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Apple: Looking Through the iPhone Gloom

A maturing iPhone business means Apple's business gets unavoidably complex as it spreads its efforts

Apple's logo in Los Angeles. The company's stock has underperformed the Nasdaq this year. *PHOTO: REUTERS*

By **DAN GALLAGHER**

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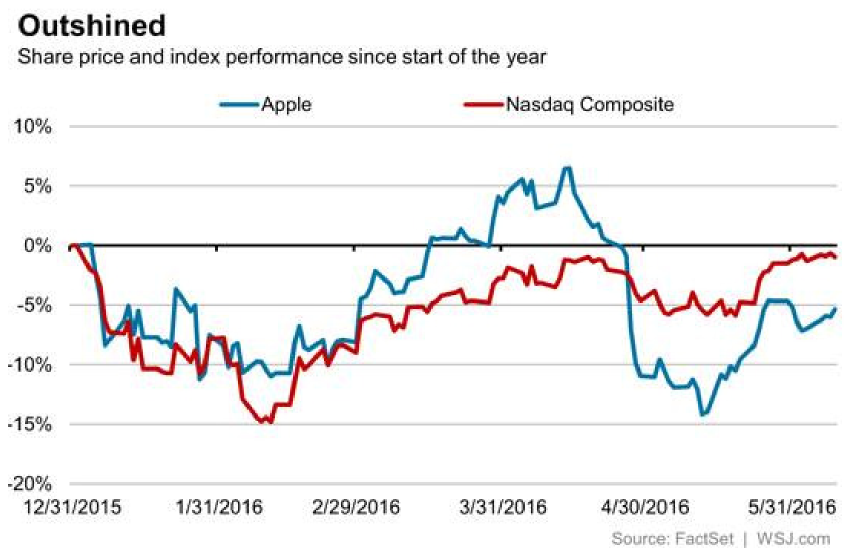
Apple has long prided itself on simplicity, but its business has become more complex. That's unavoidable, and not something investors should fear.

Fear has shrouded Apple anyway. Its stock has underperformed the Nasdaq by about 4 percentage points so far this year. But the gloom may be overdone. And Apple's Worldwide Developers Conference next week could help brighten investors' mood. The company, for example, released early some details about planned changes to its App Store that should boost its appeal to developers.

Apple still can't escape the fact that iPhone hardware drives most sales and profits. And the news there hasn't been great, of late. Saturation in the company's core markets and slowing upgrade rates by current owners are crimping growth.

Apple's practice of making incremental upgrades every other year may also be hitting its limit. This year's iPhone 6S has been a clear letdown—total iPhone unit shipments for the last two quarters since its launch are down 7% year over year.



So Apple is thinking different. It launched a new, smaller-screen phone earlier this year to widen the appeal of its smartphone to more customers. It is also focusing more on services—its best-growing segment this year.

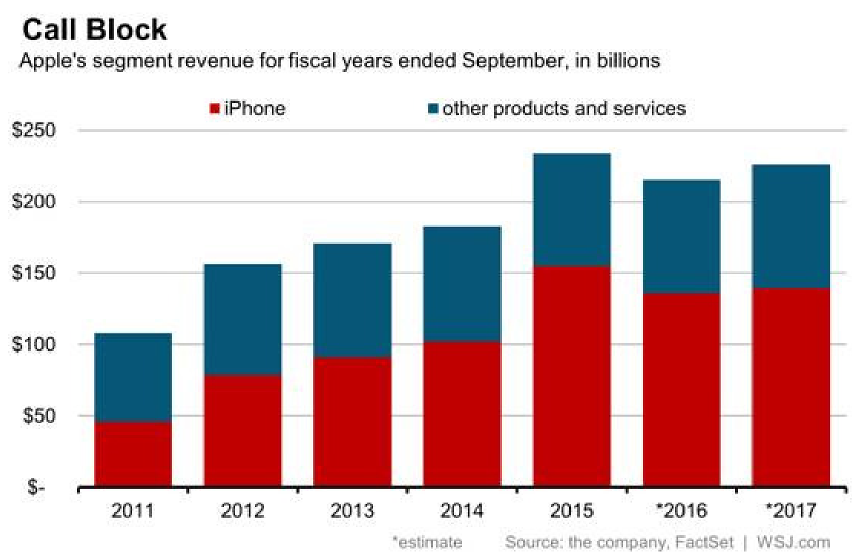
The changes to the App Store will give developers a bigger cut of some of the revenue generated there. But it could also help Apple's services business over the longer term. Those changes will be featured at next week's conference, along with new versions of its mobile and desktop operating system.

New iPhones won't likely show up until the fall. Wall Street thinks the next iPhone will revive growth for Apple's 2017 fiscal year that ends in September, but investors aren't convinced yet.

The stock's current slump reflects a worry about Apple's huge dependence on iPhone hardware, and a belief that innovation in that area is waning. But that's premature. There are still many ways to significantly improve the smartphone's performance and durability.

For example, semiconductor analyst Ed Snyder of Charter Equity projects the next iPhone will be able to work on three different carrier bands simultaneously. This is an important development, as wireless carriers aggregate signals on different spectrum bands in an effort to boost data rates. Broadcom's strong forecast last week for its mobile chipset division essentially confirmed this; the company cited demand from "a large North American smartphone customer" that is building a "next generation" device.

Future iPhone models could also include OLED displays and all-glass frames, according to recent reports. That means there may be advances in store that go beyond incremental upgrades to the phone, potentially reviving growth.



Meanwhile, Apple's push into other areas and its growing R&D spending mean that efforts to broaden its revenue and profit base are continuing. It may be tough for investors to recognize their importance given both Apple's size and that of the iPhone: The iPhone hardware business alone is large enough to rank seventh on this year's Fortune 500 list. Plus, efforts to boost revenue in other areas will take time to bear fruit.

Still, there isn't much risk to investors in biding time with Apple's stock. It remains especially cheap at 8.5 times forward earnings, excluding net cash.

Apple has started its summer under a cloud. Some rays of sunshine may soon poke through.