A Case Study on the valuation of APPLE's stock

An examination of the valuation of Apple's shares is an excellent way to demonstrate the extreme divergence that has taken place in the stock market in the last six months. Not much has changed in the underlying profitability of Apple. What has changed is that investors are willing to pay a mania-type multiple not seen since the 2000 dotcom bubble.

To be fair, the present era is different from the dotcom era. Apple and its 'Mega Cap' siblings are very profitable. More importantly, Apple is an essential provider of smart phones and services which are helping us get through this global pandemic. As we have discussed in our Q3 Letter, financial markets are awash with money looking for a safe place. Apple fits the bill as a low debt company with a consistent and slightly growing income stream. But we argue that the valuation is now extreme.

Looking back at our internal estimate of Apple's future earnings from four years ago, we believed that then current earnings of $9.00 per share could rise to $14.00 by the year 2020. This has turned out to be exactly what has happened and for the most part this was a consensus view among Wall Street analysts. When we initially purchased Apple in 2015 at around $100 (split adjusted $25) we were paying roughly 10 times 2016 earnings with our expectation that earnings would grow to $14 in 2020. We made our purchase with a good margin of safety in the valuation.

Since that time the stock has delivered great returns, but it is not because the business is growing. Rather the business has been consistent in that it has a high profit margin and then it takes that excess profit and buys back its own shares. Revenue and profit have increased slightly but earnings per share have gone up over 50% because the numbers of shares outstanding have been reduced.

What has happened since then is the multiple that investors are willing to pay for Apple has increased dramatically. Last month at its recent high share price of $535, Apple traded at 38 times this year's earnings of $14.00 per share. And now the market capitalization for Apple is $2 trillion dollars. This is the highest value that any company has ever traded at and is closing in on the value of the entire Canadian Market. Yes, you can either have an entire country the size of Canada or a company that makes a cool phone.

When we made our initial investment at 10 times earning a lot could go wrong with the business and we were still ok with our decision. Now at a multiple in the high 30s, a lot must go right for us to be comfortable owning Apple. A stock that trades at a multiple of earnings this high implies that the future must be better than today. We argue that Apple's earnings need to double to justify its current share price. Apple's business is not perfect. China makes up 15% of sales and the US and China are embroiled in a tepid trade war. Much of Apple's supply chain is China dependent. There is also a battle being fought over fees paid by app developers to access Apple's App Store, where there is threat of margin erosion.

Our point here is not to say that Apple's stock cannot continue to go up or that collapse is imminent. Rather it is an effort to make sense of what has been an extreme run up in the share price, and because of Apple's relative size, this has created a distortion affecting the valuation of the entire stock market. As investors we are trying to avoid taking unnecessary risk. We can find other equally profitable and growing businesses where the stock is trading at a much better multiple. We have now sold our shares in Apple and have added to our existing technology investments that trade at a more reasonable multiple of earnings.