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**Apple's New Normal**

The smartphone has become too interesting a product for one company to dominate.

* By HOLMAN W. JENKINS, JR.

Henry Ford didn't invent the automobile. He didn't invent the assembly line. He invented the mass-market auto industry. In its first full year of production, the Model T captured just 11% of a market consisting of 123,990 cars. Fifteen years later, in 1924, the Model T represented 62% of a market consisting of 3,185,881 cars. To say the growth of the auto market was largely the growth of the Model T would be no exaggeration.

Two years later, the market was still growing but Ford's share wasn't merely shrinking in relative terms. Sales of the Model T were plummeting in absolute terms.

**The story of** [**Apple**](http://online.wsj.com/public/quotes/main.html?type=djn&symbol=AAPL)**,** [**AAPL**](http://online.wsj.com/public/quotes/main.html?type=djn&symbol=AAPL?mod=inlineTicker)**so far, is the story of Ford before the cliff. Sales of its dominant iPhone are still growing but market share is shrinking and so are profit margins.** Apple can continue to be a strong player, but its dominance of the phone and tablet markets has begun to erode and management will have a job just defending its now-diminished share price. This is what the dramatic correction of recent weeks is telling us.



Getty Images

Henry Ford and the iPhone of the auto age.

Apple didn't invent the digital musical player, the graphical user interface or the touchscreen. It invented iTunes and the iPod, added a phone and screen and adapted them to the mobile broadband networks that were already being created. Apple also lucked into the unseen serendipity (even by Apple) of the app revolution.

Apple's accomplishments during its heyday boiled down to a single accomplishment**. Its design and engineering teams were leaps ahead of all others in incorporating the latest technological possibilities into a package that could fit in your hand. Apple was unbeatable because of its mastery of the iPod form factor.**

What was the likelihood that Apple would remain unbeatable? Zero. Nowadays the newest things being fitted into your hand aren't hardware and operating-system innovations at all. They are cloud services, which Apple hasn't been strong at ([Google](http://online.wsj.com/public/quotes/main.html?type=djn&symbol=GOOG) [GOOG](http://online.wsj.com/public/quotes/main.html?type=djn&symbol=GOOG?mod=inlineTicker)has) and which Apple isn't necessarily likely to become strong at.

**The Model T couldn't have been the Model T unless the automobile were on its way to becoming too interesting a product for consumers ever to be satisfied with a single model, a single manufacturer, a single design statement.**

**The same is true of the iPhone.** Different customers not only want different things from their smartphones, they want difference for its own sake, which explains the otherwise inscrutable shifting of coolness cachet from the iPhone to Samsung's Galaxy S line.

Some analysts still hope that ecosystem lock-in will let Apple lock in considerable dominance of a market that otherwise wants to explode into diversity. But ecosystem lock-in was never the strong force it was cracked up to be. The coming of the cloud was destined to obliterate any inclination toward winner-take-all, as Pandora and Spotify have already begun making iTunes look like a convoluted nuisance.

Nor did the slightest reality attach to the hope that Apple somehow would keep finding new industries to reinvent the way the iPod reinvented music distribution. This was a bet on soft and squishy miracles in a competitive world full of people every bit as intelligent and cunning as Apple's leadership. The desperation with which stock punters have posited TV as Apple's next opportunity has been especially pathetic to watch.

Also true, though, is that these unrealistic expectations never found their way into Apple's share price. All through the company's spectacular run, the stock was priced skeptically in relation to the growth that was actually coming. Indeed, it would not be too strong to say that a skeptical stock market has treated the cash on Apple's balance sheet (currently $137 billion) as if it were a sizable share of all the cash the company would ever earn.

The drop in Apple's share price, down 36% since mid-September, has not been the popping of a bubble or a collapse of confidence in management. The drop is easy to arrive at simply as the multiple of some modest lowering of Apple's expected sales growth and some modest lowering of its expected profit margin on those sales. The world thought Apple (in Model-T terms) was entering 1925. Now it thinks early 1926 may be closer to the mark.

Not that this means some horrible, Ford-like sequel lies ahead—wherein management refuses to adapt to a market where competitors have caught up and in some ways surpassed the Model T. Tim Cook and his management team ought to be up to avoiding self-delusion. No offense to Steve Jobs, but a charismatic founder has more leeway to commit catastrophic mistakes.

**But here's a scary thought. By definition, Apple's share price today rests even more heavily on its vast cash hoard. If the company really wants to disappoint shareholders, just keep fanning their fear that they'll never see this cash in the form of dividends or stock buybacks.**

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* The day the stock crossed the $700 mark, the moderator of a financial TV panel asked the guests if any of them could make a bear case for AAPL? Could anything go wrong or was $1,000/share inevitable? Not one participant could make any bear argument for the stock. I knew that day that the end was at hand.

END

Kass on Apple 2/7/13

NEW YORK ([*Real Money*](http://realmoney.thestreet.com)) -- Late Monday, I started a long position in **Apple**([AAPL*\_*](http://www.thestreet.com/quote/AAPL.html)) based principally on price -- the [shares](http://www.thestreet.com/story/11834310/1/kass-getting-to-the-core-of-apple.html) were dramatically oversold.

As the shares rose during the day yesterday, ending up by $16 a share, I sold out of the position for a profit.

Per "[The Bear Case for Apple](http://www.thestreet.com/story/11794629/1/kass-on-sept-24-the-bear-case-for-apple.html)" back in September, I remain of the view that the company's profits and revenue will fail to meet consensus expectations.

That said, I wanted to share with you a brief analysis/update on Apple by Seabreeze (written by part of our research team, analysts Nick Pollari and Kelley Hopkins) that explains my continued reluctance to [invest](http://www.thestreet.com/story/11834310/1/kass-getting-to-the-core-of-apple.html?puc=_btb_html_pla1&cm_ven=EMAIL_btb_html) in the company.

To me, Apple's shares remain a [trading](http://www.thestreet.com/story/11834310/1/kass-getting-to-the-core-of-apple.html?puc=_btb_html_pla1&cm_ven=EMAIL_btb_html) sardine but not an eating sardine.

In the long-term, there are numerous factors to consider when estimating Apple's revenue going forward. Most importantly, the gap is narrowing between Apple products and competitors such as **Google**([GOOG*\_*](http://www.thestreet.com/quote/GOOG.html)) and **Microsoft**([MSFT*\_*](http://www.thestreet.com/quote/MSFT.html)). For example, the processor speeds, battery life and weight of the products are becoming indistinguishable and will no longer provide Apple with an advantage.

The main driver for revenue has been the Apple ecosystem -- the entire family of products and the accessories associated with the brand. Most consumers stick with the brand because you cannot easily transfer data and information onto other products. Eventually, third-party software will allow convergence between Apple products and Google's Android system and/or Microsoft Windows 8. One of Apple's key competitive advantages will be eliminated when this eventually occurs.

The consumer view on constant yearly purchases has shifted. **Verizon**([VZ*\_*](http://www.thestreet.com/quote/VZ.html)) has noted that given the choice between iPhones, customers are choosing the older iPhone 4 and iPhone 4S models over the iPhone 5. The choice for the older model could be based on pricing or the fact that the only major distinction between the iPhone 4 and iPhone 5 models is the larger screen on the iPhone 5.

Based on estimates from press releases, the company has opened over 400 Apple retail stores. The major increase in the stores coincided with the release of the last two revolutionary products: the iPhone and the iPad.

The increase in [selling](http://www.thestreet.com/story/11834310/2/kass-getting-to-the-core-of-apple.html), general and administrative costs can be associated with the store launches. There is a strong positive correlation (R-squared) of 0.93 comparing store openings with SG&A costs. The company is opening more stores internationally while the domestic market is reaching a saturation point. In the U.S., the company is opening more stores in smaller markets and opening additional stores in markets where they already have a presence. The average SG&A cost per store is increasing by about 9% a year based on the company opening an average of 39 stores a year.

Revenue has increased by a compound annual growth rate of 35% from 2006 to 2012 while [research and development](http://www.thestreet.com/story/11834310/2/kass-getting-to-the-core-of-apple.html) costs increased by a CAGR of 25%. The consensus estimates have revenue growing at 12%. Our estimates, however, are closer to a CAGR of 9% given the cited factors of narrowing competitive advantage.

From 2005 to 2011 (excluding 2009), gross profit margins have ended higher than when they were reported in December (first quarter for Apple) of that year. The trend changed in 2012, when gross profit margins started the year around 44.5% and ended the year near 40%. Company guidance was for 36% gross profit [margin](http://www.thestreet.com/story/11834310/2/kass-getting-to-the-core-of-apple.html) and declining going forward.

Apple helped advance the idea of a company being successful by being both a software and hardware manufacturer. Google is advancing its Android software with its Nexus 7 tablet, and Microsoft is doing the same with new Windows software and the Surface. Microsoft is also betting on the success of its phones via its partnership with **Nokia**([NOK*\_*](http://www.thestreet.com/quote/NOK.html)).

Nokia has taken a beating over the years in the phone market but not without reason. Nokia is dependent on the operating systems of other software companies (Microsoft) and has had little innovation when compared to Apple. Nokia has seen little net income margin improvements and has debt on the balance sheet; Apple is debt-free with continuous innovation and improving net income margins. Apple also better manages its SG&A costs than Nokia, which leads to improving margins.

While the market continues to be optimistic on Apple's revenue and gross profit margins, as seen in the following charts, our estimates of forward [earnings](http://www.thestreet.com/story/11834310/3/kass-getting-to-the-core-of-apple.html) for Apple are still below that of the consensus.

"



Unless the company is going to release a new product that implies significant innovation and (ultimately) renewed demand, we expect continued shortfalls at Apple.

[FREE](http://www.thestreet.com/story/11834310/3/kass-getting-to-the-core-of-apple.html) **for a limited time only:** [**Get TheStreet Ratings #1 Stock Report NOW!**](http://secure2.thestreet.com/cap/prm.do?OID=020749)

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At the time of publication, Kass and/or his funds had no positions in the stocks mentioned, although holdings can change at any time.

Doug Kass is the president of Seabreeze Partners Management Inc. Under no circumstances does this information represent a recommendation to buy, sell or hold any security.

The Bear Case for Apple

**Kass on Sept. 24: The Bear Case for Apple**

By [Doug Kass](http://www.thestreet.com/author/1358076/DougKass/all.html)12/17/12 - 02:07 PM EST

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of Real Money*

*Editor's Note: This article was originally published on Real Money Pro on Sept. 24th. To see Doug Kass' latest commentary as it's published,* [***Try it Now! Free for 14 Days***](http://secure2.thestreet.com/cap/prm.do?OID=019126)*.*

*Pride goeth before a fall -- also publicity, handshakes and celebrity. The biblical injunction about the first and the last* [trading](http://www.thestreet.com/story/11794629/1/kass-on-sept-24-the-bear-case-for-apple.html) *places often has literal truth. Thus, stocks and bonds, which fared poorly in the inflationary 1970s, excelled in the disinflationary 1980s. The country's most admired companies (as listed annually in the glossy business magazines) are frequently on their way to becoming among the country's least admired investments. When a cynical investor hears that there are too many optimists in the market, he will begin to worry. By the same token, an over-abundance of pessimists will give him courage.* ***After all, he may ask, if everyone is already bearish, who is left to sell?***

-- James Grant, [*Minding Mister Market: Ten Years on Wall Street With Grant's Interest Rate Observer*](http://www.amazon.com/Minding-Mr-Market-Interest-Observer/dp/0374166013)

**Apple**([AAPL*\_*](http://www.thestreet.com/quote/AAPL.html)) has been a once-in-a-century profit dynamo that has prospered and has expanded its market share by delivering innovative products and expanding its self-sustaining ecosystem.

[Here](http://finance.yahoo.com/q/bc?s=AAPL&t=my&l=on&z=l&q=l&c=) is the remarkable chart of Apple's shares since 1985.

In the 1960s and 1970s, the [stock](http://www.thestreet.com/story/11794629/1/kass-on-sept-24-the-bear-case-for-apple.html) market was inhabited by the "[nifty fifty](http://en.wikipedia.org/wiki/Nifty_Fifty)," a small subset of one-decision stocks that had strong balance sheets, solid franchises (typically leaders in their field), relatively superior profit prospects and were generally credited with the bull market of that era. Some examples of the nifty fifty included **Wal-Mart**([WMT*\_*](http://www.thestreet.com/quote/WMT.html)), **Avon Products**([AVP*\_*](http://www.thestreet.com/quote/AVP.html)), **Disney**([DIS*\_*](http://www.thestreet.com/quote/DIS.html)), **McDonald's**([MCD*\_*](http://www.thestreet.com/quote/MCD.html)), **Polaroid** and **Xerox**([XRX*\_*](http://www.thestreet.com/quote/XRX.html)). The stocks flourished for a while but ultimately became overvalued and were weighed down by the bear market that continued until 1982.

Today there is no more nifty fifty, arguably there is the nifty one -- and that one is Apple. The [Wall Street](http://www.thestreet.com/story/11794629/1/kass-on-sept-24-the-bear-case-for-apple.html) analytical community and many money managers are unambiguously and unanimously optimistic about the company, but let's not lose sight of the fact that the sword is double-edged, as an investor who bought the nifty fifty at the end of 1972 would have had 50% less wealth by year-end 2001 relative to an investor who bought the **S&P 500**. (*Sic transit gloria*.)

Over the weekend, *The New York Times'* Joe Nocera wrote an interesting article which speculated that Apple has peaked.

It got me thinking, and below I highlight a list of 10 concerns, fully recognizing the current quarter will be ahead of expectations.

Apple's significant role in the indices as well as its extraordinary relative and absolute performances have been an important determinant of investment returns. A portfolio heavily weighted to Apple has been a ticket to outperformance. By contrast, a portfolio dismissive of Apple's prospects and underweighted the stock has underperformed.

But the above paragraph modifies the past; it does not necessarily hold for the future.

Investment history shows that when there is such unanimity of good will bestowed toward a corporation's equity, when the very share price performance of only one security has such a profound impact on aggregate investment returns, when a [record amount of analysts](http://finance.yahoo.com/q/ae?s=AAPL+Analyst+Estimates) (53) follow an individual company with enthusiasm and optimism and when a company's total capitalization is mentioned in the media constantly and throughout the trading day, resonating throughout the investment community, **it is time to be on guard if not concerned.**

**Kass on Sept. 24: The Bear Case for Apple**

By [Doug Kass](http://www.thestreet.com/author/1358076/DougKass/all.html)12/17/12 - 02:07 PM EST

*A complimentary preview
of Real Money*

***Surprise No. 10: Despite the advance in the U.S. stock market, high-beta*** [stocks](http://www.thestreet.com/story/11794629/2/kass-on-sept-24-the-bear-case-for-apple.html) ***underperform.*** *Though counterintuitive within the framework of a new bull-market leg, the market's lowfliers (low multiple, slower growth) become market highfliers, as their P/E ratios expand. With the exception of Apple, the highfliers --* ***Priceline****(*[*PCLN\_*](http://www.thestreet.com/quote/PCLN.html)*),* ***Baidu****(*[*BIDU\_*](http://www.thestreet.com/quote/BIDU.html)*),* ***Google****(*[*GOOG\_*](http://www.thestreet.com/quote/GOOG.html)*),* ***Amazon****(*[*AMZN\_*](http://www.thestreet.com/quote/AMZN.html)*) and the like -- disappoint. Apple's share price rises above $550, however, based on continued above-consensus volume growth in the iPhone and iPad. Profit forecasts for 2012 rise to $45 a share (up 60%). In the second quarter, Apple pays a $20-a-share special cash dividend, introduces a regular $1.25-a-share quarterly dividend and splits its shares 10-1. Apple becomes the* ***AT&T****(*[*T\_*](http://www.thestreet.com/quote/T.html)*) of a previous investing generation, a* [stock](http://www.thestreet.com/story/11794629/2/kass-on-sept-24-the-bear-case-for-apple.html) *now owned by this generation's widows and orphans.*

-- Doug Kass, "[15 Surprises for 2012](http://www.thestreet.com/story/11357403/1/kass-15-surprises-for-2012.html)" (Dec. 27, 2011)

I have written positively about Apple this year.

While I recognize that valuation and concept shorts are usually a [free](http://www.thestreet.com/story/11794629/2/kass-on-sept-24-the-bear-case-for-apple.html) pass to the poor house, Joe Nocera's editorial to me was a reminder that, as Grandma Koufax used to tell me, "trees don't grow to the sky."

There is no better time to consider the negative case for Apple given its marked outperformance and its recent penetration of the $700-a-share mark.

**Principal Short-Term Positive: A Blockbuster Quarter**

The upcoming quarter will be big for Apple. The fastest ever rollout for iPhone 5 will be accompanied by higher-than-expected margins, as there are two separate cost-reduced models now. Soon everyone will know that, and if not fully in analyst numbers, it will be in buy-side expectations. (See the recent rise in the stock even after what was viewed as a somewhat me-too product launch.)

**10 Concerns**

1. **Quality vs. price: Apple is now selling *less* or equal for *more* money.** The company used to sell a better product for more money, which is a great strategy. Its products were simply market-defining, and competitors were not close. Recently, however, things have changed, and competitors have caught up. Now Apple is selling an equal to worse product than the competition for more money (both phones and tablets). That strategy cannot work forever. This is the biggest issue.
2. **Delivering a more complicated product: Products are also getting more complex and Microsoft-like.** Apple's challenge is to deliver ever more complicated products (with a lot of new components) in sufficient quantities. See most recent [Foxconn issue](http://abcnews.go.com/blogs/headlines/2012/09/foxconn-closes-factory-after-massive-brawl/). Previously, we would never have seen such a story because there were never issues and nobody would dare voice them, especially not an avowed Apple zealot like the author of [this interesting article](http://battellemedia.com/archives/2012/09/am-i-an-outlier-or-are-apple-products-no-longer-easy-to-use.php).
3. **The Oracle of Cupertino: Steve Jobs is no longer around to convince consumers that his products are magical.** There is no longer a single visionary voice, especially with the vision of Steve Jobs. There are stories floating around about internal disagreements and power struggles given the unique void created by the loss of a single dominant figure in an unusual corporate structure that he controlled.
4. **Increasing product homogeneity: Apple no longer has a huge ecosystem advantage.** Most if not all the apps that consumers care about are available on Android and **Microsoft** ([MSFT](http://realmoney.thestreet.com/quote/msft)), which can also run Office apps such as Excel that Apple doesn't. The first-mover advantage might be lessened or lost if Apple continues to try to do everything on a proprietary basis -- for instance, maps (and who wants a smartphone with bad maps?).
5. **Economic headwinds: Some of the markets served by Apple are saturated, and in a worldwide economy facing strong headwinds, consumers may balk at a product that can be purchased at much lower prices from competitors.** Until last quarter, Apple never missed consensus expectations during a product transition. There is more to last quarter's miss than transition.
6. **Poor economic proposition for Apple's partners: Apple's carrier partners do not like the economics they give to Apple.** Apple's partners have shown that they can and will shift to the good alternatives that consumers seem to like (e.g., **Samsung** Galaxy).
7. **Roadblocks to new initiatives: Potential business partners in general do not like or trust Apple relative to other initiatives.** The music industry and AT&T have not had great experiences with Apple, and the company might find it hard to sign deals for new initiatives.
8. **Product cannibalization: The iPad mini may cannibalize the higher-margin iPad -- or just be a neutral at best.**
9. **Growing size mandates delivery of more product blockbusters: An investor better believe in a huge new blockbuster product next year.** TV is complex due to relationships with cable companies, set-top box manufacturers and channel guide programmers. Google may one up Apple in the space, as it owns Motorola's set-top box division and has Google Voice already. If it comes to integrating more complex solution for TVs with content, cable companies and other media partners have learned not to trust Apple given the poor outcomes other Apple partners have had (e.g., music industry, AT&T, etc.).
10. **Valuation: Apple's stock is cheap on a P/E basis but arguably very expensive on price/sales (4.4x) and total absolute market capitalization basis ($625 billion).**