

Q2 2018 Earnings Call

Company Participants

- Luca Maestri, Senior Vice President & Chief Financial Officer
- Nancy Paxton, Senior Director, Investor Relations & Treasury
- Timothy Donald Cook, Chief Executive Officer & Director

Other Participants

- Amit Daryanani, Analyst
- Brian J. White, Analyst
- Jim Suva, Analyst
- Kathryn Lynn Huberty, Analyst
- Michael J. Olson, Analyst
- Shannon S. Cross, Analyst
- Steven Milunovich, Analyst
- Wamsi Mohan, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day everyone, and welcome to the Apple Incorporated Second Quarter Fiscal Year 2018 Earnings Release Conference Call. Today's call is being recorded. At this time for opening remarks and introductions, I would like to turn the call over to Nancy Paxton, Senior Director of Investor Relations. Please go ahead, ma'am.

Nancy Paxton {BIO 1779050 <GO>}

Thank you. Good afternoon, and thanks to everyone for joining us. Speaking first today is Apple's CEO, Tim Cook, and he'll be followed by CFO Luca Maestri. After that we'll open the call to questions from analysts.

Please note that some of the information you'll hear during our discussion today will consist of forward-looking statements, including without limitation those regarding revenue, gross margin, operating expenses, other income and expense, taxes, capital allocation, share repurchases, dividends and future business outlook. Actual results or trends could differ materially from our forecast.

For more information, please refer to the risk factors discussed in Apple's most recently filed periodic reports on Form 10-K and Form 10-Q and the Form 8-K filed with the SEC

today, along with the Associated Press release. Apple assumes no obligation to update any forward-looking statements or information, which speak as of their respective dates.

I'd now like to turn the call over to Tim for introductory remarks.

Timothy Donald Cook {BIO 14014370 <GO>}

Thank you, Nancy, and to everyone joining us, welcome. We're proud to announce the results of a very successful quarter today, setting new March quarter records for both revenue and earnings. We generated \$61.1 billion of revenue. That's up 16% from last year, making it our sixth consecutive quarter of accelerating revenue growth. Our performance was broad-based, with iPhone revenue up 14%, services up 31% and wearables up almost 50%. We grew in each of our geographic segments, and in Greater China and Japan, revenue was up more than 20%.

iPhone's second quarter performance capped a tremendous fiscal first half with \$100 billion in iPhone revenue, an increase of \$12 billion over last year, setting a new first half record and achieving our highest first half growth rate in three years. iPhone gained share during the quarter based on IDC's latest estimates for the global smartphone market.

And customers chose iPhone X more than any other iPhone each week in the March quarter, just as they did following its launch in the December quarter. Since we split the line with the launch of iPhone 6 and 6 Plus in 2014, this is the first cycle in which the top of the line iPhone model has also been the most popular.

Q2 was our best quarter ever for services and momentum there continues to be incredibly strong. Revenue topped \$9 billion for the first time, up more than \$2 billion over last year's March quarter. We had all-time record revenue from the App Store, from Apple Music, from iCloud, from Apple Pay and more, all of which are a powerful illustration of the importance of our huge active installed base of devices and the loyalty and engagement of our customers.

Across all our services, paid subscriptions surpassed 270 million, up over 100 million from a year ago and up \$30 million in the last 90 days alone, contributing to the overall increase in services revenue. Apple Pay continues its strong growth with active users more than doubling and transactions tripling year-over-year.

We believe the availability of Apple Pay at major transit systems have been a key driver of adoption among commuters and in March, we launched Express Transit with Apple Pay in Beijing and Shanghai, the second and third largest transit systems in the world. Apple Pay is already the most successful mobile transit payment system in Tokyo, which has the busiest transit system of all.

With the launch of Brazil in April, Apple Pay is now available in 21 markets and we expect Norway, Poland and Ukraine to launch in the next several months.

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This was another outstanding quarter for our wearables business, which includes Apple Watch, Beats and AirPods with combined revenue of almost 50% year-over-year. Looking at its revenue over the last four quarters, our wearables business is now the size of a Fortune 300 company.

Apple Watch had another great quarter with revenue growing by strong double digits year-over-year to a new March quarter record. Millions of customers are using Apple Watch to help them stay active, healthy and connected and they have made it the top selling watch in the world.

We launched carrier support for Series 3 with cellular in Mainland China, Hong Kong and Thailand during the quarter with more markets on the way. And now with Watch OS 4.2, there are more features than ever before. For example, in addition to tracking your workouts and heart rate, skiers and snowboarders can record runs, see vertical descent and calculate speed, as well as contribute data directly to the Apple Watch activity app.

AirPods are incredibly popular and we're seeing them in more and more places, in the gym, in coffee shops, wherever people are enjoying music on their Apple devices. This product is a runaway hit, and we're working hard to meet the incredible demand.

We started shipping HomePod in February, and it's widely recognized as having the best audio quality for its size and class. HomePod is a breakthrough speaker that delivers amazing sound, and we believe it will change the way people listen to music at home. It's currently available in the United States, the United Kingdom and Australia, and we're looking forward to adding new features to HomePod and introducing it to more markets around the world soon.

In March, we announced new products for the education community, including updating our most popular iPad with support for Apple Pencil. It empowers students to be even more creative and productive, from learning to code to sketching ideas and jotting down handwritten notes to marking up screenshots.

And the new iPad's gorgeous retina display, advanced chip and enhanced cameras and sensors are designed to support the next generation of apps for immersive augmented reality experiences in the classroom.

In addition to our successful Everyone Can Code initiative, we've launched Everyone Can Create. It's a new free curriculum that makes it fun and easy for teachers to integrate drawing, music, film making or photography into their existing lesson plans for any subject.

We believe education is the great equalizer. And whether it's through our coding programs, our unrivaled augmented reality platform, or the creativity both can unleash, we're proud to help students everywhere reach new frontiers of learning with Apple technology.

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In March, we also released iOS 11.3, a major update offering new immersive augmented reality experiences, access to personal health records in the Health app and more. Apps can now deliver AR experiences that use vertical walls and doors in addition to tables and chairs and can make - more accurately map irregular shaped surfaces. The update to ARKit that made this possible came just six months after we launched the world's largest AR platform.

Also in iOS 11.3, patients in nearly 40 health systems representing hundreds of hospitals and clinics can now consolidate their medical records from multiple sources and view them all in one place, right from their iPhone. This data is encrypted and protected with the user's iPhone passcode, and it can help them better understand their health history, have informed conversations with doctors and family members, and make future health care decisions.

Consistent with our long-term focus, privacy is a key element of these initiatives for education and personal health. We're relentless about making the best products and experiences in the world, while fiercely protecting our users' privacy, because we believe privacy is a fundamental human right.

Our environmental initiatives recently passed an important milestone. All of our global facilities across 43 countries are now powered with 100% clean energy. We work with communities around the world to build clean power sources. Apple now has 25 renewable energy projects operational and 15 more under construction. We're also driving our supply chain to use clean energy. As of last month, 23 of our suppliers are committed to operating on 100% renewable energy.

We're now halfway through our fiscal 2018 with nearly \$150 billion in revenue and double digit growth in all of our geographic segments. We generated almost \$34 billion in earnings in six months, and we're very bullish on Apple's future. We have the best pipeline of products and services we've ever had. We have a huge installed base of active devices that is growing across all products, and we have the highest customer loyalty and satisfaction in the industry.

Our services business is growing dramatically. Our balance sheet and our cash flow generation are strong and that allows us to invest significantly in our product roadmap and still return a very meaningful amount of capital to our shareholders.

Recent corporate tax reform enables us to deploy our global cash more efficiently. In the United States, we expect our direct investment in the economy to exceed \$350 billion over the next five years, including \$30 billion in capital expenditures. And we expect to create over 20,000 U.S. jobs at Apple over that timeframe. We're narrowing the site selection for a new U.S. campus, and we look forward to sharing more information on that later this year.

Consistent with our annual cadence, today we're providing an update on our capital return program. Tax reform makes it possible for us to execute our program more efficiently, both through share repurchases and payment of dividend to the tens of

millions of investors who own Apple stock either directly or indirectly from large pension funds to individuals with retirement accounts.

So today, given our strong confidence in Apple's future, we're announcing a significant update to our capital return program. Our Board of Directors has approved a new \$100 billion share repurchase authorization as well as a 16% increase in our quarterly dividend, effective with our next dividend payable later this month. Luca will provide more details about our program as well as a more in-depth discussion of the quarter's results.

So I'll now turn the call over to him. Luca?

Luca Maestri {BIO 15738533 <GO>}

Thank you, Tim. Good afternoon everyone. We're very pleased to report record financial results for our March quarter with revenue growth of 16%, EPS up 30%. Starting with revenue, we generated \$61.1 billion, our highest ever for a March quarter. Revenue grew in all of our geographic segments, setting new Q2 records in most countries we track. Performance was very strong in emerging markets where revenue was up 20% and we were especially pleased to see 21% year-over-year growth in Greater China, our strongest growth rate from that segment in 10 quarters. We also set Q2 revenue records in the Americas, in Europe and in Japan.

Gross margin was 38.3%, essentially flat sequentially, as we offset the seasonal loss of leverage with cost improvements and a shift in mix toward services. Operating margin was 26% of revenue. Net income was \$13.8 billion, up \$2.8 billion over last year and a March quarter record. Diluted earnings per share were \$2.73, up 30% to a new record for Q2, and cash flow from operations was very strong at \$15.1 billion. iPhone revenue grew 14% year-over-year, with iPhone ASP increasing to \$728 from \$655 a year ago, driven primarily by the performance of iPhone X, iPhone 8 and iPhone 8 Plus.

During the quarter we sold 52.2 million iPhones, up 3% over last year, and we grew iPhone units by double digits in several markets including Japan, Canada, Switzerland, Turkey, Central and Eastern Europe, Mexico and Vietnam. Our performance from a customer demand standpoint was even stronger than our reported results, as we reduced iPhone channel inventory by 1.8 million units, 600,000 units more than the March quarter reduction last year. We exited the March quarter within our target range of five to seven weeks of iPhone channel inventory.

Our customers are extremely happy with their iPhones. The latest survey of U.S. consumers from 451 Research indicates that across all iPhone models, the customer satisfaction rating was 95%, and combining iPhone 8, 8 Plus and iPhone X, customer satisfaction was even higher, at 99%. And among business buyers who plan to purchase smartphones in the June quarter, 78% plan to purchase iPhones.

Turning to services. We had a sensational quarter with all-time record revenue of \$9.2 billion, and that's up more than \$2 billion from last year, an increase of 31% and double the services revenue we generated in the March quarter just four years ago. Our services

business is growing at a very fast pace all around the world, with revenue up more than 25% year-over-year in each of our five geographic segments.

The App Store set a new all-time revenue record in the March quarter and Apple Music reached a new record for both revenue and paid subscribers, which have now passed 40 million. iCloud storage revenue was up by over 50% year-over-year to a new all-time record, and AppleCare revenue grew at its highest rate in five quarters, setting a new March quarter record.

Our other product category also set a new record for the March quarter with revenue of almost \$4 billion. We began shipping HomePod in February and unit sales of both Apple Watch and AirPods reached a new high for the March quarter. When we combine all our wearables and home products, they accounted for over 90% of the total growth in the other products category.

Next, I'd like to talk about the Mac which set a new March quarter revenue record including new records in both the Americas and Greater China. We sold 4.1 million Macs, generating year-over-year growth in many emerging markets including Latin America, the Middle East and Africa, Central and Eastern Europe and India. We were happy to see double digit growth in our active installed base of Macs to a new all-time high, with almost 60% of March quarter purchases coming from customers who are new to Mac.

iPad grew both units and revenue for the fourth consecutive quarter. We sold 9.1 million iPads and about half of purchases were by customers new to iPad. Growth was particularly strong in Japan, in Latin America, Middle East and Africa and Central and Eastern Europe. All markets where iPad sales were up double digits compared to a year ago. We gained share of the global tablet market based on the latest estimates from IDC and our active installed base of iPads reached an all-time high.

NPD indicates that iPad has 53% of the U.S. tablet market in the March quarter, up from 40% share a year ago. And the most recent customer survey from 451 Research measured iPad customer satisfaction ratings of 95% and among business customers who plan to purchase tablets in the June quarter, 73% plan to purchase iPads.

We continue to make great strides in the enterprise market. In February, we announced a new cyber risk management solution for businesses with Cisco, Aon and Allianz. This combined approach is an industry first that integrates the most secure technology from Apple and Cisco, cyber resilience evaluation services from Aon and options for enhanced cyber insurance coverage from Allianz. Organizations will now be able to better manage and protect themselves from cyber risks associated with ransomware and other malware-related threats. We are thrilled that insurance industry leaders recognize that Apple products provide superior security.

In March, we announced two new services with IBM to bring more dynamic and intelligent insights into apps. IBM Watson services for Core ML and IBM Cloud Developer Console for Apple will enable developers to more easily build native iOS apps that bring together machine learning with artificial intelligence and cloud services.

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In healthcare, iPhones are being used across leading health systems including Cedars-Sinai, the Mayo Clinic and HCA Healthcare with iOS apps to support clinical workflows, communications and care delivery. In fact, HCA Healthcare recently announced they plan to deploy 100,000 iPhones across their hospital sites within the next three years.

We had great performance from our retail and online stores which produced their highest March quarter revenue ever. Year-over-year growth was led by iPhone as well as strong performance from AirPods and introduction of HomePod. Our stores hosted more than 250,000 of our very popular Today at Apple sessions with a particular emphasis on coding and app design.

During the quarter, we opened beautiful new stores in South Korea and in Austria, our first in both countries, and three weeks ago we opened our newest store in Tokyo, bringing us to 502 stores across the world today.

Let me now turn to our cash position. We ended the quarter with \$267.2 billion in cash plus marketable securities, and we had \$110 billion in term debt and \$12 billion in commercial paper outstanding for a net cash position of \$145 billion. We returned nearly \$27 billion to investors during the quarter. We paid \$3.2 billion in dividends and equivalents and spent \$23.5 billion on repurchases of 137 million Apple shares through open market transactions. We also retired 5.7 million shares upon the completion of our 13 ASR during the quarter.

We have now completed over \$275 billion of our current \$300 billion capital return program, including \$200 billion in share repurchases against our cumulative \$210 million buyback program. We will complete the \$210 billion program during the June quarter, three full quarters sooner than initially planned.

The biggest priorities for our cash have not changed over the years. We want to maintain the cash we need to fund our day-to-day operations, to invest in our future, and to provide flexibility so that we can respond effectively to the strategic opportunities we encounter along the way. As we said 90 days ago, the new tax legislation enacted in December gives us increased financial and operational flexibility from the access to our global cash. It allows us to invest for growth in the United States more efficiently and it also provides us the opportunity to work towards a more optimal capital structure. As we said in February, our goal is to become approximately net cash neutral over time.

Given our strong confidence in Apple's future and the value that we see in our stock, our board has authorized a new \$100 billion share repurchase program which we will start executing during the June quarter. Considering the unprecedented size of this new authorization, we want to be particularly thoughtful and flexible in our approach to repurchasing shares. Our intention is to execute our program efficiently and at a fast pace. As in the past, we will provide regular updates on our capital return activities at the end of every quarter.

We're also raising our dividend for the sixth time in less than six years. As we know, it is very important for our investors who value income. The quarterly dividend will grow from

\$0.63 to \$0.73 per share, an increase of 16%. This is effective with our next dividend which the board has declared today, payable on May 17, 2018, to shareholders of record as of May 14, 2018.

With over \$13 billion in annual dividend payments, we are proud to be among the largest dividend payers in the world and we continue to plan for annual dividend increases going forward. We will continue to review our capital allocation regularly, taking into account the needs of our business, our investment opportunities, and our financial outlook. We will also continue to solicit input on our program from a broad base of shareholders. This approach will allow us to be flexible and thoughtful about the size, the mix and the pace of our program. We expect to provide a new update to our capital allocation plans approximately 12 months from now.

As we move ahead into the June quarter, I'd like to review our outlook which includes the types of forward-looking information that Nancy referred to at the beginning of the call. We expect revenue to be between \$51.5 billion and \$53.5 billion. We expect gross margin to be between 38% and 38.5%. We expect OpEx to be between \$7.7 billion and \$7.8 billion. We expect OI&E to be about \$400 million. And we expect our tax rate to be about 14.5%.

With that, I'd like to open the call to questions.

Nancy Paxton {BIO 1779050 <GO>}

Thank you, Luca. And we ask that you limit yourself to one one-part question and one follow up. May we have the first question, please?

Q&A

Operator

Your first question will come from Shannon Cross with Cross Research.

Q - Shannon S. Cross {BIO 1891806 <GO>}

Thank you very much. I wanted to ask about your thoughts on sort of iPhone and positioning now that we're a couple of quarters out from the launch of the iPhone X. Given the \$1,000 price point, and it's clearly selling but there's been a lot of questions in the market about sustainability of that price point and how you're thinking about it as you look out sort of holistically across your lineup. So if you could talk a bit about what you're hearing from your customers and then I have a follow up. Thank you.

A - Timothy Donald Cook {BIO 14014370 <GO>}

Sure. Shannon, it's Tim. As Luca mentioned earlier, our revenues are up 14% year-over-year on iPhone and that's a combination of single digit unit growth and ASP growth that is mainly driven by iPhone X. I think that our iPhone line shows that there's a variety of

different customers in a market that is as large as a smartphone market and so we're going to continue to provide different iPhones for folks to meet their needs.

On iPhone X specifically, I think it's important to maybe emphasize again one of the things I mentioned in my opening comments, that customers chose iPhone X more than any other iPhone each and every week in the March quarter, just as they did following its launch in the December quarter.

Also, since we split the line with the launch of iPhone 6 and 6 Plus back in 2014, this is the first cycle that we've ever had where the top of the line iPhone model has also been the most popular. And so with the customer set that Luca referenced as well, the 99%, the iPhone X is a beloved product. And so I think that it's one of those things where like a team wins the Super Bowl, maybe you want them to win by a few more points but it's a Super Bowl winner and that's how we feel about it. I could not be prouder of the product.

Q - Shannon S. Cross {BIO 1891806 <GO>}

Okay. Thank you. And then, Luca, can you talk a bit about working capital, specifically inventory which went up pretty significantly quarter-over-quarter? What's driving that and how are you thinking about, I mean, it's one of the uses of cash obviously, so how are you thinking about inventory and maybe working capital in general as you're going forward?

A - Luca Maestri {BIO 15738533 <GO>}

Yeah, Shannon, you know that we've always generated significant amount of cash through working capital. We've got a negative cash conversion cycle and we plan to continue to have that. Our inventory level has gone up. It's just a temporary event. We have decided to make some purchasing decision, given current market conditions, and that should unwind over time.

Q - Shannon S. Cross {BIO 1891806 <GO>}

So that was essentially component purchases?

A - Luca Maestri {BIO 15738533 <GO>}

Correct.

A - Nancy Paxton {BIO 1779050 <GO>}

Thank you. Shannon.

Q - Shannon S. Cross {BIO 1891806 <GO>}

Okay. Thank you very much.

A - Nancy Paxton {BIO 1779050 <GO>}

Can we have the next question, please?

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Operator

From Morgan Stanley, Katy Huberty.

Q - Kathryn Lynn Huberty {BIO 6993997 <GO>}

Thank you. Good afternoon. The services growth acceleration is really the highlight this quarter in my mind. Can you talk about what the biggest drivers, whether it be products or regions that drove the acceleration and do you think that we can continue to see growth north of 30%? And then I have a follow-up.

A - Timothy Donald Cook {BIO 14014370 <GO>}

Hi, Katy. It's Tim. The services grew 31%. We hit an all-time record at \$9.2 billion, first time we cleared \$9 billion. The great news about it is, it's not a single geo or a single service. If you look at it, each of the geos, the minimum was at 25%. So each of the geos did extremely well and we set records from the App Store to the Apple Music to iCloud to Apple Pay and more. And underneath that, if you look at the subscriptions, the number of subscriptions, I think I mentioned this in my comments, paid subscriptions had moved up over 100 million on a year-over-year basis to over 270 million by the end of the quarter.

And so it's very broad-based in terms of type of service and geographic region. It's sort of exactly what we would like to see. In terms of forecasting moving forward, we've obviously made assumption for our guidance that Luca provided earlier and in terms of longer term, we're on target to our 2020 goal of doubling the services revenue of 2016 as we had talked about previously.

Q - Kathryn Lynn Huberty {BIO 6993997 <GO>}

And it doesn't look like the threat of a trade war with China slowed down that business. In fact, growth accelerated. But anything anecdotally that you see in the business in recent weeks that would suggest that that is having an impact on demand and any actions that Apple is taking as a company to preempt any risk of tariffs going forward?

A - Timothy Donald Cook {BIO 14014370 <GO>}

Yeah, I think my own view is that China and the U.S. have this unavoidable mutuality where China only wins if the U.S. wins and the U.S. only wins if China wins and the world only wins if China and the U.S. win. And so I think there's lots of things that bind the countries together and I'm actually very optimistic. I think history shows us that countries that embrace openness and diversity do much, much better than the ones that are closed.

And so I'm a big believer that the two countries together can both win and grow the pie, not just allocate it differently. And so that's our focus, and I'm optimistic that - I don't know every play by play that will happen, but over time, I think that view will prevail.

A - Nancy Paxton {BIO 1779050 <GO>}

Thank you, Katy. Could we have the next question, please?

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Operator

And that will come from Mike Olson with Piper Jaffray.

Q - Michael J. Olson {BIO 6742768 <GO>}

Hey. Good afternoon, and thank you for taking my question. Just following on the services question, I'd be curious what the next drivers of services revenue are. Will it be continued penetration of Music and Pay that you see as kind of the largest future categories of incremental growth? Or maybe when could augmented reality become a material part of services? And then I have a follow up.

A - Timothy Donald Cook {BIO 14014370 <GO>}

Well, Mike, it's Tim. Again, the great thing about services is there are several services that make up the total that are growing nicely.

And I think the other good news is that because our active installed base is at such a level, that last quarter we said that we had exceeded 1.3 billion. This year - we're not going to release this number every quarter, but we've obviously grown again. And it's growing at a double digit number on a year-over-year basis.

And so with that kind of change in the installed base and with the services that we have now and others that we are working on, I think this is just a huge opportunity for us and feel very good about the track that we're on.

Q - Michael J. Olson {BIO 6742768 <GO>}

Okay. And then any potential tariff issues aside, what's working for Apple in China right now? You talked about it being the strongest year-over-year growth in 10 quarters. I guess, what's driving that? Is it iPhone X specifically, or something else that's behind that improvement? Thank you.

A - Timothy Donald Cook {BIO 14014370 <GO>}

It's a good question. iPhone X was the most popular smartphone in all of China last quarter. And so iPhone X has done well there. In order to hit a number like 21% on the growth that you see on your data sheet there, there has to be several things working well. And the things that have huge growth rates there are the other products category, which is our wearables business in China and the services business, which you and I just spoke about.

The iPhone obviously had to do extremely well to get a 21% number. And we gained share in the market for the Mac as well. And so there's actually several vectors there that are working well for us.

We also - more broadly on the iPhone, the iPhone was the top three selling phones in China. And so it's iPhone X was number one, but we had several in the top.

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A - Nancy Paxton {BIO 1779050 <GO>}

Thanks, Mike. Could we have the next question, please?

Operator

From RBC Capital Markets, Amit Daryanani.

Q - Amit Daryanani {BIO 7113568 <GO>}

Thanks a lot. Two questions from me as well. I guess first one, just touching on the gross margin dynamics, if I look at the guidance for June on a year-over-year basis, I think sales are up double digit but gross margins are still flat at the high end, maybe down 20 basis points at the midpoint. Can you just talk about what's driving the lack of leverage on a gross margin basis on a year-over-year basis for June?

A - Luca Maestri {BIO 15738533 <GO>}

Yeah, Amit, it's Luca. We tend to look at our gross margin dynamics on a sequential basis, and essentially we're guiding to about flat on a sequential basis. On a year-over-year basis, it's less relevant for our business. But in general, I would say that this year we are seeing a more difficult cost environment, particularly we're still dealing with about 70 basis points of impact from the memory pricing environment that we're working through.

Q - Amit Daryanani {BIO 7113568 <GO>}

Got it. And if I could just follow up. Tim, you've been fairly vocal I think talking about the need for better privacy protection and well-crafted regulation over time. Could you just maybe help us understand, how does Apple protect consumer data? And how does this ongoing debate around data protection translate into a positive for Apple over time?

A - Timothy Donald Cook {BIO 14014370 <GO>}

We protect it by encrypting it, and we keep the bulk of information or a significant amount of information on the device so that the user is in control of it. We also collect much less overall than others do. Because if you look at our model, if we can convince you to buy an iPhone or an iPad, we'll make a little bit of money. You're not our product. And so that's how we look at that.

In terms of benefit, we don't really view it like that. We view that privacy is a fundamental human right and that it's an extremely complex situation if you're a user to understand a lot of the user agreements and so forth. And we've always viewed that part of our role was to sort of make things as simple as possible for the user and provide them a level of privacy and security. And so that's how we look at it.

A - Nancy Paxton {BIO 1779050 <GO>}

Thank you, Amit. Could we have the next question, please?

Operator

We'll go to Steve Milunovich with UBS.

Q - Steven Milunovich {BIO 1504637 <GO>}

Great. Thank you. Luca, could you talk a bit more about the capital allocation? The dividend increase of 16% was relatively low relative to what you could have done, so are you really thinking the stock price is attractive here? And you said you would execute the buyback at a fast pace. Can you give us any timeframe of that \$100 billion and how much debt do you think about in terms of net cash zero?

A - Luca Maestri {BIO 15738533 <GO>}

Yes. Let's start with the dividend. We're increasing it by 16%. This is the largest increase that we've done since we've reintroduced the dividend back in August of 2012. So we think it's a very meaningful increase for all the investors that value income. Obviously, when we come down to capital allocation decisions, we obviously also keep in mind that the opportunity for us to do some M&A activities which we do in an ongoing basis.

But when it comes down between dividends and buyback, our view is that for a variety of reasons we see a lot of value in the stock. We believe the stock is undervalued and so we have a bias towards the buyback. So the dividend is a very large component of capital return because we're going to be returning more than \$13 billion a year to investors through dividends but we believe that given where we are with the valuation of the stock, we think that we continue to do the buyback primarily.

We are not giving an end date to the program this time because the amount is very, very large and so we will try to execute it. As you've seen from our track record during the last five years, we will do it at a very fast pace but we also want to do it efficiently. We want to make sure that we buy back the stock at the right time. And so with that in mind, we have done \$23.5 billion of repurchases during the March quarter. We will give you an update to our activities at the end of every quarter and then 12 months from now we will actually talk about an update to the entire program. So you will be able to keep track of our progress every 90 days.

Q - Steven Milunovich {BIO 1504637 <GO>}

Thank you. And, Tim, could you talk a bit about your healthcare opportunity? Is it merely selling watches over time or do you think more broadly about it? Is there a services play? You're doing some things for your employees. Could that potentially broaden out? How do you think about the opportunity there?

A - Timothy Donald Cook {BIO 14014370 <GO>}

We think about it very broadly and you can tell that a bit by some of the things that we've had going with ResearchKit and CareKit and most recently the health records that I had referenced in my initial comments and those all came out of getting significantly engaged in the Apple Watch and sort of pulling the strings, so to speak. And we also have a heart study that is going on currently, and so I don't want to give too much away. But it's an area of great interest where we think we can make a big difference in. And so it's a major strategic thrust of ours.

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A - Nancy Paxton {BIO 1779050 <GO>}

Thanks, Steve. Could we have the next question, please?

Operator

We'll go to Brian White with Monness, Crespi.

Q - Brian J. White {BIO 6122012 <GO>}

Yes, Tim, I think there is China numbers are actually phenomenal in the quarter and third consecutive quarter of growth. I think there's been a lot of concerns just Apple in China and maybe misinformation out there. But what do you see as the drivers for Apple in both Mainland China and Greater China over the next few years? And also if you could just give us an update on what you're seeing in India.

A - Timothy Donald Cook {BIO 14014370 <GO>}

Yeah, good question. Let me start with India, and then I'll talk more about China. India, we set a new first-half record. So we continue to put great energy there and try to – our objective over time is to go in there with all of our different initiatives from retail and everything else. And so we're working toward those things. It's a huge market and it's clear that many people will be moving into the middle class over time, as we've seen in other countries.

China, I continue to believe is a phenomenal country with lots of opportunity from a market point of view, but also lots of opportunity from a app developer point of view. We have almost 2 million application developers in China that are writing apps for iOS and the App Store, and they're doing unbelievably creative work and innovative work. So we look at China holistically, not only as a market.

On the market side, we've seen iPhone X, as I had mentioned before, as being the top selling smartphone during the quarter. We gained share during the quarter. I read some notes here and there about the market itself not being good. I think on any kind of, on a 90-day clock, lots of different things can happen. But my own personal view of China is that it's a great market, and we are certainly looking far beyond 90 days and feel very bullish on the opportunity and the environment there.

I would say that the market for us is more than iPhone. The Mac gained share there as well. The Watch is getting some traction there. Services is doing extremely well. And so it has several catalysts and I'm very pleased with the results that we were able to show during the quarter.

Q - Brian J. White {BIO 6122012 <GO>}

Great. Thank you.

A - Nancy Paxton {BIO 1779050 <GO>}

Thanks, Brian. Could we have the next question, please?

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Operator

Next we'll hear from Wamsi Mohan with Bank of America Merrill Lynch.

Q - Wamsi Mohan {BIO 15994435 <GO>}

Thank you. Good afternoon. Tim, can you comment on the price elasticity of demand at the high end for iPhones, if that was in line with your expectations? Do you have a preference for unit growth versus ASP growth when it comes to maximizing that gross profit dollar growth? And I have a follow-up for Luca, please.

A - Timothy Donald Cook {BIO 14014370 <GO>}

We price for the value that we're delivering, and iPhone X is the most innovative product on the market. And I've said a few times, we have there sort of jam-packed with technologies that really set up the smartphone for the next decade. And so that's how we priced it.

We were surprised somewhat that through all of this period of time that the iPhone X winds up at the most selling, most popular for every week of the time since the launch. And so that's I think a powerful point. And it's number one in China, which is another powerful point. And so obviously at some point if those technologies move to lower price points and that there's probably more unit demand. But the way we think about it is trying to price a reasonable price for the value that we deliver and I feel that we did that.

Q - Wamsi Mohan {BIO 15994435 <GO>}

Thank you, Tim. And, Luca, your gross margins have been very robust despite the headwinds that you absorbed on commodities, which you quantified, and frankly, also from the FX hedges that are limiting somewhat the FX upside that a lot of other companies are seeing. So as you, one, when do you expect these to turn into tailwinds? And when they do turn into tailwinds, would you consider reinvesting some of those into pricing or should we think about you flowing those through to the bottom line?

A - Luca Maestri {BIO 15738533 <GO>}

Well, Wamsi, I think, let me start with where we are right now. I think you're right. I think we've been able to navigate a difficult foreign exchange environment for a number of years and now, as you know, because we have this hedging program as the dollar has weakened a bit in recent months, although during the last week it's actually started to turn the other way again, we've got the hedging program that works both ways. And also on the memory front, we feel that for NAND, we're going to be turning the corner very soon. For DRAM, we also think that we are near the peak, possibly at the end of this year. And so that should provide some level of stability.

As I said earlier this year, I think we are experiencing in total a more difficult cost environment and so hopefully that can turn into a positive for us. At the same time, it's very difficult for me to give you an indication of what is going to happen in the future because every product cycle is different, and as you know, we don't provide guidance

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past the current quarter. There are some elements that we understand quite well and we tend to manage well over the course of the cycle.

For example, our cost structures that we are able to manage throughout the year. But there are also elements that are not entirely under our control like foreign exchange. And the mix of products and services that we sell to our customers also has an impact on the overall gross margin.

Our primary consideration is always around maximizing gross margin dollars, and that is the approach that we take around for example pricing decisions.

A - Nancy Paxton {BIO 1779050 <GO>}

Thank you, Wamsi. Could we have the next question, please?

Operator

From Citi, we'll hear from Jim Suva.

Q - Jim Suva {BIO 6329522 <GO>}

Thank you very much. And I'll ask actually both my questions at the same time, one for Tim and one for Luca. Tim, strategically when we talk to investors they often say, oh, iPhone market is saturated. There's not much room for growth. Yet when we do our analysis, we kind of still see emerging markets like India and all those still are growth.

When you think about India and those markets, do you kind of believe that some of those markets could get to much higher or a more normalized market share that you have in some of the developing countries over time? And can you talk a little bit about some of those efforts you may be doing?

And then, Luca, on the question for you, is about the gross margin. When we think about if component prices start to stabilize, seeing how Apple services have been so successful and accretive to margins, should we start to look for some potential margin, gross margin upside, again should components stabilize? Thank you, gentlemen.

A - Timothy Donald Cook {BIO 14014370 <GO>}

Yeah, Jim, thanks for the question. In terms of the - let me address the smartphone market a bit and then I'll mention iPhone.

In terms of the market in general, if you look at last year, which is the last data point we have on the full market, there were still 0.5 billion feature phones sold in the world. And so many of those were sold into emerging markets, not all of them, but many of them. And we still believe that over time every phone sold will be a smartphone. And so it seems to us that with that many feature phones being sold, that's a pretty big opportunity.

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In terms of the iPhone itself, even though we sell quite a few phones across the course of a year, our market share globally is low compared to the – our sales are low compared to the full market of smartphones. And so our task is to convince people that currently – or have another type of phone to switch, while really taking care of people that have an iPhone so that they choose – when they elect to buy another phone, that they buy another iPhone. And so we've spent quite a bit of time on that, as you might guess.

I do think that India, India is the third largest smartphone market in the world. There's obviously huge opportunities there for us, and we have extremely low share in that market overall. And so we're putting a lot of energy there and working with the carriers in that market, and they're investing enormously on the LTE networks. And the infrastructure has come quite a ways since we began to put a lot of energy in there because of their leadership and so forth.

And so I do think – I don't buy the view that market's saturated. I don't see that from a market point of view or – and certainly not from an iPhone point of view. I think the smartphone market is sort of like the best market for a consumer product company in the history of the world and – but that's how I feel about it. It's a terrific market, and we're very happy to be a part of it.

A - Luca Maestri {BIO 15738533 <GO>}

Jim, on the gross margin side, I think I'll repeat what I said earlier, but you're right. Our services business, and I've said it in the past, is accretive to company margins. And so as we are able to grow the services business, that should provide a positive, a tailwind. At the same time, within the services portfolio that we have, we have services that have different levels of profitability, so we also need to take into account the mix of services that we're going to be selling.

At a macro level, because about two-thirds of our company is outside the United States, a weak dollar is a positive for our gross margins; a strong dollar, as it's been during the last four years, has been a bit of a headwind for the company. We try to make it more stable through the hedging program.

And in general, when we look at our process to innovate our products, typically when we launch a new product, that product tends to have a higher cost structure than the product it replaces. And so that is something that we need to work through every time we launch a new product and we have a pretty good track record and history of taking those cost structures down over time. So we need to balance all these different elements.

I think we've done a pretty remarkable job during the last several years at managing all these different variables and coming out with a level of gross margins that we think is really good for investors and certainly it is our plan to continue to manage them that way. But it's very difficult for me to give you a prediction of where gross margins are going to be six months or 12 months from now.

A - Nancy Paxton {BIO 1779050 <GO>}

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Thank you, Jim.

Q - Jim Suva {BIO 6329522 <GO>}

Thank you for the details and congratulations.

A - Timothy Donald Cook {BIO 14014370 <GO>}

Thank you.

A - Nancy Paxton {BIO 1779050 <GO>}

A replay of today's call will be available for two weeks on Apple Podcast, as a webcast on apple.com/investor and via telephone. And the numbers for the telephone replay are 888-203-1112 or 719-457-0820 and please enter confirmation code 5253762. These replays will be available by approximately 5:00 PM Pacific Time today. Members of the press with additional questions can contact Kristin Huguet at 408-974-2414. Financial analysts can contact Matt Blake or me with additional questions. Matt is at 408-974-7406, and I'm at 408-974-5420. Thanks again for joining us.

Operator

Ladies and gentlemen, that does conclude today's presentation. We do thank everyone for your participation, and you may now disconnect.

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