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Trouble at the top

Evan Lorenz writes:

Couple the 27%, post-November decline of the Nasdaq Composite with the drumbeat of tech-related layoff announcements and a 15.3% year-over-year slip in second-quarter personal-computer sales, and the growth-stock faithful may be starting to wonder if a depression—never mind a mere recession—is in the offing.

It would be a depression without the consolation of cheap stocks. At the peak of the dot-com bubble in March 2000, the ratio of total U.S. market cap to U.S. GDP was 141%. It reached 201% in November and even now stands at 157%. Meantime, the cyclically adjusted price-earnings ratio for the S&P 500 is quoted at 29.5 times, compared with a 50-year average of 21.1 times. Which will serve to introduce a bearish analysis of the biggest tech company, and the most valuable company of any kind, in the world: Apple, Inc. (AAPL on the Nasdaq).

With soaring inflation and souring consumer sentiment, it's hard to draw a bead on the infinitely complex system we call "the economy." Take the not-so-simple jobs report for June. Nonfarm payrolls expanded by 372,000, according to the establishment survey of the Bureau of Labor Statistics, while, according to the same agency's household survey, employment dropped by 315,000.

Because neither bankrupt businesses nor start-ups prioritize the chore of responding to government surveys, the BLS must find other ways to measure the dynamic ebb and flow of American business activity. A birth-death econometric model answers the need, and that calculation last month added no fewer than 64,000 employees to the non-farm total.

Pushing further into the weeds, we find that BLS revises these estimates as more data arrive: In booming 2021, the mean monthly estimate swelled by an average of 159,000 jobs; in busting 2008, the monthly numbers shrank by an average of 73,000.

Nor was the June disparity a one-off: April showed both a 368,000 gain (establishment survey) and a 353,000 loss (household). Suffice it to say that the two surveys are especially prone to divergent results at cyclical turning points, of which this could be one.

As usual, "the data" speak with a forked tongue. Thus, in support of the bearish argument, the U.S. Energy Information Administration reports that gasoline demand for the week ended July 8 fell to 8.1 million barrels, the lowest (after seasonal adjustment) since 1996, versus 9.3 million in the corresponding week a year ago. Conagra Brands, Inc., which sells such pantry staples as Slim Jim, Hunt's and Marie Calendar's, reported a 6.4% year-over-year decline in volume in the quarter ended May 29, while the price of copper ("the metal with the Ph.D. in economics" —John Mendelson, c. 1985) has broken. A July 8 report from *Barron's* highlights a worrying surge in automobile repossessions.

Solid readings in initial unemployment claims, tight corporate credit spreads and strength in utility capital-spending plans (Evercore ISI supplied the latter datum) figure among the representative sightings for the bullish case. A little less hazy, we are about to contend, are the vulnerabilities of the equity of an undeniably great corporation.

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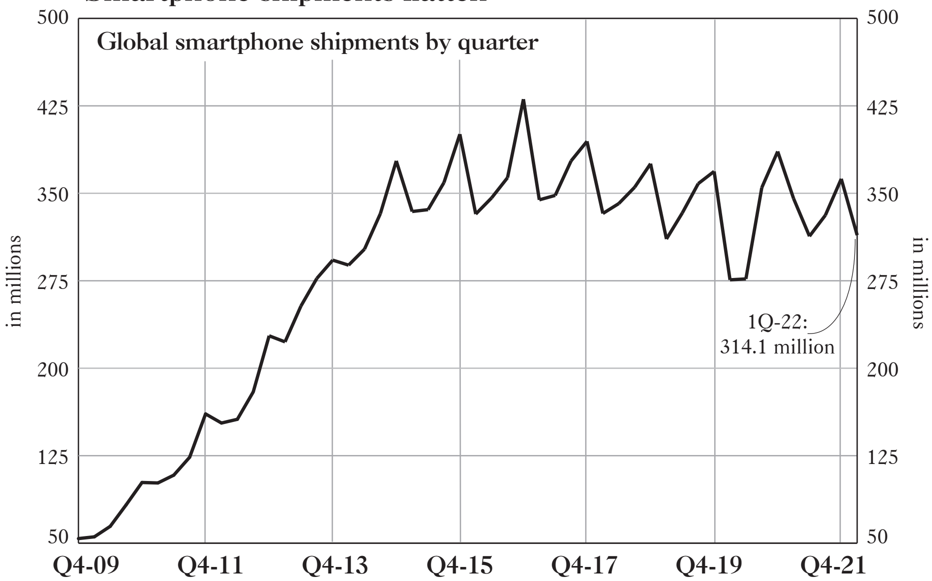
Apple was founded on April 1, 1976 by Steve Jobs, Steve Wozniak and Ronald Wayne, who sold their prized possessions (Jobs his Volkswagen bus, Wozniak his HP-65 calculator) to turn the corporate lights on. It was Wozniak—"the Woz"—who designed and hand-built the Apple I, which sold for precisely $666.66.

From such beginnings, Apple has become the most valuable company on the planet, its $2.4 trillion market cap edging out the No. 2 contender, the Saudi Arabian Oil Co., at $2.3 trillion. In the 12 months ended March 26, Apple generated $386 billion in worldwide sales, with the Americas contributing 43% of that total, Europe 24%, China 19%, Japan 7% and parts undisclosed the remainder.

Apple slices its business into five segments: iPhone (52% of trailing 12 month sales); Mac-branded computers and laptops (10%); iPad-branded tablets (8%); wearables, home and accessories (11%; products ranging from AirPods, the Apple Watch and the Apple TV streaming device); and services (19%).

That final category, a bit of a corporate grab bag, includes the advertising sold on Apple products, Apple's share of app-store revenues, Apple TV subscriptions, fees from the Apple Pay network and the Apple-branded credit card and more. Services, which generates a gross margin of 71.4% versus 36.5% for the

Smartphone shipments flatten



source: Statista

four product categories, is the corporate overachiever.

Covid lockdowns and stimmie checks were a boon for Apple as they were for many another technology vendor. Between the fiscal years ended September 2015 and 2019, the top line compounded at an annual rate of 2.7%. In 2020, the pace of sales doubled to 5.5% and then exploded to 33.3% in fiscal 2021. If there is a law of large numbers, Steve Jobs's brainchild broke it.

And not for the first time. Apple's smartphone-enhanced revenue leapt by 27% in fiscal 2007, 53% in 2008 and 14% in 2009. You'd hardly guess that those three booming years encompassed the Great Recession.

In approved Silicon Valley fashion, Apple has broken other things, too. As noted in the prior issue of *Grant's*, it upset the digital advertising industry by forbidding third-party app providers from digitally tracking their customers without the consent of those prospective trackees. As for Apple's own software, the corporate ethical stance is slightly more complicated. To opt out of Cupertino-style monitoring, the privacy-seeking consumer must jump through the hoops of a succession of sub-menus. Many will give up, deciding that it's is better to be stalked than frustrated.

Be that as it may, the Apple logo alone is worth nearly $1 trillion ($947.1 billion to be exact), according to the Kantar BrandZ Most Valuable Global Brands of 2022. "Apple is a phone, a watch, a laptop, a tablet, a streaming service, a protector of digital privacy, all of which resonate with consumers," says Kantar. "With a 55% [year-over-year] increase in brand value, Apple rose one position to secure the number one spot on Kantar BrandZ global rankings for the first time since 2015."

To be sure, smartphones, computers and tablets are mature product categories. What excites Wall Street are new end markets and the potential growth in services. An electric car has been in the works since 2014 ("one of the worst-kept secrets in Silicon Valley," according to The Information), and augmented-reality (AR) and virtual-reality (VR) glasses have been under development since 2015. "Services will account for more than 40% of revenue in 2030 compared with only about 20% currently," predicted a team of JPMorgan Chase & Co. analysts, led by Samik Chatterjee, last month. Those lush margins in the services segment mean that "two-thirds of total company profits will be sourced from services in 2030," the Morgan team contended.

Though Apple is not without flaws (of which more in a moment), the balance sheet isn't one of them. As of March 26, the double-A-plus/triple-A-rated behemoth showed a cash balance of $192.7 billion versus debt of $120 billion for a net cash position of $72.7 billion, which sum CEO Tim Cook vowed to return to shareholders. To proceed in that direction, he plans to issue debt (in the cause of avoiding taxes on funds held overseas). Over the past four quarters, Apple has bought back $85.8 billion's worth of stock and paid out $14.7 billion in dividends.

Of the 48 analysts on the case, just one says sell. Insiders, taking action, have sold 3.1 million shares over the past 12 months for proceeds of $461.1 million. Cook himself accounted for $354.6 million of that haul in a series of trades last August. The short interest is negligible.

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It's the very prosperity of the lockdown years that provides us bears with our opening argument. Sales growth before

Apple, Inc. at a glance

all figures in $ millions except per share data

	TTM*	FY 2021**	FY 2020	FY 2019	FY 2018
sales	$386,017	$365,817	$274,515	$260,174	$265,595
operating profit	119,379	108,949	66,288	63,930	70,898
net income	101,935	94,680	57,411	55,256	59,531
shares outstanding	16,403	16,865	17,528	18,596	20,000
earnings per share	6.15	5.61	3.28	2.97	2.98
cash	192,730	190,516	191,830	205,898	237,100
debt	119,981	124,719	112,436	108,047	114,483
total assets	350,662	351,002	323,888	338,516	365,725

* Trailing 12 months ended March 26, 2022.

** Fiscal year ends September.

source: company reports

the pandemic, i.e., between fiscal 2015 and 2019, was just what one would have expected from a big company serving mature, arguably saturated, markets. According to International Data Corp. (IDC), global smartphone sales declined to 368.8 million units in the fourth quarter of 2019 from a peak of 430.7 million units in the fourth quarter of 2016. Worldwide shipments of PCs, laptops and tablets had likewise slipped before the bug bit, to 412 million in 2019 from a peak of 538.2 million in 2014.

Since there was no place to go and no one to see during Covid, homebound consumers binged on merchandise. In the two years ended fiscal 2021, iPhone sales growth compounded at a 16.1% annual rate, that of Mac laptops and computers and iPads at a 19.4% annual rate. Pretty plainly, say we, the splurging pulled forward future growth.

Ignoring that possibility, the Street expects Apple to generate revenue growth at a rate above its pre-pandemic level—for instance, higher by 7.6% in fiscal 2022 and by 5.4% in 2023. How the now-unstimulated consumer will maintain that gait of spending is, to us, a mystery. According to IDC, Mac computer sales fell 22.5% in the June quarter compared with the year-ago level, outpacing the overall 15.3% tumble in PC sales.

"Our expectations for calendar 2022 industry bit-demand growth [i.e., demand for a unit of computer memory] have moderated since our last earnings call," Micron Technology, Inc. CEO Sanjay Mehrotra said on the June 30 earnings call. Near the end of the June 2 fiscal quarter, he continued, "we saw a significant reduction in near-term industry bit demand, primarily attributable to end demand weakness in consumer markets, including PC and smartphone. These consumer markets have been impacted by the weakness in consumer spending in China, the Russia–Ukraine war, and rising inflation around the world."

Apple's services division features both in the bull and the bear case. In return for making Google the default search engine in Apple products, Alphabet, Inc., Google's parent, writes big checks to Apple. Neither Apple nor Alphabet discloses the size of these payments, but Bernstein Research analyst Toni Sacconaghi estimates that they'll sum to $19 billion in fiscal 2022, or a quarter of the services unit's revenue. Given that this income stream entails almost no costs, it represents around 16% of trailing corporate operating income.

The other big component of services' revenue is Apple's cut of the sales in third-party apps. Fees are set at 30% for developers who generate $1 million or more in revenue and 15% for the smaller fry. This is a relatively new phenomenon in software. Microsoft Corp., for example, exacts no fees from developers for publishing Windows-based software. According to Sacconaghi, Apple's share of app sales amounts to around 31% of services' revenue.

These business practices came under investigation by the Department of Justice in 2019, and the pace and scope of the probe has lately intensified, according to the Axios news site. Readers may recall that Microsoft was on the losing end of an antitrust lawsuit in 2001 for bundling its series of graphical web browsers, called Internet Explorer, with the Windows operating system. AAPL holders will be disappointed if the courts wind up drawing too close an analogy between Microsoft's practices of a generation ago and the Apple-Alphabet arrangement of today.

The two income streams, Alphabet to Apple and app developers to Apple, face legal scrutiny worldwide. In a trial last September, a federal judge ruled that Apple's prohibition on third-party payments that bypass the App Store violate anti-steering laws; the decision is under appeal. Operating under the European Union's Digital Markets Act, European policymakers are pressing for an end to deals like the Alphabet-Apple tie-up and are likewise seeking to force Apple to allow the operation of competing app stores and payment systems. Last year, South Korea, too, weighed in on third-party payment issues, again putting Apple on the defensive.

Outside of the Alphabet payment and the App Store fees, the businesses within the services unit are unlikely to earn monopoly-like profit margins. The Apple TV streaming service, for example, is an also-ran with fewer than 30 million subscribers (the company divulges no figure), versus 87.6 million for Disney+ and 221.6 million for Netflix, and is having to pay up for content.

Apple climbed the greasy pole of market dominance by selling world-beating products, but it's a position as precarious as it is lucrative. Unable to interest his employer, Hewlett Packard, in his vision of a personal computer, Wozniak called his friend Steve Jobs. It's the way of the world, or, at least, of the enterprise-favoring portion of the world. Perhaps with that dynamic in mind, The Information published a series of in-depth reports this spring on attempts by the mature Apple to innovate a self-driving car and an AR/VR headset. Bureaucracy and high management turnover have stymied creativity in both.

While no release date is scheduled for the autonomous car, the current design has "four seats that face inward so passengers can talk to one another and a curved ceiling similar to the roof of a Volkswagen Beetle," The Information reports. Apple's AR/VR headset is more than fully featured—14 cameras are built in—but the proposed $3,000 price tag could present a problem. The competing Meta Quest 2, manufactured by *Grant's* click-to-pick Meta Platforms, Inc., retails for $299.

"That's what happens to big companies, and that is how they [i.e., the giants] get overcome," Fred Hickey, proprietor of *High-Tech Strategist*, tells me. "Apple is a little like IBM. Here they have all of these resources. You have control over this market, certainty in the U.S. and they are No. 2 in the world in smartphones. They generated all this cash, and they really haven't invented anything—anything [since Jobs died in 2011]. It's amazing. With such a platform, they could have slapped their name on dishwashers and sold a lot of dishwashers. They haven't even done that."

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China presents another set of headaches. The Middle Kingdom hosts 90% of Apple's final product assembly and constitutes the company's second-largest consumer market (providing 19% of trailing revenues). Following a string of conflicts with Chinese regulators, Cook signed a $275 billion investment agreement with Beijing in 2016. Not even the existence of this transaction was known until a Dec. 7, 2021 exposé by The Information laid bare its outlines.

To appease the Chinese authorities, Apple pledged to buy stakes in Chinese companies even outside of its core business. An example is a $1 billion investment in ride-hail concern DiDi Global, Inc. in 2016. Such investment mandates have mired Apple in political problems. For example, at least seven of Apple's Chinese suppliers have been accused of using forced Uyghur labor, and Apple has towed the Communist Party line both by denying privacy protection to Chinese customers and by consenting to store local customer data in China.

A pair of Chinese security laws enacted last fall, bearing on data security and privacy protection (or the lack thereof), presented foreign companies with the basic choice of complying or leaving. "Microsoft's LinkedIn and Yahoo discontinued their [Chinese] operations around the time the law took effect," The Information notes.

Whatever one might call this Apple undertaking—consent decree, *entente cordiale*?—it has proven a boon to the American signatory and, evidently, to China as well. It's a measure of Apple's perceived value to the Chinese regime that Xi Jinping took no retaliatory action against Apple following the U.S. government's sanctioning of Huawei Technologies Co. Ltd. beginning in 2019. Indeed, Apple's sales in the People's Republic jumped by 70% in fiscal 2021, a leap forward unmatched by any market in the world.

However, that Beijing-Cupertino treaty expired in May and nothing says that it must be renewed or that things must revert to the profitable status quo ante. Famous for their manufacturing efficiency, Apple and its CEO seem to have had quite enough of China's zero-Covid lockdowns. However, neither India nor Vietnam, in which Cook & Co. are building assembly plants, has the extensive supply chains and deep pools of trained labor that China boasts. Certainly, no sizable shift in operations outside China would come free of cost to Apple's margins. Nor would the Chinese Communist Party necessarily smile on the Apple operations that remained in the People's Republic.

The cost of Apple's financial engineering, too, is on the rise. You'll recall that, as a tax-avoidance measure, the front office plans to issue debt to finance the return of cash to shareholders. Notable, then, is that the Apple senior unsecured 1.7s of 2031, issued at $99.58 just one year ago, have traded down to $84.61 for a yield of 3.7%.

Apple changes hands at 24.6 times trailing earnings, a premium to FAANG peers Meta (13.3 times), Netflix, Inc. (18.3) and Alphabet (21.1). A reversion to the 2019 sales trend could send that multiple skyrocketing, as trailing net income is 84% higher than the level in fiscal 2019.

"Pretty much everything was going their way in 2020 and 2021—temporarily," Hickey says, summing things up. "We saw it go from no-growth to can't-believe-your-eyes kind of growth, and now it is going negative—down 22.5 for their PCs. Everything is in the wrong direction, from interest rates to their globalization benefits—the Chinese low-cost manufacturing—to their 30% take on the App Store. Everything."

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