

NASDAQ  
AAPL



# Stock Report

## Apple, Inc.

### Market Data

June 20, 2008

Price: \$175.16

52 Week Range:

\$111.62 – \$202.96

Market Capitalization:

\$159.49 Billion

Dividends: None Paid

### Valuation

EPS:

2007A 4.85

2008E 5.20

2009E 6.36

P/E:

2007A 36.12

2008E 27.16

PEG:

2007A 1.40

5 YearE 1.43

### Growth Outlook

Sales Growth:

2008E +36.2%

2009E +22.4%

### Financial Data

% Revenue Int'l 44%

Debt Rating NA

### Company Overview:

The Apple I computer was launched in 1976 by Steve Jobs and Steve Wozniak. In December of 1980, Apple went public and 40 employees became instant millionaires. Steve Jobs, the largest initial shareholder made 217 million.

Today, Apple designs, manufactures and sells personal computers, mobile communication devices, portable music players, accessories, software and networking solutions. In addition, Apple sells many peripheral products including printers, storage devices, computer memory, digital music and videos, and still cameras. The company also provides application and internet software.

Products include: Macintosh OS X operating system, iPod, iLife, iPhone, iTunes, Safari browser, Quick Time multimedia software and Mac, a suite of internet services. In addition, Apple offers wireless connectivity and networking services. As of March 29, 2008 Apple had 208 retail stores.

## INVESTMENT SUMMARY

**Rating: Buy.** Apple is recommended here as a buy for investors seeking growth. Apple's strategy to lower the price of the iPhone accomplishes more than increasing their market share; I believe it will bring more revenue in from other sources. Consumers will be driven to purchase iPhone accessories and related Apple products. In addition, there is also a strong possibility the Mac will benefit as well. Apple shipped 2,289,000 Macintosh computers during the second quarter, representing a 51% unit growth and 54% revenue growth over the year-ago quarter. I believe corporations may not want to take a chance on incompatibilities and may move to Apple software and operating systems.

### Valuation:

Apple's PEG ratio (1.40) is high compared to the industry average (1.26) and their sector (1.23). However, the 5 year expected PEG ratio is estimated at 1.43 which indicates a strong projected growth rate. Although Apple's current and projected P/E ratios are higher than any major competitor, I believe their stock is attractive versus competitors for two major reasons. First, Apple has projected sales growth rates of 36% (2008) and 22% (2009) and second, Apple is entrenched in the minds of the consumer. Heidi Moore states, "Apple has something Microsoft wants-and which Google also has: the attention of the American consumer."<sup>9</sup>

### **Expected Continued Strength**

"The digital download service is the number one music retailer in the US, according to the most recent data from NPD Group's MusicWatch survey."<sup>4</sup> Apple Insider reports that iTunes customers rent or purchase over 50,000 movies every day making iTunes the world's most popular online movie store. iTunes also has the largest music catalog with eight million songs. iTunes recently sold its 5 billionth song. I believe the iPhone holds tremendous promise in the highly competitive mobile communication market. According to Needham & Co. analyst Charles Wolf, "Apple will sell near 30 million iPhones next year."<sup>12</sup> Wolf expects the iPhone 3G will capture 7% of the US mobile phone market next year, with sales of 14 million units. Wolf estimates international iPhone sales will hit 15.6 million.

### **RISK**

Because the iPhone is capable of iPod functions, there is significant risk of cannibalization. Analyst Charles Wolf also estimates iPhone sales will cannibalize iPod sales by around 30%. In addition, gross margins declined by 2.2% in the second quarter. The decision to lower prices to increase market share could negatively affect future earnings.

## Q2 EARNINGS REPORT

On April 23, 2008 Apple announced financial results for its fiscal 2008 second quarter ended March 29, 2008. “The company posted revenue of \$7.51 billion and net quarterly profit of \$1.05 billion, or \$1.16 per diluted share. These results compare to revenue of \$5.26 billion and net quarterly profit of \$770 million, or \$.87 per diluted share, in the year ago quarter. Gross margin was 32.9 percent, down from 35.1 percent in the year-ago quarter.”<sup>2</sup> Apple’s fiscal year runs from October – September.

## INDUSTRY AND COMPANY OUTLOOK

Mac’s impressive second quarter sales and margin growth should be the beginning of a nice run. Yankee group research conducted a survey of more than 700 senior IT administrators and C-level executives and according to Greg Keizer, “nearly 80% of businesses have MACS in-house, nearly double the percentage that said they had users running Mac OS X two years ago.”<sup>6</sup> Industry research firm IDC reported a 10% increase in worldwide PC shipments in 2006 and a 14.5% increase in 2007. I believe PC sales will continue to experience double digit growth for years to come due to a developing worldwide

## RECENT NEWS



### **June 9, 2008 - Apple introduces the new iPhone 3G**

“The new iPhone 3G combines all the revolutionary features of iPhone with 3G networking, built-in GPS, and iPhone 2.0 software that supports Microsoft Exchange ActiveSync and runs hundreds of third party applications built with the iPhone SDK. Available in 22 countries on July 11, the iPhone 3G comes in two models: an 8GB model priced at \$199.00 (US) and a 16GB model priced at \$299 (US).”<sup>1</sup>

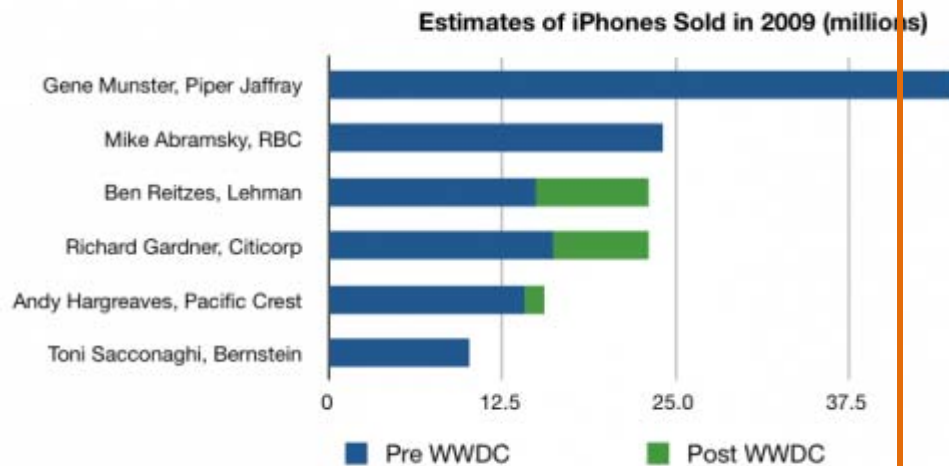
middle class and continuous technological improvements that make PC's near obsolete in as little as a few years. According to Doug Bell, an analyst with industry research firm IDC, "even in the weakened economy we saw in the fourth quarter, PC's still come out better than most consumer technologies."<sup>7</sup> The top 5 vendors for PC's are HP, Dell, Acer, Apple and Toshiba. In my opinion, Apple will increase their market share for at least 5 years for PC's because the Mac is a quality system, Apple is popular and the iPhone will bring in new Mac customers.

With Apple's recent entrance into the smart phone market, the iPhone 3G has even greater growth possibilities than the Mac. Needham analyst Charles Wolf expects the iPhone 3G will capture 7% of the US mobile phone market next year, with sales of 14 million units. Wolf also estimated the installed base of iPhone users will reach 150 million in the next ten years. As part of my research for this report, I spent some time using a friend's iPhone. I was not impressed by the iPhone, I was blown away. I am now very bullish on the iPhone and side with Gene Munster in his projections.



## “How many iPhones will Apple sell in 2009?”<sup>4</sup>

June 11, 2008 - As the chart below indicates, there's quite a range for estimated iPhone sales, from 10 million to 45 million units. All estimates are for calendar year 2009 except Lehman Brothers, which is fiscal (i.e. Oct. 08-Sept. 09).



“The reasoning behind the new estimates is as simple as Econ 101: as the price goes down, sales go up. Apple is going for volume with the iPhone, writes Charlie Wolfe at Needham. iPhone sales should increase dramatically in the second half of the year and beyond.

I also believe Apple will sell 40+ million phones in 2009. As Mr. Jobs said, "This is the phone that has changed phones forever."<sup>8</sup>

But as Piper Jaffrays Munster notes, In reducing the entry-level price of the iPhone to \$199 and eliminating revenue sharing agreements with its carrier partners (using one-time subsidies instead), Apple is clearly making a trade-off. Like most analysts surveyed, he believes it's a strategy that will pay off in the long run."<sup>3</sup>

**STRONG  
MANAGEMENT  
TEAM**

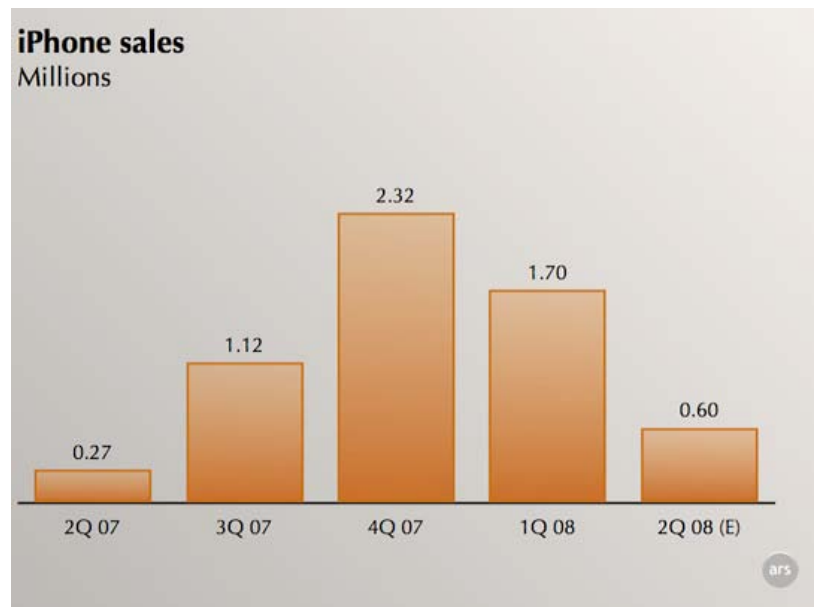


Steve Jobs, 51 CEO

In an age of extreme over compensation, questionable stock options and golden parachutes, you've got to love Steve Jobs. Annual salary: \$1.00 Mr. Jobs is the founder of Apple, who was fired from his own company and brought back in after starting companies NeXT (which was purchased by Apple) and the highly successful Pixar. Mr. Jobs is a passionate and brilliant innovator. He founded Apple, it's his baby and he's the guy every shareholder should be happy is in charge.

The following chart is from AppleInsider. Apple has sold 6 million iPhones and it is obvious from the second quarter fall off in iPhone sales that consumers have stopped buying the original iPhone and are waiting for the new iPhone3G to hit the market. Although sales for 3G's are expected to be brisk, the chart does suggest Apple has quite a bit of work to do if it is to meet most analysts' lofty sales expectations.

According to Steve Shen, "Taiwan-based component suppliers of Apple's 3G iPhones are expected to see their revenues strengthen substantially starting the third quarter of this year due to sales of the new iPhones. With the new iPhones to be available simultaneously in 22 countries on July 11, total shipments of 3G iPhones are expected to top 10 million units in the third quarter."<sup>11</sup>





Peter Oppenheimer 44,  
Senior V.P. and CFO

“Mr. Oppenheimer oversees the controller, treasury, investor relations, tax, information systems, internal audit and facilities functions. Prior to joining Apple in 1996, Oppenheimer was CFO of one of ADP’s strategic business units.”<sup>2</sup>



Timothy Cook 43, COO

“Mr. Cook is responsible for all of the company’s worldwide sales and operations. He also heads Apple’s Macintosh division and plays a key role in the continued development of strategic reseller and supplier relationships. Before joining Apple, Mr. Cook was V.P. of Corporate Materials for Compaq and also spent 12 years with IBM.”<sup>2</sup>

If Taiwan component manufacturers are correct in anticipating 10 million units will be sold in the third quarter of this calendar year, my estimate of 40 million 3G’s for 2009 may be low. In addition, Apple is considering a move which I believe would be tremendous from a strategic standpoint. Apple is considering selling iPhones through universities. According to Kasper Jade, “Apple is mulling a plan that would see the company extend sales of its upcoming iPhone 3G through top universities, and is separately considering a new protection service plan for college students. People familiar with the matter say the Cupertino-based company is “intensively” looking into the possibility of allowing on-campus stores and other educational resellers to market the new touchscreen handset to student populations.”<sup>5</sup>

### The Competition

#### “Samsung’s Instinct Doesn’t Ring True as an iPhone Clone”<sup>10</sup>

As soon as Apple introduced the first iPhone a year ago, U.S. phone carriers contacted factories in Asia to develop an offset. It seems the closest competitor is Samsung’s Instinct which was launched by Sprint on June 20, 2008.

Walter Mossberg from the Wall Street Journal writes, “I’ve been testing the Instinct, and while it isn’t a bad phone and has some features the Apple product lacks, it’s no match for the iPhone. The manufacturers haven’t replicated the iPhones greatest strength: beautiful, powerful, breakthrough software.”<sup>10</sup>



Samsung Instinct



Ron Johnson 50, Sr. V.P.  
Retail

“Mr. Johnson leads Apple’s retail strategy and is responsible for its overall execution and performance. Under Johnson’s leadership, Apple has opened over 200 stores. Johnson has over 20 years of experience in retail and merchandising as well as a strong track record for delivering consistent year over year growth for billion-dollar companies.”<sup>2</sup>



Anthony Fadell 39, Sr. V.P.  
of iPod Division

“Mr. Fadell joined Apple as the first member of its iPod hardware engineering team in 2001. He became senior vice president of the iPod Division in April 2006. Prior to joining Apple, Fadell was a cofounder and director of engineering of the Mobile Computing Group at Philips Electronics.”<sup>2</sup>

The new Instinct was designed to compete against the original iPhone. Unfortunately for Sprint, the instinct hits the market just 3 weeks before the new 3G. According to Mossberg, “this second iPhone model corrects some of the first models main weaknesses, wiping out some advantages Sprint hoped the Instinct would have.”<sup>10</sup>

The instinct looks like the iPhone, a dark slab with a touchscreen and no physical keyboard. However, as Mossberg points out, “it lacks the iPhones multi-touch system, which includes features that recognize multiple fingers and gestures, and allows actions like shrinking a photo by pinching it. The touch system on the Instinct is more like that on an ancient ATM than a cutting-edge gadget, even though it has a gimmicky feedback mechanism that gives you a tiny vibration-jolt when you press an icon.”<sup>10</sup> In addition, the Instinct’s screen is smaller than the iPhones and has lower resolution.

According to Mossberg, “The Instinct has the same \$199 price tag as the new iPhone, after a rebate and with a two-year contract. Service plans are likely to start at around \$70, in line with the minimum monthly fee AT&T will charge on the new iPhone. But it comes with just one-quarter of the memory the base iPhone includes.”<sup>10</sup>

Although I was not able to find an Instinct to try myself, my research indicates the Instinct is still far behind the iPhone 3G. Mr. Mossberg concluded his article with this statement, “the Instinct is an OK choice. But it’s no iPhone.”<sup>10</sup>

## Management Team Conclusions

All of the key executives have extremely impressive resumes. Mr. Jobs has assembled his team and I believe that is what is most important. In addition, I like the age of the key executives. For Apple to be successful long term, I feel they must continue to attract young technology minded consumers.

Apple's young and intelligent key executives should help to accomplish this.

## Manager's Insights

I was very fortunate to interview Mr. David Rolfe, Chief Investment Officer for Wedgewood Partner's in St. Louis. Mr. Rolfe is responsible for following Apple's stock. The interview took place on July 14, 2008 from 8:15 – 9:20 a.m. I sent a follow up thank you note to Mr. Rolfe on July 15<sup>th</sup>, 2008 along with a copy of my report.

**Q:** What are the greatest challenges Apple will face in the next 3 years?

**A:** Sustaining the new cutting edge product launches and meeting investor expectations.

## Financial Position

Apple's financial position is very strong. Based upon Apple's balance sheet for fiscal 2007 (Oct 1, 2006 - Sept 29, 2007), Apple has 9.35 billion in cash and another 6 billion in short term investments. In addition, it carries no debt on its balance sheet. Furthermore, Apple generated 5.47 billion in cash flow from operating activities in fiscal 2007, more than double fiscal 2006. Apple's liquidity, profitability, efficiency and market ratios are analyzed in more detail in the following sections. The following is a time series analysis of Apple's financial ratios. There are no leverage ratios as Apple has no debt.

LIQUIDITY RATIOS			
	2005	2006	2007
CR	2.96X	2.24X	2.36X
QR	2.91X	2.20X	2.32X

The current ratio indicates Apple has ample liquidity to cover its short term obligations. The decline in the current ratio and the quick ratio in 2006 would suggest investment opportunities were taken. Greater returns could result from this action. The fact that the quick ratio (CA – Inventory/CL) is moving in sync with the current ratio is a positive sign from an investment and cash management standpoint. A quick ratio so close to its current ratio indicates Apple has sufficient ability to meet its current obligations with only its most liquid assets.

**Q:** Do you have a projected earnings for Apple in 2009?

**A:** \$7.00/share

**Q:** What apple products do you own or have you used, and what is your opinion of those products?

**A:** Between my office and house, every Apple product. The Apple TV is really slick. My son's iTouch is like a third hand. We download movies onto our iPhone's and use the iPhone as a remote control and watch them on our flatscreen through Apple TV.

**Q:** Of the major phone manufacturers (RIM, Nokia, Erikson, Motorola, Samsung etc.), which if any may come through with a true competitive product in less than 5 years?

**A:** RIM (Blackberry) and Nokia will have nice smartphones but they won't compare to the iPhone because their software doesn't compare.

**Q:** Steve Jobs made the statement that the iPhone is 5 years ahead of the competition. Do you agree?

EFFICIENCY RATIOS			
	2005	2006	2007
ITO	59.9X	50.8X	45.8X
TATO	1.21X	1.12X	.95X

This is interesting. The inventory turnover ratio has been declining for 3 years, which indicates it is taking longer to move inventory relative to prior years. This seems odd considering the difficulty Apple has had in meeting demand for some of its products. However, considering Microsoft's ITO for 2007 was 9.49x and Dell's was 11.11x, I do not believe it is of concern.

TATO is the amount of sales revenue generated from its investments in assets. Usually, the higher the number the better and increases from year to year are preferred. However, Apple's investments are bringing down the TATO multiple but I believe when the investments start paying off, TATO will begin to increase again.

PROFITABILITY RATIOS			
	2005	2006	2007
ROA	11.56%	11.56%	13.79%
EPS	1.55	2.27	3.93

With Return on Assets and Earnings per Share on the rise, it is easy to see why the price of the stock is 36 times earnings. Although profit margins will decline with the new strategy, the increased revenue should generate increased earnings. Analysts are predicting EPS of \$5.20 (2008) and \$6.36 (2009).

**A:** Maybe not 5 years, but certainly multiple years. The Mac operating system is the “secret sauce”, the core of their entire product line which is why customer satisfaction is so high. All their products speak to each other without problems.

**Q:** Apple appears to be lowering prices to capture market share. Their gross margins dropped 2.2% in the second quarter. Do you believe this is the correct strategy?

**A:** Yes, but product launches with new component parts can initially affect profit margins. Apple is dropping their prices but unless the gross margin drop becomes a trend it is not a concern. Component prices will come down but there is a lag.

**Q:** How much of an impact will the cannibalization of the iPod by the iPhone have on Apple’s bottom line and is it a concern?

**A:** The iPhone and iPod touch are the best iPod’s available. The gross margins are better than the iPod. Apple knows they are cannibalizing the iPod but are not concerned.

## FINANCIAL SUMMARY

I’ve already discussed the market ratios (PEG and EPS) earlier in the report. As indicated, the PEG ratio which is used to determine the relative trade-off between the price of the stock and its expected growth is high compared to Apple’s closest competitors. However, I believe this to be a positive because of the potential for future growth. The strong balance sheet with no debt and its history of no dividend distributions puts Apple in a position to dominate product launches and invest in new technology.

## RECOMMENDATION AND CERTIFICATION

<b>Buy (B)</b>
Fundamentals and/or Valuations are compelling. <b>Hold (H)</b> Fundamentals and/or valuations are stable. Or a special situation exists, such as a merger, that warrants no action. <b>Sell (S)</b> Fundamentals are deteriorating considerable and/or a recovery is highly unlikely. The stock is significantly overvalued. <b>Short (SS)</b> Fundamentals have deteriorated and are expected to continue to do so for the foreseeable future resulting in negative growth in EPS.

I have recommended a buy for reasons outlined in this report.

**Q:** The Mac had a 51% increase in units in the 2<sup>nd</sup> quarter. Do you believe this has anything to do with the iPhone?

**A:** Absolutely. The halo effect is overused but it is absolutely true for Apple. Go into an Apple store and experience the knowledge and personal attention from the sales staff and you will understand. 55% of Mac buyers are new to the Mac line.

**Q:** The P/E of 35.62 is higher than any major competitor. Considering the efficiencies of the market, do you believe Apple is a good buy and why?

**A:** One must consider the revenue dynamics of the iPhone (24 month deferral). In addition, Apple sports a significant cash balance on their balance sheet. Both of these facts overstate the valuation of Apple in terms of a static P/E measurement. And yes, I believe Apple is still a good buy. They are the only vertically integrated hardware and software company in the world.

### Certification

I certify that the information contained in this report is the result of my primary research and has not been copied in whole or in part. All sources of information have been properly and completely documented in the *Bibliography*. Statements that are not my own have been put in quotations and are properly referenced in the *Reference* section.

I have read and understand the *University of Missouri* guidelines governing plagiarism and further certify that no statements contained in this report are other than my own. Should the professor find otherwise, I understand that I am subject to the University's rule of suspension or expulsion from the UM system.

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Floyd Thomas

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Date signed

\_\_\_\_\_  
Name Printed

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