Apple: Big Red Flags

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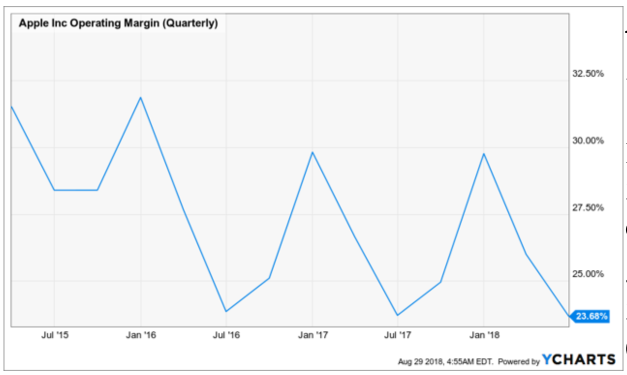
Summary

- Apple's operating margin has declined for 11 straight quarters.
- Most of the recent reports point to a lower pricing of iPhones in the next cycle.
- This would make it difficult for Apple to stem the decline in margins unless there is a significant reduction in bill of materials.
- Besides operating margin, there are other important valuation metrics which are showing red flags.

Apple's (AAPL) ability to generate high earnings can take a hit due to the decline in its operating margin. On a year-on-year basis, Apple's operating margin has fallen for 11 straight quarters. In the recent quarter, the operating margin came at 23.68% whereas it stood at 28.39% in the June quarter of 2015. There has been a cumulative decline of 471 basis points in the last three years which should reduce the long-term bullish sentiment.

As Apple prepares to launch its flagship iPhones in the next few weeks, all reports are pointing to a lower pricing for all the three models to be launched. Unless Apple is able to reduce its bill of material or BOM cost, we would see another year of falling margins. It would be difficult for Apple's stock to continue with the current bullish run as these key metrics show a big decline.



Another quarter of operating margin decline

Fig: YOY operating margin decline shown by Apple. Source: Apple filings, Ycharts

March 2015: 31.51%, March 2016: 27.67%, March 2017: 26.65%, March 2018: 26.00%, **Cumulative decline: (551 bps)**

June 2015: 28.39%, June 2016: 23.86%, June 2017: 23.71%, June 2018: 23.68%, **Cumulative decline: (471 bps)**

Sep 2015:28.39%, Sep 2016: 25.10%, Sep 2017: 24.95%, Cumulative: **(344 bps)**

Dec 2014: 32.50%, Dec 2015: 31.86%, Dec 2016: 29.81%, Dec 2017: 29.76%, Cumulative: **(274 bps)**

This decline has continued in the recent iPhone cycle when we saw high price tags on all new models of iPhones. The higher pricing provided a good bump to the ASP but it also came at the cost of higher bill of material. Although iPhone X was sporting a very high price of $999, it also had one of the highest BOM. According to a teardown by IHS Markit, the $999 iPhone X had BOM of $370.25. Hence, the BOM of iPhone X was equal to 37.06% of the retail price.

On the other hand, a teardown of iPhone 7 showed that the BOM was $224.80 while the retail price was $649. In this case, the BOM comes to 34.63% of the retail price. We can clearly see that although iPhone X was sporting a higher price tag, it produced lower margins for Apple.

The growth of Services segment is often cited as a big reason for the long-term bullish case. However, faster-growing services like Apple Music would have a much lower margin than what Apple produces through its devices or App Store. Spotify (SPOT) reported a gross margin of 21%. Recent margin models by Macquarie Research estimate only 15% gross margin for Apple Music. A higher product mix towards services which deliver lower margins will inevitably lower the overall margins of the company.

Next iPhone cycle

Apple will be launching three models in the next iPhone cycle. There would be a successor to iPhone X with 5.8-inch screen and a plus-size model having 6.5-inch screen. However, most of the focus is on the cheaper LCD version of iPhone X, let's call it iPhone 9, which will have 6.1 inch screen. Most of the analysts [have estimated this] iPhone 9 to have a sub-$700 price tag. This would be the main model which would drive the bulk of unit sales for Apple.

Unless Apple is able to show some very big improvement in lowering the BOM of this iPhone 9, it will see a big decline in margins. Last year, iPhone 8 had BOM of $247.51. If Apple manages to keep the cost inflation to 5%, it would see the BOM of iPhone 9 rise to $260. If the price tag remains at $699, this would have a BOM cost equal to 40% of the price tag. A lower retail price for iPhone 9 will further increase the percentage cost of BOM and reduce the margin for a model which could possibly show highest unit sales among new models and be the biggest contributor to revenue.

Hence, it looks highly unlikely that Apple would be able to break the margin decline in this iPhone cycle.

Other red flags

In my previous article on Apple, one of the comments pointed out that other metrics like EV/FCF should be given greater importance than margins. Even in this metric, Apple's valuation is now at the highest level after the Great Recession.

Fig: EV to FCF is at the highest level while yield is at the lowest point since the first few hikes in dividend.

While in the early part of this decade, Apple could justify the higher valuation level due to rapid growth in iPhone segment, it does not have a similar revenue growth driver. Also, the revenue base was much smaller at that time which led to a much bigger impact due to iPhone growth. It would be harder to move the needle now when its trailing twelve month revenue is over $250 billion.

Services segment is showing good growth prospects but it is still quite small compared to revenues from devices. In the last quarter, Services segment had revenue of $9.5 billion, which was equal to 17.4% of the total revenue. Other Products segment had revenue of $3.7 billion, making a contribution of 6.9% to the total revenue. Together these two high growth segments contribute less than a quarter to the total revenue.

In this scenario, if the margins are declining while valuation levels are at record levels, it would inevitably lead to greater bearish sentiment towards the stock.

Investor Takeaway

Apple has reported operating margin decline for the past 11 quarters. At the same time, its EV/FCF ratio is close to 19, which is the highest level in this decade. There are several revenue streams like Apple Music in the services segment which will further push margins down. It is unlikely that Apple will push the envelope in terms of pricing in this iPhone cycle. Keeping price hikes at moderate levels can help in increasing the unit sales but it will have a bigger negative impact on margins. For long-term investors looking for value, the margin decline is a strong signal about the future headwinds facing the company.

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