

Q1 2017 Earnings Call

Company Participants

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

Other Participants

- Amit Daryanani, Analyst
- Antonio M. Sacconaghi, Analyst
- Brian J. White, Analyst
- Kathryn Lynn Huberty, Analyst
- Shannon S. Cross, Analyst
- Simona K. Jankowski, Analyst
- Steven M. Milunovich, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day, everyone, and welcome to this Apple Incorporated first quarter fiscal year 2017 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 today. Speaking first is Apple CEO Tim Cook, and he'll be followed by CFO Luca Maestri. And after that, we will 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, 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 Form 10-K for 2016 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 good afternoon everyone, and thanks very much for joining us. I'm very happy to share with you the outstanding results of Apple's December quarter. We generated the highest quarterly revenue in Apple's history along with all-time unit and revenue records for iPhone and Apple Watch, all-time revenue records for Services and Mac, and all-time revenue records for four out of our five geographic segments. The strong performance of our business also produced all-time record earnings per share.

Revenue in the quarter was \$78.4 billion, which was above the top of our guidance range. iPhone had a tremendous quarter thanks to exceptional demand that beat our own internal expectations. While iPhone 7 is our most popular model, we saw especially strong demand for iPhone 7 Plus, which was a higher portion of the new product mix than we've ever seen with Plus models in the past. Demand for iPhone 7 Plus exceeded supply throughout the quarter, and we came into supply/demand balance in January.

iPhone 7 Plus has earned rave reviews for its advanced new features, especially the dual camera system, which produces stunning portraits and high-quality zoom. This is a uniquely Apple feature that is surprising and delighting our users. Both iPhone 7 and iPhone 7 Plus are empowering our customers to be more productive, more engaged, and more expressive than ever by integrating hardware, software, and services to create experiences that only Apple can deliver.

It was our best quarter ever for Services, with almost \$7.2 billion in revenue. App Store customers broke all-time records during the holiday quarter, including \$3 billion in purchases in December alone, making it the App Store's single best month ever.

Our innovative and vibrant developer community has created over 2.2 million apps for doing almost anything that you can imagine. Apple's developer community has now earned over \$60 billion, including over \$20 billion in 2016 alone.

Revenue from our music business grew for the third quarter in a row, and our AppleCare and iPlus storage services had all-time record results.

Apple Pay continued its strong momentum, with the number of users more than tripling over the past year and hundreds of millions of transactions and billions of dollars in purchases in the December quarter alone. Transaction volume was up over 500% year over year as we expanded to four new countries, including Japan, Russia, New Zealand, and Spain, bringing us into a total of 13 markets. Apple Pay on the Web is delivering our partners great results. Nearly 2 million small businesses are accepting invoice payments with Apple Pay through Intuit QuickBooks Online, FreshBooks, and other billing partners. And beginning this quarter, Comcast customers can pay their monthly bill in a single touch with Apple Pay.

Services are becoming a larger part of our business, and we expect the revenues to be the size of a Fortune 100 company this year. Our Services offerings are now driving over 150 million paid customer subscriptions. This includes our own services and third-party

content that we offer on our stores. We feel great about this momentum, and our goal is to double the size of our Services business in the next four years.

The Mac not only returned to growth but generated its highest quarterly revenue ever. Our latest data shows that most Mac customers are buying their first Mac, with the vast majority of them coming from a Windows PC.

The new MacBook Touch with Touch Bar is an outstanding example of the innovation made possible by integrating world-class hardware and software. We were supply constrained for the new MacBook Pro throughout the December quarter and are just now coming into supply/demand balance.

It was also our best quarter ever for Apple Watch, both units and revenues, with holiday demand so strong that we couldn't make enough. Apple Watch is the best-selling smartwatch in the world and also the most loved, with the highest customer satisfaction in its category by a wide margin. Apple Watch is the ultimate device for a healthy life, and it is the gold standard for smartwatches. We couldn't be more excited about Apple Watch.

We're also thrilled with the response to AirPods. Customers love the magical experience AirPods are delivering. And if you haven't tried them yet, you'll be delighted when you do. They're far ahead of anything else on the market today, and we're working hard to catch up with the incredible demand.

With AirPods off to a fantastic start, a strong full first year for Apple Watch, and Beats headphones offering a great wireless experience using the Apple-designed W1 chip, we now have a rich lineup of wearable products. Their design, elegance, and ease of use make us very excited about the huge growth potential for wearables going forward.

Our ecosystem is broadening to more and more of the areas where people spend their time, at the gym, on the go, in the home, and on the job. For example, every major automaker is committed to supporting CarPlay with over 200 different models announced, including five of the top 10 selling models in the United States. There are well over 1 million people using CarPlay now, and this continues to grow rapidly.

And we are leading the industry by being the first to integrate home automation into a major platform with iOS 10. With Siri and a new Home app in iOS 10, everywhere you go, you can easily and securely control all of your home accessories with your iPhone, iPad, or your Apple Watch.

The number of HomeKit-compatible accessories continues to grow rapidly, with many exciting solutions announced just this month, including video cameras, motion detectors, and sensors for doors, windows, and even water leaks. Perhaps even more importantly, we are unmatched when it comes to securing your home with HomeKit-enabled door locks, garage doors, and alarm systems.

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I'm personally using HomeKit accessories and the Home app to integrate iOS into my home routine. Now when I say good morning to Siri, my house lights come on and my coffee starts brewing. When I go to the living room to relax in the evening, I use Siri to adjust the lighting and turn on the fireplace. And when I leave the house, a simple tap on my iPhone turns the lights off, adjusts the thermostat down, and locks the doors. When I return to my house in the evening, as I near my home, the house prepares itself for my arrival automatically by using a simple geofence. This level of home automation was unimaginable just a few years ago, and it's here today with iOS and HomeKit.

We're making great progress in the enterprise market alongside our major partners. The combination of iOS and Cisco technology is giving companies everywhere the opportunity to vastly improve the user experience for their mobile employees. With enhanced networking performance, up to eight times faster roaming, better reliability for apps, and native voice experience, we're excited about how much more productive the workforce will be with these great capabilities. In fact, the total number of joint customer opportunities has grown over 70% since last quarter.

Enterprises are using IBM's new Mobile at Scale design and development model to deploy multiple iOS apps with speed and efficiency. For example, Finnair is transforming aircraft maintenance, and CEMEX is revamping activities from attracting new clients to invoicing to after-sales support. And later this spring, SAP will be rolling out its SDK for iOS, providing its community of more than 2.5 million developers the tools to build powerful native iOS apps that leverage the SAP HANA cloud platform. We're delighted with how these partnerships are making it even easier for enterprise customers to transform how work gets done with iOS.

As we reflect on a record-breaking December quarter, I'd like to thank our developers, our business partners, and our employees for their incredible contributions and commitment. And I'd like to thank all of our customers around the world for their excitement and loyalty, which ultimately drive these results.

Now I'd like to turn it over to Luca to talk about the quarter in more detail.

Luca Maestri {BIO 15738533 <GO>}

Thank you, Tim. Good afternoon everyone. Revenue for the December quarter was \$78.4 billion, the highest quarterly revenue in the history of Apple and above our guidance range. As Tim mentioned, the strength of our results was very broad-based, as we set new revenue records for iPhone, for Services, for Mac, and for Apple Watch. We also established new all-time revenue records in most developed and emerging markets, with strong growth rates in many countries, including the U.S., Japan, Canada, France, Australia, Brazil, India, Turkey, and Russia.

We accomplished all this despite a very challenging foreign exchange environment due to the continued strength of the U.S. dollar. As we had expected, our year-over-year performance in Greater China improved significantly relative to the September quarter. Total Greater China segment revenue was down 12%, but revenue from Mainland China

was even with the all-time record results from a year ago and grew in constant currency terms. In all other geographic segments, we generated all-time quarterly record results.

We had the benefit of a 14th week during the quarter this year, but this was offset by four factors. First, this year we grew China inventory significantly less than a year ago. Second, iPhone 7 launched earlier in the September quarter compared to the iPhone 6s launch the previous year, creating a more difficult comparison for the December quarter this year. Third, the stronger U.S. dollar affected total revenue growth this year by 100 basis points. And fourth, our year-ago revenue included the benefit of a one-off \$548 million patent infringement payment. Also, strong customer interest left us in supply/demand imbalance for several of our products throughout the quarter this year.

Gross margin was 38.5%, at the high end of our guidance range. Operating margin was 29.8% of revenue, and net income was \$17.9 billion. Diluted earnings per share were \$3.36, a new all-time record, and cash flow from operations was \$27.1 billion.

We had a terrific quarter for iPhone as we sold 78.3 million units, a new all-time record and an increase of 5% over last year. Customer demand was even higher than our reported results, as iPhone unit sell-through was up 8%.

We saw double-digit iPhone growth in the U.S., in Canada, Western Europe, Japan, and Australia, and even stronger growth in many emerging markets, including Brazil, Turkey, Russia, Central and Eastern Europe, and Vietnam. iPhone ASP increased to \$695 in the December quarter from \$619 in the September quarter, driven by the very strong product mix and the amazing success of iPhone 7 Plus.

Despite stronger demand than last year, we added only 1.2 million units of iPhone channel inventory across the quarter, significantly less than the increase of 3.3 million units a year ago. And we exited the quarter near the low end of our 5 to 7-week target channel inventory range.

Customer interest and satisfaction with iPhone are exceptional, not only with consumers, but also with business users. In the U.S., for instance, the latest data from 451 Research on consumers indicates a 97% customer satisfaction rating among all iPhone owners and a 99% satisfaction rating for owners of iPhone 7 Plus. Among corporate smartphone buyers, the iPhone customer satisfaction rating was 94%. And of those planning to purchase smartphones in the March quarter, 78% plan to purchase an iPhone.

Turning to Services, we generated an all-time record \$7.2 billion in revenue, an increase of 18% year over year. Our run rate growth was actually higher when taking into account two discrete items. On one hand, the 14th week added to Services revenue this December quarter. On the other hand, that benefit was more than offset by the comparison to the one-off \$548 million patent infringement payment included in Services revenue a year ago.

The App Store continued its impressive run, breaking all previous revenue records. Year-over-year App Store revenue growth was 43% through the first 13 weeks of the quarter. It's

great to see that both average revenue per paying account and the number of paying accounts grew strongly during the quarter. And according to App Annie's latest report, App Store revenue continues to outpace the industry overall, with more than double the revenue of Google Play in calendar 2016.

Next I would like to talk about the Mac. We sold 5.4 million Macs and generated our highest-ever quarterly Mac revenue. We were very happy to report double-digit unit growth in several countries, including Japan, Mainland China, India, the Netherlands, and Sweden, as well as in the U.S. education market. We ended the quarter at the low end of our 4 to 5-week target range for Mac channel inventory.

Turning to iPad, we sold 13.1 million units, which was ahead of our expectations. And we posted double-digit growth in both Mainland China and India, as we've expanded distribution channels in those countries and we continue to attract a very high percentage of first-time tablet buyers. We also reduced channel inventory by about 700,000 units as opposed to an increase of 900,000 units last year, and we exited the quarter near the low end of our five to seven-week target range.

iPad is incredibly successful in the segments of the tablet market where we compete, both in terms of market share and customer metrics. Recent data from NPD indicates that iPad had 85% share of the U.S. market for tablets priced above \$200. And in November, 451 Research measured a 94% consumer satisfaction rate for iPad Mini, a 97% rate for iPad Air, and 96% for iPad Pro.

Among U.S. consumers planning to purchase a tablet within the next six months, purchase intention for iPad is more than four times higher than any other brand measured, with iPad Pro once again the top choice for planned purchases. Corporate buyers reported a 96% satisfaction rate and a purchase intent of 66% for the March quarter. In fact, businesses of all sizes are choosing iPad and iPhone to have them reimagine their everyday activities. We're seeing strong momentum in sectors such as retail, where iOS solutions are being deployed for everything from product development to logistics to mobile point-of-sale. Companies like Toys "R" Us, Coach, and Kate Spade are using iOS and our mobility partner solutions to dramatically transform their customer and employee experiences.

Our retail stores experienced strong double-digit growth in visitors and revenue in the December quarter. And we continued to expand our global presence, with plans to open our first store in Singapore and our second store in Dubai soon. We are continually updating our stores and adding new and exciting outreach programs to educate kids on our products, entertain the community with fresh live music, teach future Swift developers to code, and empower entrepreneurs to start, grow, and evolve their businesses.

Let me now turn to our cash position. We ended the quarter with \$246.1 billion in cash plus marketable securities, a sequential increase of \$8.5 billion. \$230.2 billion of this cash or 94% of the total was outside the United States. We also had \$77.1 billion in term debt and \$10.5 billion in commercial paper outstanding at quarter end.

We returned almost \$15 billion to investors during a very busy December quarter for our capital return activities. We paid \$3.1 billion in dividends and equivalents. We spent \$5 billion on repurchases of 44.3 million Apple shares through open market transactions. And we launched a new \$6 billion ASR, resulting in an initial delivery and retirement of 44.8 million shares. We also completed our eighth accelerated share repurchase program, retiring an additional 4.4 million shares. This led to a net diluted share count reduction of 65.3 million shares during the quarter.

We've now completed \$201 billion of our current \$250 billion capital return program, including \$144 billion in share repurchases. And we plan to provide investors with our annual update on the capital return program in the spring.

Our effective tax rate for the quarter was 26%, as expected.

And as we move ahead into the March 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. This guidance range includes a \$1.2 billion year-over-year headwind from foreign exchange. We expect gross margin to be between 38% and 39%. This guidance range includes an 80 basis points sequential headwind from foreign exchange. We expect OpEx to be between \$6.5 billion and \$6.6 billion. We expect OI&E to be about \$400 million, and we expect the tax rate to be about 26%.

Also today, our Board of Directors has declared a cash dividend up \$0.57 per share of common stock, payable on February 16, 2017 to shareholders of record as of February 13, 2017.

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

Nancy Paxton {BIO 1779050 <GO>}

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

Q&A

Operator

Your first question will come from Katy Huberty with Morgan Stanley.

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

Yes, thank you. First, Luca, what are the factors that caused you to widen the gross margin guidance for the March quarter? And what are the one or two factors that put you at the low end versus the tailwinds that might put you at the high end of that range? And then I have a follow-up, thank you.

A - Luca Maestri {BIO 15738533 <GO>}

Sure, Katy. If you look back at our history, 100 basis points range for gross margin is not unusual. Clearly during a period when foreign exchange is very volatile, we think it's more prudent to broaden the range a bit. I've mentioned that we expect - assuming that rates don't move too much, we expect foreign exchange to be a major negative as we move from the December to the March quarter. You know that the dollar has appreciated significantly toward the end of the December quarter, and so we've got 80 basis points of sequential headwind from foreign exchange. We also have the sequential loss of leverage, which is typical of our seasonality, but we expect to offset these two impacts with cost efficiencies and also with our mix of products and services. So obviously if the dollar is a little less strong than it is today, we could do a bit better on gross margins. Obviously, we continue to work very hard on our cost efficiency, so we'll see where we land.

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

Thank you. And, Tim, there's a reasonable probability that you may get access to the \$200 billion-plus of cash that's been locked overseas. So I think it would be helpful to just get an update on your views around potentially larger M&A and some of the areas of interest that you've noted in the past like owning more original content to penetrate more of the TV opportunity that the company has long talked about addressing. Thank you.

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

Katy, I am optimistic given what I'm hearing that there would likely be some sort of tax reform this year, and it does seem like there are people in both parties that would favor repatriation as a part of that. So I think that's very good for the country and good for Apple. What we would do with it, let's wait and see exactly what it is. But as I said before, we are always looking at acquisitions. We acquired 15 to 20 companies per year for the last four years. And we look for companies of all sizes, and there's not a size that we would not do based on just the size of it. It's more about the strategic value of it.

In terms of original content, we have put our toe in the water with doing some original content for Apple Music, and that will be rolling out through the year. We are learning from that, and we'll go from there. The way that we participate in the changes that are going on in the media industry that I fully expect to accelerate from the cable bundle beginning to break down is, one, we started the new Apple TV a year ago, and we're pleased with how that platform has come along. We have more things planned for it but it's come a long way in a year, and it gives us a clear platform to build off of. Two, embedded in the 150 million paid subscriptions that I mentioned in my opening comments, there are a number of third-party services that are a part of that, where we participate economically in some of that by offering our platform in selling and distributing. And then thirdly, we are obviously, with our toe in the water, we're learning a lot about the original content business and thinking about ways that we could play at that. Thanks for the question.

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

Thank you.

A - Nancy Paxton {BIO 1779050 <GO>}

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

Operator

We'll go to Amit Daryanani with RBC Capital Markets.

Q - Amit Daryanani {BIO 7113568 <GO>}

Thanks a lot. Good afternoon guys. I guess the first question, I really appreciate the information you guys are providing around your Services business, which is up 18% year over year. Can you just talk about? How much of that do you think is growth in your installed base versus increased monetization on a per iOS to iOS basis? And so we are to think about those in two separate tranches?

A - Luca Maestri {BIO 15738533 <GO>}

I think you're absolutely right, Amit. We look at it that those are the two key elements for us. And what is particularly interesting to us is to see that the number of people that are transacting on our stores is increasing strong double-digits, and we're also seeing that the ARPU per paying customer is increasing double digits, right. So it's a combination of the two.

Obviously, the quality and the quantity of content that we make available in our services improves all the time. And we also see that as people getting to the platform and start transacting on the platform, and we keep track of their behavior over time, we actually see that they tend to spend more and more over time. And that's why we are excited about the future of the Services business. And that's why, as Tim said, we have a goal that - it's already become a very large business. It's going to be a Fortune 100 company this year, but we have a goal to double it over the next four years.

Q - Amit Daryanani {BIO 7113568 <GO>}

Perfect. And if I could just switch gears on a follow-up, there has been a fair amount of discussions around your market share in China and what's happening over there. Your numbers actually look fairly impressive in Greater China, China specifically. So could you just talk about what are the demand trends you're seeing there on the ground, and how do you see that transpire through the year?

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

Yeah, I'll take this one. If you look at how we did in the quarter, as I think Luca shared, our Greater China revenue was down 12%, and about 4 points of that was currency related, so it's an 8 point decline in constant currency. And then within Greater China, if you look at the PRC, our revenue was flat year over year, and that was against the all-time record quarter. And if you look at that on a constant currency basis, it was actually up 6%. So it's a significantly better performance on every way you look at it versus what we had experienced the prior three quarters.

Underneath that, what we've seen is that iPhone 7 was the best-selling smartphone in China during the quarter, according to Kantar. Singles Day, which is a huge day in China, as you know, we were the most popular U.S. brand on Alibaba. We set a new record for Services in China, as the company did. And Mac revenue was up double digit year over year. iPad units were also up double digit in Mainland China, which was obviously different than the trend that we saw in the balance of the world. We also saw 50% of our iPhone sales in China were to switchers and first-time buyers, which is a very high number that we're pleased with. And obviously, our total installed base continues to grow there in the strong double digits.

That said, the challenges that are there are, one, the currency has devalued 6% year over year. And two, Hong Kong remains a very, very difficult market. And so I look at it in - I'm encouraged with the significant improvement, but we're not without challenges there. And I wouldn't want to imply that, although I do like many, many things that I've seen and how broad-based the pluses were across our product line.

A - Nancy Paxton {BIO 1779050 <GO>}

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

Operator

From Cross Research, Shannon Cross.

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

Thank you very much for taking my question. Can you talk a bit more about the Services business? And what I'm trying to figure out is I think the number was you're going to be doubling within the next four years, at least that's your expectation. So what gets you there? I don't know, maybe if you talk about geographies and how penetrated you are in certain geographies. And then, as you grow your Services business, is there anything we should keep in mind from a margin perspective? Would these be lower margin services or similar, just so we can think about the trajectory and the contribution to the bottom line.

A - Luca Maestri {BIO 15738533 <GO>}

Yeah, Shannon, I'll take it. Obviously, within the Services business, we have a number of categories. The App Store is the one that is driving significant growth right now. I said in my opening comments that we grew 43% 13 weeks over 13 weeks, a little even more for the quarter, right.

And what we like about the App Store is that it's truly a global platform. So we are seeing significant growth not only in the developed markets, where you expect to see a lot of transaction volume, but we see great growth in places like China, for example. And we know that there are parts of the world where we can do better. We can grow, for example, our developer community in a number of emerging markets. And so as we look, as I was explaining earlier, as we look at the number of people that transact growing double digits, we see the amount spent per paid account growing so well, we think that the App Store is going to be a significant driver of growth.

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On the music front, we are the market leader in digital music. Obviously now, by having the combination of the download business with the streaming service, which we didn't have until recently, we've been able to bring our music business back to growth. We've grown over the last three quarters, and we feel very good about that. Tim has talked about original content. We've had very good success with exclusives. So we know that it's another business that we can grow.

Our iCloud storage business is growing very quickly, and so that is a business that also at a geographic level we can continue to grow significantly. Our AppleCare business is growing very well. A lot of it comes from the fact that our install base of devices around the world continues to grow very well, strong double digits. And as we've explained in the past, the vast majority of the services that we provide is not driven by what we sell during the last 90 days. It's much more driven by the install base, and that gives us a tailwind. We're also opening up several new markets because we are accepting new forms of payment. And therefore, it's easier particularly for international customers to take advantage of our services.

You were asking about the margin profile. We said many times, in aggregate our Services business tends to have margins that are above company average. They are accretive, so they help us quite a bit from a margin standpoint. Within the Services business, we have very different margin profiles, also because, as you know, we account for some of these services in different ways. In some cases, we transact on a buy/sell basis. In other cases, we perform as agents, for example, to our developers, and that drives different margin percentages.

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

Thank you. And then my follow-up is just in terms of the elasticity of demand and some of the moves from a currency perspective. I think in the past there was some concern in some of the emerging markets the you were basically not able to - you weren't you're getting the volumes because you had to raise ASPs given the currency. But you talked about a lot of the emerging markets actually doing pretty well this quarter. So I'm just curious. You raised the price on the iPhone 7 Plus and that. What are you seeing, and what are your customers saying in terms of willingness to pay up?

A - Luca Maestri {BIO 15738533 <GO>}

Shannon, I was looking back. Since June of 2014, so we're talking about 2.5 years ago, the dollar has strengthened 25% against the basket of currencies where we do business. And so obviously, it is a difficult situation for us. I've mentioned that foreign exchange is a significant headwind for us, both at the revenue level and at the gross margin level. In emerging markets, it's incredible. The level of interest for our products continues to be phenomenal. The brand continues to be very aspirational. There are more and more people that can afford our products around the world. The middle class is growing in places like China, India, Brazil, but certainly the strong dollar doesn't help us. And therefore, when we make pricing decisions, we need to be very careful. We always want to find the optimal balance between units, revenue, and margin, and it becomes more difficult as the dollar appreciates.

A - Nancy Paxton {BIO 1779050 <GO>}

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

Operator

Moving on, we'll hear from Brian White with Drexel.

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

Luca, I'm wondering if you could talk a little bit about gross margins. Sales obviously beat the high end of your revenue range. It looks like gross margin was dead down the middle. Can you talk about the puts and takes in gross margins in the quarter, please?

A - Luca Maestri {BIO 15738533 <GO>}

Sure. We were actually at the high end of the range for gross margins. We had guided 38% to 38.5%, and we came in at 38.5% exactly. And really, the slight improvement over the midpoint of the guidance range was due to the fact that our revenue was ahead of our expectations, and so we got a bit more leverage out of the increased revenue levels. We felt very good about the gross margins for the quarter. Again, keep in mind the strong dollar doesn't help us on that front.

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

Okay. And, Tim, I didn't hear much mentioned about India. How did India perform with the iPhone? And how should we think about it for 2017, especially with the 4G network going up?

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

That's a really good question. Despite the demonetization move in India that created lots of economic pressure there last quarter, despite that, we had all-time record revenue results, and so we were very happy about that. The demonetization impact has not worked its way through yet. It's still definitely having some overhang. But I think in the longer term, it's a great move, and I feel really good about how we're doing there. We are in discussions on a number of things, including retail stores, and fully intend to invest significantly in the country and believe it's a great place to be.

A - Nancy Paxton {BIO 1779050 <GO>}

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

Operator

From Goldman Sachs, we'll hear from Simona Jankowski.

Q - Simona K. Jankowski {BIO 7131672 <GO>}

Hi, thank you. I wanted to dig in a little bit more into the iPhone upside in the quarter with record revenues in every region except for Greater China. I think you touched on the

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percent of switchers in China. But can you give a little more color on the split of upgrades and switchers in some of the other regions and overall as well?

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

Simona, it's Tim. We did have an exceptional quarter with iPhone, and that was with the backdrop of not predicting the demand very well on the iPhone 7 Plus and therefore being in constraint on it through the quarter. If you look at the absolute number of upgraders, it was the highest that we've seen in any quarter. And if you look at the switcher number, it's the highest that we've seen in any quarter. If you look at the upgrade rate, it's similar to last year. However, I think the big asterisk - I share all this with you for transparency's sake. I would tell you that the way we look at this is in a quarter where you have a supply constraint, it's difficult to draw too many conclusions from it. But I wanted to share that with you anyway so you have the backdrop.

Q - Simona K. Jankowski {BIO 7131672 <GO>}

Thank you, and then just one follow-up on China specifically. As your comps get easier this year, I was curious if you think you're going to be returning to growth in that region. And then just to give us the context, I know you talked about the 6% constant currency increase in revenue in Mainland China. But curious if you strip out the double-digit increase in iPad and MacBook and potentially the mix shift to the iPhone 7 Plus, I'm curious what underlying iPhone units did in Mainland China.

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

That's a big question, and I don't have the answer in front of me. If you look at iPhone 7 Plus, it was the most popular Plus model that we've ever had. It set a unit record, so that I can share. In terms of how are we going to do, we don't provide guidance at the segment level. But sitting here today, for Q2, I wouldn't expect the year-over-year performance to be dramatically different than the year-over-year performance in Q1. The real comp really begins in the following quarter to a more significant degree, and we'll have to see how that plays out as we get closer to it.

Q - Simona K. Jankowski {BIO 7131672 <GO>}

Thank you.

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

Yes.

A - Nancy Paxton {BIO 1779050 <GO>}

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

Operator

From Bernstein, Toni Sacconaghi.

Q - Antonio M. Sacconaghi {BIO 21226758 <GO>}

Yes, thank you. I just wanted to better understand the upgrade rate dynamics. So I think iPhone units on a sell-through basis were up about 8%. You had an extra week, which gave you about 8%. I understand there were differences of the timing of the launch. So making all those adjustments, it looks like iPhone units were probably up low single digits. But, Luca, you alluded to the fact that your install base was growing double digits. So that would suggest to me that the upgrade rate, the upgrade percentage is actually declining.

And more specifically, I'd just like your broader perspective on how investors should think about upgrade rates. It looked like they peaked in the iPhone 6 cycle, and it looks like they've been extending - going lower. Replacement cycles have been extending over the last couple years. I think some of the U.S. carriers alluded to that as well.

So I'm wondering if you could step back and just talk a little bit more broadly about how investors should think about or what the trajectory has been over the last two years and how investors should think going forward. Do you believe there are opportunities for that upgrade rate to improve or replacement cycles to accelerate going forward? And what are some of the considerations we should think about?

A - Luca Maestri {BIO 15738533 <GO>}

I think it's a good question, a number of points that I want to make. Starting with the growth in the install base of iPhones, yes, it's growing strong double digits, and that's very good for us for a number of reasons, including the fact that it's a big driver for our Services business.

When we look at it geographically, I think we see different developments. For example, we felt very, very good about the unit growth that we had in many markets around the world. You've been quoting an overall total company growth rate. But when we look at a country-specific level, there were a lot of countries, I would say the majority of the countries, where iPhone units grew strong double digits, starting here in the United States, where for example, the fact that annual upgrade programs are becoming more and more popular is proving to be a positive for us. Same happened in a number of countries around the world, starting with Canada and Australia but also many places in Western Europe as well. Japan grew double digits in terms of units. So I think geographically we are seeing very, very good performance.

The point that I think I need to make when you think about upgrade rates, clearly, this issue of the strong dollar doesn't help us. Could we sell significantly more and significantly faster from an upgrade cycle standpoint in places outside the United States, where we've been forced to increase prices by up to 20%, 30%, 40% in certain countries? And you think about the impact that this is having on local demand, obviously that doesn't help us.

But overall, I would say as Tim said, when we look at the upgrade rate for and we look at it from the standpoint of the new phones, right, the new generation phones, the upgrade

rate, the percentage of people that have upgraded to the new phone has been very similar to what we've seen last year. The 6 cycle was certainly a phenomenal cycle. There was pent-up demand for the larger screen phones. And certainly as we look ahead, we have a role to play. The more we're able to innovate with new generations of products, clearly that plays a role in the upgrade rate.

Q - Antonio M. Sacconaghi {BIO 21226758 <GO>}

Okay, thank you. Tim, I have a question for you. Back in April 2012, you said on one of these earnings calls that I've always hated litigation and I continue to hate it, and I highly prefer to settle versus battle. Yet you recently decided to initiate a lawsuit against Qualcomm. I'm wondering if you can comment on the ostensible change or departure from this viewpoint, and what would be a successful end result of this litigation, and whether you can confirm whether there's any potential gross margin risk in the future as a result of this litigation.

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

I feel the same way I did in April of 2012. I don't like litigation and view it as a last resort. And so you should take from our filing that we viewed it as we didn't see another way forward. They were insisting on charging royalties for technologies that they had nothing to do with. And so we were in a situation where the more we innovated with unique features like Touch ID or advanced displays or cameras, just to name a few, the more money Qualcomm would collect for no reason and the more expensive it would be therefore for us to innovate.

And so it's somewhat like buying a sofa, and you charge somebody a different price depending upon the price of the house that it goes into. Just from our point of view, this doesn't make sense, and we don't believe it will pass muster in the courts. In addition to that, as a part of their increasingly radical steps they were taking to try to hold up that model, they withheld \$1 billion in payments that they owed us. And so we felt like we had no choice was the net of it.

In terms of where it goes, we'll see. I don't like litigation. And so if there's another way, then that would be great, but at this point I don't see it. I fully expect at this point in time that it will take some time, but in the end I think common sense will prevail and the courts will see it for what it is. And so that's the way I see it. Thanks for your question.

A - Nancy Paxton {BIO 1779050 <GO>}

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

Operator

We'll go to Steve Milunovich with UBS.

Q - Steven M. Milunovich {BIO 1504637 <GO>}

Thank you. First, I wanted to ask about the iPad. It looked like it was about to turn possibly even positive. You said it was above your plan, but I think it was pretty well below the Street's expectations. And the ASP deteriorated pretty significantly. I don't know if it's a mix shift. But maybe you can talk about the iPad and what you see going forward.

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

The iPad, Steve, we had a 1.6 million-unit swing on channel inventory between the years. In the year-ago quarter we increased by 900,000. In this quarter we decreased by 700,000. On top of that and from an ASP point of view, in the year-ago quarter we launched the iPad Pro 13 Edge. That would be the iPad with obviously the highest price on it. We would have done the channel fill plus the launch of the product, and so that would have bolstered the ASPs in that particular quarter. In addition to all of that, we did under-call the number of iPads that would be in demand for the quarter, and that compounded a shortage issue that we had with one of our suppliers. And so all in all, there were quite a few things going on there.

If I zoom out of the 90-day clock and look at it, we've got some exciting things coming on iPad. I still feel very optimistic about where we can take the product. When we look at the number of people buying iPads for the first time, which is a good thing to look at from a point of view of whether things are reaching a penetration point or not, the numbers indicate that it's not close to that kind of thing. The customer sat numbers are through the roof. Literally, the customer sat for the iPad Pro is 99%. It's stunning.

And so I see a lot of good things and hope for better results, but we are still currently in this shortage issue now, and I'm not projecting to get out of that totally during the quarter. And so it will damper this quarter somewhat. But again, beyond the 90-day clock, I'm very bullish on iPad.

Q - Steven M. Milunovich {BIO 1504637 <GO>}

Okay, that's great, thank you. And then, Tim, investors tend to think of the iPhone as mature and technology improvements as incremental, yet I believe you said there's plenty of runway left in terms of appealing new features. Do you think there are future enhancements coming that will be viewed as material by users, and particularly changes beyond form factor, beyond the way the phone looks? Are there functional things coming over time that you think could surprise people?

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

I think the smartphone is still in the early innings of the game. I think there's lots more to do. I think it's become - every year it becomes more important to people's lives and there are more things people are doing with it. I talked a little bit about home automation, but I could have talked about health. I could have talked more about CarPlay. The use of it in the enterprise is growing significantly. And so when I look at all of these things, usage going up, app developers still innovating, we've got some exciting things in the pipeline, I feel really, really good about it. So this is one that we think different about a bunch of things, but maybe this is just one more.

Q - Steven M. Milunovich {BIO 1504637 <GO>}

Thank you.

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

Yes.

A - Nancy Paxton {BIO 1779050 <GO>}

Thank you, Steve. A replay of today's call will be available for two weeks as a podcast on the iTunes Store, with a webcast on apple.com/investor, and via telephone. The numbers for the telephone replay are 888-203-1112 or 719-457-0820. Please enter confirmation code 3378275. And 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. And financial analysts can contact Joan Hoover or me with additional questions. Joan is at 408-974-4570, 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.

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