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Apple, Inc. and a Value Investor's Short Thoughts On Intangibles

Owning Apple as a value fund manager is a bit like working as an antique car dealer and recommending your friend buy a Ford Taurus. The Taurus is an excellent car, but it doesn't quite showcase your automotive knowledge like suggesting a 1975 Jaguar E-Type.

Despite this, I am an enormous fan of Apple. This article will not approach all the factors that make the business excellent. Suffice it to say, there are plenty of them: the high-margin products, continuous revenue from content being advertised on millions upon millions of Apple screens, the fantastic free cash flow. I will also steer clear of a rigorous financial dive as there may be more research reports on Apple than there are iPhones.

Instead, the focus will be on a difficult topic for value investors: the valuation of intangibles. It goes against my conservative nature to be comfortable putting a numerical valuation on something that doesn't explicitly create revenue.

When valuing intangible assets, I suggest using the same overarching basis of investing in any asset: the value of the asset is the value of the cash flows in the future discounted to present with a margin of safety relating to the likelihood of those cash flows. In valuing Coca Cola's soda recipe, perhaps an investor would use a portion of the cash flows attributable to the drink's sales. In valuing intellectual property, an investor could estimate the cash flows derived from licensing that property to others.

The valuation of intangibles becomes much more difficult when you examine brands as an asset themselves. To create a specific value, some near-impossible questions would have to be answered. What portion of a company's sales and thus cash flow is due to perception of their brand? How many of their customers wouldn't purchase their product if it didn't have the company's name on it?

Perhaps the value of a brand could be quantified by the difference in gross margins between the company's product and a comparable product i.e. Apple vs Samsung phones. However, that would only yield a measure for a premium brand such as Apple. Yet there is still value in discount brands who achieve lower gross margins on their products.

In any case, it would prove very challenging for me to put an exact dollar value on Apple's brand. Any result would undoubtedly prove fairly arbitrary. I think investors can agree that the value of their premium brand is very significant. The amount of people lining up to get the newest Samsung smart phone, one of Apple's most significant competitors, is abysmal when compared to the number of people that line up for new Apple products or even store openings, events, etc. John Huber of Saber Capital Management, a kindred spirit in the world of value investing, wrote a report discussing this as well, and I encourage you to read it here.

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With all that said, I can most certainly say one thing about the valuation of the Apple brand: it is not worth NOTHING. However, that is the value Mr. Market is attributing to it: zero. Let's take a look at a rough valuation of the company.

If an investor examines Apple's free cash flow, they will see a compounded rate of growth of roughly 27% over the past 10 years ending fiscal 2017, from $4.735B to $51.147B (Apple 10-K Reports). However, that is unlikely to be representative of results going forward as that period spanned the introduction of both the iPhone and iPad as well as a host of other services. I hope that Apple can innovate and introduce products as excellent as those in the future, but it would be safer not to count on it.

Looking at just the past 5 years, the compounded rate is approximately 3.7%. This, I believe, gives a more accurate view of the future of the company. Using the average of the past 5 years FCF (since it has bounced around a bit) of $53.979B as a normalized figure, 3.7% annual growth in perpetuity, and a 10% discount rate, we are given a total value for the company of $888.524B or $174.80 per share (using Dec 30, 2017 10-Q share count).

An investor must take into account the excess cash on Apple's balance sheet as well to have as accurate a valuation as possible. As of the fiscal 2017 annual report (Sep 30, 2017), Apple was holding cash overseas of $248.606B. The company has announced the intention of repatriating this cash to the US given the more favorable treatment from the Tax Cuts and Jobs Act.

There are a few items that need to be taken into account: the company will be paying $15.4B from this overseas cash for back-taxes in Ireland and will incur roughly $36.146B of US federal taxes to get it here. That leaves the company with $197.059B additional cash coming its way. Since we cannot estimate what cash has already been repatriated as of the most recent quarterly filing from Dec 30, an approximation of the net cash position from the 10-k will have to suffice.

Adding back the net repatriation cash to the balance sheet gives the company $217.348B in cash equivalents. As of Sep 30, the company was also holding $53.892B of short-term securities whose lifespan or intended use was within the following 12 months. Using their total liabilities of $241.272B, this shows a net cash position (cash and short-term securities remaining after all liabilities are paid off) of $29.968B or $5.90 per share.

Combining both their cash-flow generating value with the net cash on their balance sheet yields a value of $180.70, just above where the market has been trading recently.

As mentioned before, it would be very difficult to place an exact value on the Apple brand. But, the above valuation attributes no value to it at all. Investors who can acquire such an incredibly profitable company and powerful brand for such a reasonable price will most likely be very well rewarded for it in the future. Any additional margin of safety to the valuation mentioned can be considered sprinkles and the cherry on top of the sundae.

Disclosures

I/we are long AAPL.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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