Why Goldman Sachs' Downgrade of Apple Is Totally Ridiculous

Description

It's a curious thing that **Apple** (NASDAQ: AAPL), which was recently ranked by *Forbes* magazine as the number one consumer brand in the world, trades at a discount to the broad market, but it does. That's because many analysts and investors continue to view Apple as nothing but a hardware company that sells a commodity product — smartphones.

While it's true that iPhone units sales have been declining in the past year, to focus only on the iPhone ignores the great strides the company has made with the iWatch, other accessories, and Apple's growing services segment, which boasts over 420 million subscriptions and grew 18% in constant currency last quarter.

Unfortunately, one **Goldman Sachs** (NYSE: GS) analyst continues to take a limited view of Apple, ascribing a below-market multiple to this tech blue chip. When analysts have a certain view on a stock, they may tend to look for stories or new angles that reinforce that view. Unfortunately for Apple shareholders, this analyst likely stopped the stock's recent run with a negative note on Friday, September 13, lowering his price target from $187 to $165.

Fortunately, however, the logic behind the downgrade seems like a pretty big reach.

Apple TV+, a positive or a negative?

Specifically, the Goldman analyst took umbrage with the way Apple will account for the free year of Apple TV+ streaming service it's offering with the purchase of a new iPhone 11. Apple will apparently recognize the $60 yearly price for AppleTV+ in the services segment, essentially attributing that $60 to AppleTV+ while discounting the price of the iPhone by $60.

According to the analyst, that discount to the iPhone will look especially bad in the upcoming December quarter, because the holiday quarter is the highest for iPhones sales, whereas services growth tends to be steadier throughout the year. Therefore, Hall thinks December-quarter hardware profits may take a big hit.

Several flaws in the argument

None of what Hall said about the profit distribution accounting between hardware and services is incorrect, but I think his interpretation is flawed at best, and in several ways.

First of all, by sweetening the offer to get a new iPhone with this discount (anywhere between 5.5% and 8.5%, depending on the iPhone model), it's possible Apple could ignite more unit sales. That would lead to a better holiday quarter than people expect.

Even if Apple doesn't sell more units, however, it's not fair to lower your value for Apple by over 10% based on a near-term, mild, and temporary hit to earnings per share. A stock's value is the total amount of cash flows produced by a company over its lifetime, discounted back to the present. Therefore, a small hit to earnings per share in a single quarter shouldn't change one's value of Apple by nearly that much.

Third, it appears that Hall is saying investors will see lower hardware margins and therefore sell the stock, all while ignoring the corresponding *increase* in services profits. That may be true if you are focused on the iPhone and Apple's hardware as the only gauge of the business; however, the iPhone made up less than half of Apple's revenue last quarter — just 48.3% — down from the prior-year quarter, when iPhone made up 55.3% of revenue.

To believe that investors will thus solely focus on the iPhone's average selling prices and margins and ignore corresponding strength in services — all while also ignoring management's explanation of the accounting treatment — seems not to give the investment community credit for understanding these mechanics. And this is for one of the most-followed stocks in the world.

This is all a long-term positive anyway

Finally, and perhaps most importantly, the free year of Apple TV+ should be seen as a *positive*, not a negative, for Apple over the long term. By giving customers a free trial with the purchase of a new iPhone, Apple is incentivizing customers to begin watching without the "pain point" of whipping out a credit card and signing up for yet another streaming service. Then, if the content is good, it's likely many customers will stick with the service once the trial rolls off, especially given its very reasonable monthly price, which is far below those of competing offerings.

So the plan is not only a good way to boost iPhone sales in the year before the release of the 5G phone in 2020 but also a great way for Apple to bring in more subscribers to Apple TV+. Subscription services are fairly "sticky," so this free trial could very well pay off big down the road. And with over $100 billion in net cash, Apple can afford a small discount upfront for a bigger payoff later on.

Could earnings take a (small) hit because of the Apple TV+ discount in the next quarter or two? Sure. But this seems like a very elegant offer on Apple's part to maximize the long-term value of the Apple franchise. That should ultimately boost Apple's intrinsic value, not diminish it.

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