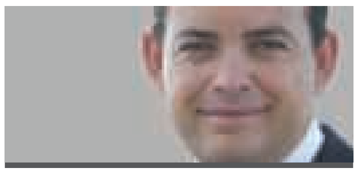
Stock Market Review

Apple Inc shares enter bear market territory



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When a particular share or a benchmark index loses more than 20 per cent of its value, it is described as having entered a bear market. Some readers may be surprised at the link between Apple and a bear market since the major financial headlines over the past few years mainly reported Apple's extraordinary rise in profits and its share price.

However, Apple's equity has indeed entered into bear market territory as its share price dropped by more than 20 per cent in a few weeks since touching its high of US$705.07 on September 21 – the same day the iPhone 5 went on sale in several parts of the world. Apple's equity entered a bear market on November 7 as the share price dropped below $564 and closed the day at $558, representing a five-month low and a loss of almost four per cent on the day.

November 7 was a particularly bad day for global stock markets with the Dow Jones Industrial Average index in the US suffering its worst decline in 2012 with a loss of 2.36 per cent. Most market commentators attribute this to the re-election of President Barack Obama that same day and the dangers of the 'fiscal cliff' in the US – a package of potential automatic tax hikes and spending cuts due to take place at the start of 2013 which could lead to a recession in the US.

Global markets also had to digest the news from the European Commission of a reduction in GDP forecasts for the region. Ongoing fears over the looming 'fiscal cliff' and the renewed worries over Europe's weak economy led to a continued downturn across global equity markets last Thursday and Friday with Apple's share price also continuing to decline and dropping to a low of $533.72 before staging a mild recovery.

While Apple's six per cent decline late last week must be put into perspective of the overall downturn across global equity markets, the drop of over 20 per cent in less than two months indicates a change in investor sentiment towards the world's most valuable company.

Investors are reacting to a number of factors that contributed to the recent underperformance of Apple's shares, namely (i) supply constraints to meet the strong demand for the iPhone 5 and the iPad mini which were launched recently; (ii) weaker-than-expected profitability for the second successive quarter; (iii) growing litigation with the company's rivals; (iv) weakening market share in the tablet market and (v) the surprise changes to the company's senior management team.

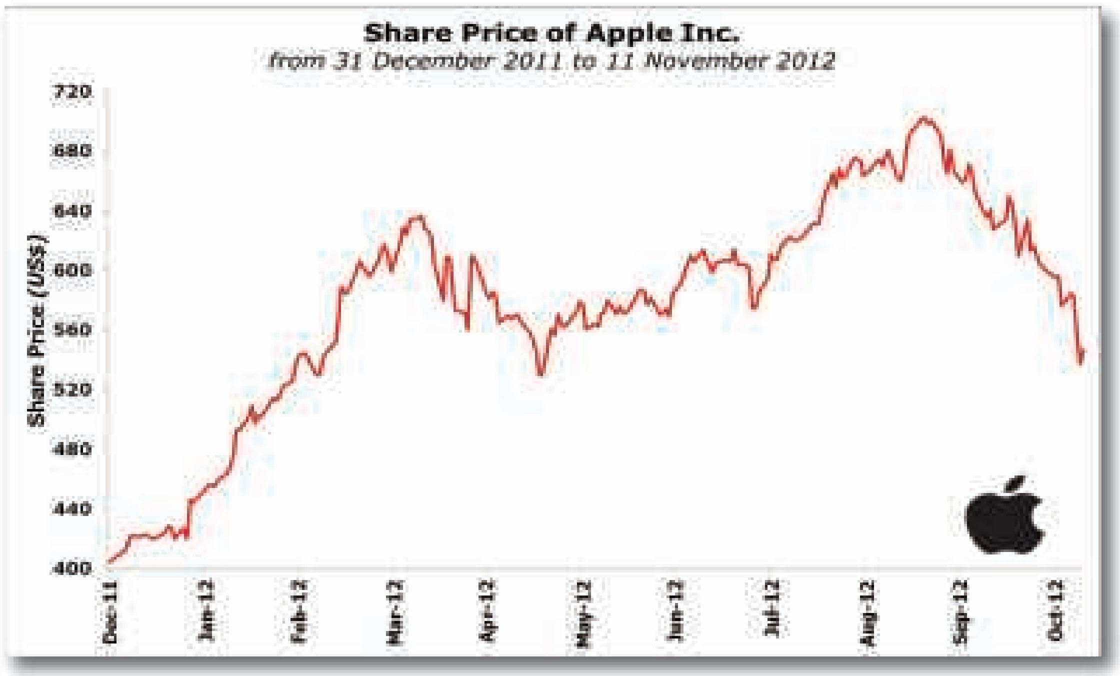
The change in sentiment possibly commenced towards the end of September when although the company reported that sales of the new iPhone 5 exceeded five million units in just three days after its launch on September 21, the share price dropped as the market seemed to have been expecting almost double this figure.

Apple introduced the iPad mini, the fourth-generation iPad and other revamped products during the third week of October, but the market became more concerned at the supply constraints to match the considerable demand for the iPhone and the other new products. One of Apple's main manufacturers reported a delay in the production of the new iPhone and, as a result, it was shipping much fewer than requested. Apple was also struggling to make enough iPad minis as it almost sold out its initial stock of units within the first few days of the launch.

Meanwhile, on October 25 Apple issued its Q4 results (July to September). Although revenue and profits grew by more than 20 per cent to $35.9 billion and $8.2 billion respectively, these figures 'disappointed' the market for the second successive quarter.

Moreover, Apple also indicated that it expects total revenue to reach a record level of $52 billion in the first quarter (October to December) of the current financial year to September 2013. This was also below analyst expectations of $55 billion.

Litigation also became a major focus on market sentiment. After the widely-publicised court room battle which saw Samsung being ordered to pay Apple $1.05 billion for infringing some of its



patents, Apple lost two cases in recent weeks. Additionally, there was growing evidence that Apple started to feel the impact of the intense competition as the company's share of the tablet market reportedly dropped from 59.7 per cent to 50.4 per cent during the third quarter of 2012 as a result of the competition from Google and Amazon with their cheaper tablets.

Statistics also revealed that Samsung's Galaxy S3 overtook the Apple iPhone 4S to become the world's bestselling smartphone during the summer. However, various analysts expect the iPhone to overtake the Galaxy S3 once again during the final quarter following the launch of the iPhone 5.

"Apple's profitability growth is expected to slow to circa 15 per cent in the current financial year"

The embarrassing launch of the Maps function as part of the new operating system (iOS6) in September also took its toll on investor sentiment. A number of errors in the new mapping software immediately turned to a public relations disaster for Apple with the CEO issuing a letter of apology to customers.

CEO Tim Cook said Apple fell short if its commitment to deliver the best experience to customers with the troubled launch of Maps. Shortly afterwards, this led to the resignation of the company's widely respected software chief, Scott Forstall. The sudden changes to Apple's senior management team also included the departure of the former Dixons boss who had been appointed by Tim Cook only six months ago to drive the company's expansion of its retail stores.

Some commentators are also speculating that the recent rapid decline in Apple's share price could also be as a result of the forced sale of a sizeable position of shares following an error by a US brokerage company Rochdale Securities. A trader at Rochdale reportedly received an order from a client to purchase Apple shares, but this trader mistakenly bought 1,000 times the number of shares requested.

The total amount purchased is reportedly between $750 million and $1 billion worth of Apple shares and the sheer size of this transaction also led to the US brokerage company seeking a capital injection or a merger as a result of the financial impact of this erroneous transaction on the company's financial position.

The decline in Apple's share price must also be placed in the context of the staggering rise in the equity over recent years and especially in the past 12 months. Despite the 21 per cent decline in recent weeks, Apple's equity is still up by a staggering 500 per cent over the past four years and by 45 per cent over the past year.

While some commentators view recent developments as a change in sentiment towards the technology giant, others may view this as an interesting entry-point given the relatively undemanding valuation multiples, the continued strong demand for the company's products and the significant idle cash on the company's balance sheet which amounted to $121 billion as at September 30, 2012.

Some international financial analysts claim Apple shares are currently trading on a forward price to earnings multiple of less than nine times earnings, which is below the average historical multiple of circa 12 times.

However, other analysts who are adopting a particularly cautious approach to Apple believe that it is correct for this equity to trade at a lower multiple than the historical average in view of the slowdown in profitability growth following the significant progress in recent years. Apple registered an impressive 83 per cent growth in profits to $25.9 billion in the financial year to September 30, 2011, followed by a staggering 61 per cent rise in profits to $41.7 billion in the financial year to September 30, 2012. However, profitability growth is expected to slow to circa 15 per cent in the current financial year ending September 30, 2013.

Since Apple is now the largest company by market cap and its iconic products have become among the most sought-after in the digital and consumer electronics area, developments in this company and wild swings in its share price as experienced over recent weeks are bound to continue to hit the headlines and attract a lot of media attention.