

Apple (AAPL) Q3 2016 Results - Earnings Call Transcript

Jul. 26, 2016 9:01 PM ET | **Apple Inc. (AAPL)** | 53 Comments

Q3: 2016-07-26 Earnings Summary

10-Q

EPS of \$0.36 **beats by \$0.01** | Revenue of \$42.36B (-14.61% Y/Y) **beats by \$249.62M**

Apple, Inc. (NASDAQ:[AAPL](#)) Q3 2016 Earnings Call July 26, 2016 5:00 PM ET

Executives

Nancy Paxton - Apple, Inc.

Timothy Donald Cook - Apple, Inc.

Luca Maestri - Apple, Inc.

Analysts

Shannon S. Cross - Cross Research LLC

Steven M. Milunovich - UBS Securities LLC

Kathryn Lynn Huberty - Morgan Stanley & Co. LLC

Toni Sacconaghi - Bernstein Research

Simona K. Jankowski - Goldman Sachs & Co.

Gene Munster - Piper Jaffray & Co.

Mark Moskowitz - Barclays Capital, Inc.

Kulbinder S. Garcha - Credit Suisse Securities (NYSE:[USA](#)) LLC (Broker)

Operator

Good day, everyone, and welcome to this Apple, Incorporated third quarter fiscal year 2016 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 - Apple, Inc.

Thank you, good afternoon and thanks to everyone for joining us. Speaking first today is Apple CEO Tim Cook, and he'll be followed by CFO, Luca Maestri. And 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 revenues, 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 2015, the Forms 10-Q for the first two quarters of fiscal 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.

In addition, today's comments will refer to a metric we describe as installed base related purchases. This is a non-GAAP measure, and a reconciliation to the corresponding GAAP measure can be found on our Investor Relations website at Apple.com/investor.

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

Timothy Donald Cook - Apple, Inc.

Thanks, Nancy. Good afternoon and thank you for joining us. Today we're pleased to report third quarter results that reflect stronger customer demand and business performance than we anticipated just 90 days ago and include several encouraging signs.

Revenue of \$42.4 billion was near the high end of our guidance range and gross margin of 38% was at the top of our guidance range. We achieved these results while reducing channel inventory by about \$3.6 billion, significantly more than the \$2 billion inventory reduction we had expected. So our sell-through was markedly greater than our sell-in.

iPhone accounted for the vast majority of the channel inventory reduction. iPhone unit sell-through was down just 8% year on year, an even greater improvement over the March quarter than we predicted, and we expect the September quarter sell-through comparison to improve further. We feel good about our channel inventory levels and believe they position us well for the months ahead.

We had a very successful global launch of iPhone SE, and demand outstripped supply throughout the quarter. We brought on additional capacity and were able to achieve supply/demand balance as we entered the September quarter. At its launch, we said that the addition of the iPhone SE to the iPhone lineup placed us in a better position to meet the needs of customers who love a four-inch phone and to attract even more customers into our ecosystem.

In both cases, that strategy is working. Our initial sales data tells us that the iPhone SE is popular in both developed and emerging markets, and the percentage of iPhone SE sales going to customers who are new to iPhone is greater than we've seen in the first weeks of availability for other iPhones launched in the last several years.

Overall, we added millions of first-time smartphone buyers in the June quarter, and switchers accounted for the highest percentage of quarterly iPhone sales we've ever measured. In absolute terms, our year-to-date iPhone sales to switchers are the greatest we've seen in any nine-month period, and our active installed base of iPhones is up strong double-digits year over year.

We saw tremendous performance from our Services businesses, which grew 19% to a June quarter record of \$6 billion. The growth was broad-based, with App Store revenue up 37% to a new all-time high, in addition to strong increases in Music, iCloud, and AppleCare. In the last 12 months, our Services revenue is up almost \$4 billion year on year to \$23.1 billion, and we expect it to be the size of a Fortune 100 company next year. Most of our terrific Services performance during the quarter was fueled by our active installed base of devices, with installed base-related purchases of \$10.3 billion accelerating to 29% growth year on year.

We had our best iPad compare in 10 quarters, with revenue growing 7% thanks to the rollout of the 9.7-inch iPad Pro. We're proud to have the most exciting lineup of tablets and accessories in the world and exceptionally high customer satisfaction and engagement. Our surveys also show that about half of iPad Pro purchases are buying them for work. iPad Pro is the ultimate upgrade for existing iPad users and the ultimate replacement device for customers switching from PC notebooks.

Apple Watch continues to be the best-selling smartwatch in the world. And just this month, J.D. Power ranked it highest in customer satisfaction among all smartwatches. With watchOS 3 coming this fall, customers will be able to update their Apple Watches with an enhanced user interface, significantly improved performance and all-new fitness and health capabilities, including activity sharing. We're just getting started with the Apple Watch, and we look forward to even more exciting announcements in this space.

On a personal note, during the past quarter I visited China and India, and I am very encouraged about our growth prospects in those countries. We remain very optimistic about the long-term opportunities in Greater China and we continue to invest there. We opened our 41st Greater China retail store during the quarter, and we also made a \$1 billion investment in Didi Chuxing.

Switchers and first-time smartphone buyers represented the lion's share of our iPhone sales in the quarter, and our installed base of iPhones in China has grown by 34% over the last year alone. According to China Mobile, there are more iPhones on their network than any other brand, with iPhone users ranking first in terms of customer loyalty, data usage and ARPU. By far, the largest portion of our global channel inventory reduction was in Greater China, so our underlying business there is stronger than our results imply.

We face some challenges in Greater China, as the economic environment has slowed down since the beginning of the year. This is reflected in consumer confidence and retail spending, and the Chinese yuan has depreciated by 7% relative to the U.S. dollar since August of last year. Hong Kong's tourism and retail businesses also continue to be significantly impacted by the stronger Hong Kong dollar relative to other Asian currencies.

Combining this backdrop with the tough comparison to last year, when revenue grew 112%, and the channel inventory reduction this year, we're reporting a decline in revenue in the June quarter. But to keep things in perspective, when we look back on our accomplishments in this segment over the last couple of years, they are truly remarkable. In the first three quarters of this fiscal year, our total revenue from Greater China was almost \$40 billion, up 55% from the same timeframe just two years ago, while iPhone units were up 47%.

India is now one of our fastest growing markets. In the first three quarters of this fiscal year, our iPhone sales in India were up 51% year on year. We just announced a first of its kind design and development accelerator to support Indian developers creating innovative applications for iOS, and we opened a new office in Hyderabad to accelerate maps development. We're looking forward to opening retail stores in India down the road, and we see huge potential for that vibrant country.

As we look forward to the fall, we are thrilled by customers' response to the software and services we previewed at our Worldwide Developers Conference last month. This was our biggest WWDC ever. And for the first time, we have four innovative Apple platforms for our developers' apps, iOS, macOS, watchOS, and tvOS. In fact, iOS 10 will be the biggest release ever for iOS.

The momentum of all four platforms shows the strong relationship Apple enjoys with customers throughout their day and wherever they go, whether it's at home, in their car, at work, or everywhere in between. The Apple ecosystem is thriving and growing, and our new OS releases this fall will take these great experiences to a new level.

Customers can look forward to more expressive ways to communicate with messages now with its own App Store, allowing users to create and share content, make payments, add stickers and more, all without leaving messages, which is now one of the largest messaging services in the world. Customers can also look forward to a broader and more intelligent role for Siri, which will work with your favorite apps from the App Store, so you can ask Siri to book a ride with your favorite ride sharing app or send money to someone with Square.

There are also beautifully redesigned apps for music, maps and news, significant enhancements to HomeKit, CarPlay, and the Health app, building on our strategy to give users a seamless experience in all aspects of their lives. There's also a major update with macOS Sierra, with new features like Siri and Apple Pay that make the Mac smarter and more helpful than ever, and even stronger continuity features across all the Apple devices.

These experiences become more powerful and intuitive as we continue our long history of enriching our products through advanced artificial intelligence. We have focused our AI efforts on the features that best enhance the customer experience. For example, machine learning enables Siri to understand words as well as the intent behind them. That means Siri does a better job understanding and even predicting what you want, then delivering the right responses to requests. To make Siri an even smarter assistant, we're opening the service to developers, and this fall Siri will be available across our entire product line.

We're also using machine learning in many other ways across our products and services, including recommending songs, apps, and news. Machine learning is improving facial and image recognition in photos, predicting word choice while typing in messages and mail, and providing context awareness in maps for better directions. Deep learning within our products even enables them to recognize usage patterns and improve their own battery life. And most importantly, we deliver these intelligent services while protecting users' privacy. Most of the AI processing takes place on the device rather than being sent to the cloud. And starting this fall, we'll be using sophisticated technology called differential privacy, enhancing our ability to deliver the kinds of services we dream of and customers love without compromising on the individual privacy our customers have come to expect from us.

This fall we'll also bring Apple Pay to Safari so users can easily make secure and private purchases when shopping on participating websites. Tens of millions of users around the world are enjoying Apple Pay today at stores and in app, with estimated monthly active users up more than 450% year on year last month.

Leading financial partners tell us that three out of four contactless payments in the U.S. are made with Apple Pay. This is amazing. There are more than 11 million contactless-ready locations in the countries where Apple Pay is available today, including 3 million locations now accepting Apple Pay in the United States. With the launch of France, Switzerland, and Hong Kong this month, Apple Pay is now live in nine markets, including six of our top 10. Adoption outside the U.S. has been explosive, with over half of transaction volume now coming from non-U.S. markets.

With our latest OS releases, the unparalleled continuity across Apple devices will become even more powerful. For example, macOS Sierra will sense other devices and use secure protocols to communicate. With an authenticated Apple Watch, I can auto-unlock my Mac when I open it without typing a password. With Universal Clipboard, I can copy and paste text, images, and even video between my iOS devices and my Mac. And I can automatically access the files on my Mac desktop and documents folder from another Mac, iOS device, or even a PC.

Innovations like these are the kinds of things that only Apple can do. We have an incredible lineup of products in our pipeline, and I'm very bullish about our long-term opportunity.

Now I'd like to hand it over to Luca to share more details with you on the June quarter.

Luca Maestri - Apple, Inc.

Thank you, Tim. Good afternoon, everyone. Revenue for the June quarter was \$42.4 billion, near the high end of our guidance range, compared to \$49.6 billion in the year-ago quarter. Customer demand for our products and services was stronger than we had anticipated at the beginning of the quarter. As Tim mentioned, we reduced overall channel inventories by roughly \$3.6 billion.

On a geographic basis, our revenue grew strongly in Japan to a new June quarter record, and we experienced healthy growth in a number of other important markets, including Russia, Brazil, Turkey, India, and Canada.

Gross margin was 38%, at the top of our guidance range. Operating margin was 23.9% of revenue, and net income was \$7.8 billion. Diluted earnings per share were \$1.42, and cash flow from operations was strong at \$10.6 billion.

For details by product, I will start with the iPhone. We sold 40.4 million iPhones in the quarter. We also reduced channel inventory by over 4 million units compared to about 0.5 million units a year ago, so sell-through was down by 8%. We exited the quarter near the low end of our five-week to seven-week target range for channel inventory. The rollout of our new entry-level iPhone SE concurrent with the channel reduction of more than 4 million higher-end iPhones resulted in a lower than usual iPhone ASP of \$595. Therefore, we expect ASPs to improve this quarter.

We experienced strong iPhone growth in many markets, with sales in Russia more than doubling year over year, and double-digit growth in many other key countries, including Japan, Turkey, Brazil, India, Canada, and Sweden.

iPhone continues to show great momentum in business markets. A recent survey by 451 Research found that among U.S. corporate buyers planning to purchase smartphones in the September quarter, 75% plan to purchase iPhones. This is the highest corporate purchase intent ever measured by the survey for the September quarter.

Turning to Services, we generated \$6 billion in revenue, an increase of 19% over the June quarter last year. We set a new record for customers transacting on our iTunes Stores. And among our customers who purchase apps and content, the average amount spent per customer was the highest that we've ever measured. The App Store's growth rate has now accelerated for four consecutive quarters, reaching 37% in Q3. The App Store is overwhelmingly the preferred destination for both customers and developers. According to App Annie, we generated 100% more global revenue than Google Play in the June quarter, widening our lead from the March quarter.

Because of this continued growth, for the first nine months of our fiscal year, Services increased from 8% of our total revenue a year ago to 11% this year, and it represents an even higher percentage of our profitability.

Next I'd like to talk about the Mac. We sold 4.3 million Macs compared to 4.8 million last year. It was a challenging quarter for personal computer sales across the industry, with IDC estimating a 4% global contraction. In addition to the overall market slowdown, we faced a very difficult compare to the year-ago quarter, when we introduced a new MacBook Pro and a new iMac. Despite these challenges, Mac continues to gain a high percentage of new customers, and our Mac installed base has grown to a new all-time high at the end of the June quarter. We ended the quarter below our four-week to five-week target range for Mac channel inventory.

Now turning to iPad, revenue grew 7%. iPad ASP was \$490 compared to \$415 in the year-ago quarter, with the increase driven by iPad Pro, and we sold 10 million iPads compared to 10.9 million in the year-ago quarter. We also reduced channel inventory by about 500,000 units and exited the quarter within our five-week to seven-week target range.

In the segments of the tablet market where we compete, we continue to be highly successful both in terms of market share and customer metrics. Recent data from NPD indicates that iPad gained share in the overall U.S. tablet market in the June quarter and has 84% share of tablets priced above \$200. And in May, 451 Research measured a 96% consumer satisfaction rate for iPad mini and a 95% rate for iPad Air. Among U.S. consumers planning to purchase a tablet within the next six months, 63% plan to purchase an iPad, almost four times the purchase intention rate of the next highest brand measured, with iPad Pro the top choice for planned purchases. Corporate buyers report a 94% satisfaction rate for iPad and a purchase intent of 71% for the September quarter.

One recent example of iPad business adoption is Sberbank, Russia's largest bank, which is adding 22,000 iPads to more than 10,000 purchased last year to deploy corporate mobility solutions across the organization and enable its consultants to serve customers in a more engaging and more efficient way.

More broadly, we're making great progress with our enterprise initiatives and we see strong growth opportunities ahead of us. In May, we announced a global strategic partnership with SAP to reimagine business processes with native iOS apps. SAP is the world's largest enterprise software provider, with more than 130 million potential users among its 300,000 global customers. In fact, it's estimated that 76% of global business transactions touch an SAP system. Our partnership will deliver an SDK to fast-track iOS projects for SAP environments, an iOS academy to enable the 2.5 million SAP developers around the world to build great native iOS apps, and a portfolio of industry-specific apps to accelerate mobile transformation in the enterprise.

Last month, we announced the first three solutions from our Cisco partnership, two that will dramatically improve the network performance of iOS traffic running on Cisco networks, and one that will bring the desk phone to the 21st century by integrating iPhone Wi-Fi calling into Cisco Spark.

Let me now turn to our cash position. We ended the quarter with \$231.5 billion in cash plus marketable securities, a sequential decrease of \$1.4 billion. \$214.8 billion of this cash, or 93% of the total, was outside the United States.

We issued a total \$2.4 billion of debt in Taiwan and in Australia, while retiring \$2.5 billion in U.S. debt, leaving us with \$72 billion in term debt at the end of the quarter, essentially unchanged from last quarter.

We returned a total of over \$13 billion to investors during the June quarter as follows. We paid \$3.2 billion in dividends and equivalent. We spent \$4 billion on repurchases of 41.2 million Apple shares through open-market transactions. And we launched a new \$6 billion ASR, resulting in initial delivery and retirement of 48.2 million shares.

We also completed our sixth accelerated share repurchase program, retiring an additional 8.7 million shares. We've now completed almost \$177 billion of our current \$250 billion capital return program, including \$127 billion in share repurchases. During the quarter, we also spent \$1 billion on a minority investment in Didi Chuxing in China, completed three acquisitions and incurred \$4.2 billion in capital expenditures.

As we move ahead into the September 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 \$45.5 billion and \$47.5 billion. We expect gross margin to be between 37.5% and 38%. We expect OpEx to be between \$6.050 billion and \$6.150 billion. We expect OI&E to be about \$350 million, and we expect the tax rate to be about 25.5%.

Also today, our Board of Directors has declared a cash dividend of \$0.57 per share of common stock, payable on August 11, 2016 to shareholders of record as of August 8, 2016.

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

Nancy Paxton - Apple, Inc.

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

Question-and-Answer Session

Operator

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

Shannon S. Cross - Cross Research LLC

Thank you very much for the question. Tim, can you talk a little bit about your thoughts on investments? You made the Didi investment this quarter. Obviously, you continue to make acquisitions over time. We just saw I guess you invested in buying some of Carpool Karaoke. I'm just curious as to how you're thinking about where you're putting your investment dollars for more of an acquisition or a potential equity stake standpoint as you look at overall capital allocation.

Timothy Donald Cook - Apple, Inc.

Shannon, we obviously invest a ton of capital in our business itself to support research and development and the production of our products. And that's the main source of our capital. However, we're constantly looking on the outside for great talent and great intellectual property. And we have been buying companies on average every three to four weeks or so, and we continue to do that. And we think we've made some really great choices there.

In terms of the investment in Didi, it was an unusual investment in that, as you know, we don't have a long history of doing a lot of these, but we have done some before. We invested in ARM in the early days. We invested in Akamai and a few other companies. So it wasn't the first.

From a Didi point of view, we see that as, one, a great financial investment. Two, we think that there are some strategic things that the companies can do together over time. And three, we think that we'll learn a lot about the business and the Chinese market even beyond what we currently know, and Didi has an incredible team there. And so that's the rationale for why we did that. Would we do more investments? Yes, but it's not something that you'll see a whole string of from us. But we will constantly look for things that are smart to do.

Shannon S. Cross - Cross Research LLC

Great. Thank you. And then just as a follow-up for Luca. If you could, talk a little bit about the gross margin puts and takes for guidance, 37% to 38%. How are you thinking about commodity pricing and mix of the new products and that just as you look to how you guided gross margin?

Luca Maestri - Apple, Inc.

Yes, Shannon. Let me correct you. It's 37.5% to 38%...

Shannon S. Cross - Cross Research LLC

Sorry. I had that written down, but I said the wrong thing.

Luca Maestri - Apple, Inc.

...for the September quarter. So essentially, we're guiding GM flat to slightly down sequentially. On the positive side, we're going to have leverage because we are guiding to a sequential increase in revenue, and we expect to have positive mix as we get into the September quarter, and these positives being offset more or less by what we call product transition costs, which are typical at this time of the year for us.

Shannon S. Cross - Cross Research LLC

Great. Thank you.

Timothy Donald Cook - Apple, Inc.

Shannon, on the commodity side and for the September quarter, we see NAND being pretty much in balance while DRAM and LCDs and other major commodities remain in an oversupply situation. And so overall commodity prices we expect to decline at at-least historical rates.

Nancy Paxton - Apple, Inc.

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

Operator

From UBS, we'll hear from Steve Milunovich.

Steven M. Milunovich - UBS Securities LLC

Great, thank you very much. Regarding your revenue guidance for September, it's up about 10% sequentially, which is clearly at the high end historically. So what can you tell us about the timing of the new iPhone model? Is that affecting this? You mentioned that 451 Research is finding business interest in phones, but their survey on consumers actually finds the lowest level of expectation for purchases in the next three months since 2008. You've seen the upgrade numbers from the carriers are quite low. So it seems like it's still a very tough demand environment. So where is the strength coming from in the September quarter?

Timothy Donald Cook - Apple, Inc.

Steve, we're not going to get into products or product transition. However, we've taken what we've learned from last quarter, and we did see a number of encouraging signs. Luca talked about the number of countries that we saw double-digit growth in during the quarter, from Japan to Brazil to India, some even stronger numbers than that in Russia. So there's a number of countries that we saw strong signals from that perspective.

We also are very happy with the switcher rate that we saw, our highest ever recorded. And the number of switchers through the nine months are the highest absolute numbers that we've ever had. And so when we look at that and then we look at the things going on, on our other products and services, and we think Services will continue to grow very briskly. We've made our best estimate of where we think we'll come in, and that's \$45.5 billion to \$47.5 billion.

Steven M. Milunovich - UBS Securities LLC

Okay, fair enough. And as a follow-up, I wanted to ask you about your platform strategy. You talk about the four operating systems essentially as platforms, which I agree with. And it's just interesting to me because Apple has such a control over the vertical integration of your products, and yet you've somehow been able to grasp the openness that's required for platforms. And I think that's reflected in WWDC, as you pointed out, opening up APIs and so forth on messaging.

And you made the case there for apps versus messaging and the anti-bot argument. I'm just curious. Is that the way – am I characterizing this roughly correctly in terms about how you think about the business? And how are you managing that internally in terms of having this vertically integrated somewhat closed view of the hardware and yet this pretty open platform where the value is created externally?

Timothy Donald Cook - Apple, Inc.

We think to have a great platform you have to have a really healthy ecosystem. And so we're really proud of the developer community and the fact that developers are earning a lot more money in writing for iOS than other apps. We think that the best experience for users include apps, and so we want to do everything that we can do to continue building that. We now have over 2 million apps in the App Store and are more focused these days on discovery and other things to bring more great apps to the service because there are so many out there. And so that's what we're doing.

The TV, and you didn't mention CarPlay, but these are trying to provide our users a seamless experience across all the different things that they do in their lives. And so that's the rationale for CarPlay. It's the rationale for why we're putting a huge investment in the home, making – really bringing home automation to life for people in a very simple and elegant way. It's the reason for Apple TV and what we're doing in the living room. And so all these things, all these things together are all about the user experience and making people's daily lives better.

Steven M. Milunovich - UBS Securities LLC

Thank you.

Nancy Paxton - Apple, Inc.

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

Operator

We'll go to Katy Huberty with Morgan Stanley.

Kathryn Lynn Huberty - Morgan Stanley & Co. LLC

Thank you. Luca, as it relates to gross margin, the guidance today is very similar to what you've provided over the last five years in terms of gross margin guidance in September versus June. And the variances that you walked through in response to Shannon's questions are very similar to the dynamics that you see in any September quarter. But there's an added factor this time around, which is you don't have the 4 million units of high-ASP, high-margin inventory drain in September like you did in the June quarter. So I guess I'd just push back and ask why gross margin guidance wouldn't be even better? Is it the more balanced NAND environment that Tim spoke to, or is there something else impacting the guidance?

Luca Maestri - Apple, Inc.

Katy, I've talked about these elements at a broad level. Of course, there are degrees of positive impact. We for example on the mix front, every cycle is slightly different on our product mix, and so that clearly has an impact on gross margins. And the other thing that we need to keep in mind as we step back for a second and now we've gone through a couple of cycles where the U.S. dollar has strengthened. And as you know, we work with our hedging program where we get protection from FX fluctuations in the short term. When these hedges roll off over time, we end up replacing them with new hedging contracts at spot rates.

And so versus September of 2014, for example, the U.S. dollar has now strengthened on average against international currencies by about 15%. And I think we need to accept that now we're living in this stronger U.S. dollar environment. We've taken a lot of actions on the cost side, on the pricing side, and obviously with hedges. But we need to deal with this situation, and that's where we are right now. We feel that 37.5% to 38% given the new FX environment I think says a lot about all the work that we've done on the cost side to get there. Just to give you a sense, on a year-over-year basis, when I look at foreign exchange, that has an impact of almost 300 basis points on our margins.

Kathryn Lynn Huberty - Morgan Stanley & Co. LLC

Okay, thank you. And, Tim, can you speak to how you envision the upgrade rate of the iPhone installed base to play out over the next quarter or the next year? Somebody mentioned that U.S. carriers have reported really weak upgrade rates, not necessarily for iPhone, but across their installed base. The press is discussing only modest technology upgrades in your next iPhone cycle. And so those data points would lead investors to believe that the upgrade rate will be low, but curious if you have a different view. Thank you.

Timothy Donald Cook - Apple, Inc.

I don't want to talk about phones that aren't announced. And so that aside, what we have seen in the past tense or current tense on the upgrade rate is that the iPhone upgrade rate for the iPhone 6S is very similar to the iPhone 5S. And I guess in retrospect, maybe that was a predictable thing, although we didn't predict it in the beginning. It took us a little time to realize that. The iPhone 6 was significantly higher than that, and so it likely accelerated upgrades that would have been in the current year ahead of those. And so what the future holds, we'll see.

But I'm very optimistic about the future because I see so many signs that are positive. I see an installed base that has gotten incredibly large. I see a switcher rate that is the highest ever. I see the smartphone itself, led by iPhone, becoming even more instrumental and important to people's lives. It's becoming essential. And all of the things that are coming both in the fall, the things that we've announced that you can see with iOS 10, hopefully you're running by now with the beta, those and other things make it even more instrumental. And AI even makes it even more and more. As the phone becomes more and more your assistant, it's one of those that you're not going to leave without it. And so I see all of those things as vectors that are incredibly positive.

I also really like what I've seen with the iPhone SE and the fact that it's opening the door to customers that we weren't reaching before and likely convincing some people to upgrade that wanted a smaller form factor but wanted to stay with iPhone, and so they were waiting for the iPhone SE. And so I see lots of positive things, and so that's how I look at it.

Nancy Paxton - Apple, Inc.

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

Operator

We'll go to Toni Sacconaghi with Bernstein.

Toni Sacconaghi - Bernstein Research

Yes, thank you. You commented about the significant inventory drawdown in the quarter, \$3.6 billion on the revenue side. So sell-through was \$46 billion effectively, over 4 million iPhones, suggesting that sell-through iPhone sales were 45 million.

When I look to your guidance for Q4, I actually have the opposite question of a previous question, which is in light of the true sell-through rate, which seems to reflect better than normal seasonality in Q3, likely some contribution and elasticity from the SE, when I look at Q4, it looks like you're guiding for iPhone unit on a sell-through basis to be flat or potentially down and for total company revenues to be only fractionally up and below the seasonality we see in Q4.

So I guess my question is, are you expecting any drawdowns in channel inventory in fiscal Q4? Are my inferences around sell-through rate incorrect? Or given the business momentum that you spoke about in response to an earlier question and the hopefulness that you expressed in your prepared remarks, Tim, I'm actually surprised that the guidance isn't a bit stronger on the top line.

Luca Maestri - Apple, Inc.

Toni, let me take it. Starting with your comments on the June quarter, I just want to point out that when we talk about a \$3.6 billion channel inventory reduction, that is not entirely related to iPhone. iPhone is the vast majority of that, but we did reduce channel inventory on all other products as well. So that probably leads you to different conclusions to the math that you have just expressed.

On the September quarter, when I look at the sequential increase for iPhone units that we are expecting, I would say that it is, even with the sell-through adjustments that you've talked about, it's still pretty much in line with what we've seen in the past. As you know, we do not provide guidance for channel inventory. But I would say, in general, I think it's important to keep in mind that if we look around the world, we do see a lot of positive signs, but we also know that the macroeconomic environment is slowing down in a number of places around the world. And that needs to be taken into account in our guidance.

Toni Sacconaghi - Bernstein Research

Okay. Luca, I did understand the \$3.6 billion, but you said over 4 million iPhones were drawn down. I added that to the 40.4 million, so that would suggest close to 45 million on a sell-through basis. So that was the basis for my observation.

I was wondering if I could direct one at Tim. You talked about the upgrade cycle and how it elongated relative to the iPhone 6 and that it's similar to what you saw with the iPhone 5S. And my belief is that one of the bigger longer-term concerns for Apple is that the replacement cycle could just structurally elongate over time, particularly as your installed base of customers becomes less affluent and more international.

So I guess my question is, you have a mechanism, which is the Apple Upgrade Program, which takes replacement cycle out of the equation and puts people on buying the phone as a service. And so I'd welcome any comments on how that program is doing. And then just more broadly, is Apple thinking about ways to sell not only the iPhone, but more of its products on a monthly type subscription basis, perhaps in a more bundled fashion so that you can add more predictability to what is now largely a transactional revenue model?

Timothy Donald Cook - Apple, Inc.

The iPhone demand is made up, as you know, of upgraders, switchers and new to smartphone. And so if you take it in reverse order for a minute and look at a new smartphone, smartphone penetration right now around the world at the end of December was 42%. And so there's quite a bit of room there. It is true that a lot of those are in emerging markets, but we have done – we've had reasonable business success in several emerging markets. And so we don't enter into those with no experience, although we will enter into them humbly.

On the switcher side, we really like what we're seeing. And we think that from a user point of view, as the smartphone itself becomes more and more essential to people's daily lives, which is a part of what I had talked about before, a part of bringing it into the home in a bigger way and in the car and at work and so forth, we think people will put more and more focus on what they're buying and the thing that Apple does best, which is provide this killer experience. A killer user experience that's integrated across their lives I think becomes more important and I think that really plays to our advantage. I also think that the deployment of AI technology is something that we will excel at because of our focus on user experience, and so I like that.

From an upgrade point of view, there are pluses and minuses as I see it. A plus is that more and more people have already joined upgrade programs. Some of these programs, like the one that you referenced that we've done, replaces the iPhone every year. There are also carriers that have similar kind of plans, where they also replace or change out the iPhone every year. Others have an 18-month clock. Some have a 24-month clock, and there are even some that have a 30-month clock. And so there's various time schedules there. And so, as of today, there are obviously a lot more people on those programs than ever before because they just started. It really got underway in a big way last year, in a smaller way two years ago. And so we'll see more of those this coming fall.

The minus side is that the bifurcation of the smartphone from the service itself has a plus and a minus into it. The subsidy, the lack of that – and this is more of a U.S. phenomenon than the rest of the world, some of that can be a shock for people that were used to paying \$199 for their smartphone. They come back in and they pay less for the service but they pay more for their smartphone. And so there's lots of pluses and minuses on this. But overall, as I look at this for Apple, and this is not a statement on the industry itself, but for Apple, I'm very optimistic.

Nancy Paxton - Apple, Inc.

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

Operator

From Goldman Sachs, Simona Jankowski.

Simona K. Jankowski - Goldman Sachs & Co.

Thank you. Tim, as you mentioned, you traveled to China during the quarter. And while you certainly sound encouraged on China and highlighted the Didi investment, there are some of the key services for Apple like iBooks and iTunes Movies that are still banned, and some of the local vendors appear to be gaining share. So can you just give us your perspective on the market, your expectations around getting those services back up, and also regaining share?

Timothy Donald Cook - Apple, Inc.

Yes, for books and movies, we currently have those stores off, as you mentioned. To put this in some context, those two stores for the months that we had them operational, which was several months, the revenue was less than \$1 million. And so it's not a revenue-related issue. From our point of view, this is a service we want to provide our customers. And so we're working very closely with the appropriate government agencies, and we hope to make books and movies available again to our customers there. And so we'll see how that goes, but we're optimistic there.

Simona K. Jankowski - Goldman Sachs & Co.

And in terms of just regaining share in that market more broadly?

Timothy Donald Cook - Apple, Inc.

I think we've always had – if you look at our share over time, our share in China tends to peak during launch windows. There's a higher high and a lower low there. There's a bigger difference between those two. And so what we have to do and what we're doing is innovating like crazy and delivering the best smartphone to our customers there. And if we do a really great job of that, which we will, then I'm confident that we'll do well.

Nancy Paxton - Apple, Inc.

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

Operator

Gene Munster with Piper Jaffray.

Gene Munster - Piper Jaffray & Co.

Good afternoon. Tim, you gave some nice data points around Apple Pay. Can you remind us? Is this a business that ultimately impacts the Services line in any measurable way, or is Apple Pay generally about selling iPhones?

And separately, when you just take a step back and look at the proof point that the augmented reality [AR] theme has had with this whole Pokémon phenomenon, how does it impact how you think about the future? I assume you think about it. I'm just curious what goes on in your mind when you see all that. Thanks.

Timothy Donald Cook - Apple, Inc.

On the Apple Pay side, the revenues from Apple Pay are in the Services line. The growth is astronomical, but the base is very small. And so for today, Apple Pay is very much about a great feature for our customers so that they can pay in a very simple, private, and secure way.

In terms of AR and the Pokémon phenomenon, it's incredible what has happened there. I think it's a testament to what happens with innovative apps and the whole ecosystem and the power of being a developer being able to press a button, so to speak, and offer their product around the world. And just a certain developer has elected not to go worldwide yet because of the pressure on their servers, et cetera, because of the demand. But I'm sure that they will over time.

It also does show, as you point out, that AR can be really great. And we have been and continue to invest a lot in this. We are high on AR for the long run. We think there are great things for customers and a great commercial opportunity. And so we're investing, and the number one thing is to make sure our products work well with other developers' products like Pokémon. And so that's the reason why you see so many iPhones out in the wild right now chasing Pokémons.

Gene Munster - Piper Jaffray & Co.

Would you say there's going to be a computing shift to AR longer term?

Timothy Donald Cook - Apple, Inc.

I notice there are people that want to call it a new computer platform, and we'll see. I think there's a tendency in this industry to call everything new the next computer platform. However, that said, I think AR can be huge. So we'll see whether it's the next platform. But regardless, it will be huge.

Gene Munster - Piper Jaffray & Co.

Thank you.

Nancy Paxton - Apple, Inc.

Thanks, Gene. Can we have the next question, please?

Operator

We'll go to Mark Moskowitz with Barclays.

Mark Moskowitz - Barclays Capital, Inc.

Yes, thank you. Good afternoon. I just want to follow up, Tim, if I could, related to the R&D pace of growth, clearly a lot of momentum there over the last couple years. But we're just trying to figure out how much of that is dedicated to existing products and services versus what's next? Can you give us a sense in terms of when investors should think about the ROI coming back to them from the R&D perspective? And a corollary to that, is it really restricted just to products and services currently, or can we see more of a cloud services apparatus evolve over time where you do more and more in the enterprise just given the core trips with SAP and Cisco and IBM?

And then my follow-up for Luca is around ASPs for the iPhone. We keep getting a lot of questions around iPhone SE in terms of how cannibalistic could it be to the core iPhone franchise. Are you seeing any moderation in terms of the ASP pressures here?

Timothy Donald Cook - Apple, Inc.

On R&D growth, we do continue to invest significantly in R&D. The growth rates are still large on a year-over-year basis, and Luca can share the exact ones. But I think the recent quarter was in the mid-20% for R&D. The balance of the company we're managing more flattish from a year-over-year point of view. The products that are in R&D, there is quite a bit of investment in there for products and services that are not currently shipping or derivations of what is currently shipping. And so I don't want to talk about the exact split of it. But you can look at the growth rate and conclude that there's a lot of stuff that we're doing beyond the current products.

Luca Maestri - Apple, Inc.

Mark, on the ASP question, I talked about the \$595 in Q3. It's down \$65 on a year-over-year basis. Keep in mind, about \$20 of that \$65 is foreign exchange. So during the quarter, we had this combination of starting with no iPhone SE units in channel inventory, so we had to do an at least a partial channel fill that obviously had an impact on ASPs. And then the other element was the fact that we've reduced more than 4 million units of channel inventory on the high end. So the combination of these two things obviously had an impact on ASPs. But I think as I said or Tim said during the prepared remarks, we do expect iPhone ASP to improve sequentially as we move into the September quarter because these two factors that I just mentioned are not going to repeat.

On cannibalization, of course we've got limited experience because the phone has been in the market just for a few weeks. But when we look at our survey data on iPhone SE, as Tim was saying, we believe that the iPhone SE is doing exactly what it was intended, which is we are seeing a higher rate of new to iPhone customers, which is obviously very important to us because we bring new people into the iOS ecosystem. And we see a higher rate of previous iPhone owners that really prefer the four-inch form factor. We have not seen clear evidence of cannibalization from iPhone 6S or iPhone 6S Plus. Of course, there's always going to be some level of cannibalization. But really to us what is much more relevant is the much bigger opportunity to bring more people into the iOS ecosystem.

Nancy Paxton - Apple, Inc.

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

Operator

From Credit Suisse, we'll hear from Kulbinder Garcha.

Kulbinder S. Garcha - Credit Suisse Securities (USA) LLC (Broker)

Thanks, just a couple questions for me. Luca, I just want to clarify that last point on ASPs on iPhone because last quarter it seemed that you were quite clear that that was a negative driver to the gross margin of the company. So I understand there are other drivers going into the September quarter. But just to be clear, the phone units you didn't sell through that were depleted in channel inventory, those are relatively high gross margin as well. That's the clarification.

And then for Tim, on the Services side, as Apple has spoken more and more loudly I guess in the last three or four quarters, I just think about some of the comments you've made about the TV market and how it's been stuck I think in the 1960s and the 1970s and the experience hasn't changed. I understand you've got the Apple TV box out. But in terms of driving actual video-on-demand services, is that something that Apple wants to do themselves? Do you want a partner? Could you even build content? How do you think about that as an actual business opportunity as opposed to here's an Apple box and we sell some units, but it's not that meaningful to the overall company in terms of size? I'm just curious given the installed base and users you have. Thanks.

Luca Maestri - Apple, Inc.

Kulbinder, on your question on iPhone ASP, I'm not sure if I understood it correctly. But clearly the iPhone SE has a downward impact on iPhone ASP, of course, because it comes at the low end of the range. From a gross margin perspective, it is slightly dilutive to company margins, but the impact is not particularly large.

Kulbinder S. Garcha - Credit Suisse Securities (USA) LLC (Broker)

Okay, okay.

Timothy Donald Cook - Apple, Inc.

On the Apple TV question, the introduction of Apple TV and tvOS last October and the subsequent OS releases and what's coming out this fall, think of that as building the foundation for what we believe can be a broader business over time. And so I don't want to be more precise than that. But you shouldn't look at what's there today and think we've done what we want to do. We've built a foundation that we can do something bigger off of.

Kulbinder S. Garcha - Credit Suisse Securities (USA) LLC (Broker)

Okay, thank you.

Timothy Donald Cook - Apple, Inc.

Thank you for the question.

Nancy Paxton - Apple, Inc.

Thank you, Kulbinder. A replay of today's call will be available for two weeks as a podcast on the iTunes Store, as a webcast on Apple/investor, and via telephone. And the numbers for the telephone replay are 888-203-1112 or 719-457-0820. Please enter confirmation code 4944387. These replays will be available by approximately 5 PM Pacific Time today. And members of the press with additional questions can contact Kristin Huguet at 408-974-2414. 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.

