

Apple, Inc. (AAPL): Short @ \$80.00

Short Thesis: Expect further weakness in *iPhone* Unit Sales in 2H16. Negative catalysts include a Saturated Smartphone Market (i.e., fewer first-time buyers and longer upgrade cycles), Slow Growth in China and the Lack of an Exciting New Product Lineup this year. We also believe that Unit Sales for the upcoming *iPhone 7* will underperform relative to the *iPhone 6S/6S+*. We don't see any Positive Catalyst until the Launch of the *iPhone 8* next year.

I. Apple Misses Both Top- and Bottom-line Consensus Estimates

Apple posted a quarterly revenue decline for the first time in 13 years, raising questions as to whether or not its best days are behind it (see Table 1). Revenue of \$50.6B missed analysts' estimate of \$51.9B declining 33% sequentially and 13% y/y. EPS of \$1.90 also came up short of consensus forecast of \$2.00. Management guided next quarter revenue lower by ~17% at the mid-point also missing consensus.

TABLE 1: Apple F2Q16 Results

F2Q16 Results			F3Q16 Guidance			F2Q16 Results			F3Q16 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
1.90	2.00	miss	n/a	1.40	n/a	50.55B	51.97B	miss	41-43B	47.32B	miss

Source: Apple, Inc.

We expect the *iPhone 7* to underperform relative to last year's *iPhone 6S/6S+*. We are forecasting a modest uptick in 2H16 revenue and unit sales (see F3Q16e, F4Q16e and F1Q17e in Table 2) as consumers delay their *iPhone* purchases in anticipation of the launch of the *iPhone 7*. While Apple ended F1Q16 strong with 74.8M units sold and \$51.6B in *iPhone* revenue (+1% y/y), we are projecting F1Q17 to close with 65M units sold (down 13% y/y, includes *iPhone 7*) with *iPhone* revenues down 12% y/y at \$45.3B. We are also projecting F1Q17 average selling price (which includes the new *iPhone 7* model) to rise a modest 1% y/y to \$697.80 from \$689.84 in the year-ago quarter.

**TABLE 2: *iPhone* Quarterly Projections for Fiscal 2017:
 Revenue (Million), Unit Sales (Million) and ASPs (incl. *iPhone 7* sales)**

	Revenue	Y/Y Change	Units	Y/Y Change	Avg. Selling Price	Y/Y Change
F1Q16	\$51,600	1%	74.8	0%	\$689.84	0%
F2Q16	\$32,900	-18%	51.2	-16%	\$642.58	-2%
F3Q16e	\$25,511	-3%	45.0	-5%	\$566.91	2%
F4Q16e	\$34,063	6%	49.5	0%	\$688.14	6%
F1Q17e	\$45,357	-12%	65.0	-13%	\$697.80	1%

Source: Apple, Inc. and Viola Advisory, LLC estimates

I. No Exciting New Products for 2016 – iPhone 7 Underwhelms

One of the reasons why the *iPhone 6+/6S+* was such a big hit when it launched was its bigger screen. While the older *iPhone 4* and *iPhone 5* models had a 4-inch screen, the newer 6+ and 6S+ models had a 5.5-inch screen (see Figure 1 left side). Before Apple launched the 6+, its competitor Samsung ran an ad called “screen envy” that depicted an *iPhone* owner jealous of the bigger screen of his friend’s *Galaxy S5* phone.

FIGURE 1: Evolution of the iPhone – Screen Size (Models shown left: 6S+, 6 and SE) and Thickness



Source: Apple, Inc.

When Apple announced the release of the *iPhone 6/6+* models in September 2014, a large number of *iPhone* users surveyed by *comScore* indicated that they planned on upgrading before the year ended. The numbers were staggering: 43% of *iPhone 4* users (from a total installed base of 13M) said they were planning on upgrading; 40% of *iPhone 4S* users (from an installed base of 19M) and 36% of *iPhone 5* users (from a user base of 16M) said they were planning on switching. Even those who bought the most recent *iPhone 5S* model last year, 24% (from an installed base of 15M) indicated they were planning on upgrading to the 6/6+ model.

All told, around 22.5M existing *iPhone* users were planning on upgrading that year. When Apple released the next version, the *iPhone 6S/6S+* in September 2015, unit sales were also relatively strong despite the minor difference between the *iPhone 6* and the *iPhone 6S*. The *iPhone 6S* came with a thinner body relative to the *iPhone 6* (see Figure 1 right).

We do not believe that the *iPhone 7* scheduled to launch on September this year will have any compelling product features that will re-accelerate declining *iPhone* unit sales. Most product specs leaked so far in the media show the *iPhone 7* to be very similar to the *iPhone 6S* with the exception of a few minor “under-the-hood” changes – like a better dual-lens camera that will take better pictures at low light conditions or a second speaker that gives it a clearer stereo sound. There are also rumors as to whether the new phone will or will not include headphone jacks, thus enabling the use of Bluetooth earpods only.

We believe Apple is saving the major breakthrough changes for the *iPhone 8* which is scheduled for release in 2017 which also happens to be the 10-year anniversary of the *iPhone*. Some of the innovative features which are rumored to be incorporated in the *iPhone 8* include a curved *iPhone* display featuring an OLED screen (versus the current LCD screen) manufactured by Samsung. Rumors also include an all-glass *iPhone* chassis.

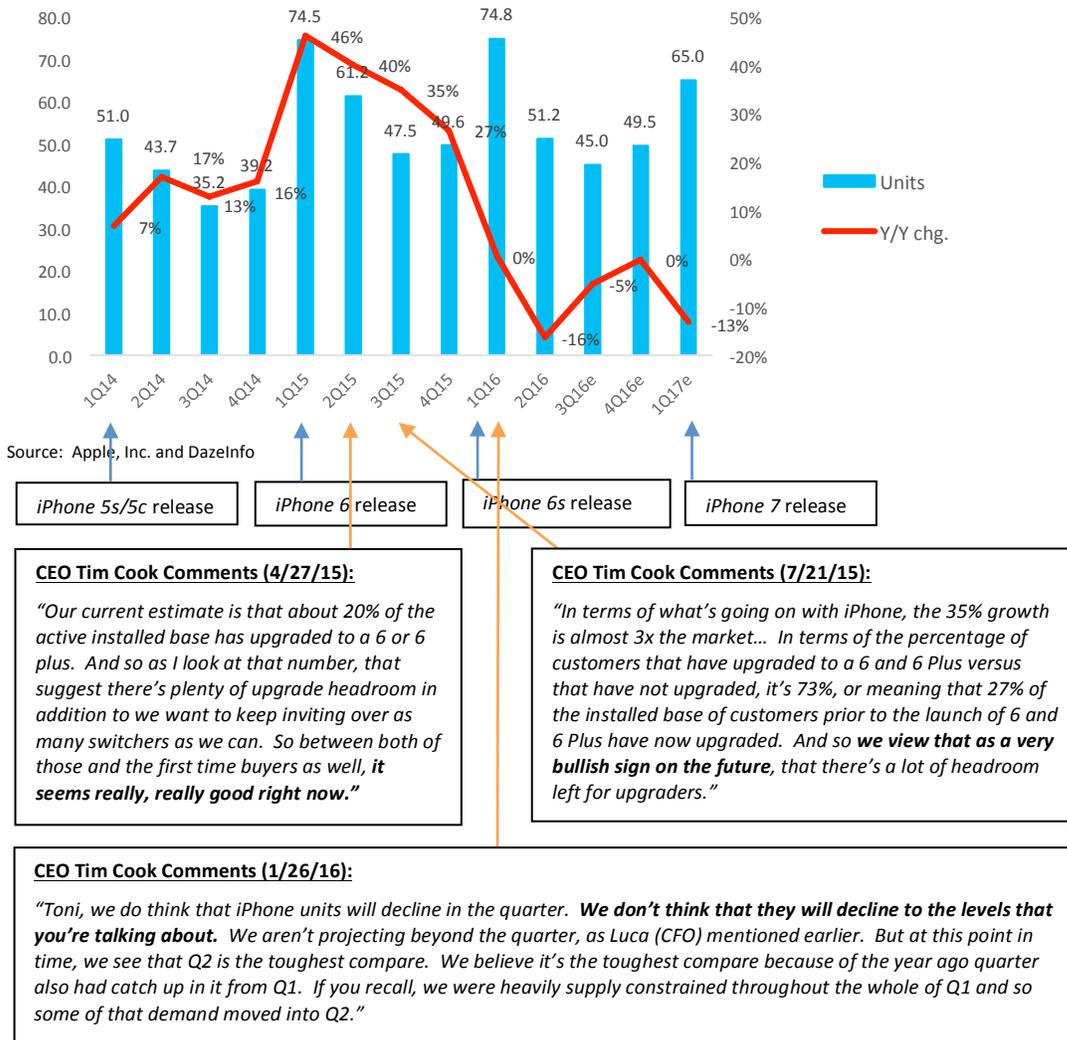
II. Saturated Smartphone Market

The reason for the current quarter’s dismal results is the slowdown in *iPhone* sales and a saturated smartphone market. In addition, *iPad* sales have slowed for more than two years and the *Apple Watch* is still in the early days and has not yet gained any traction. But the *iPhone* is the main revenue driver at 65% of total revenue for the current quarter while sales of the *iPad* and *Mac* only generate 9% and 10% of revenue respectively. Figure 2 shows quarterly *iPhone* unit sales and their percent y/y growth.

A. *Enthusiasm for New iPhones Tends to Wear Off Quickly*

Figure 2 shows that on the full quarter when sales for the new model *iPhone* is reported, (typically F1Q), there is a surge in unit sales followed by a drop in demand in F2Q and F3Q. However, Figure 2 also shows that the drop in demand in F2Q has become steeper since the release of the *iPhone 5s/5c*. This indicates that consumer enthusiasm for the newer *iPhone* models tends to wear off quickly after their release. For example, sales for the *iPhone 5s/5c* fell by 7.3M units in F2Q14 while sales for the *iPhone 6* and *iPhone 6s* decreased by 13.3M units and 23.6M units respectively, in the quarter following their release.

FIGURE 2: *iPhone* Unit Sales (Million Units) and Y/Y Growth (%)



B. Growing Concerns over CEO Tim Cook's Failure to Predict the iPhone Slowdown

One of the downsides to Apple's disappointing F2Q16 quarter is that analysts and investors are questioning why CEO Tim Cook failed to prepare them for the recent downturn in *iPhone* sales when he had several opportunities to do so. For example, in 2015, when the possibility of a 2016 sales decline was brought up, Tim Cook said he was bullish, pointing to the low percentage of *iPhone* customers that had upgraded and highlighting the *iPhone*'s upside. This has brought up two growing concerns: first, did management completely misread the *iPhone* trends, or second, was management massaging the truth (being too aggressive) when it came to the underlying sales trends?

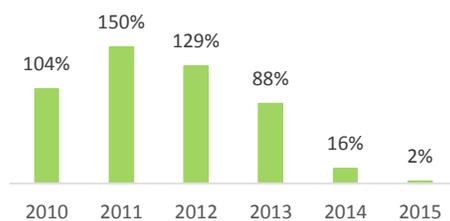
For example, on April 27, 2015, in response to an analyst question at the F2Q15 earnings call, CEO Tim Cook emphasized the low upgrade rate to the latest *iPhone* and that there was "plenty of upgrade headroom" left in the *iPhone 6* cycle (see the first Boxed Comment in Figure 2 above). Unit sales declined by 13.7M units (a drop of 22.4% q/q) in the following quarter (F3Q15) after the bullish comments were made.

Another example was on July 21, 2015 during the F3Q15 earnings call, when Tim Cook was asked about the larger than normal unit sales decline, he talked about a "bullish sign on the future" (see second Boxed Comment in Figure 2 above). While F1Q16 unit sales did increase, it only grew by 300K units more than the year-ago quarter, translating to a flat y/y growth.

A third example was on January 26, 2016, when analyst Toni Sacconaghi from *Sanford C. Bernstein* asked Tim Cook why Apple's revenue projection implied a 15-20% decline in *iPhone* unit sales for F2Q16 given some positive data around *iPhone* switchers. CEO Tim Cook responded that *iPhone* unit sales were likely to decline next quarter, but not at the 15-20% level mentioned (see third Boxed Comment in Figure 2 above). When Apple reported F2Q16 results, *iPhone* unit sales did drop by 16% y/y (see Figure 2), right in the mid-point of the analyst's estimate.

III. China Growth Slowdown

FIGURE 3: China Smartphone Market Growth



Source: Canalys and Bloomberg

After four years of high growth from 2010 to 2013, the economic recession in China has slowed down the smartphone market from 88% y/y in 2013 to 16% in 2014 and finally to a mere 2% in 2015 (see Figure 3).

Moreover, *Gartner* predicts that global smartphone sales will only grow by 7% in 2016 with China and North America growing at a rate of 0.7% and 0.4% respectively.

The *Gartner* forecast does not bode well for Apple's *iPhone* sales this year. Table 3 below shows Apple's three biggest markets – the U.S. and the Americas at 38% and Greater China (Mainland China, Hong Kong and Taiwan) at 25% of total revenue. Europe is third with sales at 23% of total revenue.

As Table 3 shows, only Japan was able to buck the negative growth trend with F2Q16 sales growth at a positive 24% y/y. Revenue growth in Greater China fell 32% sequentially and 26% y/y while sales at the Americas and Europe decreased 35% q/q and 36% q/q respectively. Much of the slowdown can be attributed to a saturated market which extended the replacement cycle by two to three years.

TABLE 3: Geographic Revenue Breakdown (\$ Million)

	F2Q16	% of Total	F1Q16	F2Q15	Q/Q Change	Y/Y Change
Americas	19,096	38%	29,325	21,316	-35%	-10%
Europe	11,535	23%	17,932	12,204	-36%	-5%
Greater China	12,486	25%	18,373	16,823	-32%	-26%
Japan	4,281	8%	4,794	3,457	-11%	24%
APAC	3,159	6%	5,448	4,210	-42%	-25%
Total	50,557		75,872	58,010	-33%	-13%

Some of the cause of the slowdown can also be attributed to a lack of innovative new products with new smartphones lacking any significant features that distinguish them from older models or from their closest competitors.

Source: Apple, Inc.

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Analyst Certification

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