Earnings preview Oct 27, 2022

AAPL: Investor expectations need resetting

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Going into the call today, we reiterate our negative view of AAPL due to the divergence between fundamentals and investor expectations. While we expect the company to report an inline quarter, we think investors are likely to find the FQ1's qualitative guidance muddled – anything too positive is likely to be dismissed by investors, anything too negative is likely to disappoint the bulls. Investors have been rewarding companies that provide clarity into 2023; take for instance the surge at LRCX when it provided WFE outlook into next year. One hardly expects AAPL management to provide an early look at 1CH23. And yet, we think 1CF23 is where the rubber meets the road for iPhone and Mac sales. We think there is downside to the stock from current levels; we would fade a pop.

We are looking for a reset to investor expectations and an alignment of AAPL's prospects with end market expectations. While AAPL may well be the best house in a bad neighborhood of hyper-scale tech names, that hardly justifies a 15+pp ytd outperformance vs. tech peers and a 23x multiple to Fy23 consensus eps estimate vs. S&P500 multiple ~15x to NTM eps. Our bottom-up reasons for cutting our PT to $125 a few months ago haven't changed (link). And so hasn't the top-down high interest rate argument we provided a month ago (link).

We are looking for overall and iPhone y/y decline in FQ1 vs consensus up low single digit. We are looking for Services growth below 10% as gaming apps lose traction in China. We are looking for Mac revenue growth materially below the modest decline consensus is looking for. We expect Watch/Airpods to be the sole area of growth in hardware. Our Fy23 estimates in Exhibit 4.

We maintain our FY23 estimate at $388bn/$5.92, among the lowest on the Street, with overall revenue down 1.5% and iPhone revenue down 7%. At a 21x multiple to our eps estimate we maintain our $125 price target. If there is any upside risk to our stock view, we suspect that would come from an improving interest rate environment. We note that real rates started backing down two weeks ago, after a near vertical increase since Powell's Jackson Hole speech.

Our checks show 1) PCB suppliers don't have visibility in Apple orders into early 2023, 2) the initial weeks of iPhone14 sell-thru in China, as reported by local papers, shows marked decline from iPhone13 run rate, 3) major telcos are likely to maintain slim inventory of high-priced smartphones due to high interest rates and, most concerning of all, 3) we believe TSM is likely to zero out 5nm capacity expansion in 2023, which tells you something about AAPL's growth or the lack thereof. AAPL is TSM's largest 5nm customer.

On the other hand, treasury rates have turned supportive of equities. In the past, we had pointed out the inverse correlation between AAPL stock and the 10-year treasury yield. We find that AAPL correlation is even better vs the 5-year real rate (Exhibit 1). A turn-up in AAPL (and broader equity indexes) the past 1-2 weeks, coincided with the 5-yr RR breaking its upward trajectory, plateauing out and even falling modestly (Exhibit 2). Falling RR could soften the impact of EPS estimate cuts.

If we look past the daily noise of build plans and lead times, what stood out in recent days – Murata and Corning, both dependent on Apple's business, provided grave warning regarding smartphones. China and Europe, important markets for Apple, are sliding down an economic crisis, likely worse than that in the US. We think AAPL bulls are reading too much into concurrent data points for Sept qtr and early Dec qtr. We are concerned about the gap in investor expectations vs. early indicators of iPhones and Macs a few months down the road.

Poor visibility at PCB suppliers: Most component suppliers have indicated satisfactory orders from premium smartphone makers. We think this may have been due to AAPL building safety stock of components, given the severe shortages in recent quarters. In contrast to semi component suppliers, we have been hearing PCB suppliers may not be seeing visibility into early 2023, a likely harbinger of order cuts at semis component suppliers. Apple's CM Foxconn typically maintains a low inventory of PCB for AAPL, and order them only as needed. PCB order rate are likely more sensitive to changes in AAPL's demand expectations.

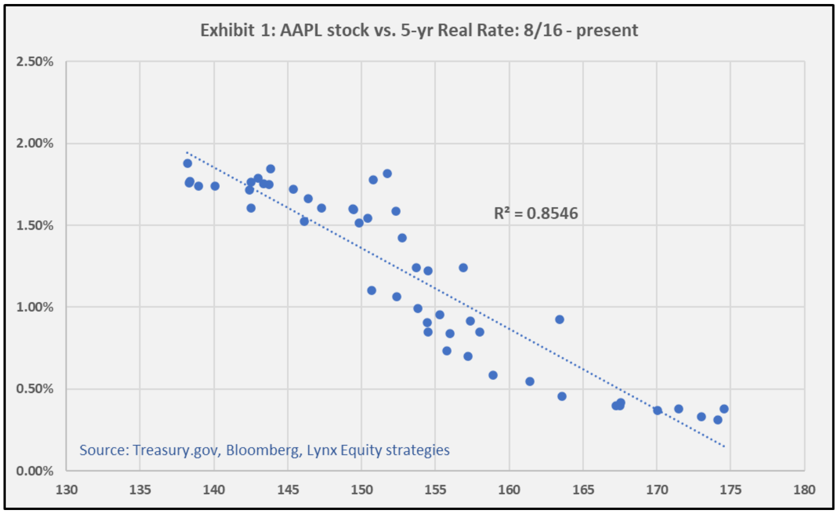
Soft initial iPhone14 sell-thru in China: iPhone14 was launched in September. The latest CAICT report is for Aug. CAICT's data from September has not been published yet. According to domestic media reports (not CAICT), in the first two weeks of launch in Sept'22, iPhone14 sold-thru in China at the rate of 1.5mn/wk. This translates to a run-rate of 6.6mn/month. At the peak month of iPhone sales last year, CAICT reports 9.9mn in Oct'21. This implies, the initial iPhone14 sell-thru run-rate could be down by as much as 30% vs. iPhone13.

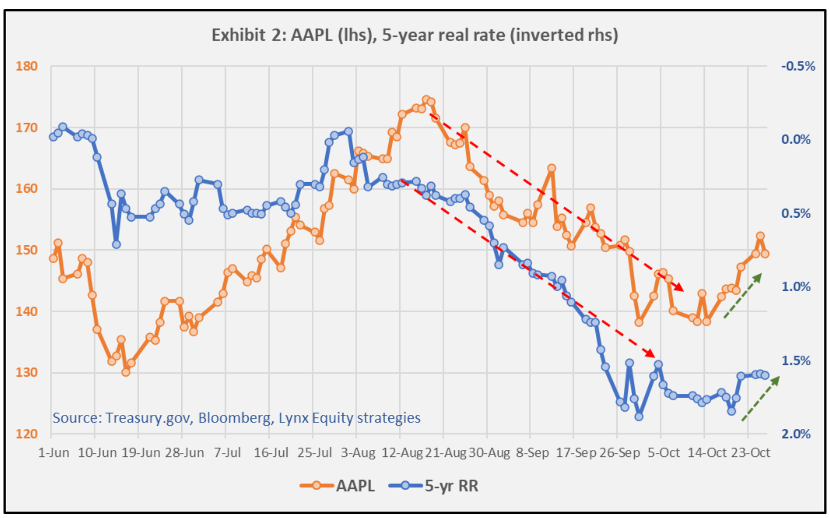
Telcos are likely to not favor high-priced iPhones in this difficult interest rate environment due to carrying cost. They are more likely to stock up on low-priced models. Even the US, where telcos have historically favored high-priced models from Apple and Samsung, the penetration of low-priced models (sub-$250) is at 25% since last year vs. de minimis penetration 2 years ago. US carriers are increasing adapting to low-priced models. Meanwhile in China, its China Mobile telco operator has been a key player in enabling elevated sale of iPhones in previous years. This year though, given the difficulties in China's subsidy environment, we are hearing China Mobile is not in favor of maintaining inventory of high-priced iPhones. European carriers, given the severe economic stress in those markets, are even less likely to carry high-priced models.

TSM – 5nm expansion next year is likely on the chopping block: Apple has been the predominant customer of TSM's 5nm this year. Even as AMD, QCOM and NVDA adopt 5nm next year, Apple is likely to remain the dominant customer, until it switches to 3nm in 2H23. We believe most of the capex cuts at TSM next year falls on 5nm. We expect 5nm capex to have been ~25% of the advanced node spend at TSM next year. We were anticipating ~10K-15 wpm addition at 5nm in 2023. We think this expansion is likely to be cut out. With the capacity at 5nm exiting 2022 in the 50k-60k range, this cut translates to a loss of ~20% increase in 5nm capacity. Now, some of this cut could be because of lower forecast from AMD, QCOM and NVDA at 5nm. However, our view is that most of the cut at 5nm is tied to weaker forecast from iPhone14 and Mac m1/m2.

AAPL and the role of real rates – could soften the impact of EPS cuts: As per Powell's statement at the press conference following the September FOMC meeting, it is the intent of the Fed to elevate real rates across all maturities into positive territory. Fed's effort to morph its monetary policy from accommodative to restrictive can be seen more clearly in the upward trend in real rates rather the more commonly used nominal rates. We choose to work with 5-year real rate.

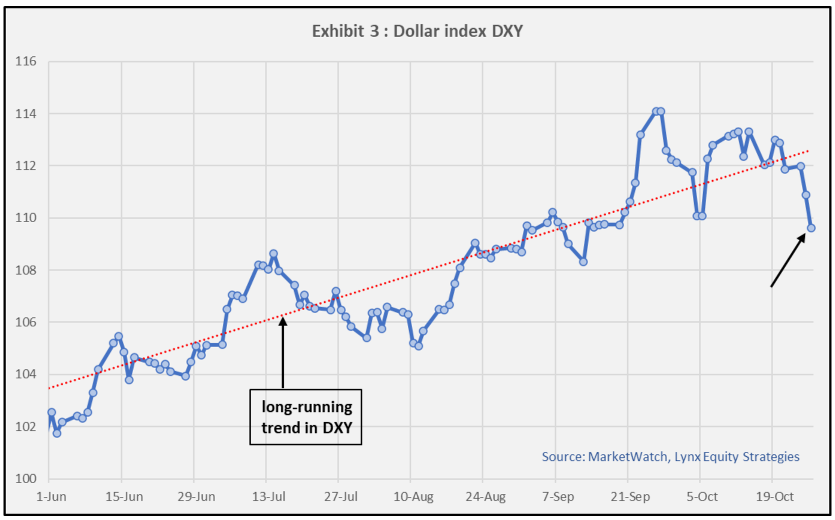
Exhibit 1 shows an extraordinarily high 85% R-sq correlation between AAPL stock movement and 5-yr RR in the time-frame mid-Aug thru the present. Exhibit 2 overlays AAPL stock and 5-yr RR in a time-series chart. Starting mid-Aug (see the red arrows), AAPL stock declined as 5-yr RR increased (shown on an inverted axis). And then, in the past two weeks (green arrows), 5yr RR turned down, causing AAPL (as well most equities) to turn up. The downward turn in the RR simply captures the odds of the Fed slowing down the pace of rate hikes in coming months. Falling RR could soften the impact of cuts to consensus EPS estimates.





Tim Cook's 2019 letter to shareholders provides pointer to 2023: The extraordinary move up in the US$ is unhelpful for AAPL, given that over half its revenue comes from overseas. During AAPL's FQ4 the dollar index DXY strengthened by ~600bps. The strength of the US$ was included in the list of factors Tim Cook provided to shareholder in a 2019 letter to shareholders explaining the reasons for missing the guidance in the Dec2018 quarter (link). Besides the strengthening US$, he listed other factors - slowing China economy, contraction of smartphone market in Greater China and macroeconomic challenges in some developed markets - as negatively impacting anticipated iPhone revenue in the 1FQ19 quarter. These factors are worse off today than they were in late 2018, in our view.

On the plus side, the DXY weakened in recent days. It dropped significantly below its long-running linear trend. If it is remains below the liner trend line, that is supportive of equities. Note that the June-Aug rally in equities was associated with the DXY remaining below the long-running trend (Exhibit 3)



In closing: There is little reason for AAPL to be immune to a global economic crisis. And yet, going by the outperformance of the stock vs. tech peers, investor seem to believe just that. Even before the sell-off yesterday, the likes of MSFT/GOOG were down 30+% for the year vs. AAPL a mere 15%. If AAPL's peers can sound dour, what is keeping AAPL too from sounding dour, if not for this quarter, but by the next quarter? If cloud and advertising revenues have slowed down at MSFT and GOOG, why shouldn't Services spending at AAPL slow down as well. More to the point, if game revenues at MSFT slowed down in the Sept quarter, why wouldn't AAPL's gaming-dependent app revenue slow-down even further than it already had a quarter ago? If MSFT reported severely down Windows and PC sales, why would AAPL's Mac revenue hold up flattish, as per Fy23 consensus estimate? And why indeed would iPhone consensus estimate for FY23 be up for the year when ww smartphones units in 2022 are down ~10% and likely to remain depressed into 2023?

Exhibit 4: Key financial estimates

$bn	Lynx ES	y/y	Consensus	y/y
iPhone	191.0	-7%	210.4	2.7%
Mac	36.9	-5%	38.4	0.6%
iPad	27.9	-7%	30.9	3.0%
Wearables	45.5	11%	45.4	11.0%
Services	87.1	10%	89.2	12.6%
Total	**388.4**	**-1.3%**	**411.2**	**4.7%**
Gross margin	42.3%		43.1%	
Op margin	28%		30%	
EPS $	5.92		6.48	

Source: Bloomberg, Lynx Equity Strategies

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