Earnings preview Aug 03, 2023

AAPL: Macro tailwinds subside as fundamentals struggle

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The stock has drifted up 17% since the previous earnings call, inline with the Qs and substantially better than SPX up 10%. There has been no change in investor expectations from earnings, if anything, a slight degradation. The move up is obviously because of earnings multiples moving up due to the macro disinflation trend. However, as we show in the treasury breakeven chart (Exhibit 1), this trend appears to have run its course, as breakeven rates, a measure of future inflation expectation, come down from elevated levels earlier in the year and appears to stabilize over the past three months. If so, ***macro tailwind to earnings multiple may have run out of steam****. If anything, in recent weeks, b/e rates appear to be moving up, thereby threatening to take back gains in earnings multiples.*

Investors, with muted expectations from iPhones in the June quarter, may be willing to accept modest miss to consensus and then look forward to better guidance for the Sept quarter. Our checks into the retail channel shows AAPL having resorted to ***aggressive discounts near the end of the quarter****, which may signal weakness. We suspect AAPL may have had issues hitting quarterly revenue target. We believe that the challenges AAPL may have faced in closing the June quarter may persist into the next quarter.*

AAPL's ultra-low DOI is a risk factor few investors wish to consider, an unravelling of which could impact cash available for stock buybacks. The unexpected ratings downgrade of US treasury debt might force AAPL's upstream partners to take another look at their exposure to AAPL's balance sheet, as their gross exposure approaches gargantuan levels.

We model FY24 revenue down 3% vs. consensus at up 7%. At 30x to eps of FY24 modeled at $369bn/$5.57 vs. consensus at $410bn/$6.59, ***we derive at PT of $170****. We raise our PT from our previous level of $110 set back in Feb (link), not because of an improvement in our earnings view but to account for market multiple moving higher as inflation fears subside. Back in Feb too we modeled FY24 down 3%.*

We are modeling FQ3 and FQ4 below consensus. We expect earnings today to be a negative catalyst.

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Financial model and price target: We model 3FQ $80.5bn/$1.16, revenue down 3% y/y vs. consensus $81.5bn/$1.2, revenue down ~1.7%. We believe the weakness in June quarter bleeds into the next quarter. We model 4FQ $87.4bn/$1.27, revenue down 3% y/y vs. consensus $90.5bn/$1.36, revenue flat y/y. Our 4FQ revenue is up 8.7% q/q, is similar to seq growth in 4FQ22 versus consensus modeling 4FQ stronger than last year, at up 11% q/q. We model FY23 at $379bn/$5.85, revenue down 6.5% vs. consensus at $384bn/$5.97, revenue down 2.6%. We model FY24 at $369bn/$5.57, revenue down 3% vs. consensus $410bn/$6.59, revenue up 7%. At 30x to Fy24 eps, we derive a $170 price target.

QCOM vs QRVO – high-priced smartphones fare poorly: The earnings call from QCOM and QRVO last night is instructive. QCOM, with an emphasis on high-priced Android models, sounded worse off than QRVO which has a tilt towards lower-priced Android models given QRVO's exposure to MediaTek.

We suspect the spike in consumer interest in high-priced smartphone models seen during the pandemic years is now firmly behind. Mid-range Android models offer just as many 'luxury' features- OLED screen, 128GB storage, multiple cameras, and 5G. With shrinking differentiation between the variously priced models, high interest rates and stretched pocketbooks may have tilted consumers towards mid and entry level models, leaving the likes of Samsung's Galaxy series and iPhones with a less receptive market.

We think weakness in QCOM's Sept quarter guidance cannot be disassociated from iPhones. With the Mac garnering little incremental interest and with the VR product looking like a bust into next year, AAPL continues to rely on iPhones to generate sales and to grow installed base.

Aggressive discounts for some AAPL products: M1 **Macbook Air** went on sale during the quarter across retail channels worldwide at discounts of as much as **25%**. Its is not just the level of discounting, it is also the timing. Typically, discounts on Macs go into effect in CQ3, just ahead of back-to-school season. Going on sale a quarter earlier implies Apple may have had challenges meeting June quarter.

Recall that the initial reception of M2 Macs was weak, with March quarter Mac sales down ~30% y/y. Macs based on Apple Silicon, selling in at 25mn unit annualized, appear to be selling no better than x86-based Macs, a disappointment given the substantially superior power/performance of Apple Silicon based machines.

Close to the end of June quarter, we are aware of **refurbished iPhone11** going on sale in US pre-paid market at, what would appear to be, aggressive discounts. Refurbished iPhone11 units have been on a limited time special offer of a **mere $50** versus retail channel pricing of $300. More curiously, the iPhone11 discount at AT&T's pre-paid partner expires today, **on the day of AAPL's earnings call**, implying AAPL may have had a difficult quarter. A quarter ago as well, we believe AAPL had to resort to aggressive tactics to meet investor expectations.

Low DOI is a risk factor: Despite the least attractive earnings growth among its mega cap peers, AAPL has held investor interest. Given its reliably massive annual stock buyback and dividend payout, investors took shelter in AAPL, a low-risk investment during a tumultuous period of inflation scare. The cash machine required to reliably return $90bn-$100bn every year to shareholders, is levered to the AAPL's ultra-low days-of-inventory, usually ~10days. **AAPL has depended on the kindness of its upstream and downstream partners** willing to accommodate AAPL's inventory on their balance sheet.

But if iPhone's cache is to decline and if high interest rates weigh on carrying cost of inventory, how long would this kindness be extended? AAPL's extraordinarily **low DOI is a risk factor to cash return** that few investors are willing to acknowledge. We note that AAPL's DOI abruptly ticked up to 12.9 days at the end of the last reported quarter. The June DOI reading will tell us if the March uptick was merely noise.

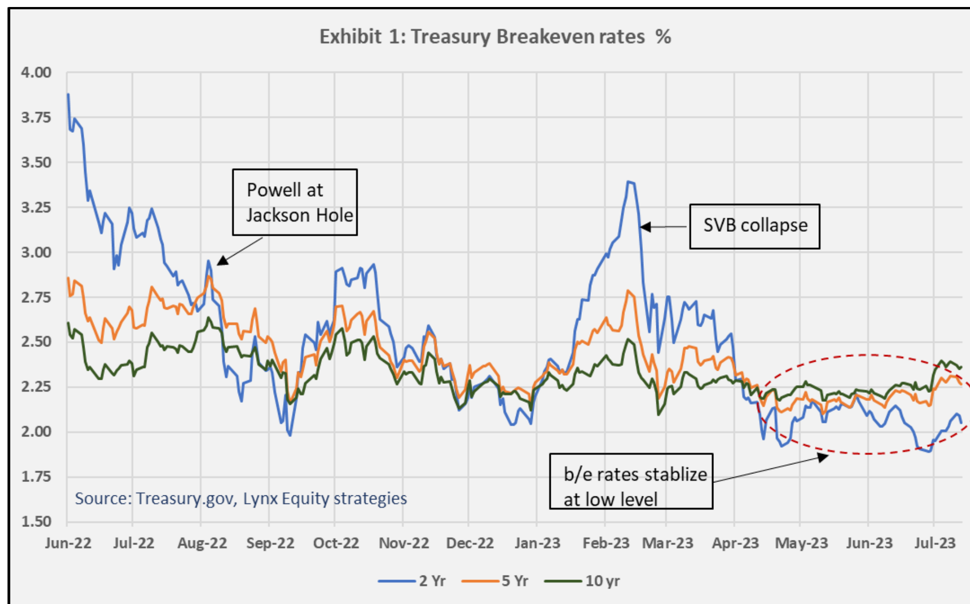
An abrupt **ratings downgrade** in US Treasury debt may be an occasion for lenders worldwide to take another look at their exposure to AAPL, if P&L metrics do not inflect upwards.

AAPL – a macro holding: In deriving our new price target we have had to raise our eps multiple from 19x set in February to the 30x we have set now. The steady improvement in inflation outlook justifies multiple expansion for companies with investor expectation of steady free cash flow stretching out for multiple years into the future

However, we believe this disinflation-driven multiple expansion is now at an end. We believe future inflation expectations, as seen in treasury breakeven rates, have fallen far enough and may fall no further (Exhibit 1). From here on out, we think large-cap secular names, such as AAPL, need to demonstrate earnings growth for stocks to show further appreciation. **A down revenue year may no longer be tolerated once disinflation has run its course, as it appears to have**.

If AAPL is to keep its stock momentum, it is critically important for the company to guide FQ4 revenue up y/y, which could then give confidence that perhaps FY24 may be an up year. We are taking a negative view on both counts; we expect revenue in FQ4 and FY24 to be down y/y.

Net/Net: We expect the earnings call today to be a negative catalyst for the stock.



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