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Opinion

Why Apple Is the Future of Capitalism

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An Apple Store in Hong Kong. Credit: Marcio Rodrigo Machado/S3studio, via Getty Images

With Apple Inc. now exceeding $1 trillion in market capitalization, it's tempting to understand this moment in terms of the dominance of all-too-large companies and technology in our lives.

Those interpretations obscure Apple's other accomplishment — pioneering a financial model that is the envy of corporate America. Sure, Apple produces innovative phones and laptops, but look inside its sleek exterior and you'll find an elegant financial machine that has become the ideal for corporate America. Without investing significantly in hard assets, Apple spins cash and returns it to shareholders at a stunning rate. It's difficult not to admire.

But the model that has been perfected at Apple is risky and imitated poorly by many American corporations. The next decade will reveal whether these imitations were a series of brilliant moves or large-scale financial engineering.

First, consider the changes in how Apple rewards its shareholders and is financed. Six years ago, the company owed no debt and had never undertaken a share buyback or paid dividends. Pressured by a shareholder revolt in 2013, it is now transformed.

Apple has $115 billion of debt outstanding, and it has distributed $288 billion to its shareholders in the past six years, most of it through share buybacks. In the most recent nine months alone, Apple bought back $54 billion worth of shares.

This transformation is representative of trends in corporate America. According to the Federal Reserve, corporations have issued on net over $1.3 trillion of debt and retired over $1.9 trillion of equity over the past four years. American companies are borrowing money to buy their own shares in what is tantamount to a huge, slow-motion leveraged buyout.

Apple has conducted its buybacks responsibly: It bought shares when they were relatively cheap, rewarding the patient shareholder. Other companies have not been so prudent, taking on debt to make ill-timed purchases of expensive shares rather than investing in growth opportunities. In some cases, they have done so simply to push up share prices so that management can meet goals for quarterly earnings or metrics that trigger compensation.

Second, Apple's financial model emphasizes cash flow over profits. Apple is not simply immensely profitable; in 2017, it generated $16 billion more in operating cash flow than profits. It does that in part by running its day-to-day operations in a distinctive way. Typically, a company has to use external funds to fund the process of stocking goods and collecting revenue from customers.

Apple's model turns this upside down. Its retail stores collect cash from customers quickly, it is ruthless on keeping inventory low, and it takes forever to pay suppliers. In the process, Apple's operations are extremely effective cash generators. This is no coincidence. It is the result of the canny supply chain that Tim Cook built. In effect, Apple has largely been financed on the backs of its suppliers, who are willing to hold their inventory and wait more than 100 days to get paid, just for the pleasure of doing business with Apple.

This restructuring of operations to minimize inventory, move to subscription models (which generate predictable streams of cash) and keep suppliers waiting has become the dominant pattern in large corporations. Amazon, for example, generates relatively small profits but mountains of cash through this process. But this emphasis on cash also means that executives can become wary of making capital expenditures, such as new factories or server farms. This kind of spending can increase profits in the long run but bites into cash flow in the short run. That is a recipe for sluggish corporate investment, just as we've seen in the wake of the financial crisis.

Finally, Apple is the epitome of an "asset light" company: It owns very few hard assets and therefore needs almost zero outside capital to run its business. As of mid-2018, Apple has $105 billion of operating assets and $120 billion of operating liabilities. What does that mean? Miraculously, its operations rely on no capital from outside financiers.

How does one achieve this apotheosis of the asset-light strategy? First, create a supply chain in Asia run by companies willing to invest in low-return projects that create your products. Second, hold those suppliers under your thumb. Idolizing asset-light strategies, however, can also lead to underinvestment, an excessive reliance on outsourcing and the artificial division of companies to avoid hard assets.

The accomplishments of Apple's model are substantial. But the financial strategy that has worked so well for Apple is a risky one for less capable companies with weaker strategic positions. For them, aping Apple can just as easily result in too much debt on their balance sheets, precarious supply chains and deferred opportunities for investments.

The financial archetype defined by Apple — asset-light strategy, leveraged share buybacks and cash flow above all — is a high-wire act. Boards should guard against the temptation to follow Apple's path blindly. Big investors, especially mutual funds and pension funds that represent so many individuals, should question the management of any company that does. Many of Apple's imitators are more likely to mortgage the future than create it.

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