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# APPLE, DIDI, AND OCCAM'S RAZOR; UBER IN CHINA

*Monday, May 16, 2016*

Good morning,

It seems this is the most anticipated Daily Update in Stratechery's short history, so let's get to it: yes, **Amazon is selling diapers** again.

Oh, and Apple invested $1 billion dollars into Didi. On to the Update:

## APPLE, DIDI, AND OCCAM'S RAZOR

I am often asked why I don't write more about China; the reason, **as I've explained in the past**, is that the country, particularly anything having to do with the government — which by extension covers all big businesses, tech included — is basically unknowable to an outsider, and the more you learn about China, the more you realize this is the case. To that end, while I feel relatively confident about what I am going to write, given the Chinese angle I am unashamed to admit that I could be 100% wrong; frustratingly, we will probably never know for sure.

That said, it is very difficult for me to come to any conclusion other than my strong suspicion that Apple's decision to **invest $1 billion in Chinese ride-sharing startup Didi** wasn't really a decision at all: the company likely felt it had no choice, and the only question in my mind was whether said choice was one the iPhone maker came to on their own (to curry favor), or if it was dictated to them (invest or else).

Again, there is no way to know for sure, and I will touch on some alternate explanation at the end of this update, but first I want to walk through a lot of context that explains why I came to that conclusion; many of these points have been covered on Stratechery over the last three years, which hopefully adds credence to my conclusion.

**Apple's China Advantage:**

Apple has **long been uniquely positioned** to succeed in China, at least relative to other Western tech companies: software companies like Microsoft suffer from widespread piracy, service companies like Google or Facebook are blocked by the Great Firewall, and traditional hardware companies like Dell or IBM (before their sell-off to Lenovo) are ripped off and commoditized by competitors with impossible-to-compete-with cost structures. Apple, though, with its model of status-delivering hardware differentiated by software locked to its devices, has been uniquely successful in the world's most populous country.

For many years Apple's model freed them from the usual hoops that most Western tech companies have had to jump through to get a piece of the irresistible Chinese market. For example:

- Microsoft spends $500 million a year in China, mostly at its **Beijing R&D center** (its largest outside of Redmond), and has promised to up that total after a recent antitrust investigation
- Cisco pledged to **invest $10 billion in China** last year after being increasingly frozen out from Chinese purchases after the Edward Snowden revelations
- Qualcomm, after **settling an antitrust case**, formed **a $280 million joint venture** with a provincial government that included technology transfer
- Intel has promised **up to $5.5 billion** to transform a chip plant that it originally said would be two generations behind to become cutting edge; a few months later the company **formed a joint venture** with two local firms in direct response to Chinese concern about reliance on foreign companies in the chip industry. That follows a previous $1.5 billion investment in two other chipmakers partially owned by the Chinese government
- Dell **adopted a new strategy last fall** predicated on partnering in China to the tune of $125 billion over five years, forming a joint venture with the Chinese Academy of Sciences, and deep partnerships with Kingsoft Corporation for work in the cloud "fully supporting and embracing the China 'Internet+' national strategy."

The Internet+ strategy is a plan to integrate the Internet with traditional industries, but its introduction has gone hand-in-hand with an increasingly strong preference for Chinese technology from Chinese firms. Thus the partnerships, joint ventures, and investment. And yet, until now, the most successful American tech company in China has operated mostly without interference.

### Apple's China Growth

It was only three years ago, in January 2013, that **Tim Cook told Xinhua News Agency** that "I believe China will become our [biggest market]." A couple of weeks later, while announcing its FY2013 Q1 results, Apple began breaking out Greater China as its own segment, **revealing** that the region was already responsible for 12.5% of Apple's revenue, good for 3rd place behind the Americas 37% and Europe's 23%.

**Fast forward to last quarter**, and Greater China was solidly in second place, accounting for 25% of Apple's revenue; the Americas were at 38%, and Europe was 23%. Go back to the first quarter (to allow for better comparisons), and Apple's revenue over the last three years was up 39%; Greater China, though, was up 169%, having accounted for 54% of Apple's revenue growth over those three years.

Still, Apple's success in China raised its risks as well. I **wrote in August 2014**:

> Apple is more exposed to China than any other U.S. tech company, mainly because they are the U.S. tech company with the most to lose. I've written in this Daily Update several times that Apple is uniquely suited to succeed in China…The result is that Apple is on pace to make more money from China than anywhere else in the world, and that to truly understand Apple's increased focus on fashion and branding has to start with understanding their positioning in the China market.
>
> However, while this is all good news for Apple and its shareholders, it does mean that were the Chinese government to take meaningful action against Apple it would be much more damaging than whatever punishment the government exerts against Microsoft, for example. As I noted, I think Apple's position in the Chinese consumer market makes this much less likely, but it's certainly something to keep an eye on.

Then, just a month later, that risk became very real when **the iPhone 6 was delayed in China** for mysterious reasons that were never entirely explained. Would the iPhone 6, with the big screen Chinese customers demanded, actually be blocked? Obviously the answer was no: the **delay was resolved** a month later, but still, one couldn't help but speculate that the government was flexing its muscles in Apple's direction. The problem is Apple was out of reach: Chinese consumers really wanted the iPhone, and Apple's unblockable and unpirateable hardware model showed its strength once again.

Given this amazing success, it was no surprise that last October, on the **FY2015 Q4 earnings call** (after insisting Apple was not affected by China macro-economic environment, another area where Cook would **reverse himself** on the next two calls), Cook effectively doubled-down on his comments to Xinhua news three years prior:

> We're very bullish on [China], and I would point out that we're investing in China not for next or the quarter after, or the quarter after, we're investing for the decades ahead and as we look at it our own views is that China will be Apple's top market in the world. And that's not just for sales, that's also developer community is growing faster than any other country in the world. And so, the ecosystem there is very, very strong.

Indeed, the App Store in China is massive: it already has more downloads than any other country, including the U.S., and is second in revenue at **an estimated** $3.4 billion in 2015; that number is expected to hit $4.6 billion this year, surpassing the United States, making China the most important market when it comes to **Apple's services-as-growth opportunity** narrative.

### Occam's Razor

Just last month, though, sometime during the week of April 10, something very interesting happened: China blocked the iBooks and iTunes Movie stores. While neither was much of a money-maker for Apple, they revealed that China had a point of leverage against Apple they did not have previously: services that could be blocked.

Coincidentally, just a few days later, Didi President Jean Liu "stopped by" in Cupertino to see Tim Cook; **according to Bloomberg** that April 20 meeting resulted in this $1 billion investment just 22 days later — and four days before Tim Cook arrived in Beijing to meet with government officials.

Obviously, I'm not convinced this was a coincidence: I think there are very decent odds that Apple has realized the importance of improving its standing in China, and the Didi investment is a particularly good vehicle for doing so: Apple has a ton of money sitting offshore, the company may very well earn a return (although you can be sure Didi will be back to ask for more), and maybe there will be some sort of learnings to leverage when it comes to the Apple Car.

However, none of these benefits stand up on their own (except maybe the one about all the extra cash lying around). Apple has never done strategic investments, particularly at this dollar amount, which doesn't even give the company an iota of control. To that end, it is very difficult to envision Apple getting actionable data for Project Titan, and wild-eyed speculation that this is the start of an Apple Car Service belies a big misunderstanding of the sort of vehicles that would undergird any car service (and the attendant margins therein). As for owning the car service itself, again, Apple is *investing*, not *buying* Didi. There's a big difference (and it works to Apple's advantage: they have no obligation to share intellectual property).

Ultimately, that Apple is investing in Didi to demonstrate its commitment to China and to curry favor with the government (itself an investor in Didi) is by far the **Occam's Razor** explanation. Nothing else makes sense relatively speaking. The main two questions I have are:

1. Has Apple been contemplating this move for a while, or did the blocking of the iBooks and iTunes Movie Stores jar them out of complacency?
2. Was this Apple's idea or one that was "strongly suggested" to them by the Chinese government? To that end, and related to question one, was the blocking of iBooks and the iTunes Movie Stores a warning shot?

Apple investors should certainly hope that this was Apple's idea: it's worrisome enough that China is transforming from pure upside to something with a lot higher variance; if Apple didn't see that transformation coming then the downside may arrive a lot quicker than anyone, including myself, may have predicted.

## UBER IN CHINA

Just a few quick words on Uber in China: while the **company has impressed me with their execution in China**, I've long been very skeptical of their prospects. I've simply seen no way that the government tolerates foreign ownership of something as foundational as transportation infrastructure.

I suspect this deal is the beginning of the end: Didi was already winning (albeit with a worse experience), and the company now has another $3 billion (including Apple's $1 billion) to spend Uber into the ground. I wouldn't be surprised if the U.S. ride-sharing company withdraws sooner rather than later, and with a lower valuation to boot: the spin will be that Uber China was always a separate company, and frankly, Uber proper will be better off without the distraction.

But hey, it's China, so who really knows?

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