

Deutsche Bank Markets Research

North America

United States

TMT

IT Hardware and Supply Chain

Industry

Scribner's Slice of Apple

Date

22 September 2017

Periodical

A weekly take on Apple news

For the week ending September 22, 2017

In a relatively quiet week for Apple related news, the company acknowledged connectivity issues with the new Apple Watch Series 3 LTE without oﬀering a speciﬁc timeline on the release of a software ﬁx. Sprint is oﬀering a free iPhone 8 for trade-ins, potentially kicking oﬀ a price war with U.S. carriers, and Bain is now looking for Apple to contribute $7B to its bid for Toshiba's chip unit. Also this week, early iOS adoption lagged the prior two iOS releases, growth in Apple Music subscribers contributed to a 17% increase in U.S. music sales in C1H-17, and eﬀorts to improve the monetization of the Apple News app have yet to produce meaningful results.

Connectivity issues with new Apple Watch Series 3

Apple disclosed that its new Watch Series 3 with LTE is experiencing connectivity issues that can prevent users from making or receiving calls and text messages, according to The Verge. The Watch's cellular connectivity reportedly gets blocked when it attempts to connect to an unauthenticated Wi-Fi network. Apple is investigating the issue with plans to oﬀer "a ﬁx for a future software release." (ht[tps://www](http://www.theverge.com/2017/9/20/16337874/apple-watch-lte-connectivity-).thev[erge.com/2017/9/20/16337874/apple-watch-lte-connectivity](http://www.theverge.com/2017/9/20/16337874/apple-watch-lte-connectivity-)- problems-software-update)

Sprint oﬀering the biggest deal so far on new iPhones

Sprint is now oﬀering customers a free iPhone 8 with a trade in, according to Bloomberg. Bucking last week's trend for more modest iPhone discounts, Sprint will now give customers a new iPhone 8 with the trade in of an iPhone 7, Samsung Galaxy S8, or Samsung Note 8. The trade in of older devices will be eligible for a 50% discount on the iPhone 8. As we highlighted in last week's Slices, Sprint was previously oﬀering 50% oﬀ lease payments for the new iPhone 8. It is unclear if Sprint will extend the deal to include the iPhone X when available or if the promotion will spur a price war with other U.S. carriers, similar to last year. (ht[tps://www.bloomberg.com/ne](http://www.bloomberg.com/news/articles/2017-09-18/sprint-ups-ante-as-%EF%AC%81rst-)ws/art[icles/2017-09-18/sprint-ups-ante-as-ﬁrst-](http://www.bloomberg.com/news/articles/2017-09-18/sprint-ups-ante-as-%EF%AC%81rst-) to-oﬀer-a-free-iphone-with-trade-in)

Bain seeks higher ﬁnancial commitment from Apple for Toshiba's chip business Bain Capital has asked Apple to step up its ﬁnancial support for its bid to acquire Toshiba's memory chip business, according to Bloomberg. Bain is reported asking

Apple to contribute $7B to the deal versus the initial $3B contribution. The $7B proposal is expected to include roughly $1B in equity and $6B in debt. Separately, Toshiba announced this week that its Board has chosen the Bain-led consortium

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Companies featured

Apple Inc. (AAPL.OQ),USD156.07 Hold

2016A 2017E 2018E

EPS (USD) 8.31 9.06 9.87

P/E (x) 12.6 17.2 15.8

EV/EBITDA (x) 6.0 9.3 8.6

*Source: Deutsche Bank*

*Our price target is based on shares trading at 14x our FY-19E EPS. 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. Negative risks include slower smartphone sales, market share losses in smartphones, and weaker growth in Services sales*

as the buyer of its chip unit, although the deal has not been ﬁnalized with all parties.

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Slower early iOS 11 adoption versus prior releases

An estimated 10% of iOS devices installed iOS 11 within the 24 hours of its release, according to Mixpanel. The rate trailed the 24 hour adoption rate for iOS 10 and iOS 9 of 12.6% and 14.5%, respectively. Problems with prior new releases may be holding users back as well as the lack of support for 32-bit apps. (ht[tps://www.macrumors.com/2017/09/20/ios-11-10-percent](http://www.macrumors.com/2017/09/20/ios-11-10-percent-adoption-24-)-adopt[ion-24-](http://www.macrumors.com/2017/09/20/ios-11-10-percent-adoption-24-) hours/)

(https://mixpanel.com/trends/#report/ios\_11)

Apple Music contributing to growth in U.S. music sales in C1H-17

U.S. paid subscriptions to streaming music services, including Spotify and Apple Music, reached 30.4M in C1H-17 and grew by 10M or 50% Y/Y, according to the Recording Industry Association of America. Sales from paid subscriptions increased by 61% Y/Y to $1.7B and accounted for 43% of total U.S. retail recorded music sales in the period. We view continued growth in paid subscriptions to streaming music as a positive for Apple Music, although the service’s 27M global subscriber base is still well below market leader Spotify’s 60M paid subs. [(http://www.riaa.com/wp-content/uploads/2017/09/RIAA-Mid-Year-2017-News-](http://www.riaa.com/wp-content/uploads/2017/09/RIAA-Mid-Year-2017-News-) and-Notes2.pdf)

Few signs of progress in Apple News app turnaround

Changes in Apple New's advertising strategy made nine months ago have reportedly had limited eﬀects on publisher sales, according to Digiday. Since January, Apple News ad inventory has been handled by NBCUniversal (NBCU). While a handful of large publishers have suggested the change has not yet improved monetization, they are happy with traﬃc and engagement levels from Apple News. Lower app revenues may also stem from Apple’s delay in integrating third-party ad measurement, the app's older demographic who are less sought after by advertisers, and Apple’s restrictions on advertisers' use of customer data to run targeted ad campaigns.

(https://digiday.com/media/9-months-apple-news-ad-sales-deal-nbcu- publishers-wonder-ads/)

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 15x. 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.