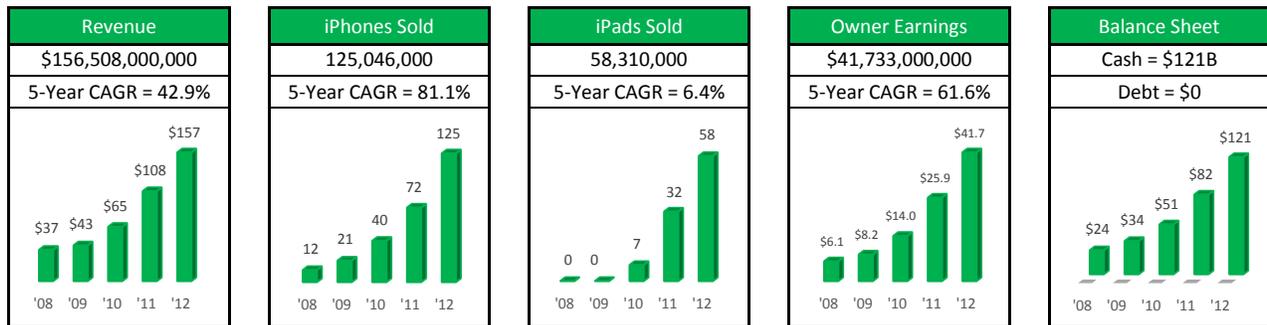




Apple Inc.
April 24, 2013

General Overview

Apple Inc. (AAPL) creates software and manufactures computing devices that add tremendous value to millions of individuals around the world. The company's flagship products include the iPhone, iPad, iPod, and MacBook. In the last 6 years AAPL has revolutionize the way people view computing by introducing 'mobile' devices that allow individuals access to thousands of applications, or Apps, directly through their mobile device. The iPhone is arguably the most successful product launch in the history of the world in terms of gross profits generated.



Purchase Logic

AAPL needs no introduction. The company earned just over \$41 billion dollars in 2012 and is neck and neck with Exxon Mobile for the most profitable company in existence. We made our purchase based on the strong 'ecosystem' that surrounds mobile software platforms, namely iOS by AAPL and Android by Google. These two companies have an effective duopoly on the mobile software industry.

The duopoly is largely protected by the purchasing habits of mobile customers. Consumers purchase mobile devices for the myriad of Applications, or Apps, available on these two operating platforms and selling a mobile device without a large App market is nearly impossible. There is a nasty catch 22 in the world of mobile software development that creates a very strong barrier of entry - developers do not make Apps for devices that don't have market share and devices can't gain market share if they don't have Apps. Microsoft and Blackberry have spent billions of dollars attempting to enter this space to no avail.

We purchased our stake in AAPL at a market capitalization of \$400 billion, but the business also has \$150 billion in cash. We believe that approximately \$100 billion of this cash is available to pay out to shareholders - meaning our effective purchase price is \$300 billion. AAPL should easily be able to earn more than \$25 billion per year for the next decade. The company earned \$41 billion in 2012 so this seems conservative, but our logic behind the \$25 billion floor is outlined below.

- 1) AAPL has 500 million devices 'installed' worldwide and the number is increasing daily. This means that people currently own and are actively using 500 million AAPL devices.
- 2) More than 90% of all AAPL owners repurchase an AAPL product when it breaks or it's time to upgrade. This high retention rate is typical of software products that have a learning curve because people don't like learning new things. The same is true even for the highly intuitive smart phones with lower learning curves. Our previously described catch 22 with App development also keeps competition away.
- 3) We also assumed that iPhones last 4 years, iPads last 6 years, Mac Books last 8 years, and iPods are not material.

We took the replacement assumptions and applied them to the install base for each product category while simultaneously decreasing gross margins as pricing pressure increases. This calculation yielded earnings in excess of \$25 billion per year simply on replacements. Based on this conservative calculation we believe we purchased AAPL for roughly 12x earnings.

Key Metrics

The key metrics for AAPL include Revenue, Gross Profit, iPhone Units Sold, iPad Units Sold, and Owner Earnings. The business factors that drive each of these key metrics are outlined below.

Revenue

AAPL generates more than 90% of revenue from four major product lines: iPhone, iPad, iPod, and Mac Books. The contribution to overall revenue is presented in Table 1:

Table 1

Product	Revenue Contribution
iPhone	51.4%
iPad	20.7%
iPod	3.6%
Mac Books	14.8%
Other	9.4%

iPhones are mobile devices that allow users access to the internet, cell phone services, and the App store. The iPhone was a revolutionary new product introduced June 29, 2007 and has since seen several revisions. AAPL sells the iPhone for roughly \$700 dollars and cell phone providers pay a substantial portion of this upfront and recoup their investment through monthly cell phone contracts. These cell phone companies are effectively financing the sensational growth of the iPhone product. iPad's were introduced in 2010 and are alternatives to the traditional PC experience. These devices cost between \$300 and \$500 dollars and are significantly more mobile than the PC competition. The iPod was a music player that allowed individuals to carry their entire music library in their pocket. This device is largely being replaced by the iPhone and not material to our calculation of revenue for AAPL. The Mac Book line includes both the portable and desktop version of computers sold by AAPL. While the PC industry has been shrinking in recent years the Mac Book continues to gain market share and experience growth despite these secular headwinds. Other revenue includes sales from the iTunes store, App Store, software (such as FinalCut Pro) and other hardware accessories.

Gross Profit

The gross margin for AAPL is impacted by the product mix sold. For example, the iPhone has higher profit margins than the Mac Books, meaning that as the iPhone becomes a larger percentage of revenue relative to the Mac Book the gross profit margin expands. Our primary focus is the total gross profits generated by all product lines. We will monitor the gross margin of each line individually to evaluate AAPL's pricing power for each product, but our primary focus is the overall gross profits from all lines combined.

iPhone Units Sold

The number of iPhone Units sold is the total number of iPhones sold across all iPhone models in the given year. This is the primary driver for revenue and gross profits at AAPL accounting for 51% of the revenue in 2012.

iPad Units Sold

The number of iPad Units sold is the total number of iPads sold across all iPad models in the given year. This is a major contributor to revenue and gross profits at AAPL accounting for 20% of the revenue in 2012.

Owner Earnings

The owner earnings for AAPL is calculated by subtracting the selling, general, administrative, and R&D expenses from gross profits. Owner earnings represents the cash flow generated by the business that is available for distribution to shareholders without impacting the competitive position of the business.

Historical Performance of Key Metrics

Year	'08	'09	'10	'11	'12
Total Revenue	\$37,491,000,000	\$42,905,000,000	\$65,225,000,000	\$108,249,000,000	\$156,508,000,000
<i>Gross Profit</i>	\$13,197,000,000	\$17,222,000,000	\$25,684,000,000	\$43,818,000,000	\$68,662,000,000
iPhone Units Sold	11,627,000	20,731,000	39,989,000	72,293,000	125,046,000
iPad Units Sold	0	0	7,458,000	32,394,000	58,310,000
Owner Earnings	\$6,119,000,000	\$8,235,000,000	\$14,013,000,000	\$25,922,000,000	\$41,733,000,000
Cash	\$24,490,000,000	\$33,992,000,000	\$51,011,000,000	\$81,570,000,000	\$121,251,000,000
Debt	\$0	\$0	\$0	\$0	\$0

Revenue

In the last 5 years revenue has increased dramatically compounding at a rate of 42.9% per year. The tremendous growth can be attributed to the product launch of the iPhone and the iPad – two products that revolutionized the world and created entirely new product categories. The sensational growth of these two product lines was greatly assisted by the massive ‘greenfield’ opportunity as new product categories. Prior to 2007 consumers did not have access to smart phones or tablets and as new products AAPL was able to sell to all individuals globally at a rapid pace. Today the market for new smart phones is slowly becoming saturated – especially at AAPL’s higher price points. While there is potential for modest growth moving forward the massive ‘greenfield’ opportunity from five years has been fully realized. We anticipate modest to no growth in AAPL’s revenue over the next 10 years with annual fluctuations ranging from +20% to -20%, depending on product launch dates. We believe the no growth scenario may prove to be conservative, but considering lower pricing on smart phones and the massive size of AAPL it will be very hard to move the needle.

Gross Profit

Over the last half decade the gross profit at AAPL has soared at a pace of 51% per annum. The growth in gross profits stems from the same product launches that drove revenue – namely the iPhone and iPad. We anticipate gross profit to remain relatively stable during the next 10 years with similar fluctuations as revenue. We expect pricing of the iPhone and iPad to decrease over time, but to be slightly offset by production efficiencies and unit volume.

iPhone Units Sold

The number of iPhone Units sold has sky rocketed from 0 in 2006 to more than 125 million in the last 12 months. We anticipate the number of iPhone Units sold to stabilize at around 125 million units per year with modest growth upward. Today 260 million iPhones are in ‘installed’, meaning 260 million are in use, and that number will likely continue to grow as AAPL penetrates further into emerging markets, such as China. We expect the install base to reach approximately 500 million and believe the average lifetime of an iPhone is roughly 4 years. This would mean that the replacement cycle in a mature market for iPhones will be roughly 125 million annually. We expect this number to fluctuate based on product launches and range from 100 million to 170 million per year with a slight upward trend as emerging markets become more affluent during the next decade.

iPad Units Sold

The number of iPad Units sold has grown from 0 in 2009 to 60 million in the last months. We believe that the install base for iPads will be significantly less than the iPhone with the overall install base reaching roughly 150-200 million at maturity. We also believe that the replacement cycle will be longer – roughly 6 years – meaning that the replacement iPads will be approximately 25 to 35 million per year. We do anticipate this figure to trend slightly upward for the same reasons as the iPhone.

Owner Earnings

Owner earnings have compounded at a rate of 61.6% over the last 5 years. In the last 12 months AAPL generated \$41 billion in owner earnings - a truly sensational accomplishment. We have similar expectations for owner earnings as revenue and gross profit. It should be noted that stable owner earnings over the next 10 years will be a difficult feat for AAPL and the issues with maintaining such a high level of owner earnings is addressed in the section on risk.

Summary of Key Metrics

Metric	Expectations
Revenue	~\$150 Billion +/- 20% depending on product launches
Gross Profit	~\$65 Billion +/- 20% depending on product launches
iPhone Units Sold	Between 100 and 170 million units 10 year average of approximately 125 million annually
iPad Units Sold	Between 25 and 35 million units 10 year average of approximately 30 million annually
Owner Earnings	Minimum of \$25 billion based on replacement Between \$25 billion and \$45 billion annually

The Moat Around The Metrics

AAPL enjoys one of the widest economic moats in the world. The company benefits from a widely recognized brand name, a strong ecosystem of App developers, and high switching costs. Each of these factors is described in detail below.

Brand Name

In 2012 Apple was voted the number one most valuable brand in the world by BrandZ ranking list. The company is known globally by consumers worldwide and people tend to enjoy the company's products. The company's commitment to excellence has created a following of consumers that are advocates for AAPL products. This brand name has allowed AAPL to command higher prices than the competition across all of the company's product lines. While this brand recognition is an important factor we believe the network effect contributes more to protecting the company's competitive position.

Network Effect

AAPL benefits from a very powerful network effect that is the primary factor when considering AAPL's economic moat. The company's products, namely the iPhone and iPad, have a large developer base that create Apps for end users. These Apps range in function from flash lights, to chess clocks, to video games, and everyone customizes their smartphone based on the Apps they enjoy. This ecosystem is nearly impossible to penetrate for a few simple economic reasons. Developers refuse to make Apps for products that don't have market share because of the time and energy involved – it is uneconomical. Products that do not have Apps cannot gain market share because end users are interested purchasing mobile products for the features these Apps provide. This makes it extremely difficult for competitors to gain market share against APPL and Google. Microsoft and Blackberry have both invested billions of dollars competing against iOS and Android and have gained little traction. This ecosystem of Apps creates a strong barrier of entry that will ensure APPL remains center stage in the world of mobile for many years to come.

Switching Costs

AAPL also benefits from switching costs that users experience when they change operating systems for their mobile products. Consumers typically use their phones and various features constantly throughout the day. Many individuals are extremely comfortable with how their phone operates and the Apps they've installed to customize their experience. When offered the option to switch operating systems, from iOS to Android, 90% of all users refuse – even at lower prices. This refusal has to do with the switching costs associated with relearning and customizing a new operating system. High switching costs is a common feature of the software industry and helps to protect profits.

Risks

As a technology company AAPL faces more risk than our average investment. Despite the wide economic moat the wild success and outstanding profitability of the iPhone and iPad will make it difficult for AAPL to post similar profits in the next decade. The major risks we've assumed as owner of AAPL are outlined below.

Short-Term Risks

- **Compressed Margins.** If the gross margins across the various product lines compress more than anticipated owner earnings would be adversely impacted and replacing the lost income would be very difficult. AAPL is so large that a 15% decline in owner earnings would equate to \$6 billion dollars in lost income. Replacing this income would be extremely challenging - Visa Inc. earned roughly \$5 billion in the last 12 months, Coca-Cola \$9 billion, and Facebook roughly \$3 billion. Replacing \$6 billion in owner earnings would require global domination of an entire category and could prove very challenging.
 - High Risk
- **Market Saturation.** In the last 5 years AAPL benefited from 'greenfield' growth, meaning no consumers had a smartphone or tablet. This market is slowly becoming saturated and the growth from greenfield purchases will decline dramatically. The majority of new purchases moving forward will be based on the replacement cycle of existing products.
 - Moderate Risk
- **Longer Replacement Cycles.** We've assumed the replacement cycle for various AAPL products and believe those assumptions are conservative (meaning replacement will occur faster than our projection). In the event that products last longer than anticipated and replacement rates are slower than anticipated it would have a material impact on AAPL's income. One benefit to deriving the majority of sales from the smartphone is that these devices are carried with the user 24/7. The number of phones that need replaced due to accidental damage is significantly higher than the PC and we believe a 4 year replacement cycle is conservative given the high frequency use of such devices.
 - Low Risk

Long-Term Risks

- **Product Obsolescence / Lack of Innovation.** We believe that the ecosystem of Apps surrounding AAPL's products greatly reduce the probability of product obsolescence. If the smartphone or tablet categories are replaced by an innovative product we believe that AAPL would acquire the competitor and utilize the existing ecosystem with a new product line. Developing all the existing Apps for a new operating system would be extremely difficult and costly and would give AAPL a competitive advantage against the new product.
 - Low Risk

Conclusion

Apple Inc. (AAPL) creates software and manufactures computing devices that add tremendous value to millions of individuals around the world. The company's flagship products include the iPhone, iPad, iPod, and MacBook. We calculated the future earning power of AAPL conservatively using only the replacement cycle of existing products and believe the company will earn more than \$25 billion per year in the next 10 years. The company has an outstanding competitive position based on the 'ecosystem' that surrounds the company's products. We purchased our stake in AAPL for an effective purchase price of \$300 billion or 12x earnings.

Works Cited

- 1) *AAPL Annual Report - SEC Filing 10-K*. EDGAR, 2012.

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