Stock Market Review

The great Apple debate

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The steep decline in the share price of the world's most valuable company has sparked widespread debate across international financial journals. Apple's equity had rallied to a peak of $705 shortly after the launch of the iPhone 5 last September. However, the share price has since tumbled by 37 per cent to a recent low of $440, forcing Apple to briefly lose its position as the most valuable company. The sharp drop was due to several factors, including the increasing competition from Samsung and Google, lower profit margins due to higher manufacturing costs and more intense competition in the smartphone and tablet markets as well as weaker growth rates. The faulty mapping application launched on the iPhone 5 also dented the company's credibility.

The share price tumbled by more than 10 per cent on January 24, following the publication of the company's Q1 results for the 2012/13 financial year resulting in a decline of $50 billion in the value of the company. Although between October and December 2012, Apple registered a rise of 18 per cent in revenue to $54.5 billion and generated record profits of $13.1 billion, the results were only marginally higher than in the comparable period of the previous year. The technology giant posted its slowest rate of profitability growth since 2003 mainly due to weaker-than-expected iPhone sales over the Christmas period and a 6.1 percentage point decline in profit margins to 38.6 per cent.

Investment analysts expected sales of iPhones to reach 50 million; however, Apple sold 47.8 million units. Despite the shortfall, the actual figures still represent a strong rate of growth compared to the 37 million units sold in the equivalent period of last year at the time of the iPhone 4S. Various analysts had very high expectations for Apple's Q1 numbers due to the new product launches in previous months related to the iPhone 5, a fourth-generation iPad, a new iPad mini, a new iPod touch and an iPod nano as well as a new version of the MacBook Pro.

Ironically, Apple's executive management team blamed the weaker numbers on the troubles in meeting the strong demand for the new iPad's and the Mac computers. The company indicated sales could have been stronger had production kept up with demand. The market was also disappointed by the guidance provided by the executive management for the next quarter indicating revenue to range between $41 billion and $43 billion against initial analysts' forecasts of $45 billion.

The news of the weaker guidance prompted many international analysts to reduce their price targets for the company's equity which in turn led some investors to sell their shares in Apple. The average consensus 12-month share price target for Apple dropped by 14 per cent after the results announcement from over $770 to $650.

While some analysts have responded by slashing their share price targets in response to the weaker-than-expected guidance, others remain bullish and point to the company's large cash pile ($137 billion as at December 31, 2012) and the cheap valuation multiples. The US investment bank Goldman Sachs estimates that Apple is trading on a forward price to earnings multiple of only seven times based on the financial expectations for the current financial year ending September 30, 2013, and also excluding the cash on the balance sheet.

Goldman Sachs expects Apple's revenue to grow by 17 per cent for the 12 months to September 30, 2013. Bank of America Merrill Lynch estimates Apple's profits will increase by 20 per cent in 2014 and by an additional 15 per cent in 2015. This should prompt a large cash payout to shareholders, improving the dividend yield on the shares which would in turn attract more 'value-oriented' investors.

> **Given the huge cash pile at Apple of over $137 billion, there should be sufficient cash both to distribute to shareholders and to maintain healthy liquidity levels**

Although many analysts slashed their price targets, the average share price forecast remains attractive at $650 a share (41 per cent above the current price of circa $460). The recent pull-back in the share price could therefore be regarded by many as a buying opportunity taking a medium to long-term view.

The company could also benefit from new initiatives to stem off the growing competition as Apple followers await the launch of some widely-anticipated innovative products which could give a boost to the company's fortunes. The launch of the iPod in 2001 revolutionised the music-player market whereas the iPhone had a strong impact on the smartphone industry. Similarly, the more recent launch of the iPad stimulated strong demand for tablets to the detriment of the PC industry.

In recent months, many commentators have speculated that the company is planning to launch a much cheaper iPhone later this year aimed at increasing penetration among price-sensitive customers mainly in emerging markets. China is also a very important market for Apple and CEO Tim Cook had claimed some time ago that China will soon surpass the US in terms of the company's geographic spread. Apple is reportedly close to concluding a distribution agreement with China Mobile, the largest mobile carrier with 700 million subscribers.

The market has been rife with speculation that the company will enter the TV market. The CEO had stated in an interview that TV is an area of "intense interest" although it is doubtful whether Apple can rely on TV to fuel blockbuster sales given the already-wide penetration of smart TV's by many manufacturers and the likely high price tag which could limit their mass-market appeal.

The greatest challenge for the future of Apple is to replicate the astounding success of the iPhone and the iPad. These two products contributed more than 70 per cent of Apple's total revenue of $157 billion during the 2011/12 financial year and a new blockbuster product would also need to be a huge success to help the company maintain the strong growth rates seen in recent years. Most analysts have been indicating that an iTV is shortly expected to be launched while others are indeed speculating that Apple is also developing an iWatch to perform some of the tasks now being done by the iPhone and iPad.

The company was also in the headlines in recent weeks since one of its minority shareholders (the hedge fund Greenlight Capital Re) proceeded to take legal action against the company as a means to seek new ways of distributing part of Apple's substantial cash pile. Although Greenlight Capital owns a stake of only 0.12 per cent in the company, Apple reacted immediately and issued an official statement on February 7 claiming that the "management team and board of directors have been in active discussions about returning additional cash to shareholders".

This statement was well received by the market and led to an immediate upturn in the company's share price. Apple is arguably in the midst of a change in its cycle from a growth company to a 'value stock'. Critics believe issuing higher dividends to shareholders is an admission that the innovation and growth phase is coming to an end. On the other hand, distribution of cash is very important and given the huge cash pile at Apple of over $137 billion, there should be sufficient cash to distribute to shareholders and to maintain healthy liquidity levels to invest in new innovative products and other growth initiatives such as through outright acquisitions.

Shareholder activism has become the order of the day in international markets and this should be emulated locally. Minority shareholders of local companies including institutional investors should take a cue from international developments and make formal representations to companies on future strategic developments and dividend policies. This should lead to healthier debates between top company representatives and investors not only at annual general meetings but throughout the year.