The Wrap Up

A-P-P-L-E Find Out What it Means to Me

Markets and yields have temporarily reversed their trend, with this past week's momentum adding close to 4% to both the S&P 500 and the TSX. Considering the lack of change to the macro picture, we are not overly excited about this week's rally, even if we are happy to welcome it. Each week we look at how macro events or sector developments impact our holdings, this week we want to address our most asked about omission: Apple.

The market's most profitable firm reported their quarterly results yesterday and, as absolute figures, they are massive: revenue came in at $89.49B and profits of $22.9B (yes, that's a quarterly figure). Closing their fiscal year, the company touched $383B of revenue and $96.9B in net income, the third consecutive year that they are at that impressive level. In the year past, the company spent $15B on dividends, $82B on share buybacks and they now sit on $51B net cash (that's $162B of cash and marketable securities against $111B of debt). I cannot overstate how big this company is and how massive their profits and cashflows are. I do not need convincing about any of this and yet, I am not convinced to hold the company in our investment model. Why?

Growth

The impressive dollars behind their quarterly numbers are actually a decline from last year; revenues and net income dipped 2.8% versus last year's results and last year the company posted 7.8% and 5.4% revenue and net income growth. The company has posted 10% growth in revenue and profits in only 3 out of the last 10 years and it's fairly evident that 2021 was an anomaly caused by the generous stimulus distributed to consumers throughout the pandemic. Breaking down the growth by segment, only services revenue has shown consistent growth over the last few years, while iPhone sales (making up 52% of this year's revenues) are down from last year while Mac sales are below 2020 levels, wearables posting 2 year growth of only 3.9% and iPad revenues below their 2021 figures. Looking ahead, earnings per share growth is expected to be around 6.3% next year and 8.8% the year after (these figures are aided greatly by the company's large share buybacks).

Risks

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Every company has risks that it must contend with, Apple included. Generally, the risks are accounted for and discount the company's valuation; surprisingly there's been no discount to valuation in spite of some growing risks. China is the world's largest smartphone market, one that Apple masterfully navigated to support its multiyear ascent. This past quarter, revenue from the country came in 11% below expectations (at $15.08B or 16% of total revenue); growing competition from domestic brands like Huawei, a recent ban of iPhones across government agencies (likely due to the current tensions between China and the United States) and expressed encouragement from the Chinese Communist Party for consumers to consume more local brands are all risks that should be accounted for. Even the high margin, healthy growth services segment could face challenges in the medium term; there is a strong focus on the fees that Apple charges app developers for sales made through the App Store with a class action lawsuit currently taking place in the UK. Considering the FTC's more activist agenda, there could be a greater focus in this area. The costs of the lawsuits are immaterial to a company this large, however, it could weigh in on future margins.

Valuation

Company valuations as an absolute figure tell us very little, comparing them to other companies gives us a little more insight. In the case of a company as large as Apple, it is best to be compared to other large tech companies, in this case we will use Microsoft, Google and Meta. The first measure is the forward P/E ratio (the price paid for each dollar of next year's expected profit) and what is important to understand about this figure is growth rates, consistency and margins all have an impact on this figure. Apple trades at 27.5 times next year's earnings versus 31x for Microsoft, 19.3x for Google and 18x for Meta. The expected earnings growth varies, however with MSFT looking at 14%, Google at 16% and 20% for Meta against Apple's 6.3%, not only are these companies growing faster than Apple (and have been growing faster than Apple over the last 10 years) capital expenditures vary greatly amongst these firms. Apple is at $10.9B, Microsoft is at $31B, Meta is at $28.6 and Google at $28.8B. Capital expenditures are funds used to acquire, upgrade and maintain physical assets; while the business models do vary, the gap (which has been consistent for the last few years) should at least bring up questions as to whether Apple is reinvesting sufficiently for the future. While all four companies are expected to benefit from AI applications, Apple seems to be the least invested in this venture (I could not find the word being used once in their quarterly earnings call) which bring up the all-important question: where will future growth come from? The virtual reality headset could be interesting, but current pricing limits the scale of that product. Last point on valuation: even compared to its historical range, Apple can be seen as expensive; between 2010 and March 2020, the P/E only exceeded 20 once – December 2019.

It is not lost on me that Apple has an intangible value as a status symbol; some people's identities are engrained in the smartphones they use. That being said, companies that have achieved that status have also lost it. Remember Blackberry? The smartphone market is mature, growth opportunities will remain limited and the pressure will be on Apple to find the next big thing. At this size, there's no major concern about the company's health: they are a safe and healthy company. At this valuation, when compared to its large peers, when considering the intense competition and impressive innovation in tech, there are more interesting ideas. The beauty of a company of this size is that they can use their cash to buy a business that can alter their trajectory; even there, however, they are not an active company in large M&As. We follow the company closely, as we do own the shares for clients that request it (as stated previously, we do not see a danger in holding the shares) and at the right valuation, it could be an interesting buy. As of today, however, we are happy to watch it from the sidelines.

Healthy distraction

This week was Halloween; a day for kids and our own inner child. As usual, Christina and I handed out candies, with the most innocent moment occurring: a little girl stuffed her entire face in one of our flower pots as she wanted to smell them. It was an adorable little moment, one that warmed our hearts.

It made me reflect that at this particularly volatile moment, with wars going on in both Europe and the Middle East, there's few things more refreshing than watching kids be kids. They do not carry the burden of history, the weight of economics or the division of politics; they are fresh canvases that can become beautiful works of art.

As we enter the holiday season, a time for giving, I cannot think of a better gift than to give a child a chance to be happy and to be great. For those of us privileged enough, consider toys drives or volunteering at children's hospitals. And to parents who give their all to their own kids, I see in my own environment how demanding it can be, but know that you are the difference in your children's' lives.

Have a wonderful weekend!

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