



Apple Inc – Looking beyond the device game

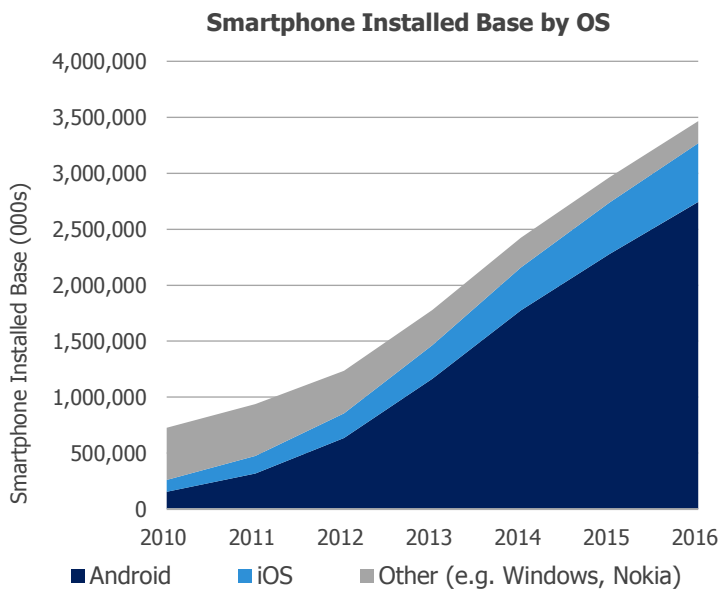
Apple Inc ('Apple') is amongst the largest companies in the world. The company enjoys strong brand recognition globally and extensive market penetration for its flagship products, most notably the iPhone. While speculation around the success of Apple Watch, Apple TV, iPad, or even the likelihood of an Apple Car often captures headlines, we estimate that iPhone and iPhone-related services represented around 70% of Apple's revenue and 80% of Apple's gross margin in FY16. Despite its relatively high price, there is strong demand for the iPhone in both developed and emerging markets, with China now contributing 21% of Apple's total revenue.

Apple's growth has been driven through its position as a consumer hardware vendor. There are few, if any, examples of consumer hardware vendors which have endured over the long term as the products have typically commoditised over time. However, having built a powerful, enduring ecosystem, we view Apple today as a leading mobile platform and services company with sales of its devices reflecting effectively a "subscription" payment to access its platform and services.

Apple displays several attractive investment characteristics which support our longer-term outlook for the company.

Global digital platform

Along with Windows and Android, Apple's iOS is one of the major global digital platforms. There are only two main mobile platforms globally – Apple's iOS and Google's Android – which is unlikely to change in the foreseeable future. Almost all consumer software and services will be developed for these two platforms and the vast majority of digitally connected people will connect via one of the two. Importantly, while iOS is not the leading mobile platform by users, it currently dominates use among premium phones and the highest-spending consumer demographic, which is particularly valuable.



Source: Gartner, Magellan Asset Management Limited estimates.

Mobile devices are increasingly central to people's lives, with a 2015 Deloitte study finding that the average American checks his or her phone 46 times per day. Being the mobile platform owner provides Apple with tremendous optionality in terms of new devices and services such as Apple Pay (payments), HealthKit (health wearables) and HomeKit (home network connectivity). Even though it is very difficult to estimate the impact of these on Apple's consolidated earnings given the immense profitability of the iPhone, more iOS devices and services make the platform increasingly valuable and make switching harder, thereby lowering iPhone churn and helping to cross sell other Apple devices.

Increasingly annuity-like revenues

iPhone sales are becoming more annuity-like. As the installed base of iPhone users has grown, Apple's dependence on winning new users has diminished. User satisfaction among iPhone users is typically very high and thus renewal rates are also high. We expect sales of new devices to existing users will represent a significant majority of iPhone revenues going forward.

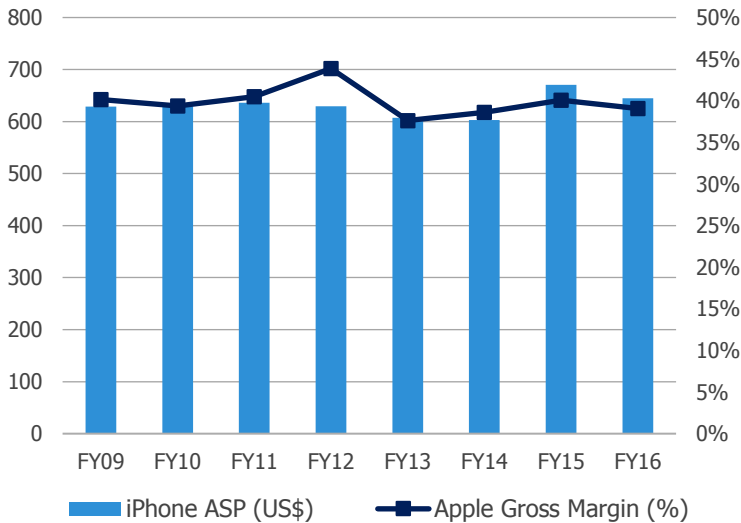
Little exposure to typical hardware commoditisation

During the rapid expansion in the smartphone market over the past decade, we held concerns that these devices would face commoditisation similar to that seen historically in the PC market. Apple has achieved impressive growth as a consumer hardware vendor, but our historically cautious approach has been prompted by the tumultuous history of the mobile phone vendor market structure, with market leadership rapidly changing hands in recent history - consider prior leaders - Motorola, Sony Ericsson, Nokia, Blackberry and HTC.

Our initial concerns were three-fold: (i) the relatively high price of the iPhone, (ii) the continual functional improvements of lower-priced Android phones, and (iii) greater phone price transparency as carriers moved away from subsidies (by explicitly listing the monthly cost of the phone rather than recovering the cost of the phone via service fees). Despite these issues, Apple has continued to grow its installed base of iPhone users and increased average iPhone selling prices at high margins.



iPhone ASP & Apple Gross Margin



Source: Magellan Asset Management Limited, Apple Inc.

We believe this resilience in iPhone prices and Apple’s margins will continue due to the iPhone’s premium positioning, the iOS ecosystem and very high user retention. The latter will be driven by brand loyalty and user preference, as well as the switching costs associated with user reluctance to learn a new interface, desires to maintain access to iOS-only apps (e.g. Facetime) and services (e.g. photo collection in iCloud), and preserving the integration benefits of multiple Apple devices (e.g. iPhone and Apple TV).

Growth opportunity

At the end of 2016, smartphones represented an installed base of approximately 3.5 billion phones globally and are expected to reach 4.7 billion in 2020¹. While smartphones now enjoy very high penetration rates among high-value device user groups, much of the market’s growth will come from low-value device users. We see Apple’s growth being generated from:

- **Growing share of high value device segment.** Android switchers to iPhone have risen to record levels since release of the large-screened iPhones.

- **Growth in high value device users.** We estimate that emerging markets contribute over 30% of Apple’s sales and the company is seeing rapid growth in the proportion of the population able to afford an iPhone. While there is some caution around global consumer weakness in the short term, the expanding middle class globally is expected to benefit Apple over the long term.
- **iPhone addressable market expansion.** Apple’s recent decision to lower the cost of its entry level iPhone demonstrates Apple’s increased focus on expanding its market.

Investment case

Our view of Apple’s long-term prospects is framed by the growth and resiliency of the iPhone installed base and its pricing power. These characteristics are driven by strong customer loyalty, brand strength, and ecosystem engagement (as evidenced by high usage of apps and content). Apple’s ecosystem affords it tremendous opportunity over time to sell more devices and services to its highly engaged installed base of users. At prevailing market pricing, we consider Apple to be an attractive investment.

¹ Source: Gartner, 24 March, 2016

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