

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 April 20, 2018

The key Apple news this week was weak C2Q-18 guidance from iPhone chip supplier TSMC, which implied further cuts in iPhone X production. The news weighed on Apple shares this week and kicked oﬀ a wave of concerns around upcoming results from other key iPhone suppliers. In other news, iPhone OLED display production could begin in May, the average U.S. iPhone user increased

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| their in-app spend by $9 Y/Y in 2017 to $58, Apple Music is growing but remains  a drag on proﬁtability, and Apple is reportedly losing ground in the smart home market. Also, Apple accounted for 31% of C1Q-18 phone activations trailing | [Jeﬀrey Rand, CFA](mailto:jeffrey.rand@db.com) Research Associate |  |
| Samsung's 39% share, iPhone X accounted for 25% of global mobile phone proﬁts | +1-212-250-0639 |
| in C4Q-17, and Apple is reportedly developing a subscription-based Apple News |  |
| service. | Companies featured |  |
| Weak C1Q-18 supply chain results and C2Q outlook point to iPhone X order cuts | Apple Inc. (AAPL.OQ),USD172.80 Hold  2017A 2018E 2019E | |
| Key iPhone supplier TSMC provided disappointing C2Q-18 sales guidance due to | EPS (USD) | 9.21 10.88 10.80 |
| weakness in premium smartphones, which was widely attributed to the iPhone | P/E (x) | 14.9 15.9 16.0 |
| X. We note that DB's Asian supply chain analyst Birdy Lu generally expects | EV/EBITDA (x) | 7.9 9.5 10.0 |
| other iPhone suppliers to report below-expectation C1Q-18 results due to iPhone | *Source: Deutsche Bank* |  |

X order cuts and Chinese smartphone destocking (l[ink](https://research.db.com/Research/Document?rid=0900b8c08e89f900&amp;kid=RP0001&amp;documentType=R)). However, while DB's European IT Hardware analyst Rob Sanders anticipates a 2-month sales gap for suppliers between the end of production of 2018 iPhones and the start of 2019 iPhone production ([link](https://research.db.com/Research/Document?rid=0900b8c08e8a0e91&amp;kid=RP0001&amp;documentType=R)), both Lu and Sanders expect a more positive demand environment in C2H-18 following the release of the new 2019 iPhone line. [(http://www](http://www.tsmc.com/english/investorRelations/quarterly_results.htm)).[tsmc.com/english/investorRelations/quarterly\_results.htm)](http://www.tsmc.com/english/investorRelations/quarterly_results.htm))

iPhone OLED screen production could start in May

Samsung is expected to begin ramping production of OLED displays for 2018 iPhones in May and double capacity in June, according to the Economic Daily News as reported by Apple Insider. Forbes suggests that the timing of the start of display panel production indicates Apple is planning to build inventory ahead of the new iPhone release in order to prevent a recurrence of last year's shipment delays.

(https://appleinsider.com/articles/18/04/16/oled-screen-production-for-2018- iphone-releases-expected-to-start-in-may) (ht[tps://www](http://www.forbes.com/sites/ewanspence/2018/04/16/apple-iphone-x2-iphone-).f[orbes.com/sites/e](http://www.forbes.com/sites/ewanspence/2018/04/16/apple-iphone-x2-iphone-)w[anspence/2018/04/16/apple-iphone-x2-iphone-](http://www.forbes.com/sites/ewanspence/2018/04/16/apple-iphone-x2-iphone-) se2-display-notch-screen-price/#708a2927b00e

Average U.S. iPhone user app spend up 23% Y/Y to $58 in 2017

*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.*

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The average U.S. iPhone user spent $58 on in-app purchases and premium apps in 2017, an increase of $9 Y/Y, according to Sensor Tower. The analysis estimates gaming was the largest spend category at roughly $36 of the average per user spend, although the data excludes key categories like shopping and ride-share app spend.

(https://sensortower.com/blog/revenue-per-iphone-2017)

Apple Music is growing but likely a drag on proﬁts

Paid subscribers to Apple Music grew by 11% over the past two months to reach 40M earlier this month, but the business is unlikely to be contributing to the company's proﬁtability, according to the Wall Street Journal. The report suggests that high royalty payments to artists and music labels result in low margins for streaming music services. While Apple does not disclose the margins of either Apple Music or the broader Services segment, streaming music leader Spotify disclosed FY-17 gross margin of 21% and recently guided FY-18 gross margins to 23%-25%. In the case that Apple Music's gross margins were on par with Spotify's, they would still be dilutive to Apple's 38.5% overall gross margin. Spotify remains the streaming music leader with 71M paid users according to company reports although both the WSJ and Variety indicate that the number is now 73M. While Apple has the second largest paid subscriber base with 40M, we note that competition in the market remains intense. This week, Amazon revealed that its paid Amazon Music subscriber number is in the "tens of millions" with membership more than doubling over the past six months. (ht[tps://www.wsj.com/articles/apple-f](http://www.wsj.com/articles/apple-faces-the-music-1524043801))aces-t[he-music-1524043801)](http://www.wsj.com/articles/apple-faces-the-music-1524043801)) (ht[tps://www.musicbusinessworldwide.com/windowing-on-spot](http://www.musicbusinessworldwide.com/windowing-on-spotify-is-%EF%AC%81nally-)ify[-is-ﬁnal](http://www.musicbusinessworldwide.com/windowing-on-spotify-is-%EF%AC%81nally-)ly- happening-but-is-it-worth-it-for-the-labels/)

(https://blog.aboutamazon.com/2017-letter-to-shareholders/) [(http://variety.com/2018/music/news/as-spotify-goes-public-ho](http://variety.com/2018/music/news/as-spotify-goes-public-how-do-its-)w[-do-its-](http://variety.com/2018/music/news/as-spotify-goes-public-how-do-its-) competitors-measure-apple-music-amazon-1202741460/)

Apple losing ground in smart home market

Apple is reportedly losing market share to Amazon in the smart home market, according to The Information. An increasing number of developers and homebuilders, including Lennar and Shea Homes, are partnering with Amazon to build homes with preinstalled Alexa-enabled accessories, rather than Apples’ HomeKit-based products. The article suggests that Alexa's more advanced and broader skill set, compared to Siri's, is contributing to a preference for Amazon in new home construction.

(ht[tps://www](http://www.theinformation.com/articles/apple-loses-ground-to-amazon-in-).t[heinformation.com/articles/apple-loses-ground-to-amazon-in-](http://www.theinformation.com/articles/apple-loses-ground-to-amazon-in-) smart-home-deals-with-builders) (ht[tps://www](http://www.digitaltrends.com/home/amazon-apple-smart-home-builders-).d[igitaltrends.com/home/amazon-apple-smart-home-builder](http://www.digitaltrends.com/home/amazon-apple-smart-home-builders-)s- report/)

Samsung tops Apple in C1Q-18 U.S phone activations

Survey data from Consumer Intelligence Research Partners (CIRP) suggest that Samsung had the highest share of mobile phone activations in the U.S. in C1Q-18 with 39% share. Apple was in second place with a 31% share, followed by LG at 14%, and all other brands accounting for the remaining 17% of activations. CIRP notes that Apple led in U.S. activations in C4Q-17, due to the rollout of the iPhone 8, 8 Plus, and iPhone X, while Samsung's recent launch of the Galaxy S9 and S9+ contributed to its greater share in C1Q-18. The data suggests that Apple smartphone user loyalty has reached a new high over the past ﬁve quarters, with the percentage of phone activators that remained with Apple more 90% in the quarter. Samsung's equivalent brand loyalty measure was just above 70%.

[(http://ﬁles.constantcontact.com/150f9af2201/c998c117-866a-43a0-](http://ﬁles.constantcontact.com/150f9af2201/c998c117-866a-43a0-) a1d3-85f1d7f99caa.pdf)

iPhone X accounts for 35% of total handset industry proﬁts in C4Q-17

iPhone X accounted for 21% of total sales and 35% of total proﬁt in the mobile phone market, according to Counterpoint Research. The report noted that overall global handset proﬁts fell by 1% Y/Y in C4Q-17, and that all iPhones combined accounted for 86% of the market's total proﬁts in the quarter. (ht[tps://www.cnbctv18.com/telecom/iphone-x-pocketed-35-of-total-handset](http://www.cnbctv18.com/telecom/iphone-x-pocketed-35-of-total-handset-)- industry-proﬁts-in-q4-2017-37151.htm)

Premium subscription-based Apple News service in the works

Apple is reportedly developing an upgraded version of its Apple News app and will be launching the subscription-based service within a year, according to Bloomberg. Technology and employees acquired with Texture, a magazine subscription app that Apple acquired last month, are being integrated into the Apple News team and will be involved in the development of a premium service oﬀering.

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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.