Should you bite this Apple?

by Roger Montgomery

Key points

- *Despite being one of the largest companies in the world, Apple grew its third quarter sales by 33%.*
- *China now represents a quarter of the company's revenue and profits, compared to the US at 40%, and accounted for 60% of the growth.*
- *Apple's global share of premium sales had always been in the 60% range but our estimates have that number now much closer to 70% last quarter.*

As I sit and prepare to write about this company, I realise that it actually sounds quite boring. Everyone knows this company. The big sigh I can hear stems from this undeniable fact. But just maybe that sigh is a global one and the yawning is why the stock is trading for a cash-adjusted price to earnings ratio of about 10 times.

The company is Apple (NSDQ: AAPL) and I am legally obligated to disclose that both the Montgomery Global Fund and the Montaka Global Fund own shares in Apple.

Apple (NSDQ: AAPL)

Source: Yahoo!7 Finance, 30 July 2015

The numbers

Buying Apple shares is not only an investment in technology, growth and China, it is also, for Australian investors, an investment in maintaining international purchasing power as (or if) the Australian dollar declines further.

Recently, Apple shares fell more than 8% from their July highs because Apple missed consensus analyst expectations for the third quarter 2015. As an aside, when that happens, I always have to ask myself whose fault is that: the company's or the analysts'? Did the company miss expectations, or did the analysts miss?

But the numbers weren't at all bad. Despite being one of the largest companies in the world, Apple grew its third quarter sales by 33%. No, that is not a misprint!

The third quarter growth rate was the fastest the company had experienced in more than three years. What is particularly exciting is that much of the growth is coming from China – a country where many other industries are suffering from the decline in economic growth. In other words Apple's devices are so desirable they are enjoying economic immunity.

Back in 2009, the company earned US$42 billion in sales, in 2014 sales had reached US$182.8 billion and in 2015 that number was reached in the first three quarters alone. It could be exceeded by US$60 billion.

Of the US$49 billion in sales revenue, $13.2 billion came from China – up 112%. China now represents a quarter of the company's revenue and profits, compared to the US at 40%. China accounted for 60% of the growth, and units shipped grew by 87% versus China's smartphone market growth in units shipped of 5%.

The power of the iPhone

In China, the iPhone 6 has achieved icon or cult status, and globally the company is enjoying the benefits of the network effect.

We observe that Apple has the most valuable customers because they are higher spending and more desirable by both telco providers and merchants.

Developers of iOS apps make double the revenue of those on the Google Play store. Amazon's most profitable customers are on iPhones. Google's most profitable customers are on iPhones. Phone carriers' most profitable customers are on iPhones.

And because higher value customers are more desirable for app developers (they can charge more) more apps are developed for iPhone.

Obviously where there are more apps, that is where users will congregate. To use all those apps, you need an iPhone. And because of the higher revenue, apps are always developed first for iOS over Android.

Globally, Apple has enjoyed the highest ever switch rate from Android. Asking yourself how long this might last yields an interesting answer. You see, only 27% of iPhone owners have switched to iPhone 6 and in China 4G penetration is only 12%.

More stunning is just how quickly the growth might come. To date, phone switching or upgrading to iPhone has been predicated on an industry standard of two and three-year phone plans but phone companies are moving to one-year plans and any time upgrades.

Meanwhile, the global PC market is contracting at 12% per annum but Mac sales are growing at 9%.

AAPL's closed IOS operating system has a security advantage over Android, which may give it significant strategic advantages in the cashless payments environment. This is over and above the relative attractiveness of iPhone users greater propensity to spend.

Apple's iPhone market share is hovering around 20% of the total installed base of smart phones and was about 15% of smart phone sales last quarter. No other vendor offering a premium priced phone sells anywhere near the volume of the iPhone. Apple's global share of premium sales had always been in the 60% range but our estimates have that number now much closer to 70% last quarter.

According to Techpinion, Apple's share of premium smartphone sales in 2014 was ~65%. Samsung's was ~24%, and the others like LG, HTC, accounted for ~10%.

Not boring at all

After all that, it is reasonably safe to say that this is not a boring story at all. The question that remains is whether or not the shares are cheap. If you consider the cash on the balance sheet and remove it from the market capitalization of the company, you are effectively buying the business for just on 10 times earnings.

That compares to over 50 times for Domino's Pizza. No wonder the company is turning 180 degrees from Steve's Jobs rejection of Warren Buffett's advice to buy back [US$140 billion worth of] its shares.

Earlier in the year Apple borrowed $1.35 billion of Swiss-franc denominated debt in two tranches at "microscopic" interest rates of 0.28% and 0.74% and this was after borrowing US$6.5 billion, in 10-year notes and 30-year bonds at rates ranging from just 1.6 % to 3.5%. In total, the company has borrowed more than US$40B to buy back shares that like us, it believes are cheap.

Roger Montgomery is the founder of Montgomery Investment Management. The Montgomery Global Fund and the Montaka Global Fund own shares in Nasdaq listed APPL.

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