

**From:** Richard Kahn <[REDACTED]>

**To:** "jeffrey E." <jeevacation@gmail.com>

**Subject:** Fwd: AAPL Update / Hedge Large Cap Exposure in QQQ

**Date:** Wed, 03 May 2017 13:51:44 +0000

**Inline-Images:** image002.jpg; image003.jpg; image004.jpg; image005.jpg; image006.jpg; image007.jpg; image008.jpg; image009.jpg

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FYI

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Begin forwarded message:

**From:** "Ens, Amanda" <[REDACTED]>

**Subject:** RE: AAPL Update / Hedge Large Cap Exposure in QQQ

**Date:** May 3, 2017 at 9:51:09 AM EDT

**To:** Richard Kahn <[REDACTED]>

Rich, the AAPL May 19<sup>th</sup> \$150 calls are trading at 0.25/0.26 (ref \$144.52)

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**From:** Ens, Amanda

**Sent:** Wednesday, May 03, 2017 8:41 AM

**To:** 'jeffrey E.' <jeevacation@gmail.com>; 'Richard Kahn' <[REDACTED]>

**Subject:** AAPL Update / Hedge Large Cap Exposure in QQQ

[Apple Inc.](#) (-1% \$146; +27% ytd) – key debate issues: lower accrual of QCOM royalty benefit on gross margin (see table below), Services growth deceleration to 18% from 20%+ (adj for 1x – still ok), China (weak sales due to increased 6/6S competition)...next catalyst WWDC in June where potentially new products may be launched (SIRI speaker?)...Wamsi rates Buy / PT \$155...longer-term holders likely adding ~\$144-145

AAPL report attached: ***More controversies than expected, but reiterate Buy ahead of iPhone 8 cycle***

- Shares likely to be under near term pressure due to: Apple could be accruing for QCOM royalties at a lower rate vs. history and we estimate a ~100bps q/q tailwind to GMs, which came at high end of guide. Services growth decelerated from 20%+ to 18%. China growth was weak despite easy comps as sales of 6/6S more challenged given no form factor update and market turning more competitive. China is mixed: high end demand is strong but older models are facing competition, especially with FX headwinds.
- There could be a pause in momentum in the short term following concerns that we think aren't well understood (service deceleration in particular). However, we continue to remain buyers for the iPhone 8 given; Increased capital return (up by \$50bn) and the expected return of another \$89bn over 2 years (12% of mkt cap). Potential for significant cash repatriation, for M&A or cap returns. iPhone 8 super long cycle with higher ASPs.

- Our PO of \$155 is unchanged, based on 14x C18E EPS of \$11.14.

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### Hedge Large Cap Exposure in QQQ

- With AAPL trading lower pre-mkt after earnings (\$146.03 last), FB earnings today and QQQ at all-time highs as of yesterday's close, consider hedging long exposure or instituting new shorts ahead of upcoming events (French Election, Fed (2PM Today), Payrolls Friday) as QQQ looks especially vulnerable to a FB negative earnings surprise and/or bearish Macro data.

**Vol Story:** Put skew is elevated with 2M 90-97.5 skew in the 96<sup>th</sup>-ile over a 2yr lookback, take advantage of this elevated skew via put spreads

**Trade:** Buy the QQQ JunQ (6/30) 127-134 put spread for \$1.10 (ref 137.13, 5.4x net payout, 21 delta)

**2M 90-97.5 Put Skew Elevated (2yr Lookback):**



**Amanda Ens**

Director

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Global Research



## Apple Inc.

# More controversies than expected, but reiterate Buy ahead of iPhone 8 cycle

Reiterate Rating: BUY

PO: 155.00 USD | Price: 147.51 USD

Equity | 03 May 2017

### Key takeaways

- Some controversies around gross margins relative to QCOM, services trajectory and China weakness
- Bull thesis is iPhone 8 super long cycle, higher ASP for iPhone 8, larger capital return authorization, increased dividend
- The biggest risks remain FX and commodity pricing that can change the ASP/GM for the iPhone 8 followed by China

**FULL  
REPORT**



### Qualcomm royalty questions; Services, China growth

Shares of Apple could be temporarily under pressure given the following concerns: (1) gross margins likely benefited q/q from lower accrual of QCOM royalties by our estimate (Fig 1), (2) services growth deceleration from 20%+ to 18% although some adjustments (Fig 2) alleviate these concerns, (3) China growth weak despite easy comps as sales of 6/6S more challenged given no form factor update and market turning more competitive, and (4) a slower rate of switching when adjusted for the China slowdown. However, despite these concerns, we continue to like: (1) the increased capital return (up by \$50bn) and the expected return of another \$89bn over 2 years or 12% of market cap, (2) potential for

significant cash repatriation and associated optionality for incremental capital return and M&A, (3) iPhone 8 super long cycle with higher ASPs, and (4) increased traction in services including App Store, content, Music, Apple Pay, etc. Reiterate Buy.

## Gross margins and ASP puts and takes

In our opinion Apple could be accruing for QCOM royalties at a lower rate vs history, which Apple deems appropriate and we estimate a ~100bps q/q tailwind although there are many moving pieces (see Fig 1 for details). We expect Dec to March bridge of GM as FX (-100bps q/q), volume leverage (-50bps), commodity pricing (-50bps) vs warranty accrual (+50bps), positive mix (+100bps) as the remaining moving pieces. The ASP q/q decline of \$40 can be explained by \$14 for FX and \$26 for seasonally lower memory capacity of iPhones. Apple Watch (est \$4.7bn LTM revs)+ beats (est \$500mn) + airpods (~200mn although supply constrained) are as large as a fortune 500 company (\$5bn).

## Main risk remains FX and commodities into iPhone 8 cycle

We model GM in 2H17 to remain robust given our expectation of ASP increases on iPhone 8, however potentially large swing factors include: (1) FX (particularly relative to China which faced a 5% headwind and weaker demand), (2) tight commodity pricing (memory), where management noted a continued tight market (positive for WDC).

## Adjusting estimates, PO stays at \$155

Our PO of \$155 is unchanged, based on 14x C18E EPS of \$11.14.

**Wamsi Mohan** [Se](#)

Research Analyst  
MLPF&S

This report is intended for 

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