CASE TWO

APPLE AND THE iFAD[1]

The fall of 2009 marked new highs in the runaway success of Apple, Inc. In the 12 years since his return to Apple, CEO and founder Steve Jobs had transformed Apple from an almost bankrupt also-ran into a consumer technology powerhouse that was the envy of Silicon Valley.

Job's turnaround strategy focused on Apple's most profitable products. He also revitalized the brand through a series of advertising campaigns and carefully choreographed product launches. This resulted in a slew of successful new product lines, including the iMac in 1998, the iPod in 2001 and the iPhone in 2007. Apple leveraged these product lines by integrating key services with its products, including retail stores in 2001, iTunes in 2003 and the App Store in 2008.

As Apple's sales and profits grew, its stock price skyrocketed. Sales grew from $6 billion in 2003 to $36 billion in 2009, while profits grew from just $68 million in 2003 to a staggering $5,704 million by 2009. Adjusting for splits, Apple's stock price grew from $10 in late 2003 to $200 by late 2009. Apple's stock was understandably popular on Wall Street, with over 30 sell-side analysts covering it. The consensus forecast for Apple's 2010 earnings was $8.37, representing 33% growth relative to 2009 EPS of $6.29. Most analysts were forecasting that Apple's stock price would rise substantially as well. Following Apple's fourth quarter 2009 earnings announcement, one enthusiastic analyst summarized his opinion as follows:[2]

> Fourth quarter revenues are up 25%Y/Y to $9.9B and EPS is up 45%Y/Y to $1.82. Apple crushed consensus $9.2B/$1.44 on strong Mac upside. iPhone supply constraints are no worse than feared, gross margin +30bps Q/Q to 36.6% (as higher mix and OS X Snow Leopard offset rising component costs) and 11c tax help. Moreover, we continue to see a BIG Dec-qtr driven by iPhone supply now catching up to demand and a MacBook/iMac refresh we think is imminent including lower entry prices. We are reiterating our buy rating and raising our FY10 EPS estimate to $8.40 and our price target to $260 from $235, valuing AAPL at ~16x EV/FCF on our CY10E FCF estimate of $11,241M.

Yet despite Apple's success, signs of a possible slowdown were appearing. Annual sales growth had slowed from 35% in 2008 to 12% in 2009. Aggressive competitors, such as Google and Microsoft, were introducing new products to challenge the iPhone and iPod. Apple's suppliers were also pushing for a bigger share of Apple's fat profit margins. Finally, Apple faced the relentless challenge of new product innovations in order to fuel sales growth and margins.

Detailed information on Apple's business strategy and financial situation is provided in Apple's Form 10-K for the year ended September 26, 2009. For comparative purposes, we will use an abridged version of International Business Machines Corporation (IBM) Form 10-K for the year ended December 31, 2009. These documents are available online at:http://www.lundholmandsloan.com

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[1] This case was prepared by Professor Richard Sloan as the basis for class discussion, rather than to illustrate either effective or ineffective handling of a business situation.

[1] Apple's fiscal year ends in September and Apple's earnings for the fiscal year ended September 2009 were announced on October 19, 2009. The analyst quote is the case writer's synthesis of the views expressed by representative analysts.

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(*Note:* case data can be imported by going to the Case Data sheet in *eVal* and selecting the yellow block of data for the company, and then pasting this block of data into the yellow cells at the bottom of the Financial Statements sheet using Paste Special - Values from the Edit menu.)

QUESTIONS

Business Strategy Analysis

1. Identify Apple's source(s) of competitive advantage in the technology sector.
2. Identify the key risks associated with Apple's strategy in the technology sector.
3. Briefly describe the key differences between Apple's and IBM's business strategies in the technology sector.

Accounting Analysis

4. Briefly explain Apple's revenue recognition policies for iPhone and Apple TV.
5. Assume that instead of using its then existing revenue recognition policies for iPhone and Apple TV, Apple instead recognized all revenues and associated costs at the time of sale. Estimate the Net Income that Apple would have reported for the fiscal year ended September 26, 2009.
6. Which of the above two methods of accounting for Apple TV and iPhone sales do you think better reflects the underlying economics of the business? Briefly explain your answer.

Ratio Analysis

7. Start the *eVal* software, load the data file for Apple and examine the Advanced Dupont Model on the Ratio Analysis worksheet. Next, repeat the same steps for IBM.
8. Using the analysis in question 7 above, identify the primary underlying reasons for differences in the 2009 return on equity (ROE) for the two companies.
9. Does your analysis identify any opportunities for Apple to potentially increase its return on equity?

Forecasting Analysis

10. Start the *eVal* software, load the data file for Apple and examine the default forecasting assumptions on the forecasting assumptions worksheet. Are these assumptions plausible? If not, which assumptions do you feel are the most implausible and how would you change them to make them more plausible.

Valuation Analysis

11. Start the *eVal* software, load the case data for Apple and set the valuation date to November 2, 2009. How does the estimated price per share in *eVal* differ from Apple's November 2, 2009 stock market price of around $190/share? Which do you think better approximates Apple's intrinsic valuation on that date?
12. The analyst quoted in the case write-up is forecasting a 12 month price target for Apple of $260. Provide a critical evaluation of the justification used by the analyst to arrive at this price target.