
From: Richard Kahn <[REDACTED]>
Sent: Wednesday, May 23, 2018 9:09 PM
To: jeffrey E.
Subject: Fwd: Apple, Inc.: The Emerging Power of Apple Services, Part 2: The App Store

Richard Kahn
HBRK Associates Inc.
575 Lexington Avenue 4th Floor
New York, NY 10022
tel [REDACTED]
fax [REDACTED]
cell [REDACTED]

Begin forwarded message:

From: "/b>"Morgan Stanley" <[REDACTED]>

Subject: "/b>Apple, Inc.: The Emerging Power of Apple Services, Part 2: The App Store

Date: "/b>May 23, 2018 at 5:08:06 PM =DT

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Katy L. Huberty, CFA =E2 Morgan Stanley

May 23, =018 9:00 PM GMT

In this follow-up to our =arch Services report, we counter the bears, arguing that App Store =rowth is sustainable and take rates are defensible. As a result, we =elieve Services margins have room to expand and the market is =ndervaluing the Services business. Raising SOTP PT to \$214 (from =200).

Services is fast becoming Apple's primary growth =river. Apple revenue grew at an 8% CAGR over the last five years, =riven in large part by sales of its flagship iPhone. But as device =eplacement cycles extend and device installed base growth slows to =ingle digits, we believe Services will pick up the growth baton and =ccount for ~67% of Apple revenue growth over the next five years. We =lready see the early stages of this transition, with normalized =ervices revenue growth accelerating from 18% Y/Y to 31% Y/Y in the last =ive quarters (1), while iPhone unit growth averaged just 1% Y/Y growth =ver the same period. We acknowledge that iPhone data points remain =elevant to the Apple thesis, but we believe investors instead ought to =ocus on understanding the drivers and growth trajectory of the Services =usiness. We are using this follow-up to our March 2018 Apple Services =eep dive to explore the largest business within Services, the App =tore, which we estimate already accounts for nearly 40% of total =ervices revenue and is the greatest contributor to Services revenue =rowth. Why focus first on the App Store? Two reasons. First, the App =tore is the largest and most significant contributor to Services =rowth. We estimate the correlation between Apple Services revenue and =pp Store net revenue (i.e. what is recognized on Apple's P&L) is =.98, with an r-squared of 0.96 (2), implying Services revenue is =irectly linked to the performance of the App Store. Second, Apple is =otoriously reticent when it comes to Services data points, and the App =tore is one of the only Services segments where there is detailed third =arty data available to analyze. As a result, we have a bette

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