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Apple

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## Apple defies naysayers in third quarter

Apple, the largest listed US company by market capitalisation, surged 4.7% in trading on Wednesday. This helped the Dow Jones Industrial Average close above 22,000 for the first time. The technology giant posted better than expected profits, decent iPhone unit sales and stronger than expected iPad unit sales.

### 3Q17 snapshot

Apple's posted revenue of \$52.9 billion in the fiscal third quarter (ended July 1, 2017), representing 7% year-on-year growth. iPhone unit sales came in at approximately 41 million and iPhone revenue edged up by 3% to US\$24.8 billion. This was broadly in line with analysts' expectations for a seasonally soft quarter. Unit sales were strong considering the tough comparative quarter when it launched the cheaper SE model.

The quarterly iPhone numbers stilled analyst concerns that demand for the iPhone may be weakening. Apple reduced channel inventory by 3.3 million units in the quarter, leaving the company with its lowest channel inventory in 2.5 years.

The iPhone ASP (average selling price) was \$606 in the quarter, up from \$595 a year ago. This was primarily due to strong demand for the iPhone 7 Plus, which represented a higher percentage of the iPhone sales mix than a year ago. Apple has now sold some 1.2 billion iPhones to date and in recent years has taken the lion's share of profits the smartphone industry. The swelling base of Apple users bodes well for future Services income (i.e. purchases made in the App Store) and bolsters network effects of popular Apple software like FaceTime and iMessage.

The gross margin came in at 38.5%, which was at the high-end of guidance and a solid result given recent component price increases in the industry. Earnings per diluted share came in at \$1.67 (+17.6% year-on-year) and beat forecasts as net income rose by an impressive 12% to \$8.7 billion.

	Three Months Ended	
	July 1, 2017	June 25, 2016
Net sales	\$ 45,408	\$ 42,358
Cost of sales	27,920	26,252
Gross margin	17,488	16,106
Operating expenses:		
Research and development	2,937	2,560
Selling, general and administrative	3,783	3,441
Total operating expenses	6,720	6,001
Operating income	10,768	10,105
Other income/(expense), net	540	364
Income before provision for income taxes	11,308	10,469
Provision for income taxes	2,591	2,673
Net income	\$ 8,717	\$ 7,796
Earnings per share:		
Basic	\$ 1.68	\$ 1.43
Diluted	\$ 1.67	\$ 1.42

Source: Apple filings

Earnings per share growth is supported by Apple's ongoing share repurchase program. The share base used to calculate diluted EPS in 3Q17 shrinking more than 4% from a year earlier.

Investors were also pleased with the upbeat outlook from the company. Apple is forecasting revenue in the range of \$49 billion to \$52 billion in the next quarter, marking a rise of between 5 and 11% year-on-year. The lower end of the range matched the Wall Street consensus estimate of roughly \$49 billion. Apple management also alleviated concerns that the typical iPhone release season would be delayed, resulting its release moving into the next fiscal year.

Some of the new features that are rumoured for the new high-end iPhone model are high-resolution OLED displays, 3D imaging, retina scanning and wireless charging. The price is speculated to be on high side, at \$1,000 or more, but we think it is a pretty safe bet many Apple fans will still be ready to shell over that amount of cash for the new phone.

Apple's 7% revenue growth was driven by broad-based strength across its segments. As stated earlier, iPhone revenue was up 3% and Services continued to post strong growth of 22% year-on-year to deliver \$7.3 billion revenue in the quarter. The Services business is fuelled by the company's huge and growing installed base of users and generates high-margin revenue.

Apple is likely to make a serious foray into original content in the future, in our view, in order to drive digital sales. The company recently hired two senior entertainment industry executives with a lot of experience in creating popular content like "Breaking Bad" and "The Crown." This suggests the company is looking to expand into video, with most of its content creation to date having been in the music arena.

Apple will continue to bring new services online, and we do not see the App Store and Google's Play Store duopoly being displaced anytime soon. While Apple's App Store may not have as many users as the Play Store, App Store users are a higher spending demographic and the store generates nearly twice the revenue of the Google Play store. The App Store is benefitting from a symbiotic relationship between Apple customers and app developers. The large number of Apple customers and their willingness to spend money attracts high app development talent, which in turn is attractive to the users.

We expect to see Services continue to grow as a percentage of the total revenue mix and for this to be margin enhancing.

Other products are also a fast-growing segment at 23%, but is a less meaningful contributor with revenues of \$2.7 billion in the quarter. iPad sales were surprisingly strong in the quarter, with unit sales up 15% year-on-year, which helped segment revenue eke out 2% year-on-year revenue growth to almost \$5 billion and reverse quarters of revenue decline.

Turning to the geographic drivers and the Americas, Europe and Rest of Asia Pacific delivered double-digit growth and Japan saw low-single-digit growth. Greater China revenues fell by 10% year-on-year to \$8.0 billion. Chinese revenues faced a stiff foreign exchange headwind and CEO Tim Cook said a conference call that Mainland China sales were up 6% in constant-currency terms. At the group level, Apple's CFO said the company faced about a 200-basis point headwind from currency movements in the quarter.

**Apple Inc.**  
**Q3 2017 Unaudited Summary Data**  
(Units in thousands, Revenue in millions)

Operating Segments	Q3 2017		Q2 2017		Q3 2016		Sequential Change		Year/Year Change	
	Revenue		Revenue		Revenue		Revenue		Revenue	
Americas	\$20,376		\$21,157		\$17,963		- 4%		13%	
Europe	10,675		12,733		9,643		- 16%		11%	
Greater China	8,004		10,726		8,848		- 25%		- 10%	
Japan	3,624		4,485		3,529		- 19%		3%	
Rest of Asia Pacific	2,729		3,795		2,375		- 28%		15%	
<b>Total Apple</b>	<b>\$45,408</b>		<b>\$52,896</b>		<b>\$42,358</b>		<b>- 14%</b>		<b>7%</b>	

Product Summary	Q3 2017		Q2 2017		Q3 2016		Sequential Change		Year/Year Change	
	Units	Revenue	Units	Revenue	Units	Revenue	Units	Revenue	Units	Revenue
iPhone (1)	41,026	\$24,846	50,763	\$33,249	40,399	\$24,048	- 19%	- 25%	2%	3%
iPad (1)	11,424	4,969	8,922	3,889	9,950	4,876	28%	28%	15%	2%
Mac (1)	4,292	5,592	4,199	5,844	4,252	5,239	2%	- 4%	1%	7%
Services (2)		7,266		7,041		5,976		3%		22%
Other Products (1)(3)		2,735		2,873		2,219		- 5%		23%
<b>Total Apple</b>		<b>\$45,408</b>		<b>\$52,896</b>		<b>\$42,358</b>		<b>- 14%</b>		<b>7%</b>

Source: Apple filings

Overall, it was a solid quarter for Apple and the outlook was upbeat, removing some concerns about a delay in the iPhone cycle.

Apple management was typically tight-lipped about what is going on in the company's R&D department, but Tim Cook said on the call with analysts that, "In terms of autonomous systems, what we've said is that we are very focused on autonomous systems from a core technology point of view. We do have a large project going and are making a big investment in this. From our point of view, autonomy is sort of the mother of all AI

projects. And the autonomous systems can be used in a variety of ways, and a vehicle is only one, but there are many different areas of it.”



Turning to the technical picture and regarding the monthly chart, prices have closed above the 78.6% Fibonacci retracement of \$124.90 in February. This is a bullish development and has activated two additional longer-term upside targets. The initial target of \$146.80 which is the 127.2% Fibonacci extension has been achieved. This now leaves the 161.8% Fibonacci extension of \$162.39 as the next broader term focal point. Adding to the bullish case is the fact that both momentum and the long-term trend are very much in favour of the Apple camp.



Turning to the daily chart, overhead resistance is situated at the August intra-month high of \$159.75 as shown by the horizontal red line. However, it should be noted that the rapid increase in share price has resulted in the RSI to venture within reach of overbought territory (exhaustion of short-term upward momentum). Hence, should the bears emerge over the near-term, a temporary pullback in price could follow. Positively, should this occur, we would view this short-term pause as corrective. Medium-term momentum is in favour of the bulls, as the share price has comfortably cleared both the 50 (red) and 200 (green) day moving averages.

## Summary

Although some of the 'easy upside' of the investment story has already played out after the strong share price appreciation over the past year we continue to view Apple as offering an attractive risk to reward proposition versus the broader market. The stock trades on 17.5 times FY17 forecast earnings, falling to 14.6 times the following year. Net cash equates to approximately one-fifth of the market capitalisation and the EV/EBITDA multiples over the same time frame are 11.9 and 10.3 times. The projected dividend yield in FY17 is 1.5%, expanding to 1.7% the next year. Apple's forecast annual dividend pay-out is roughly four times covered by estimated earnings.

We like Apple's huge installed base, strong consumer loyalty and the fast-growing 'services' business. There is also the potential for increases in capital returns and the shares trade on a reasonable valuation. The iPhone remains a tremendous product and we expect Apple to release other innovative services and products in the years ahead. A new breakthrough product is possible at any time given the company's significant R&D spending.

## Apple will remain held in the Fat Prophets portfolio. For Members without exposure we recommend it as a buy around current levels.

Apple is on our conviction buy list.

Disclosure: Apple is held in the Global Opportunities Fund.

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## Snapshot AAPL

### Apple

**Latest Closing Price: \$155.57**

Apple Inc. designs, manufactures and markets mobile communication and media devices, personal computers, and portable digital music players, and a variety of related software, services, peripherals, networking solutions, and third-party digital content and applications. The Company's products and services include iPhone, iPad, Mac, iPod, Apple TV, a portfolio of consumer and professional software applications, the iOS and OS X operating systems, iCloud, and a variety of accessory, service and support offerings. The Company also delivers digital content and applications through the iTunes Store, App Store<sup>SM</sup>, iBookstore<sup>SM</sup>, and Mac App Store. The Company distributes its products worldwide through its retail stores, online stores, and direct sales force, as well as through third-party cellular network carriers, wholesalers, retailers, and value-added resellers. In February 2012, the Company acquired app-search engine Chomp.

**Market Capitalisation: \$811.12B**

	FY1	FY2
Price to Earnings	17.5	14.6

Dividend Yield (%)	1.5	1.7
Price to Book	6.2	5.1
Return on Equity (%)	35.5	37.2
EV/EBITDA	11.9	10.3

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