

## An Apples to Apples Comparison?

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At Matarin, we tend to invest in a contrarian manner. We tend to favor out-of-favor, low-expectation, inexpensive names. While at first blush, Apple (AAPL) may not appear to be a typical Matarin holding, we believe that it presents an interesting case of how popularity and valuation can diverge.

Over the past few years it has become nearly impossible to read the newspapers, tune into CNBC, or engage in a discussion on the stock market without Apple (AAPL) coming up. This is not surprising given the incredible growth and success of the company. In August 2011, Apple surpassed Exxon Mobil (XOM) to become the world's largest company by market capitalization. Apple has continued to distance itself from the pack thus far in 2012, returning close to +50% versus +2% for ExxonMobil, thus giving Apple a market capitalization of a whopping \$560 billion versus \$405 billion for XOM. As noted by Howard Silverblatt, a senior index analyst for S&P, Apple became only the 11<sup>th</sup> company since 1926 to attain this status as North America's largest company.

Apple has truly come a long way.... In the 9 years since March 2003, the company (then known as Apple Computer), has grown its market capitalization from just over \$5 billion to well over \$500 billion today. On a split adjusted basis, Apple shares could have been purchased at \$7/share then versus \$600/share today. Interestingly, at that time, AAPL had well over \$4 billion in cash and equivalents on their balance sheet with few liabilities, so shares could have been purchased at only a small premium to liquid book value. This essentially means that the market was assigning little value to Apple's business. In 2003, both fundamentals and sentiment were weak; Apple's personal computer business was flailing, the iPod was a new product struggling for traction, the iTunes store was on the verge of opening, and the iPhone and iPad were years off. It is amazing to fast forward to Q4.2011, when Apple sold 5 million Macs, 15 million iPads, and 37 million iPhones in a single quarter. Wow.

Given the run-up in the stock, and its huge market capitalization, Apple has its share of doubters. Many critics contend that Apple has simply grown too large, and that current rates of growth cannot be sustained into the future. When attempting to predict where Apple might go from here, analysts and commentators often use examples of other companies that grew to a similar size. Two of the more commonly used examples are Microsoft (MSFT) which exceeded \$600 billion in market capitalization in late 1999 and Cisco (CSCO), which peaked at over \$550 billion in market capitalization in March 2000. The critics are quick to point out that these names have been HORRIBLE investments after growing to over \$500 billion in market capitalization as Microsoft has returned -30% since December 1999 and Cisco -60% (price returns only) since March 2000. It's impossible to deny that it has been 12 difficult years for buy and hold investors in these names.

But at Matarin, we believe that these comparisons fail to tell the whole story. While Apple (today), and Cisco & Microsoft (1999-2000) are/were similar in terms of market capitalization and growth characteristics, and are all in the technology sector, from a valuation standpoint comparing these companies is like comparing apples to oranges. Let's dive a bit deeper into Apple today versus Cisco in March 2000 and Microsoft in December 1999. As you can see in the following chart, sentiment towards Cisco and Microsoft was extremely positive in early 2000. Like others during the "tech bubble", CSCO and MSFT were bid up to nosebleed valuations at the time. In Warren Buffett's 2008 Annual Report he was quoted, having learned from Ben Graham that "Price is what you pay, while value is what you get". In 2000, you were not getting much for your money in terms of fundamentals when purchasing shares of Cisco or Microsoft.

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	Microsoft	Cisco Systems	Apple
	(MSFT)	(CSCO)	(AAPL)
	12/31/1999	3/31/2000	3/31/2012
Market Capitalization	\$604 BB	\$533 BB	\$561 BB
Enterprise Value	\$629 BB	\$534 BB	\$538 BB
Trailing 1-year SALES	\$22 BB	\$15 BB	\$142 BB
Trailing 1-year GAAP Earnings	\$8.7 BB	\$2.5 BB	\$39 BB
Trailing 1-year Operating Cash Flow	\$9.4 BB	\$5.4 BB	\$53 BB
Trailing 1-year Capital Expenditures	\$713 MM	\$718 MM	\$5.2 BB
Trailing 1-year FREE CASH FLOW	\$8.7 BB	\$4.7 BB	\$48 BB
Price-to-sales	27x	35x	4x
Price-to-earnings	69x	213x	14x
Price-to-Operating CF	64x	99x	11x
EV-to-Free Cash Flow	72x	113x	11x
Trailing 5-year Sales Per Share Growth	30%	46%	44%
Trailing 5-year FCF PS Growth	42%	55%	66%
Trailing 1-year Sales Growth	27%	50%	63%

On the other hand, Apple has actually been a stronger grower than Cisco or Microsoft were at their peaks over a prior 5-year measurement period, and based on absolute levels of sales, earnings, and cash flows, its valuation seems quite reasonable. Its free cash flow generation (almost \$50 billion in free cash flow over the past 12 months) certainly provides a "margin of safety." Unlike Cisco or Microsoft, Apple can deliver a solid return to shareholders without having to continue its incredible past growth well into the future. While it is generally a profitable strategy to buy what is hated, and sell what is loved, in this case Apple's valuation actually reflects little love as it sells at close to market multiples. The bottom line is that given Apple's reasonable valuation, efficient business, incredible cash flow generation, impressive and stable growth, and strong catalysts, we would not be surprised to see Apple become the first \$1 trillion market capitalization company in history.