

“Why Services Are Apple’s Future & Will Improve Apple’s PE Ratio and, as a Result, Apple’s Share Price”*

Apple services are already generating \$20+ billion a year. Services businesses enjoy a higher PE ratio than manufacturing businesses. It won’t be long before Apple’s share price rises significantly due to a justified higher PE ratio resulting from Apple’s larger service business revenue.

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When you think of Apple, your mind typically things about all of their gorgeous, beautifully designed products – the iMac, MacBook, iPhone and iPad. In other words, we most typically think about the hardware when discussions of Apple come up. But, there’s a lot of other products that Apple produces including software and services.

Apple produces a lot of software. You could think of Apple being more of a software company than hardware company because none of their hardware devices would work without elegantly built software that makes it so easy to use the devices. The Mac OS (for desktop and laptops) and iOS (for mobile devices) are the heart of the company’s software. Apple also produces productivity apps called iWork that is similar to (but not as popular as) Microsoft Office. It includes three main software apps: 1) Pages for word processing, 2) Numbers of spreadsheets and 3) Keynote for presentations. These software apps help Apple sell their hardware.

However, Apple also produces and sells a lot of services that generate recurring revenue for the company. Apple has just started to report service revenue: the last quarter resulted in \$5.5 billion in service revenue which itself is greater than the size of Starbucks.

Apple's service business includes (but is not limited to):

- iTunes – Apple's original music portal that fed the original iPods. But, iTunes has evolved into a generic media library of music, TV shows, movies and other rich media resources for users in which users store their library of personal music (often going back to when their 'ripped' their CDs and uploaded the CD's songs to iTunes). iTunes still has a wider reach over rich media than Apple Music which is totally focused on music and providing the best delivery mechanism in the market.
- iCloud – Apple's cloud storage service. The company was smart to provide automatic loading and syncing of the user's contacts, calendar and other personal information and then extend it to all of the user's media and other storage. I found that most of my iCloud storage is to hold all the little videos I take with my iPhone. An interesting challenge is for Apple to eventually provide search that can both identify and organize the user's iCloud content.
- AppleCare – This is that little thing you get asked when you buy an Apple device in a store. It's more than an extended warranty. It also provides preferred access to technical support and replacement of our mobile device if it is dropped and broken via AppleCare+ (and AppleCare Pro for Mac). AppleCare+ used to provide replacement of the device for a service fee of \$79 but with the introduction of the 6s and 6s Plus, that fee is now \$99.
- ApplePay – This is Apple's automatic payment system when you use an iPhone that has been tied to one or more of your credit cards. It enables you to easily pay for something by tapping your phone on/near the card reader that has near field communications (NFC). Apple gets a small and not disclosed fee from each transaction.
- Apple Music – Apple's service that's focused on streaming music to its subscribers. Apple Music accesses the company's library of millions of songs and provides access to them for \$9.95 per month. It also accesses the music in your iTunes library. Apple provides curated music channels, e.g. Country, Classics, Rap, etc. Apple also provides the ability to create play lists and to share play lists with others just as other popular services such as Spotify do.
- Apps Store – Apple's App Store takes 30% of the sale of apps that are sold through the App Store. This is almost hidden in the overall service business but is steadily growing and part of why Apple's service business is becoming so successful.
- Apple TV – Right now, Apple TV enables users to play their videos on large TV screens (via AirPlay) and to access (sometimes for a cost) rich media content. This could be Apple's 'hidden service asset' to provide direct programming similar to what a cable company

provides. This would require a lot of additional arrangements with media and content companies – something that is very difficult to do.

Each of these services generates recurring revenue, e.g. Apple Music generates \$9.95 per month after a three month trial period and iCloud generates annual fees based on the amount of storage customers require to store their music, photos and videos. iCloud also acts as a backup service. It has been [reported](#) that Apple generates as much as \$36 per month in revenue for every Apple device that's in the market. Whatever the number, it is most certain to grow over the coming years.

Apple executives Tim Cook and CFO Luca Maestri have started emphasizing Apple's services and associated service revenue in their quarterly call with financial analysts. In the most recent call, Apple reported that the company generated \$5.5 billion in total service revenue. If you deduct warranty revenue as not being a productive service business, the company still generated \$4.7 billion in direct service revenue.

Why is the service business so important to separate out for Apple? It all has to do with how service revenues affect Apple's stock price. Apple's average price earnings (PE) ratio is about 11. However, if you look at other companies that are primarily software services such as Google and Facebook, you'll find that their PE ratios are much higher: Google is 33 and Facebook is 97.

While Apple will never give up their design and manufacturing of devices, it makes perfect sense that Apple's service business (as listed above) will generate a higher proportion of Apple's overall revenue. And when that happens, Apple's share price will most likely rise significantly. It is entirely plausible that Apple's share price will double as a result of services becoming more successful.

Just think for a minute what would happen if Apple finally becomes aggressive with Apple TV and becomes a primary service for user's daily TV and movie consumption? Service revenue will go through the roof. And then, there is Apple Music. Since Apple acquired Beats and put Beats executives in charge of the music business, the number of Apple Music subscribers and revenue have continued to rise. I believe that Apple Music will before too long have more paying subscribers than industry leading Spotify. And, in addition, ApplePay's service revenue will continue to rise as iPhone owners begin to see how easy it is to use.

While I am not a financial analyst, it seems to me that the future of Apple is their service revenue. The company will continue to produce hundreds of millions small, but beautiful device portals that provide access to Apple's garden of services.

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