Apple's Cash Pile

an oditorium U case study

Disclaimer: Whilst inspired by real events, this case study is fictional, and any similarities with real persons and events are coincidental. All facts used in the preparation of this case have been explicitly referred to, mainly in form of news paper clippings, and in Apple's 10-K report. Any other statements made should be considered part of the pedagogic narrative, not facts.

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Teaching Notes

This case study comes in two different parts. The first one is about gathering the necessary information, and to also get both a feel for the company - Apple - as well as of the workings of an investment bank. The second part is the heart of the case, where the students work on the different ways of how Apple could issue a perpetual bond in order to distribute its cash pile to its shareholders in a (tax-) efficient manner.

Especially in Part II, this case is in the tradition of the 'process' case studies that do not lead to an obvious best solution - some things might work, some others might not. We do not have the benefit of hindsight, as at the time of writing Apple was apparently not planning to issue any kind of perpetual bond or preferred shares. As you might have noted, the name of our protagonist is a nod to Mr Arthur Keller, whose 'insolvable' case was the first case study that many MBA students at INSEAD had been subjected to.

Ultimately, our case is about a number of different things

1. ability to creatively explore the different structuring options in a real world environment, with some of the suggestions being (probably) dead ends
2. ability to work with a fixed time budget, in competition, and to switch from a competitive to a cooperative mode
3. ability to extract relevant data from the financial reports, and to find the reports in the first place
4. understanding the reasons why (or why not) it is in a company's strategic interest to return (excess) cash
5. understanding the repatriation tax issues, including the political and lobbying angle
6. understanding the impact of corporate and personal taxation
7. pricing and structuring of perpetual bonds / preference shares

Point 1 is addressed in Part II. All other points are addressed in Part I. If desired, the case assignments of Part I can be skipped. Part I should probably still be given as reading - with a brief Q&A session afterwards - to make sure that the students understand the concepts to attack Part II.

Part I

Part I is about introducing Apple, and whilst it is happening in a tongue-in-cheek manner, the company's main strategic issues are covered

- ubiquitous product offering, influencing a large part of our lives
- extraordinary growth rates in the past, driven by Apple redefining whole product categories, but now facing competition and possibly saturation in those categories
- death of Apple's legendary founder who was highly involved in the user experience, to the point of micromanaging it - hence the (completely made up) reference to him redesigning the annual report; uncertainty as to whether the new management team will be able to maintain his visionary style
- existence of a large cash pile which would incur significant taxes upon repatriation / distribution; one important focus is on the political component, and in particular the likelihood of another amnesty in the years to come as this plays heavily into the structuring angle
- level of the P/E ratio - some back-of-the envelope calculation is provided to incite a discussion as to which valuation is reasonable; one key factor to understand here is that Apple is not a stable company, and that its earnings (which are still multiplying yoy!) have been driven by constant innovation and market expansion, and that extrapolating past earnings is pointless without an understanding as to whether Apple will launch another must-have product, or whether they will simply ride on incremental changes to their existing product line.

Apart from introducing Apple, this case also introduces the world of investment banking, through the eyes of an Analyst - which is the entry level for undergraduates - called Arthur K Lar. He is paired with an Associate (2-3 years out of an MBA) called Chris, and an MD called Phillip who is never in the office - he keeps travelling, and transmits his orders to Arthur via Chris.

A lot of the information given here is meant to be practically useful for future Analysts (and for future Associates who have not been

Analysts pre-MBA), for example what 10-K's and 10-Q's are, that you can find them on EDGAR, etc.

The main assignment in this part is to quickly extract the information from the 10-K. Students should have 30-60min to go through the report (that they might have to download for themselves, either from Apple or fro EDGAR) and to collect the necessary information. Care should be taken that indeed they have noted the exact source for any of their number, eg by putting them on the spot and asking some more detailed questions ('could you give me the figure without rounding? what was the number in 2010?'). This part of the assignment should be done individually, and maybe in timed competition.

Apple's excess cash. This is the only difficult question here, and one can spend quite a bit of time on it. It will be asked again in Part II, and it is more added here to engage the students' time management and working-on-a-budget skills - if they spend the whole 30min answering this question and have nothing else this is an issue. Students should also understand that in some respect this is the least important of the numbers to extract - everyone agrees that it is big, and how big it is exactly should be subject to a later debate.

The other assignments are more contextual, and should be discussed in groups, maybe for 30min before the main assignment is started.

Dividend policy. Key issues are signalling ('growth is over'), and the roundtrip cost of returning and raising capital (paying taxes on the distribution, investment banking fees, ...)

Group balance sheet. This is mainly about recognising that the 'consolidated' group is not a real entity, and that the cash of a sub is not in the parent - only the sub's equity is on the parent's balance sheet, not the entire sub, as consolidation might suggest.

Tax holiday. This is mainly a political discussion. Key learning is that it is likely to happen again at one point, especially if the pressure applied is big enough, and that companies might be better off waiting.

Miller Modigliani. This is quite a nice opportunity to show an anti-MM situation where a company delevers rather than levers. Of course, standard MM arguments apply here, ie the shareholders could borrow against the cash component of the shareprice if they preferred more leverage. Therefore MM applies, and in the MM world it is irrelevant whether or not Apple distributes its cash. In practice it is of course very relevant, and excess cash generally valued at a M/B < 1, for example because of the cost of returning it, and because there is always an incentive squandering it on some ill-advised acquisition.

Should he have asked Chris. No right answer here, but potentially an interesting topic for discussion.

Personal taxes. Key learning here is that the value of a company is driven by the money that ends up with the investor after all taxes (including personal taxes!) are paid. Dividend tax credits ultimately remove the tax advantage of debt, because effectively both are now subject to personal tax, but free of corporate tax (in circumstances where dividends are taxed at a preferential rate and interest payment are not, equity financing might event be more tax efficient than debt financing). As for buy-backs, one should talk about capital gains tax vs income tax, and also about the individual investor's ability to time the gains, as those taxes only crystallise upon sale of the shares.

Pricing. Fixed rate perpetual: *price = coupon/rate*. Risk free floater always at par. Risky floater around par (more details are not necessary).

Part II

This part is the core of the case, and this is where it becomes a really messy 'process' case without real solution. I personally do not believe that it is possible to structure something that would effectively issue the perps out of the sub, without going through the parent (and in particular, without incurring the repatriation tax) but I might stand corrected. In any case, it is worth thinking about it, and to understand and analyse the various structuring instruments (carve-out etc) and to play with them.

It is important that the students follow a systematic approach of evaluating the different options, and if possible some mediation and coaching at the beginning of the process is probably helpful, to avoid that the group either goes off on a tangent, or just sits around flabbergasted.

If the students develop their own approach, they should be allowed to follow it. Otherwise the following structure could be suggested:

1. for each of the 3 choices (fixed/floating, callable, parent/sub) there should be an independent pros/cons analysis, initially in brainstorming format
2. the students the should look for co-dependencies
3. students then need to decide to drill deeper; in particular 'sub-level issuance' will certainly need a more detailed analysis
4. they should also go through Philip's list and make sure that they are covering everything he asked; two issues stand out: (1) is another tax holiday coming up? (2) what are the political ramifications of aggressive structuring? - those are independent of the other issues and need to be treated separately
5. finally all of the above needs to be translated into a communication strategy, with a couple of visuals; care should be taken that the students don't go overboard with the production of the visuals

When debriefing the case it is important to zoom in onto the process. Issuance out of the sub is (probably) a red herring - it's a nice idea, but probably it can not realistically be done. Managing Directors have those ideas from time to time, and their subordinates need to make sure they manage the situation. This means that they need to spend enough time analysing them to make sure that they are correct in thinking that they do not work, but not to go overboard in this analysis at the expense of the more pedestrian and more realistic options.

On the next level one might also point out that those radical ideas also have a certain 'marketing appeal'. Sometimes presenting some out-of-the-box solution, even if it ultimately does not work, keeps the client's interest, despite ultimately the vanilla solution being chosen.

What students need to understand - possibly after the case, because they did it wrong - is that regardless of what they do with respect to the sub-level issuance, they need to carefully analyse all the different options for the easier and more likely option, the parent level issuance. A number of points that they should find are the following

1. already the *promise* of paying a coupon every year allows the shareholders to sell the security at par, meaning that they can effectively already receive the cash whilst it is still trapped in the subsidiary

2. provided it is structured such that the coupons are tax deductible, the instrument is neutral with respect to repatriation tax - the tax shield generated cancels this tax liability[1]
3. if additionally the instrument is structured in a way that its coupons are considered dividends for personal tax purposes (what Chris' *Einhorn Notes* suggest), then the (in the US) more favorable dividend tax regime applies
4. in case of a repatriation tax holiday, Apple could benefit from a windfall gain, in that paying out money that has never been taxed (or that has been taxed at a lower rate) could give rise to a tax shield at the full corporate rate
5. issuing the perp might put some shareholders in an awkward position as they might be liable for dividend taxes on the par amount, ie they might be forced to sell (see below)
6. in relation to #4, the callability discussion is important - Apple might want to retire the perp once they have repatriated the cash, even though this would mean to forego the windfall gain
7. once callability is on the table, fixed vs floating should be discussed, and the effects of a call at par for a fixed rate security in a changing interest rate environment
8. once floating is on the table, the reference rate should be discussed, and what to do if it disappears (...perpetuity is a long time...); whilst a secondary issue, this is good housekeeping, and it should at least be 'flagged for the lawyers'

Points 1-4 above are the core 'factual' findings of the case - **issuing a perpetual security allows investors to walk away with a significant part of the excess cash pile today (possibly taxed at the most favourable personal tax rate) whilst Apple can repatriate the money needed to pay for it - ie the interest - in a tax efficient manner. A future tax amnesty would either provide an opportunity to retire the instrument, or to reap a windfall gain.** This is a win/win situation for everyone except the government.

Whilst on the face of it, it might seem that the above mechanism ('issue perp to avoid corporate tax') would apply to any company with excess cash, deeper analysis reveals that this is not the case. For this strategy to work, the taxed-only-upon-repatriation feature of our case

[1] this is likely to be slightly more complicated if there is more than one tax involved (federal, state, etc), and in this case there might only be a partial offset

is crucial, as otherwise the interest income on the cash - which is needed to pay for the coupon of the perpetual - is subject to corporate taxation, and hence the tax shield provided by the perpetual is already used up.

Finally - and this is the discussion of point 5 above - it is important whether the issuance of the perp to the shareholders is considered a distribution, or akin to a carve-out. In the former case - which I would consider the baseline - investors would incur a dividend tax liability at the full notional amount of the perp, in the year in which it was issued. This of course is only relevant for investors who are subject to dividend taxation: many offshore (hedge) funds - and also the offshore investment trusts that large individual share holders might have in place - might be structured in a way that dividend payments are not taxable.

In order to meet those tax payments, they might have to resort to selling some of the perps they have just received, which necessitates a certain liquidity in the market, otherwise they could be out-of-pocket if the price significantly drops when everyone tries to liquidate their holdings ahead of the tax liability being due. Note that selling Apple shares is probably not be a viably alternative for many share holders, as (a) they seem to like them for their upside (maybe they hope that they will go back to $700), and (b) their sale might trigger significant amounts of capital gains tax, which the investors might not want to incur in that particular year.

So if Apple where to go down that route - issuing a perp that triggers a significant income tax liability for their investors in that particular year - then they would probably have to ensure that the necessary liquidity is there. They could offer this liquidity themselves - the foreign subs that hold the cash would simply be the 'buyer of last resort' in the market. However, for the tax authorities this might be one step to many. Alternatively, an investment bank - or investment manager - could step into this role, possibly with an appropriately structured hedge into said Apple subs.

Handouts

This case is designed to be worked through without providing additional handouts - all the relevant information is provided in the body of the case. If the assignments of Part I are given, then the students will need a copy of the 10-K, but I would consider it part of the exercise that they identify and download it either from EDGAR or from Apple. If this is not possible - eg because of a lack of Internet connection during the assignment - then the 10-K would need to be provided.

At the time of writing the case, it can be found on the Apple website here
http://investor.apple.com/secfiling.cfm?filingID=1193125-12-444068&CIK=320193 (allows pdf download)
and at EDGAR here
http://www.sec.gov/Archives/edgar/data/320193/000119312512444068/0001193125-12-444068-index.htm (10-K and all related filings)
and here
http://www.sec.gov/Archives/edgar/data/320193/000119312512444068/d411355d10k.htm (10-K only, in paginated html format)

One might also consider providing a printout of the page of the Einhorn website referred to in the document, but in principle all relevant parts are contained in Chris' notes.

Apple's Cash Pile - Case Study Part I

Arthur's morning with Apple

29th January 2013, 8:30 am, the iPhone rang. Arthur K Lar woke up and was glad; glad that he had got at least three hours of sleep, and that it was the *alarm* on the iPhone, rather than a call from his MD who had some last minute questions before he boarded the plane with the pitch book Arthur had helped preparing until the early hours in the morning.

Even though Arthur had only joined J.C. Silverman Fichtel - the venerable investment bank - six months ago, he already had a good understanding how things worked: if he worked long hours, he could get to the office until 9:30am. In any case, the work would only trickle down to him and his fellow Analysts by lunchtime, if not mid-afternoon. At least he would have ample time to scour the tech blogs for rumours on what would be the next big category that Apple would shake up - watches maybe?

Arthur was looking for his MacBook Air, until he realised that it was still at the Apple store - he had brought it there four weeks ago, because the battery had needed changing, and he had not got around picking it up yet. So he switched on his 27-inch iMac that he had bought mainly for producing short-films when he was at university - for that, and because it looked gorgeous. He quickly called his girlfriend on Skype - she had gone to work in Tokyo after university, and this was about the only time in the day they could speak due to the time difference. He only spoke to her for a minute though, because he had to really dash off, and she was about to go out with her team. He then switched on his iPad and launched the FT app so that it would update with the latest news before he'd descend into the subway.

After a quick shower he left, checking what his friends were doing on his iPhone's Facebook app. He clicked on a map-link that a friend had posted, launching the map app. For the umpteenth time he kicked himself that he had upgraded to iOS 6 the week it came out, and with a shudder he remembered how he had run out of petrol in the Australian outback, because the Apple-designed map that had replaced the Google-designed one that had been on the iPhone since the beginning had placed the town of Mildura at completely the wrong spot. Again, he was wondering whether Tim Cook could continue the legacy of the late Steve Jobs - under whom Apple's share price had grown from $5 or thereabouts to a max of just about $700 - or whether the era of Apple was over and its share price would decline further from its current level of just above $500.

In fact he had not checked AAPL for a while, so took his iPhone and looked it up - and he was surprised and dismayed to see that at the end of the last week the stock had suddenly dropped by almost 15%, and was now trading below $450! But then he remembered that this still corresponded to a market cap of about $400bn, and whilst 10-odd times 2012 earnings did not seem outrageously high he remembered that Apple had shown a tremendous earnings growth, and that $400bn would be about 15 times 2011 earnings and almost 30 times 2010 earnings. And he also remembered that the two big *"another"* things on Tim Cook's watch had been a 7-inch tablet - a product pioneered by Samsung that Steve Jobs had derided as useless at the time - and a slightly longer and thinner iPhone without any memorable new features other than the infamous iOS6. He wondered whether Apple would maintain its phenomenal growth, or whether it would become just another cash-cow stock that would finally start paying some significant dividends out of its hoarded cash - more than $100bn if the remembered well.

In the office

When Arthur came to his desk at 9:25 he found a Post-It on his screen that read: *"Taking half a day off? Call me when you get in! C."*. He checked with his neighbour when Chris - the Senior Associate with whom he was mainly working - had come by and he was relieved to learn that he had only been there five minutes earlier, clearly only just stepping foot into the office himself.

So Arthur decided to first get himself - and Chris, always better to be on the good side of one's senior colleagues - a Venti Latte from the Starbucks located on the adjacent floor of the skyscraper. Then he walked over to Chris' open-plan desk that looked just like his own, just with a number of tombstones celebrating the deals Chris had been involved in. He was on the phone - *"diligence call with Tokyo"* he whispered - and he motioned him to stay for a moment (and to leave the Latte) whilst he was jotting something on a piece of paper. He then handed the paper to Arthur and motioned him to leave.

Back at his desk, Arthur looked at the paper and tried to make sense of it

- *AAPL*
- *Annual report*
- *Cash holdings? Where?*
- *Taxed?*

He wasn’t entirely clear about what all that meant, but the first step was fortunately obvious: get Apple's annual report. So following best practice, he went to *apple.com* and was looking for the *Investor Relations* link - but he could not find anything that even looked remotely like it. He finally located the *Site Map*, and there it was, *Investor Relations*. But still no *Annual Report*, only '*SEC Filings*', and '*Financial History*'. He went into the *SEC Filings*, and found a document called *10-Q Quarterly Report*. A bit further down was also a document called *10-K Annual Report* and he clicked on it, but it did not look anything like he expected: black and white, no photos, a lot of legalese at the beginning. So he clicked on Financial History and came across the following statement

> *Annual Reports*
>
> *Apple does not produce a glossy annual report. You may view current and previous years' 10-K filings by selecting the links below.*

Arthur went back and downloaded the 10-K. He considered printing it for a moment but then decided against it - it was 88 pages long, and from experience he knew that the amount of information relevant for him would be small. So he forwarded it to his private email address instead, to flip through it on his iPad - he largely preferred its incredibly sharp "retina" screen to the Dell monitor that he had on his desk.

When Arthur started reading the 10-K he was pleasantly surprised - whilst clearly an ugly duckling when compared to an annual report, this one was actually much easier to read without all the photo- and memorable-quote-inserts. He quickly identified Apples cash holdings, but then he got stuck, and fortunately Chris stepped by.

"Did you get the annual report"?

"Sort of. They don't have an annual report, they only have something called a '10-K', but it seems to be more or less the same thing"

Chris was grinning. *"Yeah - I know. The story is that at one point Apple staff produced an annual report, and they showed it to Steve. He had a fit, and told them that the user experience was awful and that they should go and completely redesign it. Long story short - they decided that it was in everyone's best interest to only file a 10-K. But that's only a story, probably not even true..."*

He continues*: "Where did you get the report? From EDGAR?"*

"Edgar? The research guy on the 42nd floor? I thought he was called Edward! No, I downloaded it myself, from the Apple website."

Chris laughs *"EDGAR is the repository for all SEC filings, on the SEC website. Very useful for 10-K's (annual reports) and 10-Q's (quarterly reports) and also for some prospectuses."*

Arthur felt kind of stupid, but then, how should he have known? This had certainly not been part of his curriculum at university. Chris then asked: *"So? Did you get me what I asked for?"*

"Actually ... to be honest ... I am not sure. I did get the cash number, but other than that I am not quite sure what to do..."

"Alright. I'll have a few minutes before I have to jump back onto a call, so let me get you the skinny. You know that Apple is a tech company, and tech companies - like all growth companies - are not generally very keen on paying dividends".

Arthur nodded. He was not quite sure, but he would think about it. He vaguely remembered something about signalling, and about taxes, and about fees as well, maybe. **[Can you help Arthur out?]**

"Apple was incredibly profitable in the last couple of years, and the amount of cash they have made is enormous. There is another complication though: apart from possibly not wanting to pay the cash out, they actually can't. As you know, a group balance sheet is a mirage, something that does not really exist, right?"

Again, Arthur nodded, and decided to think about this later. **[Can you help him out again?]**

"Shareholders have shares not in the group, but in the parent company, and if the parent company wants to pay a dividend - or buy back its shares for that matter - it needs to have the cash in its own accounts in the US."

This made sense to Arthur.

"Now there is a particularity in the US that is meant to keep the US economy competitive, meaning that companies do not move their headquarters elsewhere: whilst the parent company is in principle taxable on the world-wide group income, those taxes only need to be paid when - and if - this money is repatriated into the US. And I am saying if because companies can invest their profits outside the US".

He continues: *"Now this is one of the unintended consequences of that law, because whilst we might keep the headquarters in the US, some groups now have an incentive to invest their cash anywhere but in the US, which is not great for US jobs. So we get periodic calls to allow companies to repatriate their cash without having to pay taxes, possibly under the condition that they use it for investments in the US. But of course money is fungible, and it is not easy to assert whether or not certain investments would have happened anyway. In fact, I have a number of newspaper clippings here on this subject"*

He hands Arthur a couple of photocopies with the following passages highlighted:

> *Finally, America should scrap tax policies that make it attractive to conduct R&D and production abroad. For a company with big profits outside the US, it can make more sense to invest in manufacturing and R&D overseas than to repatriate dollars that would be taxed at one of the world's highest corporate tax rates.[...] Allowing companies to repatriate foreign profits tax-free, provided they are invested in R&D, training, and capital expenditure, is another [solution].*
>
> *Gary Pisano and Willy Shih, FT, 5 Nov 2012*

> *Because the US currently penalises companies when they repatriate offshore cash, many treasurers are waiting, hoping the law will change before they move their funds.*
>
> *Gillian Tett, FT, 24 Jan 2012*

[Gene Sperling, Obabam's top economic advisor] said the administration was not looking at another tax holiday allowing companies to repatriate profits from abroad.

Johanna Kassel, FT, 13 Oct 2011

Efforts by US multinationals to secure a tax holiday on overseas profits were bolstered by a fresh bipartisan push in the Senate [...]. The new proposal in the Senate was greeted warmly by campaigners for the tax holiday in corporate America – including top executives at Cisco, Oracle, Microsoft, and Duke. [...] In 2004, under President George W. Bush, the US pushed through a similar tax holiday.

James Politi, FT, 6 Oct 2011

The chamber also calls for a temporary tax "holiday" to allow companies to repatriate at a low or zero tax rate the estimated $1,200bn held in foreign countries.

Ed Crooks, FT, 7 Sep 2011

In 2004, the US set a temporary tax rate of 10 per cent for repatriated foreign profits. As long as they believe another such concession may be possible, companies will delay.

Richard Waters, FT, 31 Aug 2012

Arthur was eyeballing those articles, and he was wondering whether such a repatriation tax holiday was likely, and - if yes - when and under what conditions. **[Maybe you could share your opinion with him?]**. But Chris already continued:

So Apple is in the same boat as many other companies - they have made a fair share of their profits abroad, they did not really know what to do with them, so they are just sort of sitting there, invested in some lowly yielding assets, the returns not at all commensurate with what Apple shares should be earning.

Arthur remembered his finance classes at university and wanted to ask whether it mattered - after all there was the famous Miller Modigliani Proposition - but he thought the better of it. **[Can you help Arthur sort out his thoughts: In theory, does MM apply**

here? If yes, how and why? And in practice? And should he have asked Chris?]. Chris saw that his assistant was gesturing him to come over, so he finished

"I have to go now - another call. The next steps are clear: please look at the 10-K and - using your judgement where needed - get me the answers to the following questions

1. *How much cash does Apple have on its balance sheet?*
2. *How much of it does it need? How much is 'excess'?*
3. *How much of it is sitting untaxed in foreign subsidiaries?*
4. *Is it untaxed, or simply taxed at a lower rate? At which rate?*
5. *What is the tax rate that Apple would pay would they repatriate all the cash? How much in dollar terms?*

Oh, and just for good housekeeping: ***ALWAYS NOTE THE EXACT SOURCE (INCLUDING PAGE NUMBER) NEXT TO ANY NUMBER THAT YOU COPY****, otherwise you'll end up doing it all over again."*

Chris continued: *"Just a few more things. You do understand why - in the absence of dividend tax credits, and assuming no preferential tax rates for one case or the other - debt financing has a tax advantage over equity financing, right? And also that there is a difference between dividends and share buyback?"*

Arthur nodded, with one more thing on his to-think-about list. He remembered the word 'tax-shield' in this context, but he was confused by *dividend tax credits*. He sort of remembered what it was, namely that investors could reduce their own personal tax bill by offsetting it against the corporate taxes corresponding to the dividends that they had received, but he did not quite know how this related to tax advantages. It had certainly not come up in his finance lectures where the professor had stated pretty early in the analysis of MM that from now on he would ignore personal taxes. And buybacks were somewhat related to capital gains of course. **[Could you explain this to Arthur?]**

"Also, you know what perpetual bonds and preferred shares are? They are very similar, except the latter sometimes implies that it is subordinated, with cancellable or deferrable coupons, and paid out of post-tax earnings, whilst the former is usually a form of senior debt. I just want to make sure you know how they are priced. Also:

would you know the price of a perpetual floating rate bond where the payments are indexed to LIBOR?"

Arthur gulps. **[Can you get him the pricing formulas?]**

"I am sure you got by now why we are doing all of this - Phillip [the MD] is going to see Tim [Cook] next week, and he wants to talk to him about what Apple could do about their cash pile."

Chris dashed off, and Arthur started working on his assignment **[Can you help him?].**

Apple's Cash Pile - Case Study Part II

Arthur worked for about half an hour on the 10-K report, and things were going very well, so when Chris came back he was very pleased.

"Hey Chris. I've got your answers:

- *the cash position is simple - $121.3bn - it is on p24 and on the balance sheet on p37; it has increased dramatically by the way, it was $81.6 and $51 in the years before*
- *on p30 we have a breakdown of the sales by region - if everything else fails we could use this as a proxy for untaxed earnings; you see that 40% of sales are in the US (I excluded the retail segment; this is probably all their stores worldwide)*
- *taxes are provided in the income statement on p43; they are called 'tax provisions', and on p46 you can see that the cash taxes paid in the respective years were much lower - half or less I'd say*
- *as for tax rates, the previous figures give you a tax 'provision' rate of ca 25%, and a 'cash' tax rate of 10-15%*
- *also, by doing the difference between the tax provision on p43 and the cash taxes on p46 you find that we are talking about $13bn in taxes to be paid upon repatriation*
- *if we assume that the foreign earnings have not been taxed at all - which is consistent with the fact that about half the sales are outside the US, and the cash tax rate is half the provision - then those $13bn would correspond to ca $50bn of cash that is outside the US. That's 40% of their pile, which sounds in the ballpark.*
- *on p54 you'll find details of how they've invested their cash - you haven't asked for it, but maybe this comes handy later*
- *on p59 we find that deferred tax liabilities are $13.8bn which is consistent with the number that we have found above*
- *on p61 we hit the mother lode: $82.6bn of cash is outside the US, out of which $40.4bn correspond to earnings not yet taxed in the US, and this corresponds to the above DTL's of $13.8bn."*

Chris nodded, and went off. *"Great work. I'll let you know what to do once I have news from P".*

In anticipation of more to come, Arthur took a moment to write down the key facts of the case as he saw it

- *Apple has $121.3bn in cash ($82.6bn outside US)*
- *$40.4bn earnings untaxed, repatriation DTL's of $13.8bn*
- *some of their cash is excess; precise numbers are depending on one's personal view, but returning $40-80bn seems defendable*
- *repatriation tax holiday not imminent, but likely to happen*
- *dividends and buy-backs paid post-tax, interest paid pre-tax*
- *dividends and interest taxed as personal income (in the US special, lower rate for dividends!); capital gains attract capital gains tax, but only in the year in which the shares are sold*
- *perps value: cpn/rate (fixed) or around par (floating)*

Later, Chris dropped by at Arthur's desk and told him about the instructions he had received from Philip, the MD.

"I got word from P. He'll be in the office tomorrow - probably about 10pm - and he would like us to knock up some pages for that. He has a couple of options for Apple he would like to discuss. I'll forward you the list in a moment. Could you start putting something together and circle it with me when you are done? Keep a few things in mind though

- *pages can be handwritten or PowerPoint - P does not care as long as he can see some thought behind the layout (and don't worry too much about pretty - we have production to clean that up later)*
- *do not just dump information - you can produce 'backup' pages if you really think this is necessary*
- *you know that P might ask you to present the pages the way you'd present them to a client, so be prepared*
- *P is not always right when he barks out his creative solutions - if you think something does not work just be clear about it*

He continued*: "I just want to make sure that you understand what P is suggesting, so I'll get you a short rundown if some of the things you'll see in his email and that you might not have come across yet.*

*Firstly, he talks about a **carve-out**. Think about it as a demerger - you have one company that consists of two parts, and the share* *represents both parts. You then split the company in two, and you split the shares in two as well, so that they trade independently. The key issue here is that this split is not considered a distribution, as this would trigger an income tax liability for the shareholder.*

*He also talks about an **SPV** - a special purpose vehicle. This can mean many things - what he refers to here is that you create a new company - possibly in a friendly jurisdiction - that warehouses some of your assets during the transaction, and that is collapsed at the end of the transaction. I am not sure what he exactly has in mind, but one thing I could think about is that the foreign subsidiaries that hold the cash also hold some operating assets that Apple still needs, and that an SPV might be helpful to separate the financial from the operating assets.*

*He also mentions a **bridge** (loan). What he means there is that in some cases things need to happen in a certain order. For example, the SPV might have to buy some assets just to sell them a few days later. Sometimes things work better when you use outside cash to do that, even if the company in principle would have the necessary resources.*

*Lastly, he uses some terms that are important for subordinated debt securities / preferred shares: a **cancellable** coupon can be cancelled by the issuer, but if it is **cumulative** it will need to be paid eventually. A **(dividend) pusher** ensures that not dividend can be paid (and no shares be bought back) as long as any of the cumulative coupon money is still outstanding.*

Oh, and one more thing - I am pretty sure that this whole thing is related to Einhorns proposal last May. I made you a copy of the notes I had taken at the time"

Before Chris leaves, he hands Arthur a copy of some handwritten notes:

Greenlight's Structure "GO-UP's"
May 2012
https://www.greenlightcapital.com/default.asp?S=893606

- preferred shares, 4-6% dividend rate
- taxed at preferential rates (for investors)
- payments subject to board approval (cumulative, ie need to be paid eventually; dividend stoppers?!?)
- preferred claim only in liquidation / wind-down

Chris left, and moments later Arthur received Philip's list in his inbox, in his usual terse Blackberry style

- *choice 1: fixed / floating coupon (reasons for/against?)*
- *choice 2: issuance at parent / sub level*
- *choice 3: callable / truly perp (at which price)*
- *coupon cancellable? cumulative? pusher?*
- *is giving perp to shareholders a dividend? yes -> carve-out?*
- *if carve out - how to maintain opco? reverse into spv? bridge?*
- *sub level distribution of perp possible? how? how is this different from distributing cash?*
- *repatriation tax? another holiday coming up? when?*
- *other taxes? at corporate level? for investors?*
- *high profile situation - political ramifications?*

Arthur took a pile of white sheets of paper, a pencil, a black pen, and some correction tape, and went to work in a quiet meeting room near his desk, hoping that his other deal would be somewhat quieter than the day before. **[maybe you can help him?]**

A while later, Chris dropped by.

"How is it going? You know, I was thinking. I am not quite sure about this whole sub-level distribution thing. Of course this is very elegant as they will never have to repatriate the earnings - they pass directly through to the shareholders - but I just don't see how we can get the securities from the sub to the shareholders without triggering a whole lot of taxes. And Einhorn uses parent-level preferred stock as well, probably for good reasons, so we need to make sure that we have our bases covered here. What do you think?"

Arthur did not really think anything at this point. **[And you?]**

Author's note: Arthur obviously did not know that at the time, but shortly afterwards, this proposal would make news because of Einhorn's decision to sue Apple. Chances are the Philipp knew that something was coming when he had arranged the meeting with Tim Cook....

> *The decision by David Einhorn's Greenlight Capital to sue the world's most valuable company is the latest effort to unlock the huge cash piles being hoarded by large technology groups. [...] Greenlight on Thursday said it had taken legal action against Apple over proposed changes to its corporate charter that would prohibit it from issuing a new high-yielding class of share, which could pay out billions of dollars from its $137bn cash pile [, without explicit shareholder approval]. [...] "Greenlight believes that Apple has the capacity to ultimately distribute several hundred billion dollars of preferred, which would unlock hundreds of dollars of value per share," he said.*
>
> *Tim Bradshaw et al, FT, 7 Feb 2013*