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## Above Avalon: The Big Question Now Facing Apple

11-13 minutes

Predictions are nothing more than attempts at manufacturing clarity for what is inherently a sea of unknown. With New Year predictions, two things need to happen. The person issuing the prediction needs to come up with what may happen, and the predicted event has to occur within an arbitrary time period. The probability of finding value in such an exercise is low.

Instead of coming up with predictions for Apple at the start of a new year, there is value found in embracing the unknown and looking at questions facing the company. This has led to my annual tradition of coming up with a set of questions facing Apple at the start of a new year. The irony found with questions is that asking the right ones is equivalent to coming up with a surf board for successfully catching waves in the sea of unknown.

Previous year's questions are found below:

- [Questions for Apple in 2015](#)
- [Questions for Apple in 2016](#)
- [Questions for Apple in 2017](#)
- [Questions for Apple in 2018](#)
- [Questions for Apple in 2019](#)

### Questions for Apple in 2020

The topics that serve as source material for Apple questions in 2020 can be grouped into two buckets: growth initiatives and asset base optimization.

#### Growth Initiatives

- **iPhone Business.** The narrative facing the iPhone business has been off the mark for years. Skepticism and cynicism has continued to mask what has been a resilient business. There is now too much talk of 5G kicking off some kind of mega upgrade iPhone cycle. Such a focus ignores what is ultimately taking place with the iPhone: The business is maturing. This presents a set of challenges that will require a fine-tuning of strategy. This involves changes to the device lineup, release schedule, pricing, and feature set.
- **Paid Content Distribution.** Following a very busy 2019 for Apple's content distribution arm, all eyes are on whether or not Apple will bundle its new paid content services. Ultimately, bundling is a tool that Apple has at its disposal to support a weaker service while increasing the stickiness found with its services.
- **Wearables.** Apple's wearables business is a runaway train with the company selling approximately 65M wearable devices in FY2019. Based on my Apple Watch installed base estimate ([available here](#)), just 7% of iPhone users own an Apple Watch. Similar ownership percentages are found with AirPods despite the product having been in the market for less time. The question isn't if Apple wearables momentum will continue but instead how fast will adoption grow.
- **Margins.** Apple follows a "revenue and gross margin optimization" pricing strategy. This has led to Apple's products gross margin percentage declining by 10% over the past two years while products gross margin dollars have declined by only 2%. Apple is willing to let products gross margin percentages decline (via lower product prices and higher cost of goods sold relative to revenue) if it results in stronger customer demand for those products. Attention will be placed at determining the level at which Apple product pricing is too low in order to maximize gross profit dollars.

- **R&D.** There have been two general themes found with Project Titan and Apple's efforts related to developing a pair of AR glasses: 1) Continued progress and 2) Extended timelines.

### Asset Base Optimization

- **Leadership.** With Jeff Williams officially serving as the link between Apple's design team and the rest of Tim Cook's inner circle, it will be interesting to see if Apple makes any refinements to its leadership structure.
- **China.** The boogeyman known as U.S. / China trade has been put to bed, for now. With rhetoric having been dialed back in a very big way, attention will shift to the various decisions Apple still has to make regarding its long-term approach to China. The company can continue to rely heavily on China for its supply chain and manufacturing apparatus, accelerate a diversification strategy away from the country, or follow more of a status quo approach that recognizes the benefits (and weaknesses) of being so dependent on one country.
- **Capex.** In FY2019, Apple reported just \$7.6 billion of capital expenditures (capex). This was a significant drop from the \$16.7 billion of capex in 2018. The most likely reason for the decline in capex was a decline in tooling and manufacturing machinery. The company also slowed spending on corporate facilities. By not providing capex guidance for FY2020, the variable is accompanied by a greater level of intrigue as to what it means about Apple's near-term product pipeline.
- **Capital Return.** Apple shares were up 89% in 2019, exceeding the S&P 500's 31% gain. For the first time with Tim Cook as CEO, Apple shares now trade at a premium to the overall market when looking at forward price-to-earnings multiples. This has led some financial writers to call for Apple to slow the pace of buyback and instead push a larger increase in the quarterly cash dividend. In the event that Apple's market value exceeds intrinsic value, it's not clear how Apple would remove tens of billions of dollars of excess cash still on the balance sheet in addition to nearly \$60 billion of free cash flow generated per year. Special dividends aren't great from a tax perspective while there are limitations found with simply funneling all of the excess cash into quarterly cash dividends.

### The Big Question

Taking a closer look at the preceding list of unknowns facing Apple, the product categories that have served as the primary engines for Apple's new user growth are quickly maturing while new product categories have been more ARPU (average revenue per user) drivers. There are more than 500 million people who own just one Apple product: an iPhone. This group represents a prime target market for Apple when selling additional tools. Apple is ending one growth phase and is about to enter into a new one.

Exhibit 1 shows the growth trajectory for the number of Apple users, also referred to as Apple's installed base, over the past 10 years. Based on my estimates, the Apple installed base grew from approximately 90 million people at the end of 2009 to a little more than a billion people at the end of 2019. Apple's new user growth has slowed dramatically. Thanks primarily to the iPhone, Apple saw spectacular new user growth in the range of 25% to 60% in the early to mid-2010s. More recently, new user growth has been trending in the mid single-digit range.

#### Exhibit 1: Apple Installed Base (Number of Users)

The methodology and math used to reach my estimate for the number of Apple users is available for Above Avalon members [here](#).

Reaching a billion users is quite the accomplishment for Apple considering how the company doesn't give away its products for free. It's one thing to reach a billion users with a "free" service. However, to get a billion people to pay directly for a service or tool is an entirely different thing.

When thinking about Apple's future, the big question facing the company isn't about how it will sell additional tools to its existing user base. Instead, the major unknown facing Apple is found with management's ability to continue expanding its installed base. This raises one overarching question that covers Apple's largest challenge and opportunity:

#### How will Apple find its next billion users?

It may be tempting to classify Apple's first billion users as the "easy" growth or low-hanging fruit. In reality, those billion users primarily came from the premium segments of the various industries that

Apple competes in. This means that to find the next billion users, Apple will inevitably need some strategy adjustments.

### The Strategy for the Next Billion

The major building blocks for Apple's plan to find its next billion users are already in place. Apple will come up with [tools capable of making technology more personal](#). This pursuit will involve new user interfaces and inputs that allow people to get more out of technology without having technology take over people's lives.

Taking a look at the geographical makeup of Apple's current installed base, developed markets still contain plenty of new users for Apple to target. However, the potential found with emerging markets is a completely different story. Indonesia, Brazil, the Philippines, and Vietnam have a total population that is twice that of the U.S. Meanwhile, there are more people in China and India (2.6 billion) than the next 20 most populated countries combined.

It may be easy to think that Apple can just cut product pricing in order to grab its next billion users. However, the situation ends up being more complicated. Socio-economic trends will contribute to tens of millions of people moving into Apple's addressable market each year. In addition, relying on the gray market for allowing gently-used Apple products to flow to lower price segments is a more effective strategy for Apple. Not only does the gray market reduce the need for Apple to come up with low priced products lacking in features, but Apple can also benefit from continued product focus in terms of its supply chain and manufacturing apparatus.

As for some of the granular initiatives that stand to promote continued growth in Apple's installed base:

- **A truly independent Apple Watch.** Advancements such as [a truly independent Apple Watch](#) that doesn't require another Apple device to activate and use will expand the device's addressable market by nearly four times overnight.
- **Continuing to run forward with wearables.** New product categories that allow Apple to break down the barriers between users and technology will allow the company to target a wider audience. New form factors [such as glasses](#) will be designed to make technology even more personal than what is possible with Apple Watch and AirPods.
- **Longer device longevity.** By giving Apple devices longer lifespans via more durable hardware and additional years of software updates, devices will be able to have more owners over time. This will have a direct benefit on the gray market for Apple devices as more devices are recirculated and eventually able to reach customers in lower price segments.
- **Expanding device repair and support networks.** Apple's current retail store footprint is not capable of handling the additional product servicing and support associated with having another billion users in its ecosystem. This is especially true in developing markets. By building out [a device repair and support network](#) to include authorized third-parties, Apple will go a long way in ensuring the next billion users have access to many of the same experiences that are valued by Apple's current users.

The path to two billion users won't be easy for Apple. The trajectory may very well end up looking quite different than the path to a billion users. However, there is nothing found with Apple's long-standing mission to create products that can change people's lives that limits its reach to a billion people.

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