-apple-custom-chips/)](http://www.bloomberg.com/graphics/2018-apple-custom-chips/))

Wistron looking to expand iPhone assembly in India

Wistron is reportedly working on plans to purchase land in India’s Bengaluru tech hub, as part of an initiative to expand its iPhone assembly capacity, according to Reuters. The report suggests the company plans to spend around $157M to develop a new iPhone assembly site.

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 14x 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.