Apple the Next Microsoft…We Could Be So Lucky

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> The only question now is whether Apple is just going through a short-term transition, or is slowly becoming a modern-day version of its long-time nemesis Microsoft.
>
> Jeff Macke, founder and president of Macke Asset Management and CNBC contributor, January 25, 2013

The idea that Apple might be the next Microsoft strikes primal fear into the hearts of Apple shareholders. The nightmare is reinforced by an eerie similarity between Apple's recent stock price chart and a December 1999 chart of Microsoft when the stock peaked at $58; it subsequently dropped to $22 in a year and then wandered aimlessly between $17 and $36 for the next 13 years.

The bad news for Apple shareholders is that Mr. Market is signaling an important inflection point in the company's business. The peak in Microsoft stock correctly foreshadowed a future for the company characterized by slower growth, heightened competition and more frequent strategic blunders. The message implied by Apple's slumping stock price may prove equally prescient.

It makes sense that it would. Slower growth is inevitable. Competitors are gaining ground on Apple, most notably Samsung. And Apple's embarrassing attempt to replace Google Maps with a totally inadequate home-grown version serves as an important warning for future strategic gaffes. The company's rumored entry into the television industry (Apple TV) may be another mistake on the horizon.

However, investors' fears over a sluggish future for Apple's stock are misplaced. Even as Apple's business succumbs to the same economic forces that humbled Microsoft a dozen years ago, the future for Apple's stock is vastly more hopeful. This is because the initial conditions for Apple's stock in 2013 are totally unlike the conditions were for Microsoft stock at its own inflection point in 1999.

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The difference is valuation. Apple's stock is currently priced at 10.4 times its earnings per share over the past 12 months. Microsoft was valued at 75-times earnings in December 1999. The dismal performance of Microsoft's stock beginning in 2000 is not a cautionary tale for Apple; if Microsoft could have been purchased then at a multiple as low as Apple's is today, an investor would have substantially outperformed the S&P 500.

Assume you could have purchased 1,000 shares of Microsoft in January 2000 at an "Apple multiple" of 10.4 times earnings, instead of the actual multiple of 75 that prevailed at the time. The investment would have cost you $7,280. Assuming reinvestment of dividends during the ensuing years, you would now own 1,643 shares of Microsoft worth approximately $43,880, representing a cumulative return of 870% over 13 years. For context, the S&P 500 Index delivered a cumulative return of 30% over the same period, also including dividends.

Price matters. Microsoft's business and progress over the past 13 years did not justify the initial conditions of its stock price at the beginning of the period. Yet a hypothetical purchase of the stock at a modest price-to-earnings multiple – like the one that prevails for Apple today – produced a spectacular hypothetical result for the stock from the same underlying fundamentals for the business.

Here's why: Over the past decade Microsoft's business produced an average return on total capital of 31.9% per annum. Whatever your estimate of the company's cost of capital, it is way below 31.9%, which means Microsoft's business model created economic value over time — a lot of it.

Any business that generates a double-digit spread over its cost of capital can afford to make a few mistakes with the new ventures it attempts, as long as the magnitude of those mistakes never overwhelms the core business. Consider the Xbox video game platform. This venture has been a black hole for Microsoft on a cumulative basis since its inception, but its scale has been moderate relative to the core business, so the Microsoft machine continues to create substantial value.

Microsoft's experience was not unique. The table below shows the cumulative return for a number of technology stocks between January 2000 and December 2012, assuming each stock was purchased at the same price-to-earnings ratio that Apple commands today.

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Cumulative Return if Purchased at a P/E of 10.4 in January 2000

	Hypothetical	Actual
Cisco Systems	933.4%	-62.7%
Dell, Inc.	45.7	-73.2
Hewlett-Packard	8.1	-60.1
IBM	480.6	100.1
Intel	328.9	-47.3
Microsoft	869.9	-27.9
Oracle	848.6	38.2
S&P 500 Index	30.4	30.4

Even basket cases like Dell and Hewlett-Packard would have delivered a positive rate of return if the initial purchase price had been low relative to earnings. Lowly Dell would have outperformed the S&P 500 during this period had you paid 10.4 times earnings to own it.

Now consider Apple. Since launching the iPhone in 2007, Apple's return on total capital has averaged 27.7% per annum. Last year Apple generated a return on capital of 35%, with a quarter of its market capitalization earning next to nothing in cash. While Apple's days of capturing two-thirds of the total industry profits from smart phones are over, the stickiness of its products with consumers suggests a sustainable competitive advantage for Apple's business more similar to Microsoft than Dell or Hewlett-Packard.

No doubt, Apple will make even bigger mistakes than the maps fiasco in the future. When that happens, talking heads will lament that Steve Jobs no longer runs the company. Yet if the history of other competitively advantaged businesses is a relevant indicator, Apple will survive its mistakes as long as users continue to replace a reasonable percentage of their smart phones, tablets and laptops with products made by Apple.

A 35% drop in any stock should shake the confidence of its shareholders. The wide range of possible outcomes for a company like Apple is daunting to consider. A sinking stock price pushes investors to assume the worst. Yet the price of entry for participating in Apple's future is low enough right now to tilt the odds heavily in shareholders' favor. A best-case scenario is a future for Apple's business similar to the past 13 years at Microsoft. Indeed, Apple shareholders could be so lucky!

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