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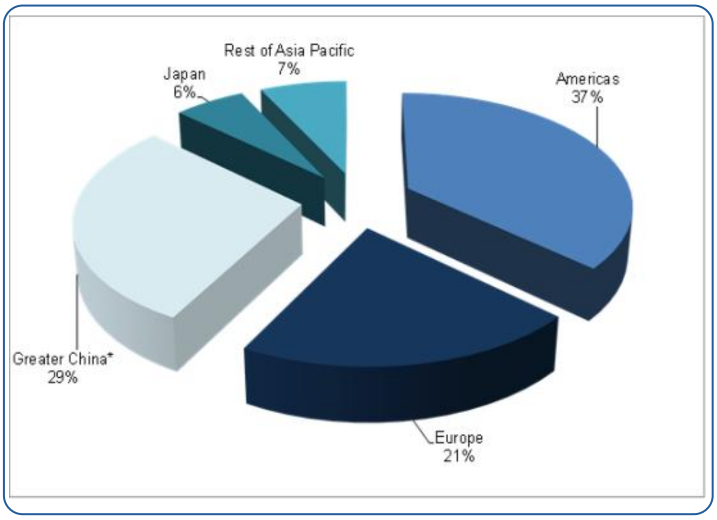
Apple: The impact of current market instability in China/ Apple watch sales update

Background:

- In 1Q15, Apple became the dominant smartphone seller in China (overtaking Xiaomi), with a 14.7% market share, according to the *International Data Corporation (IDC).*
- In Apple's most recent quarter (2Q15), Greater China (China, Hong Kong, Macao, and Taiwan - Apple doesn't break out revenue from China into a single geographic segment) accounted for c. one-third of the company's total revenue and, at $16.8bn, revenue from this segment was second only to Apple's Americas segment ($21.3bn in revenue).
- Among emerging markets (EMs), China is now the most important growth market for Apple. In 2Q15, revenues from Greater China grew at 71% YoY.
- Mac unit sales were up 31% YoY and App Store revenue in China increased over 100% YoY (*this according to Tim Cook on the last results conference call*).
- Apple has also boosted its store count from 15 to 21 in the past six months and by mid-2016 Apple plans to have 40 stores open in the region.

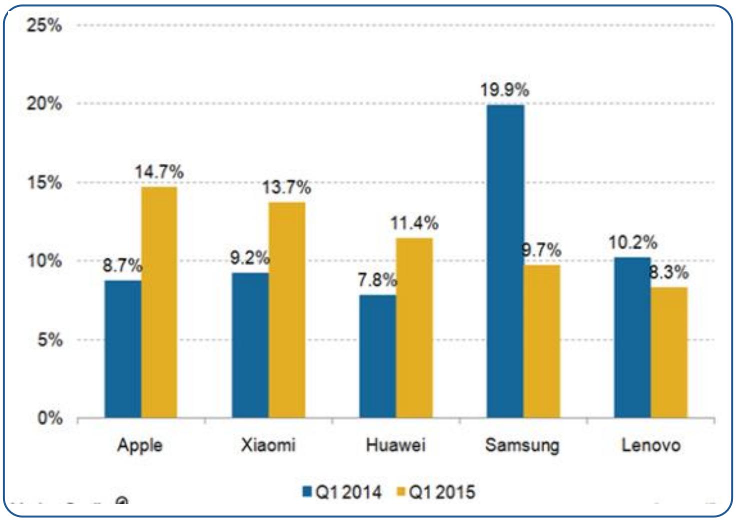
Apple 2Q15 revenue contribution by operating segment:



Source: Company data, Anchor Capital

Most pundits expect Apple to report strong iPhone sales for the (current) quarter ended 30 June — estimates, on average, are for c. 50mn iPhones sold during 3Q15. Any impact from the current China financial market upheaval is therefore only likely to feed through in Apple's 4Q numbers.

China smartphone market share, 1Q14 vs 1Q15:



Source: IDC, Market Realist

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Global Ideas is a newsletter published three times a week (Monday, Wednesday and Friday) and available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

Contacts

Anchor Capital reception	**011 591 0677**	**Trading Desk**	**012 665 3461**
Investment/ Sales	mnyoung@anchorcapital.co.za	General Enquiries	info@anchorcapital.co.za
Brokerage/ Trading	trading@anchorcapital.co.za	Newsletter Enquiries	newsletters@anchorcapital.co.za

Apple is extremely popular in China and, while the knock-on effect of the current China market turmoil may impact Apple's growth in 4Q and beyond, we highlight the following:

- According to the China-based *Hurun Research Institute*, Apple products, ranging from iPhones to Macbooks, were the most popular gifted items among China's "luxury consumers" in 2014, beating out established luxury brands such as Louis Vuitton and Chanel. Will these wealthy consumers be impacted by the market collapse to such an extent that they no longer buy Apple products?
- Apple is a price maker in China. *Bloomberg* reported this week that despite a trend towards more affordable mobile devices in China, the average selling price of smartphones in that country has jumped significantly in recent months. More specifically, the latest *IDC* data shows that the average price of smartphones in China increased by $71 over the past two quarters. This can be directly correlated to Apple's push into China's smartphone market.
- While Xiaomi, Huawei and other local brands continue to compete for the lowest price, Apple has proven that there is still a market for premium-priced hardware. Although the global trend might be heading south in terms of average selling price of smartphones, this does not mean there aren't still millions of customers ready to purchase a product that is seen as upmarket, at higher prices (as Apple's success in China proves).
- Its success in Greater China is prompting Apple to invest heavily in that market, particularly in an expansion of its retail stores. The company boosted its store count in the region from 15 to 21 in the past six months. By the middle of next year, Apple plans to have 40 stores open.
- Apple has also slowly been building a presence in the fashion space in China and after unveiling its Apple Watch, the company's device showed up on the cover of Vogue China – which showcases fashion and caters to wealthier individuals.
- Apple will also continue to benefit from its partnership with China Mobile which is the world's largest telecom provider with over 800mn subscribers. In 1Q15, sales of the iPhone 6 Plus in China were also buoyed by China Mobile's rapid 4G expansion and the demand for large-screen models. The larger-sized (and also gold-plated) iPhone 6 models appeal more to the Chinese consumer and sales in the country since the release of the bigger iPhone 6 Plus have been phenomenal.

Apple's involvement in China was always in a way provisional because the company was never going to change its business model in order to suit local conditions (Apple wasn't going to drop the price of its premium smartphones just to sell more). This has proven to be a successful strategy and is also an indication that the people buying iPhones (as well as Apple Macs and iPads) are likely the upper-middle class to wealthy individuals. Apple also has an extremely loyal customer base and it's unlikely that someone who has switched to Apple will turn their back on the product when it's time for an upgrade (Research firm, Piper Jaffray indicated in a report earlier this year that investors should focus more on the stickiness of Apple's platform).

While we do think that China's current stockmarket slide and the possibility of sales dropping dramatically in one of its biggest EMs might be a bump in the road for Apple in the short-term, we do not believe it will stymie Apple's growth going forward to such an extent that the company is unable to escape from the quagmire. Apple would also then have to focus more on its primary markets (the US and Europe) as well as search for other EMs on which to capitalise. We note there is also still significant growth opportunity for Apple in India (India is the world's third-largest smartphone market with the second-highest number of mobile phone accounts behind China – *see more in the section on India below*).

Although the increasing concentration of Apple's revenues around a single (and maturing) product line (the iPhone) might be of concern to some, we highlight that this issue was also raised prior to the release of the larger iPhone, which ended up proving naysayers wrong and providing the company with explosive growth. To counter this argument we also note that Apple estimates that in the US, for example, just c. 20% of active iPhone users have upgraded to the latest iPhone 6 and 6 Plus units – still opportunity for growth. Added to that, with the release of the bigger iPhone 6 Plus the company said it was seeing a higher rate of switching from Android to iPhone than it had experienced in any of its past product cycles.

At the same time, Apple's current ventures into payment (Apple Pay) and Music, as well as future ventures into new categories such as automobiles (CarPlay) and the internet of things (IoT), as well as aforementioned growth in iPhone sales, will likely see these products and categories help buffer the company against potential losses from China. It is also not set in stone that the current issues in China will see consumers turn their back on the (more expensive) Apple brand. As an example, *AppleInsider* notes that in 1Q15 the overall Chinese smartphone market contracted 4% YoY (its first contraction in six years), yet Apple still saw its sales jump by c. 62% YoY. Earlier this week, a report by HSBC's chief economist Qu Hongbin said that "The stock market wealth effect in China is smaller than many assume, as stocks represent less than 15% of household financial assets and equity issuance accounts for less than 5% of total social financing,…".

Apple and India:

If Apple sales in China are indeed impacted significantly by the market collapse we also need to take into account Apple's plans for India. India is the company's next big growth market especially for the iPhone (its potential sales in India has significant upside – currently Apple's market share is only c. 10% - Samsung is the largest Indian smartphone player, followed by Micromax). India is also the world's third-largest smartphone market and it has the second-highest number of mobile phone accounts behind China. At the same time, the Indian e-commerce and smartphone market is experiencing strong growth. According to Cisco Systems, there will be 650mn smartphones in the country by 2019, while the number of tablets will increase 9% to 18.7m by then.

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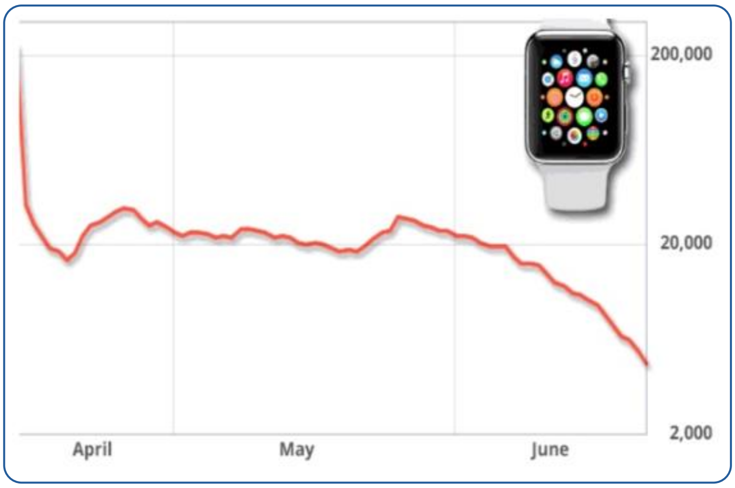
Apple continued...Over the past few months, Apple has been making initial moves to increase its presence in that country. It recently said it is looking to double its retail reach in India by signing new deals with distributors and, according to a recent report in *The Times of India*, Apple has plans to double its iPhone sales in that country in each of the next three years.

Apple's relatively small current market share in India (the aforementioned c. 10% according to data from *Counterpoint*), means it still faces tough competition from Samsung and local Indian brands (such as Micromax), which produce similarly specified smartphones for around half the cost (or even less) of an iPhone 6. However, this is very similar to the situation in China when Apple initially entered that market yet Apple was able to make a significant impact and grow its market share there significantly.

Apple's share price dropped 2.04% yesterday as concerns around China weighed on the share price.

Apple Watch: Sales update:

Over the past few days it was widely reported in the press that, according to market research group, *Slice Intelligence*, Apple Watch sales have dropped by 90% since its opening week. The reports were accompanied by the following chart from *Slice Intelligence* showing the purported drop in Apple Watch sales:



Source: Slice Intelligence

The market-research group based its research on electronic sales receipts which Apple sent by email following a Apple Watch purchase (Apple has thus far not released any data on Apple Watch sales and also said last year that it would not be publishing separate unit sales of the new device in its quarterly earnings reports). In terms of the data from Slice Intelligence we note the following:

- *Slice Intelligence* obtains a large part of its consumer data from a shopping assistance app which allows users to track their online orders. It is important to keep in mind that, according to Apple Insider, the report from Slice only includes *online sales* tracked through the Group's app, email-scanning and partner services. The data therefore does not include or take into account any in-store sales of the watch.
- Added to that *Slice* primarily compared Apple Watch sales (at $350 to $1,000 and upwards) to FitBit fitness trackers (these are products that range in price from $60 to $250—much lower than the Apple Watch and therefore is not comparing like-for-like). *Apple Insider* notes that "…comparing low-cost FitBit activity trackers to Apple Watch is like comparing $50 to $250 iPods to high-end smartphones."
- The Slice data being cited also only pertains to the US. Apple's international sales, particularly in China, are growing and have for some time represented the majority of its overall sales, so the Slice data only represents a portion of total worldwide Apple Watch sales.
- Slice also excludes sales data from websites such eBay, noting that it sought to eliminate secondary sales from the data. Again, according to Apple Insider, given constrained Apple Watch supplies, it is therefore very possible that significant volumes sold at launch were bought by speculators and resold later, contributing to the steep decline of first-party sales that Slice observed.
- By mid-May less-than-half (c. 48%) of total Apple Watch orders had been delivered. This could also indicate that the dramatic drop in sales reflected orders and not sales where buyers had actually taken possession of their new Apple Watch. Following on from this the Slice data very likely shows an initial demand peak that supplies have only recently played catch up on.
- Apple product categories have different cyclical patterns in the various regions (iPad sales are down in US, for example, but are still rapidly growing in China). In addition there are also holiday sales peaks – in the West sales peak during Christmas but in China sales will more likely surge during that country's Lunar New Year celebrations. The Apple Watch was released after both these holiday seasons, and sales of the watch have been constrained by very short supplies (this is not taken into account at all by the Slice data).
- While the sales of the Apple Watch might come across as weak (it will come nowhere near the sale of Apple's iPhone), it has, by most accounts, performed better than any current (or previous) smartwatch rivals. Slice data actually shows that Apple's first attempt to sell a smart watch has significantly outsold everything else on the market, and continues to far outsell other similar products even after it "collapsed."
- Finally, and probably the most significant, historically even iPhone sales are known to surge at launch and then fall off at different rates as time goes on. This could certainly also be the case with the Apple Watch.

In other Apple-related news, the company reportedly wants suppliers to produce 85mn-90mn of its new iPhone 6S units by the end of this year. The screen sizes of the new models are expected to be the same as in the iPhone 6 and iPhone 6 Plus. As a comparison, Apple ordered a then-record initial production run of 70mn-80mn units of its first larger-screen iPhones in 2014, according to the Wall Street Journal.

Marco de Matos

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