

Deutsche Bank Markets Research

Rating

Hold

North America

United States

Company

Apple Inc.

Date

27 September 2017

Company Update

TMT

IT Hardware and Supply Chain

Reuters

AAPL.OQ

Bloomberg

AAPL US

Exchange

NSM

Ticker

AAPL

Price at 27 Sep 2017 (USD)

Price target

52-week range

154.23

140.00

164.05 - 105.71

Expectations are pricing in more than Apple can chew

Optimistic expectations will make it hard for stock upside to continue

We remain wary that investor expectations for the iPhone 8/X cycle are more optimistic than realistic. In our July 10 note, "[FY-18 'supercycle' is more likely just](https://ger.gm.cib.intranet.db.com/ger/document/pdf/0900b8c08d21e01d.pdf) [a cycle](https://ger.gm.cib.intranet.db.com/ger/document/pdf/0900b8c08d21e01d.pdf)," we detailed how our fundamental analysis on the smartphone market leads us to expect iPhone units to be well below market expectations in FY-18 and FY-19. With shares up 37% year-to-date into the debut of the new models, and Consensus estimates having consistently moved higher through 2017, we believe upside has already been priced in. Given the substantial additional upside needed to drive further share gains from here, and our view that FY-19 estimates need to come down to realistically reﬂect a year after a strong cycle, we see modest downside risk to shares near-term. Long-term, we believe shares are fairly valued in the $140 range.

Strong cycle is already priced in

Historically, AAPL's shares trade up into a new iPhone launch and see limited upside post a launch. Into the iPhone 8/X launch, AAPL's shares were up 37% year-to-date, beating the stock's performance into the iPhone 6 launch by 9ppts. Through the year, Street estimates have also moved higher, with FY-18E sales revised up $19B versus expectations in late January. This is roughly 2x the estimate revision in front of the iPhone 6 cycle, when Street estimates moved up

[Valuation & Risks](https://ger.gm.cib.intranet.db.com/ger/disclosure/Disclosure.eqsr?ricCode=AAPL.OQ)

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Key changes

EPS (USD) 9.06 to 9.05 ↓ -0.0%

*Source: Deutsche Bank*

Price/price relative

200

150

100

50

roughly $10B in the 6 months prior to the iPhone launch. Given the stock's strong performance and substantially higher Street expectations, we believe shares are already reﬂecting a very strong cycle.

|  |  |  |
| --- | --- | --- |
| Performance (%) | 1m | 3m 12m |
| Absolute | -4.2 | 5.0 35.7 |
| S&P 500 INDEX | 2.2 | 2.4 16.3 |
| *Source: Deutsche Bank* |  |  |

Repeat of iPhone 6 upside is unlikely, but iPhone 6s's downside is very likely The iPhone 6 cycle far exceeded Street expectations, with FY-15 sales coming in

$31B higher than where expectations had been at the time of the iPhone 6 launch. We believe these upward revisions drove the atypical post-launch outperformance of AAPL's shares, which were up 16% in the 3 months after the iPhone 6 launch. To beat expectations by a similar magnitude ($30B) this cycle would require that AAPL ship 45M more iPhone units in FY-18 than current expectations, or nearly 290M iPhones in total. We view this as highly unlikely. Street expectations are modeling roughly 245M iPhones ship in FY-18, which would be a record year for the company. Moreover, after a strong iPhone 8/X cycle in FY-18, Street estimates expect a repeat in FY-19. We believe it is more likely that unit forecasts decline, similar to the iPhone 6s cycle, and Street estimates for FY-19 need to come down to reﬂect a more realistic down year following the iPhone 8/X cycle.

Tweaking ests on higher iPhone ASPs, but units still well below Street

Jan '16 Jul '16 Jan '17 Jul '17

**Apple Inc. S&P 500 INDEX (Rebased)**

Our $140 PT is based on shares trading at 14x our FY-19E EPS, in line with AAPL's historical ranges of 9x to 15x since 2010. Positive risks: stronger-than- expected iPhone sales, smartphone share gains, and signiﬁcantly higher margins. Negatives: slower iPhone sales, smartphone share loss, and weaker Services growth.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Forecasts and ratios |  | | | |
| Year End Sep 30 | 2016A | 2017E | 2018E | 2019E |
| 1Q EPS | 3.28 | 3.36A | 3.76 | 3.55 |
| 2Q EPS | 1.90 | 2.10A | 2.60 | 2.48 |
| 3Q EPS | 1.42 | 1.67A | 1.85 | 1.76 |
| 4Q EPS | 1.67 | 1.91 | 1.98 | 1.94 |
| FY EPS (USD) | 8.31 | 9.05 | 10.20 | 9.75 |
| OLD FY EPS (USD) | 8.31 | 9.06 | 9.87 | 10.00 |
| Dividend yield (%) | 2.1 | 1.6 | 1.7 | 1.9 |
| Revenue (USDm) | 215,639.0 | 228,400.0 | 250,044.0 | 239,776.0 |
| *Source: Deutsche Bank estimates, company data* |  |  |  |  |

# A strong cycle is already priced into shares

Apple's shares were up 37% year-to-date into the launch of the iPhone 8 and iPhone X, and are currently up more than 30% year-to-date. As seen in Figure 1, most of this performance came early in the year, as shares are up just 11% since the end of March. Apple's stock performance into the iPhone 8/X launch is now 9ppts ahead of the stock's performance into the iPhone 6 launch, when shares were up 28% year-to-date at the time of the iPhone 6 debut. Clearly, investors are expecting an impressive refresh cycle. In less successful cycles, like the iPhone 6s and iPhone 7, stock performance into a launch was more modest at ﬂat and

+2%, respectively.

**24/10**

**hone 4S**

Expectations for the success of the iPhone 8/X cycle have also steadily moved higher through the year. As seen in Figure 2, FY-18 sales expectations have moved up from $244B in January to $263B today, an increase of roughly $19B. These increases have largely been driven by higher estimates for iPhone ASPs. The $19B increase in FY-18 sales expectations compares to the roughly $10B sales increase in FY-15 sales expectations seen into the iPhone 6 launch. To put it another way, into the launch of the iPhone 8/X, Consensus sales estimates increased two times more than they did into the iPhone 6 cycle. We believe this suggests much of the potential sales upside of this cycle is already being factored in to Apple's shares.

# A repeat of the iPhone 6 cycle is unlikely

In general, Apple's shares trade on sentiment for the expected success of the next iPhone cycle. Historically, most of the performance comes before the launch, with shares generally seeing more limited upside post the launch of a new iPhone. When including every Apple iPhone launch since the 2G, three months after a phone launch, shares were up on average just 3%. When analyzing more recent phones and including models since the 4S, shares have been roughly ﬂat on average 3 months post a launch. In general, Apple's shares see upside before an iPhone launches and see limited upside after.

One exception was the launch of the iPhone 6. As seen in Figure 2, shares were up 16% three months post the launch of the iPhone 6 and the stock continued to rise until its peak in May 2015. We believe this strong performance was driven by the better-than-expected success of the iPhone 6 cycle. As seen in Figure 2, roughly a month after the launch of the iPhone 6, expectations were that Apple would have $203B in sales in FY-15. This number proved too conservative, and Apple continued to deliver upside to iPhone expectations through the December and March quarters. When FY-15 ﬁnished, Apple had delivered $234B in sales, or $31B more in sales than had been expected the prior year. We believe the consistent upside to expectations drove the stock performance.

What is the likelihood that the iPhone 8/X cycle will deliver the same type of upside to expectations as the iPhone 6 did? We think the likelihood is low given a number of factors. First, a positive cycle has already been reﬂected in the share price. Street numbers have already moved up $19B this year, and into the launch, shares have outperformed the iPhone 6 cycle by 9ppts. Second, the likelihood that Apple can deliver $31B in sales upside versus expectations is very low, in our view. FY-18 sales estimates for Apple are already high, at $263B. In order to top that by $31B, which is what the company did during the iPhone 6 cycle, Apple would need to sell an additional 43M iPhones at an ASP of $730, or sell close to 290M iPhones in total in FY-18.

As we've noted, in our installed base analysis published in July, a refresh of Apple's installed base would lead to anywhere from 200-230M iPhone shipments in FY-18, which is well below Street expectations for shipments of 245M. At current levels, Street assumptions are expecting Apple to ship 14M more iPhones than the iPhone 6 cycle, essentially adding at least 14M new users. We struggle to understand where these new buyers will come from given (1) 65% of smartphone shipments are for phones priced below $300, (2) the smartphone market is largely saturated, and (3) Apple's installed base increasingly includes secondary phones which are highly unlikely to refresh to new, high-priced iPhones.

Figure 3: Apple expectations for FY-18E relative to FY-15

# "But everyone wants a new iPhone X and will upgrade this year"

The push back we continue to hear on our more cautious call is that the installed base is ripe for an upgrade, and the features of the iPhone X will compel everyone (well maybe not everyone, but lots of people) to upgrade in FY-18. There is a possibility that we could be wrong, and maybe 245M iPhones are sold in FY-18, or even the 290M we would need to outperform expectations enough to drive the stock substantially higher. But let's assume this cycle turns out to be as good as or even better than expected. If a lot of people upgrade to the iPhone 8 or the X, what will that mean for FY-19? The Street is assuming that Apple can compel the

same number of people to upgrade again in FY-19, with Consensus iPhone unit estimates roughly ﬂat Y/Y. If FY-18 really is a supercycle, then we think FY-19 is very likely to be a down year. After Apple's best cycle ever, the iPhone 6 cycle, the next cycle, the iPhone 6s was a disappointment, with units down 8% Y/Y in FY-16. In addition, ASPs fell 4% Y/Y, leading to a 12% Y/Y decline in iPhones sales in FY-16. We think it's more likely that FY-19 is a down year for iPhone, and it will be hard for the stock to work if the Street is taking down numbers throughout the year.

# 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.

Figure 4: Apple income statement

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IT Hardware and Supply Chain Apple Inc.

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