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The iPhone may not be what finally pushes Apple over $1tn
Growth of tech giant’ s services business finally being noticed by Wall Street

Tim Bradshaw in Los Angeles May 29, 2018

There may never be another product as profitable as the iPhone.

Even Apple’ s chief executive, Tim Cook, came close to admitting as much this month. “ The smartphone market is sort of like the best market for a consumer product company in the history of the world,” he said after the company’ s quarterly earnings.

Apple has ridden the iPhone’ s success to record-breaking profits and now it stands on the brink of becoming the world’ s first trillion-dollar company. But investors are split on whether the iPhone has enough momentum to push it over that symbolic market capitalisation — or if the device is the very thing holding it back.

The iPhone makes up more than 60 per cent of Apple’ s revenues. No other device it makes comes anywhere close. No wonder Apple investors get jumpy about iPhone sales every three months.

The quarterly cycle is familiar to seasoned Apple watchers: leaks from Chinese electronics manufacturers or cautious comments from Apple’ s suppliers in their own earnings calls start to sow doubts over the iPhone’ s performance. Apple’ s shares start to fall, its stock market valuation sometimes shedding tens of billions of dollars in a matter of days.

Then, when Apple reports its numbers, Mr Cook is forced to defend the iPhone’ s prospects. Its revenues have swung around sharply, from growth of 52 per cent in its 2015 financial year to a decline of 12 per cent in 2016, back to 3 per cent growth last year.
Apple revenues dominated by iPhone

Yet there is stability and predictability to be found in another part of Apple’ s quarterly numbers. The company’ s second-largest source of revenue is not the iPad, the Mac or even the Apple Watch — but its “Services” business. Digital items such as App Store downloads, iCloud storage and Apple Music subscriptions together brought in more than $9bn in the last quarter, up 31 per cent year-on-year.

The performance of this services division, largely overseen by senior vice-president Eddy Cue, has been a model of consistency when placed next to the feast-or-famine performance of the iPhone. Since 2006, it has grown at an average rate of 23 per cent year on year, according to Gene Munster, a veteran Apple analyst turned investor at Loup Ventures.

If it was valued like other “software as a service” companies such as Adobe, Dropbox or Intuit, Mr Munster reckons, at a multiple of 10 times 2018’ s estimated revenues, Apple’ s services business would be worth $381bn all by itself.

Yet many shareholders are still sceptical Apple's services are worth quite that much. It is other things that have driven the stock price higher over recent months, namely iPhone X sales and the redistribution of Apple's overseas profits.

Mr Cook and his finance chief, Luca Maestri, have been trying to make investors pay more attention to the App Store and other services for more than two years now, highlighting a target of $50bn in annual revenues from the division by the end of 2020.
Race to a trillion, market cap

In January 2016, the company disclosed for the first time that it had more than 1bn active iOS devices, including smartphones, tablets, watches and its TV set-top boxes, to which it can sell its services.

That installed base has now grown to more than 1.3bn, and services revenues have doubled in four years. "With that kind of change in the installed base, with the services that we have now and others that we are working on, I think this is just a huge opportunity for us," Mr Cook enthused earlier this month.

A small but growing band of Wall Street analysts are finally starting to buy the story. Morgan Stanley called services Apple's "primary growth engine" in a recent note. "We don't see services growth slowing anytime soon," the bank's analyst Katy Huberty wrote. She said she expected "more predictable, higher-margin services revenue" driving Apple's share price to $200 — within a whisker of the $1tn mark.

Subscriptions are a big part of the unit's predictability. The number of paid subscriptions to Apple's own services, including Music, as well as third-party apps that charge through the App Store such as Netflix or Spotify, have grown to 270m, up 100m in the last year alone. Apple takes a cut of subscriptions sold through the App Store.

"The Street has started to give more credit to Apple for its services business," says Daniel Ives, analyst at GBH Research. "You're yearning for that second piece of the growth story."

Both Mr Munster and Mr Ives concede that most investors still see Apple's value as inextricably tied to the iPhone.

If the number of iPhone users were to fall, says Mr Munster, so too would services income. "It's a pretty big hurdle for people mentally to get over, that iPhone sales can be stable," he says.
iPhone growth is volatile

Some on Wall Street believe the current growth spurt in services cannot last. Toni Sacconaghi at Bernstein Research estimates the recent performance was boosted by as much as $5bn worth of payments this year from Google, to ensure it remains the iPhone's default search engine.

"Google's willingness to share material revenues with Apple is a testament to the power of Apple's iOS platform, but we see it as a double-edged sword," Mr Sacconaghi wrote in a recent note to clients. “While it’s hard to say if Google might ever stop paying Apple … it certainly represents a potential risk.”

Nonetheless, Mr Munster predicts that Apple will reach that historic 13-digit valuation “sooner rather than later”, and that the services argument is what keeps it there in the long term.

“I think that anticipation of the next iPhones can tip us over the trillion-dollar point,” he said. “But that’s not the way people are going to think about it three years from now.”