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Apple's Key Competitive Advantage

January 31st, 2017

We can't compete head to head with Apple. There is a branding issue: Apple is premium…"

–a high-level source at Lab126, Amazon's code name for its Fire Phone project

The above quote is taken from an excellent Fast Company article which I'd encourage you to read. It is indirectly related to a point I'd like to make on Apple.

A few months ago, I did a presentation where I described three possible edges that investors can have in the market. The first is informational advantage (knowing something the market doesn't). The second is analytical advantage (thinking about the same information differently). And the third is time-arbitrage (having the same general information and analysis, but simply being more patient than the majority of market participants).

Apple is obviously a company that everyone knows about, and there is absolutely no advantage in trying to compete with the armies of analysts who are all trying to predict the exact number of iPhones sold this quarter. But I do think it's possible to have both a variant perception with Apple as well as more patience than the average Wall Street analyst or fund manager.

Thus, this post will contain no groundbreaking new information on the largest company in the market. It will simply contain my thoughts on how I think about the company and its main competitive advantage.

As I write this on Tuesday morning (1/31), Apple is set to report earnings later this afternoon. That report may impact the stock price one way or the other, but it won't impact the crux of my investment thesis for this business.

And that crux is basically that Apple is not a hardware company that sells a commodity-based product, but a consumer product company that sells a brand.

I think that foundation is a very important distinction to make, and I think the brand is extremely valuable and quite durable, as Apple continues to build out and grow its high-margin software and services business (which is now big enough (nearing $30 billion in sales) to be a Fortune 100 company on its own).

Apple's Brand

Let me discuss just one minor example to illustrate the power of Apple's brand. I used this example in an investor note to clients last year. This is one piece of anecdotal evidence that illustrates Apple's brand. Here is what I wrote last year, which I think is just as relevant now:

> *On May 21st, Apple opened its redesigned retail store in San Francisco. Videos can be found of this event on the web. The videos show massive lines (similar to the familiar lines we've all seen before product launches). They show raving fans cheering for one another as they walk through the newly designed store. Spontaneous chants of "Apple, Apple" were similar to cheers you'd hear at a college football game.*
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> *The interesting thing was that no new product was being launched on this particular Saturday morning. All that was happening was the reopening of a retail store that was already there. Anyone could have simply stopped by the store later that day, or later that week, or simply the next time they needed a product. But instead there were lines down the street of people waiting to enter.*
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> *I think that day was a microcosm of the brand that Apple has built over time, and it makes me feel confident that five years from now, Apple will still be selling significant amounts of phones, tablets, and computers, and will likely succeed in their efforts to expand into new product classes. Just as they've proven before by entering the music business and then the phone business, Apple's brand has proven to be effective at transcending products and even industries. If they end up producing a car at some point, I wouldn't want to bet against their success.*

Apple's brand allows the company to predictably sell huge volumes of its hardware to new and existing customers over time. I think the hardware business is actually a very good business. The brand that is stamped on each device allows Apple to achieve much higher markups than most hardware manufacturers, and the stickiness of the brand (the remarkably low number of people who switch from Apple to a competitor) ensure a fairly predictable amount of recurring revenue with each new product cycle (even if the replacement cycle gets longer over time).

Services

The hardware business is a good business and produces the lion's share of the revenue and cash flow at Apple, but the best economics reside in the relatively smaller but fast-growing services segment.

Apple now has over 1 billion active devices around the world. Each of these 1 billion devices are like miniature retail stores that allow Apple to grab revenue from apps and subscription products like Apple music, which now has 17 million subscribers.

Apple's service revenue is a great business—recurring, growing and high margin—and this year will do somewhere close to $30 billion in revenue. If Apple's service revenue was its own stand-alone business, it would now be in the Fortune 100. It generates revenue roughly equal to companies such as 3M, 21st Century Fox, and Nike, but it's growing much faster. The business is three times the size of Netflix. And yet this business line represents less than 15% of Apple's total revenue.

The App Store alone did $28 billion in revenue in 2016, and in return for providing the platform, Apple takes a 30% cut of that revenue, which largely drops straight to the bottom line. This business is growing at 40% annually.

Value Proposition

I often look at the value the company is providing for its customers, because while this value (or lack thereof) may or may not be reflected in the current financial statements, it will show up over time. The best businesses are often the ones that are offering a product or service that the customer finds significant value in (i.e. the product or service is undervalued from the customer's perspective).

I think smartphones generally, and the iPhone specifically, offers significant value for customers. As Tim Cook said on the recent conference call, the smartphone is just getting started, and is becoming a more and more central part of our daily life.

Pessimism and Outlook

There has been an enormous amount of pessimism surrounding Apple in the past year, and it has largely centered on the maturing smartphone market and the worries that has created about Apple's future. But the company added over 100 million new units to its active installed base, and while the upgrade cycle is lengthening, the company still sold 212 million iPhones last year. While the quarter-to-quarter and year-to-year numbers will bounce around, the company will sell an enormous amount of hardware over coming years, and in much of the emerging and developing world, Apple's business will grow.

One potential growth spot is India, which is the fastest growing and second largest smartphone market in the world with over a quarter billion smartphone users last year, up about 20% from the previous year. While India is largely a poor country (India's GDP per capita of around $1500 hovers around the level of many third world countries), the Indian government is making some pragmatic decisions about economic policy issues, with the prime minister focused on modernizing the country's infrastructure. India's economy is growing faster than the developed world, and millions of people each year are edging their way out of poverty and into the middle class.

While there have been some initial roadblocks, it's only a matter of time before Apple gets approved to develop retail stores in India. Apple's significant potential investments in manufacturing and expanding its retail footprint are too lucrative for the Indian government to pass up (not to mention the jobs those investments would create). Once the two parties settle on a deal for manufacturing a certain amount of the product in India, Apple will be able to open retail stores, which will further enhance its growing brand in India, where Apple is still largely considered the #1 brand.

It's not a bad call option for Apple, which has under a 1% market share in a country with 1.3 billion people. There is a long runway ahead with less than 25% of its population using smartphones and a rapidly growing middle class. Right now, India isn't even registering in Apple's financial statements. But that could change over the coming years in a big way. For now though, this "call option" isn't reflected at all in the stock's modest valuation.

Valuation

Update: Apple just reported earnings a couple hours ago, so I am updating this section with the most current numbers, but nothing major has changed. Overall, Apple is doing over $200 billion of revenue and $50 billion of free cash flow (or around $9.50 per share). The company has around $170 billion of net cash ($32 per share), and even after adjusting for taxes should Apple decide to repatriate this cash to the US, the company has around $22 of net cash per share. In the last twelve months, Apple has spent $35 billion on buybacks, and $12 billion on dividends—and since 2011 has returned over $200 billion to shareholders. This free cash flow is after expensing a sizable chunk for research and development—Apple spent $10 billion last year alone. The company is a cash machine.

I think the valuation is quite reasonable at about 10 times free cash flow (excluding the excess cash).

Apple is big. There are fears that Apple won't be able to grow. Reasons for the pessimism:

- Everyone has a smart phone.
- Samsung (or Huawei, Xiaomi, or some other competitor) will begin to eat into Apple's huge profit margins.
- Upgrade cycles are getting longer—you no longer need a phone every two years.
- Android is open-source, and with its huge market share will encourage developers to focus on developing apps for Android over iOS

But I think the power of the brand is what makes Apple interesting. And I think the current valuation is ascribing no value to this brand. My feeling is that the pessimism surrounding the company will at some point abate, and we'll be able to sell our shares at a more reasonable valuation. In the meantime, we own a great business with a great brand at a double digit free cash flow yield.

John Huber is the Managing Member and Portfolio Manager of [Saber Capital Management, LLC](), an investment firm that manages separate accounts for clients. Saber employs a value investing strategy with a primary goal of patiently compounding capital for the long-term.

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