Apple

David Gardner | January 18, 2008

CURRENT PRICE: AAPL $ 367.08 ↑ $ 8.21 (2.3%)

It's lovely, it's juicy, it's even (at times) a low-hanging fruit. Yet **Apple** (NASDAQ: AAPL) has never found itself on the plate of any Motley Fool service. Until today.

With its iPod, iPhone, and increasingly popular Mac desktops and laptops, Apple needs little introduction. Heck, it's already one of the most discussed stocks in Fooldom. It has nearly 12,000 active recommendations in CAPS (with more than 95% of All Stars calling for it to outperform) -- and I've caught more than a little flack from readers who've wondered why I've overlooked it for so long.

Late to the Party

I'll admit, I'm not a user of Apple's products (though my kids all have iPods), which partly explains why I "missed the boat." While I don't expect this stock to quintuple over the next five years, I want to make the case to you that even using some fairly conservative assumptions, this stock -- which is often derided in the press as overvalued because of its lofty price-to-earnings ratio -- is *still cheap* ... and has some great gains ahead of it.

Apple makes most of its revenue (78% in fiscal 2007) from two product categories: iPods and Mac computers. We can now add the iPhone as the company's third major line. Software, services, the iTunes music store, and various peripherals added "only" about $5.3 billion to revenue that totaled $24 billion in fiscal 2007.

I expect Apple's revenue to about triple in the next five years. And to get there, I don't need to make wildly optimistic assumptions. Even if iPod sales go essentially stagnant from here, even if the incredible growth in Mac sales gradually tapers off to about 15% (from the 40% it enjoyed in 2007), the iPhone should get Apple to about $72 billion in revenue by 2012.

This amounts to a projection of 24.5% annual growth, which isn't greatly out of line with analysts' estimates, but warrants some explanation.

WHY BUY?

- Designs, manufactures, and sells premium quality computers, mobile devices, and personal electronics.
- Why Buy-- For far too long, we've ignored this masterfully innovative icon, but we refuse to sit on the sidelines any longer. Apple's presence in the mobile device market is bound to explode, delivering even greater spoils to the bottom line. We expect great things from Apple, and look to Steve Jobs and the gang to take the iPhone from a toy to an industry standard.

KEY COMPANY DATA

- Headquarters: Cupertino, Calif.
- Website: apple.com
- Recent Price: $169.04
- Position in Industry: Juggernaut
- Revenue (TTM/07/06): $24,006/$24,006/$19,315
- Earnings (TTM/07/06): $3,496/$3,496/$1,989
- Insider Ownership: 0.7%
- Biggest Threat: Stalling innovation
- The Team Says: It's never too late!
- Visit the AAPL discussion board.

Hidden Revenue

Scroll left/right to view wide tables

Market Cap:	$139,771
Risk-Level Rating:	Medium
Cash/Debt:	$15,386/$0
Owner Earnings Run Rate:	$-

Data as of 1/15/08. Market cap in millions

The iPhone -- a popular $399 gadget that Apple expects to sell at least 10 million of in 2008 -- requires a two-year contract with **AT&T** (NYSE: T), which shares the revenue with Apple. The terms aren't disclosed, but estimates run from about $11 to $18 per month (over the two-year contract) for subscribers that Apple brings to AT&T. That means Apple could receive as much as $831 for each iPhone it sells. If you believe some projections of 45 million iPhone sales in 2009, that gets us pretty close to our revenue triple in just two years without a whole lot going on in the rest of the business.

I'm not projecting 45 million iPhone sales in 2009. I *am* expecting a price drop for the iPhone and possibly a decline in revenue sharing. But I think the iPhone, like the iPod, is a great way to leverage sales of Mac products, is a great way to leverage sales of software and peripherals, and so on.

So if Apple's sales triple, what happens to the stock? I wish I could say it would triple, too, but of course a lot of enthusiasm and expectation is factored into the current price. With so much revenue coming from an AT&T kickback with a 100% gross margin, we should see Apple improve its net and cash flow margins.

Apple produced about $5.33 in free cash flow per share in fiscal 2007, and the stock trades at about 33 times this figure. If the 19.7% free cash flow margin it produced this year holds steady, it will have about $14.2 billion in free cash flow in 2012. Even at 4% annual dilution (about the rate it's had during the past five years), that's $13.12 per share in free cash flow. Trading at just 20 times that figure will put the stock over $260 per share.

Risks

There's a lot of variability in that analysis. I am counting on the continued success of the iPhone and the Mac, so some iPhone killer like the "Android" phone under way at **Google** (NASDAQ: GOOG) could hurt Apple, though imitators certainly never derailed the iPod. Could Mac penetration start heading south again after some stunning gains? It's possible, although now that Macs have Intel processors, users have the flexibility of running Mac and Windows software with no relative heartache.

But here's what the above projections don't account for: new products -- the types of innovations that spurred an annual bottom line growth rate of 122% during the past five years. It doesn't account for new twists on existing business, like additional carriers, "unlocked" phones (those that aren't beholden to a single carrier), or dual-mode cell/Wi-Fi phones. Those are just a few of the modest innovations on existing products that could skew things further in Apple's favor. I also don't pretend to know the mind of Steve Jobs, a CEO I very much admire and who has proved time and again that he can outfox expectations.

Though I'm not a Mac fanatic -- or Machead, as they're known around our office -- I recognize and appreciate the loyalty. It's what makes Apple one of the most powerful and beloved brands in the world and what makes it the type of great company I want in my portfolio (I own Apple stock, though it was my kids who picked it out for me!). It's the kind of company you can -- and should -- hold for a long period to smooth out the volatility that comes with high expectations. This is not for short-term investors.

The Foolish Bottom Line

It's never too late to own a great company. And although businesses with market caps north of $100 billion usually fall off my radar, Apple maneuvers like a much smaller company. World-class management and unparalleled products make this one worth owning, and reasonable projections of future cash flow based on current product lines suggest solid returns are ahead. But will Apple really just be selling its current products five years from now? I can't imagine so.

It's one of the best design firms in the world, and it takes fast-evolving technology and turns it into products that people *have* to own. That's what will keep this company on top -- and that's how Apple will continue to surprise us.

- Visit the AAPL discussion board.

David owns shares of Apple. Tim Beyers and Nick Kapur contributed to this report.

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