Daiwa Securities

Apple Inc (AAPL)

Global Credit Research GCRE014

FICC Research Dept.

Q1 FY19 Results

- Revenues down 5% y/y to $84.3bn, EBITDA down 8% y/y to $26.7bn due to weak macro conditions in Greater China, lower iPhone upgrades;
- Excellent liquidity supported by $23bn of FOCF and $130bn of adjusted net cash position;
- Apple's expanding ecosystem, strong growth of Services and Wearables, high customer satisfaction rates are credit positive.

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Daiwa Securities Co. Ltd.

Credit Opinion

In Q1 FY19, Apple's revenues decreased 5% y/y to to $84.3bn, EBITDA decreased 8% y/y to $26.7bn primarily due to weak macro conditions in China and lower iPhone upgrades. While iPhone sales declined 15% to $52bn, Services, Wearables and iPad showed double-digit growth rates.

Our credit positive view is unchanged taking into consideration Apple's strong ecosystem, decreasing dependence on iPhone and increasing of stable revenues from services segment. Apple has a unique position in the smartphone market with an integration of hardware and software that gives Apple flexibility in coordinating product development and ability to create a user friendly platform both for end-users and for application programmers. As a result, Apple products enjoy a high level of customer satisfaction and loyalty and it has a growing installed base of devices. Total active installed base of devices has grown from 1.3bn at the end of January 2018 to 1.4bn by the end of December 2018, reaching a new all-time high for each of the main product categories and for all reportable geographic segments. The strong brand recognition allows Apple to charge a premium for its products with total gross margins at 38%.

Services grew 19% y/y reaching an all-time high of 10.9bn driven by a growing installed base of devices. The growth in service is credit positive as it reduces dependence on iPhone sales, it provides a stable income and it is accretive to Apple's overall margins. Apple is on track to reach its FY20 revenue target of $49bn which is double FY16 Services revenues.

Apple has an excellent liquidity position supported by $64 bn of annual FOCF (FY18) and $130 bn of adjusted net cash position that provides the company with considerable financial flexibility to follow its growth strategies. Apple has a consistent financial policy and it has been historically managing conservatively its balance sheet. From 2018, Apple is implementing a buyback program up to $100bn of common stock. Even if this program reduces significantly Apple's cash holdings, we expect Apple to maintain an adequate level of liquidity. Apple announced it targets a net zero cash position over time.

The main risk factors remain the maturing smartphone market and the aggressive competition in Chinese market. According to IDC, the global smartphone volumes declined 4% in 2018. However Chinese makers like Huawei, Xiaomi grew their smartphone revenues over 30% y/y.

Changes in the financial reporting

Starting with December quarter, Apple made the following four changes to their financial reporting:

1. Reporting the costs breakdown between total products and total services.
   This change is aimed at providing more transparency on services which have an increased importance in Apple's product portfolio.
2. The revenue corresponding to the amortization of the deferred value of bundled services such as Maps, Siri and free iCloud services are reclassified from product revenue to services revenue. The change in classification applies also to the costs associated with the delivery of these bundled services.
   The reason behind this change is the adoption of the FASB's new standard for revenue recognition.
3. Unit sales for iPhone, iPad and Mac are not reported as Apple considers it is no more relevant given the breadth of product portfolio and the wider sales price dispersion within any product line.
4. "Other products" segment is renamed to "wearables, home and accessories" to provide a more accurate description of the items included in this product category.

Q1 FY19 Results Highlights

Apple announced Q1 FY19 results on January 29th, 2019.
Revenues decreased 5% y/y to $84.3bn primarily due to weak macro conditions in emerging markets, especially Greater China and lower iPhone upgrades, partially offset by growth of Services, Wearables.

Apple manages its business primarily on a geographic basis with five reportable segments:
(1) Americas, including both North & South America
Americas revenues were up 5% to $36.9bn with all-time revenue records in the US, Canada, Latin America. Americas is the largest among geographical reportable segments with a share of 44% in total revenues.
(2) Europe, including European countries, India, the Middle East and Africa
Europe has the second largest share in total revenues (24%) and its revenues decreased 3% to $20.4bn.
(3) Greater China, including China, HK, Taiwan
Sales in Greater China decreased 27% y/y to $13.2bn with declines across iPhone, Mac and iPad, partially offset by revenues growth in Services and Wearables segments.
App Store has seen a slowdown due to new regulations in China that slowed down the process of games approval.
(4) Japan
Japan revenues decreased 5% y/y to $6.9bn mainly due to weak iPhone revenues. iPhone purchases were traditionally subsidized by carriers and bundled with service contracts. However local regulations have significantly restricted those subsidies which had a negative impact on iPhone upgrades.
(5) Rest of Asia Pacific, including Australia, other Asian countries
Revenues in Rest of Asia-Pacific increased 1.1% y/y to $6.9bn with record iPhone revenues in Korea.

Total active installed base of devices has grown from 1.3bn at the end of January 2018 to 1.4bn by the end of December 2018, reaching a new all-time high for each of the main product categories and for all reportable geographic segments.

Gross profit decreased 6% y/y to $32.0bn due primarily to lower iPhone unit sales and the weakness in foreign currencies relative to US dollar, partially offset by higher net sales of Mac, iPad, Wearables and Services. Total gross margin decreased 40bps y/y to 38%.
Products gross margin decreased 180bps y/y to 34.3% mainly due to a different product mix and the impact of lower iPhone unit sales on Apple's products fixed cost structure. On a sequential basis, Products gross margin increased 60bps q/q to 34.3% due to positive leverage from the holiday quarter partially offset by higher cost structure related to launch of new products and headwinds from foreign exchange.
Services gross margin increased 450bps y/y to 62.8% due primarily to a favorable mix of services with higher margins and the impact of higher services net sales on Apple's fixed cost structure. On a sequential basis, Services gross margin increased 170bps q/q due to a favorable mix and leverage from the holiday season, partially offset by foreign exchange.

Apple has a net cash position (cash and marketables- total debt) of $130bn and targets a zero net cash position over time.
Cash and marketables amount increased 3% q/q to 245bn.
Total debt was stable q/q at $114.7bn. Total debt is made up of $102.8bn of term debt (senior unsecured obligations) and $12bn of commercial paper outstanding with maturities generally less than 9 months.

$63bn left of the buyback program.
On May 1st 2018, Apple's Board of Directors authorized a new program to repurchase up to $100bn of Apple's common stock. In Q1 FY19, Apple repurchased $8.2bn worth of Apple common stock. The repurchase program does not obligate it to acquire any specific number of shares.

Segment Information

iPhone revenues declined 15% y/y to $52bn mainly due to lower iPhone unit sales.
According to IDC, unit sales declined 12% y/y to 68.4 units. iPhone share in total revenues dropped from 69% (Q1 FY18) to 62% (Q1 FY19). Global active install base of iPhones surpassed 900m devices at the end of December.
There are two main factors that caused the decline of iPhone revenues.
First, macro and foreign exchange conditions in EM are weak, especially China. According to IDC, China accounts for roughly 30% of world's smartphone consumption and volumes were down over 10% in 2018. We also notice the strong competition in China, as Chinese makers are growing their market share. (Please refer to Chart 1 and Chart 2 below).
Second, smartphone replacement cycle is becoming longer due to reduction of carrier subsidies, battery replacement program, consumer's frustration with continuously rising prices.
To address the slowdown of iPhone revenues, Apple is undertaking a few measures like making it easier to trade an iPhone in Apple's stores and paying for the phones over time with installment payments.

Chart 1: Smartphone Shipments in Q4 2018 (millions of units)

Company	4Q18 Shipment Volume	4Q18 Market Share	4Q17 Shipment Volumes	4Q17 Market Share	Year-Over-Year Change
1. Samsung	70.4	18.7%	74.5	18.9%	-5.5%
2. Apple	68.4	18.2%	77.3	19.6%	-11.5%
3. Huawei	60.5	16.1%	42.1	10.7%	43.9%
4. OPPO	29.2	7.8%	27.3	6.9%	6.8%
5. Xiaomi	28.6	7.6%	28.2	7.1%	1.4%
Others	118.4	31.5%	145.3	36.8%	-18.5%
Total	**375.4**	**100.0%**	**394.6**	**100.0%**	**-4.9%**

Source: IDC

Chart 2: Smartphone Shipments in 2018 (millions of units)

Company	2018 Shipment Volumes	2018 Market Share	2017 Shipment Volumes	2017 Market Share	Year-Over-Year Change
1. Samsung	292.3	20.8%	317.7	21.70%	-8.0%
2. Apple	208.8	14.9%	215.8	14.70%	-3.2%
3. Huawei	206	14.7%	154.2	10.50%	33.6%
4. Xiaomi	122.6	8.7%	92.7	6.30%	32.2%
5. OPPO	113.1	8.1%	111.7	7.60%	1.3%
Others	462	32.9%	573.4	39.10%	-19.4%
Total	**1,404.9**	**100.0%**	**1,465.5**	**100.0%**	**-4.1%**

Source: IDC

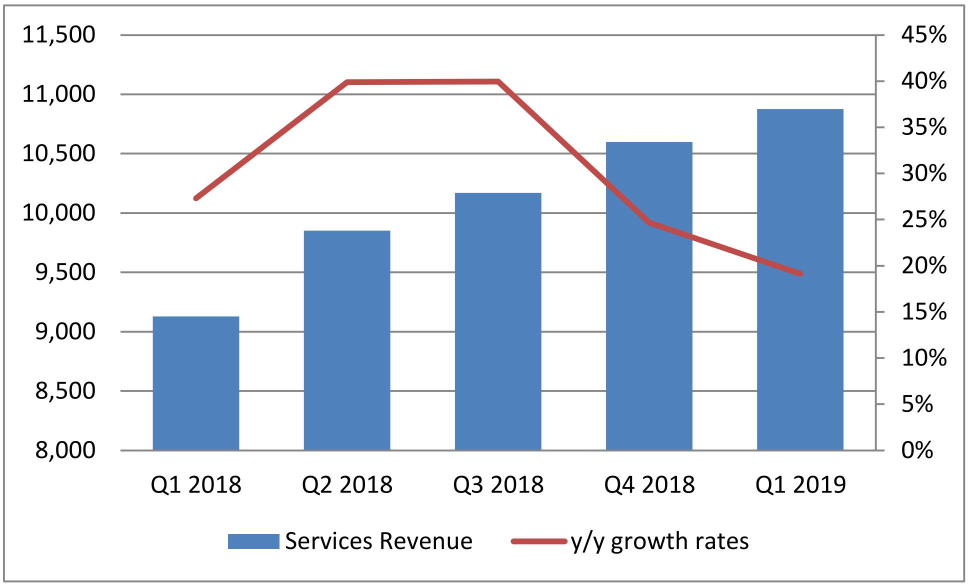
iPad revenues increased 17% y/y to $6.7bn due to the release of the new iPad Pro in November.
Active installed base reached a new all-time high as half of customers purchasing iPads were new to iPad.

Mac sales increased 9% y/y reaching an all-time record of $7.4bn due to launch of a new MacBook Air and Mac mini in October.
Mac revenue reached a new all-time record with double-digit growth in US, Western Europe, Central and Eastern Europe, Japan, Korea and South Asia. Active installed base of Macs reached a new all-time high and half of all the customers purchasing Macs were new to Mac.

Wearables, Home and Accessories revenues increased 33% y/y, reaching an all-time record of $7.3bn mainly due to higher sales of Apple Watch and AirPods.
Both Apple Watch and AirPods were supply constrained in the end of the quarter.

Services increased 19% y/y to $10.9bn with all-time records across multiple categories of services including the App Store, Apple Pay, Cloud Services and App Store Search Ad business.
Services include revenue from Digital Content and Services (iTunes, App Store, Apple Music), iCloud, AppleCare, Apple Pay, licensing.
Apple's large and growing active install base is driving Services growth and Apple is on track to reach its FY20 revenue target of $49bn which is double FY16 Services revenues. Across all of Services offerings, the number of paid subscriptions surpassed 360 million. While Service segment is showing a strong growth, we notice the deceleration in growth rates (Chart 3). There are four factors that caused the decline in the growth rates. First, starting from Q1 FY19, the amortization of free services was reclassified from Products to Services. Second, FX had an adverse impact on revenues as US dollar appreciated and 60% of Services are outside US. Third, App Store has seen a slowdown due to new regulations in China that slowed down the process of games approval. Fourth, AppleCare growth rates are declining from the high level in FY18.

Chart 3: Services Revenue ($m) and y/y growth rates



Source: Company materials, Bloomberg; compiled by Daiwa.

Company's guidance for Q2 FY19

Apple expects revenues to be between $55bn- $59bn, down 4%- 10% y/y.
The forecast includes FX headwinds of $1.3bn.
Gross margins are expected to be between 37%- 38% down from 38% in Q1, reflecting seasonal loss of leverage and 60bps unfavorable FX impact, partially offset by commodity cost savings.
Operating expenses are expected to be between $8.5bn- $8.6bn.

Chart 4: Financial results

($m) Period End		Q1 2018 12/30/2017	Q2 2018 03/31/2018	Q3 2018 06/30/2018	Q4 2018 09/29/2018	Q1 2019 12/29/2018	Y/Y	QOQ
■P/L								
Revenues		88,293	61,137	53,265	62,900	84,310	-4.5%	34.0%
Gross profit		33,912	23,422	20,421	24,084	32,031	-5.5%	33.0%
	Gross margin	*38.4%*	*38.3%*	*38.3%*	*38.3%*	*38.0%*	*-0.4%*	*-0.3%*
EBITDA		29,019	18,633	15,277	18,872	26,741	-7.9%	41.7%
	EBITDA margin	*32.9%*	*30.5%*	*28.7%*	*30.0%*	*31.7%*	*▲ 1.1*	*1.7*
Operating Income		26,274	15,894	12,612	16,118	23,346	-11.1%	44.8%
Pretax Income		27,030	16,168	13,284	16,421	23,906	-11.6%	45.6%
Net Income		20,065	13,822	11,519	14,125	19,965	-0.5%	41.3%
■C/F								
Cash from operations		28,293	15,130	14,488	19,523	26,690	-5.7%	36.7%
	Depreciation & Amortization	2,745	2,739	2,665	2,754	3,395	23.7%	23.3%
Cash from investing		▲13,590	28,710	3,947	▲3,001	5,844	---	---
	CapEx	▲2,810	▲4,195	▲3,267	▲3,041	▲3,355	19.4%	10.3%
Free cash flow (FCF)		14,703	43,840	18,435	16,522	32,534	121.3%	96.9%
Free operating cash flow (FOCF)		25,483	10,935	11,221	16,482	23,335	-8.4%	41.6%
Cash from financing		▲7,501	▲26,272	▲31,523	▲22,580	▲13,676	82.3%	-39.4%
Net cash flow		7,202	17,568	▲13,088	▲6,058	18,858	161.8%	---
■B/S								
Assets		406,794	367,502	349,197	365,725	373,719	-8.1%	2.2%
	Current assets	143,810	130,053	115,761	131,339	140,828	-2.1%	7.2%
	Cash&Marketables	285,097	267,226	243,743	237,100	245,035	-14.1%	3.3%
Liabilities		266,595	240,624	234,248	258,578	255,827	-4.0%	-1.1%
	Current liabilities	115,788	89,320	88,548	116,866	108,283	-6.5%	-7.3%
	Total Debt	122,400	121,840	114,600	114,483	114,730	-6.3%	0.2%
	Adjusted Net Debt (*)	▲ 162,697	▲ 145,386	▲ 129,143	▲ 122,617	▲ 130,305	---	---
Equity		140,199	126,878	114,949	107,147	117,892	-15.9%	10.0%
■Financial Ratios								
Equity Ratio		34.5%	34.5%	32.9%	29.3%	31.5%	▲ 2.9	2.2
Adjusted NetD/E		▲1.16	▲1.15	▲1.12	▲1.14	▲1.11	0.1	0.0
Adjusted NetD/EBITDA		▲2.19	▲1.90	▲1.64	▲1.50	▲1.64	0.6	▲ 0.1
ROA		12.9%	13.8%	15.7%	16.7%	16.1%	3.2	▲ 0.6
ROE		36.8%	39.9%	46.4%	53.6%	52.8%	16.0	▲ 0.8

Source: Company materials, Bloomberg; compiled by Daiwa.

Chart 5: Revenues breakdown by products

($m) 3 Months Ending	Q1 2018 12/30/2017	Q2 2018 03/31/2018	Q3 2018 06/30/2018	Q4 2018 09/29/2018	Q1 2019 12/29/2018	Y/Y
Total Revenues	**88,293**	**61,137**	**53,265**	**62,900**	**84,310**	**-4.5%**
iPhone	61,104	37,559	29,470	36,755	51,982	-14.9%
Services	9,129	9,850	10,170	10,599	10,875	19.1%
Mac	6,824	5,776	5,258	7,340	7,416	8.7%
Wearables, Home and Accessories	5,481	3,944	3,733	4,223	7,308	33.3%
iPad	5,755	4,008	4,634	3,983	6,729	16.9%

Source: Company materials, Bloomberg; compiled by Daiwa.

Chart 6: Share in total revenues

($m) 3 Months Ending	Q1 2018 12/30/2017	Q2 2018 03/31/2018	Q3 2018 06/30/2018	Q4 2018 09/29/2018	Q1 2019 12/29/2018
Total Revenues	**88,293**	**61,137**	**53,265**	**62,900**	**84,310**
iPhone	69%	61%	55%	58%	62%
Services	10%	16%	19%	17%	13%
Mac	8%	9%	10%	12%	9%
Wearables, Home and Accessories	6%	6%	7%	7%	9%
iPad	7%	7%	9%	6%	8%

Source: Company materials, Bloomberg; compiled by Daiwa.

Chart 7: Revenues growth rates (y/y)

3 Months Ending	Q1 2018 12/30/2017	Q2 2018 03/31/2018	Q3 2018 06/30/2018	Q4 2018 09/29/2018	Q1 2019 12/29/2018
Total Revenues	**13%**	**16%**	**17%**	**20%**	**-5%**
iPhone	12%	13%	19%	27%	-15%
Services	27%	40%	40%	25%	19%
Mac	-6%	-1%	-6%	2%	9%
Wearables, Home and Accessories	36%	37%	36%	31%	33%
iPad	4%	3%	-7%	-18%	17%

Source: Company materials, Bloomberg; compiled by Daiwa.

Chart 8: Revenues breakdown by geographical segments

($m) 3 Months Ending	Q1 2018 12/30/2017	Q2 2018 03/31/2018	Q3 2018 06/30/2018	Q4 2018 09/29/2018	Q1 2019 12/29/2018	Y/Y
Revenue	**88,293**	**61,137**	**53,265**	**62,900**	**84,310**	-4.5%
Americas	35,193	24,841	24,542	27,517	36,940	5.0%
Europe	21,054	13,846	12,138	15,382	20,363	-3.3%
Greater China	17,956	13,024	9,551	11,411	13,169	-26.7%
Rest of Asia Pacific	6,853	3,958	3,167	3,429	6,928	1.1%
Japan	7,237	5,468	3,867	5,161	6,910	-4.5%

Source: Company materials, Bloomberg; compiled by Daiwa.

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[Standard & Poor's]

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[Moody's]

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[Fitch]

The Name of the Credit Rating Agencies group, etc

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May 2018

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• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction.
In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

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The Financial Futures Association of Japan
Japan Investment Advisers Association
Type Ⅱ Financial Instruments Firms Association