

## **Operator**

Good day ladies and gentlemen and welcome to this Apple Incorporated First Quarter Fiscal Year 2015 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**

Thank you. Good afternoon, and thanks to everyone for joining us. Speaking first today is Apple's CEO, Tim Cook; and he will 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 revenue, gross margins, operating expenses, other income and expense, taxes and future products.

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 2014 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. And I'd also just like to remind you that as we indicated in our last quarterly call, we're now including the results of our retail stores in the geographic segments where the stores are located and retail is no longer classified as an operating segment.

We've also updated our product summary reporting and we're now reflecting five categories of results; iPhone, iPad, Mac, Services and Other Products. We've prepared schedules showing reclassifications of historical operating segment and product results for each of the last 12 quarters to conform to these new groupings and they are available now on our Web site at [apple.com/investor](http://apple.com/investor).

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

## **Tim Cook**

Thanks, Nancy. Good afternoon, everyone and thank you for joining us. Today we're reporting on a historic quarter and I'm incredibly proud of everyone who contributed to the amazing results you're about to hear. Interest in Apple products is at an all time high, with over 0.5 billion customer visits to our physical and online stores during the quarter. Demand for iPhone has been staggering, shattering our high expectations with sales of over 74 million units, driven by the unprecedented popularity of iPhone 6

and iPhone 6 Plus. This volume is hard to comprehend. On average we sold over 34,000 iPhones every hour, 24 hours a day, everyday of the quarter.

The execution by all of our teams to achieve these results was spectacular. By the end of the quarter, our new iPhones were available in 130 countries around the world, making this our fastest and most successful roll out ever. Additionally, the App Store and the Mac each set new records for quarterly revenues. Mac units were up 14% to 5.5 million, while the rest of the PC market continued to decline. App Store revenues was up a remarkable 41%. Demand was strong around the world. Flurry estimated that Apple products accounted for over half of all mobile device activations globally from December 19th to December 25th.

It was truly a momentous quarter for iOS. On November 22nd we shipped our 1 billionth iOS device. It was a Space Gray 64 gigabyte iPhone 6 Plus, which we've saved here at Apple. 1 billion devices is an almost unfathomable milestone, and we are all incredibly proud to be a part of it. Apple's mission is to make the greatest products on earth and enrich the lives of others. Through the success of iOS we have provided hundreds and millions of people with powerful personal technology that is simple and fun to use. Our customers are using Apple products to transform education, discover new ideas for business and express their creativity in ways that no one could have imagined when we sold the first iPhone less than eight years ago. It's amazing to watch and it reminds that people and great ideas are the reasons we make the things we make.

Our strong overall performance in the December quarter resulted in total company revenue of \$74.6 billion, and earnings of \$18 billion. Both of these numbers are all-time records for us, with revenues up 30% and earnings up 38% over last year. And due to our very large capital return activities, earnings per share were up even more at 48% to \$3.06, also an all-time quarterly record. Our results would have been even stronger, absent fierce foreign exchange volatility.

We've also made great progress on a number of very exciting new initiatives to further strengthen our ecosystem. We've been blown away by the reaction to Swift, our new programming language. Inventing a new programming language is something very few companies can do, and we believe it will have a profound effect on our ecosystem. Swift became available in September as part of the Xcode tools and in the first month those tools were downloaded over 11 million times. A recent report from Redmonk showed that Swift has had unprecedented growth and is quickly climbing the list of the most popular programming languages.

We've seen many of our developers choosing Swift as they build significant new projects, and we are seeing fantastic work with Swift going on in education. Very recently, Stanford University released their Developing iOS 8 Apps with Swift course, which was posted to iTunes University making this amazing resource available to everyone in the world.

There has also been incredible interest in HealthKit with over 600 developers now integrating it into their apps. Consumers can now choose to securely share their health and wellness metrics with these apps and this has led to some great, new and innovative experiences in fitness and wellness, food and nutrition and healthcare.

For example, with apps such as an American Well, users can securely share data such as blood pressure, weight or activity directly with physicians, and leading hospitals such as Duke Medicine, Stanford Children and Penn Medicine are integrating data from HealthKit into their electronic medical record so that physicians can reach out to patients proactively when they see a problem that needs attention.

With HealthKit and the iOS health app, we believe we're just at the beginning of amazing new health and wellness solutions for our customers. Our extensions of iOS in the home with HomeKit and in the car with CarPlay also continue to progress and this year we are looking forward to amazing HomeKit enabled products from several companies, and CarPlay enabled vehicles from over 30 automotive brands.

Also as you know, we introduced two new categories in the fall and we're making great progress on both of them. Apple Pay is off to a very strong start and the feedback that we are getting from both individuals and institutions is extremely positive. Today about 750 banks and credit unions have signed on to bring Apple Pay to their customers, and in just three months after launch, Apple Pay makes up more than \$2 out of \$3 spent on purchases using contactless payment across the three major U.S. card networks.

In merchants who already accept Apple Pay, the rates are even higher. Panera Bread tells us Apple Pay represents nearly 80% of their mobile payment transactions, and since the launch of Apple Pay, Whole Foods Market had seen mobile payments increased by more than 400%. You can use Apple Pay up and down Mainstreet, to pick up a prescription at Walgreens at Duane Reade, get office or school supplies at Office Depot and Staples and shop for groceries at national and regional stores from coast-to-coast, including BI-LO, Harvey's, Save Mart, Wegmans Food Markets, Whole Foods and Winn-Dixie among others.

More merchants are excited to bring Apple Pay to their customers and adoption is strong. Just today USA Technologies announced they made Apple Pay available at about 200,000 places where everyday payments happen, including vending machines and businesses, airports and schools, commercial laundry machines and colleges, universities and laundromats and parking meters and payment kiosks in lots across the country. Point-of-sale suppliers tell us they are seeing unprecedented demand from merchants, and all of our partners and customers simply love this new service. With all of this momentum in the early days, we are more convinced than ever that 2015 will be the year of Apple Pay.

Development for Apple Watch is right on schedule and we expect to begin shipping in April. Developers are hard at work on apps, notifications and information summaries that we call Glances, all designed specifically for the Watch's user interface. The creativity and software innovation going on around Apple Watch is incredibly exciting and we can't wait for our customers to experience them when Apple Watch becomes available.

We're also making great progress in our partnership with IBM and our collaboration is winning over new customers. In December, we delivered the first 10 MobileFirst for iOS apps for banking, retail, insurance, financial services, telecommunications, governments and airlines, making iPhone and iPad even more productive for enterprises by providing [Apple] [ph] Cloud services with IBM's Big Data and analytics capabilities. Another 12 apps will be released this quarter, including three new industries, healthcare, energy and utilities, and industrial products. This will bring us to a total of 22 apps and we're on track to have over 100 by the end of 2015.

In just over a month, more than a dozen enterprise customers have signed on as foundation clients to transform their companies with iPhone, iPad and IBM MobileFirst solutions including Miami Dade County, the seventh largest county in the United States by population, and American Eagle Outfitters, which operates more than 1,000 retail stores and ships to over 80 countries worldwide. And the list of new customers is expanding rapidly. IBM is engaged with more than 130 additional companies looking to empower their employees with MobileFirst for iOS solutions and the list keeps growing. We couldn't be more pleased with this partnership.

In addition to all these initiatives, we have a robust product and services pipeline that we are very excited about, and we look forward to sharing more about them with you throughout the year. In addition to the contributions we make to humanity through our products, we made great progress on imported projects during the quarter including ConnectED and (PRODUCT)RED. With ConnectED we're focused on making a difference for students in communities who need it the most. We recently chose 114

schools across 29 states to receive an Apple ConnectED grant. Despite their economic challenges, all of these schools share a vision of what their students' lives would be like with Apple technology and we're proud to help them bring that to life.

And in December, we undertook our largest ever initiative to help (PRODUCT)RED achieve the goal of an AIDS free generation. To commemorate World AIDS Day, we worked with some of our developer partners to create and donate the proceeds from 25 special apps and we also contributed a portion of sales at our retail and online stores on two of the year's busiest shopping days. As a result, Apple's donation set a new record.

Delivering the results we're reporting today reflects months and years of focus and determination from teams across Apple as well as our amazing developers and business partners. I'd like to thank all of them for their commitment and performance and I'd also like to thank our incredible customers for their ongoing loyalty and enthusiasm.

With that, I'd like to turn the call over to Luca to discuss our December quarter results in more detail.

### **Luca Maestri**

Thank you, Tim and good afternoon everyone. In the December quarter we generated all time record revenue of \$74.6 billion, an increase of \$17 billion, or 30% year-over-year. We achieved this exceptional performance despite significant foreign exchange headwinds from many currencies.

Our growth was broad based across the world, with revenue from developed countries up 20% and revenue from emerging countries up 58%. The performance of our Greater China segment was particularly impressive, with revenue up 70%. Sales were well ahead of our expectations in a number of areas. The unprecedented demand for iPhone 6 and 6 Plus combined with our tremendously successful production ramp allowed us to build and ship several million more iPhones than we had expected when we provided guidance back in October. And also Mac revenue and services revenue reached all-time highs.

Gross margin was 39.9% above our guidance range and operating margin was \$24.2 billion, representing 32.5% of revenue, and our highest operating margin percentage in 10 quarters. Net income was \$18 billion, surpassing our previous all-time record by almost \$5 billion. This translated to diluted earnings per share of \$3.06, a 48% year-over-year increase. Cash flow from operations was exceptional at \$33.7 billion, also a new all-time record.

For details by product I will start with iPhone. We sold 74.5 million iPhones, an increase of 23.4 million over last year, representing 46% growth. iPhone sales grew strongly in both developed and emerging markets. Among many great results around the world, unit sales were up 44% in the U.S. and up 97% in the BRIC countries.

Sales doubled year-over-year in China, our second largest iPhone market, as well as in Brazil and in Singapore. Thanks to the popularity of iPhone 6 Plus, and the increased value customers saw in our higher storage capacity offerings, iPhone ASPs were \$687, an increase of \$50 over the year ago quarter. This led to iPhone revenue growth of 57% year-over-year, with quarterly sales exceeding \$50 billion for the first time ever.

We had a 200,000 unit decline in iPhone channel inventory during December quarter this year, compared to an increase of about 1 million iPhones during the year ago period, and we were not able to reach supply demand balance until this month. This left us below our target range of five to seven weeks of channel inventory on a look forward basis. We're now working with about 375 carriers, representing 72% of the world's mobile phone subscriber base, and we have over 210,000 points of sale for iPhone across the globe.

Our customers love their iPhones. A December ChangeWave survey measured a 97% customer satisfaction rating for iPhone. A study published by Chitika Insights last month indicated that iPhone accounts for 53% of North America smartphone web traffic, almost twice the level of the next closest brand. And in the corporate market ChangeWave found that among IT buyers planning to purchase smartphones in the March quarter this year, 77% intend to purchase iPhones.

Next I'd like to talk about the Mac. We sold 5.5 million Macs, an increase of almost 700,000 units over last year, a 14% growth rate. Thanks for the popularity of our stunning new iMac with Retina 5K display, Mac ASPs increased by \$58 sequentially, driving all time record revenue for Mac of 6.9 billion. We achieved double-digit year-over-year unit growth in both desktops and portables. These results are truly remarkable, given the contraction in the global PC market which IDC estimates declined by 3% in the quarter. We have now gained market share for 34 of the last 35 quarters. We ended the quarter with Mac channel inventory slightly below our four to five week target range.

Turning to iPad, we sold 21.4 million units compared to 26 million in the December quarter last year. Given the introduction of new iPads in October, we increased iPad channel inventory by 1.1 million units during the quarter, compared to an increase of about 2.1 million in the December quarter last

year. This left us within our five to seven week target range of channel inventory on a look forward basis.

Customer experience and usage data for iPad continue to be excellent. In our November survey, ChangeWave measured a 98% customer satisfaction rate for iPad Air, and also found that among people to finding a purchase a tabled within 90 days, 60% plan to purchase an iPad. And among businesses planning to purchase tablets, the intent was even stronger at 78%.

Chitika Insights' most recent report indicated that iPad users in North America generate over 70% of tablet based web traffic, more than six times the web traffic of the next closest competitor and Custora's latest e-commerce report indicates that iPad accounts for 82% of all U.S. e-commerce transactions from tablets.

All these results are consistent with usage data from the holiday shopping season. IBM's digital analytics benchmark service found that iOS devices accounted for more than twice the online traffic and almost four times the e-commerce sales on Android devices during November and December. The Apple ecosystem continues to thrive. Combining all of our services, revenue grew to 4.8 billion in the December quarter, a new all-time high and an increase of 9% year-over-year.

This record performance was driven primarily by the tremendous momentum of the App Store, with revenue growing 41% in the December quarter. Our iOS developers have earned over \$25 billion from the App Store to date, and we're thrilled with their success. Total sales of media and software from iTunes were \$2.6 billion, compared to \$2.4 billion in the year ago quarter.

Our direct China performance was also outstanding. We welcomed more visitors than ever before and generated record revenue in both our physical and online stores. We opened 10 new retail stores during the quarter, bringing us to a total of 447, 182 of which are outside the United States. We've opened two new stores this month in Greater China and we're on track towards 40 stores in Greater China by mid-2016.

Let me now turn to our cash position. We ended the quarter with \$178 billion in cash plus marketable securities, a sequential increase of \$22.7 billion. We completed our first international debt offering, issuing 2.8 billion euro denominated notes at very attractive interest rates and greatly diversifying our debt investor base. We spent 5 billion to repurchase 45 million Apple shares through open market transactions, paid 2.8 billion in dividends and equivalents, and utilized over 500 million to net share settle vesting employee RSUs. We also retired an additional 8 million shares in connection with our accelerated share repurchase programs.

We have now taken action on almost \$103 billion of our \$130 billion capital return program, including \$73 billion in share repurchases, with four quarters remaining to its completion. In the last 12 months alone, we have returned over \$57 billion to our investors. We review our capital return program on an ongoing basis. We continue to solicit feedback from a broad base of investors and we're on track to announce an update to the program in April when we report our second quarter results.

Now 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 \$52 billion and \$55 billion, compared to \$45.6 billion in the year ago quarter, and this represents a very significant revenue increase, despite growing foreign exchange headwinds from the continued strengthening of the U.S. dollar against most currencies.

We expect gross margin to be between 38.5% and 39.5%, we expect OpEx to be between \$5.4 billion and \$5.5 billion and we expect OI&E to be about \$350 million and we expect the tax rate to be about 26.3%. Also today our Board has declared dividend of \$0.47 per common share payable on February 12, 2015 to shareholders of record as of February 9, 2015.

With that let's open the call to questions.

### **Nancy Paxton**

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

### **Question-and-Answer Session**

#### **Operator**

[Operator Instructions] First we'll hear from Shannon Cross with Cross Research.

#### **Shannon Cross**

Thank you very much and nice iPhone numbers. Can you talk about Luca about currency? How you are thinking about it? What it did this quarter? What it does to gross margin? And what's it's going to do during the year? Because that's clearly a big topic of conversation?

#### **Luca Maestri**

Yes, Shannon I'll do that now. I'll talk about Q1. I'll talk about what we are looking for Q2 and possibly even further. Obviously, what we've seen during



Q1 has been unprecedented movements in currencies. I would say during the course of the quarter the biggest impact came from the Japanese yen, the Russian rubel, but also from euro, Australian dollar, Canadian dollar. Our revenue growth during Q1 would have been four percentage points higher on a constant currency basis.

On a profitability standpoint, our hedging program partially mitigated the impact from the volatility in currencies. As we look forward, and we look into particularly the March quarter, the foreign exchange headwinds will be stronger in Q2 than they were in Q1 for two main reasons. The first one is the fact that the U.S. dollar has continued to appreciate against foreign currencies during the last few weeks. And the other one is the fact that our existing hedges expire. They get replace by new contracts at current levels and therefore the protection that is provided to us by our hedging program diminishes over time.

What that means to us going forward for the March quarter is that revenue growth on a year-over-year basis in constant currency would be five point higher than what we are guiding to, if it wasn't for the FX movements. In terms of gross margins, and you know that we look our gross margins on a sequential basis, the gross margin percentage after the offset that we're getting from the hedging program will be impacted by over 100 basis points.

Now having said that, we have factored the impact that I just described into the guidance that we provided to you. So that's where we are right now. Of course, as you look further out, you know we do not provide guidance past the March quarter, but it goes without saying that at current levels, again those headwinds will continue to become stronger for the reason I explained earlier, that our hedges continue to expire, they get replaced by new hedging contracts at current levels and so -- and there is the impact that we would see during the course of the year.

It goes without saying strong U.S. dollar has negative impact on our international business. Having said all that, we have provided what we believe is very strong guidance for the March quarter. We remain very, very confident about the portfolio of products and services that we have in the market today and we remain very, very confident in the pipeline of products and services that we have.

### **Shannon Cross**

And as a follow-up to that, can you talk a little bit about pricing power? Basically as you think about currency and euro movements and that -- and then the contracts you have with the carriers, can you talk about maybe the

opportunities to raise prices, because I know it's something that a lot of companies are balancing right now?

**Luca Maestri**

I think as you know, we prefer to adjust local pricing at the time of new product launches. That will be obviously our preference. That's what we do in normal times. When currencies move as much as they have been in places like Russia for example, sometimes we need to take mid-cycle action to realign pricing. So we'll see what happens. As you know currency markets tend to be very volatile. So we just want to understand a bit better what is happening.

**Operator**

From UBS we'll hear from Steve Milunovich.

**Steve Milunovich**

I wonder if you could address the mix of the iPhone 6 line. Specifically, how did the 6 Plus do? I don't know if you can give us a sense relative to total units, maybe geographic view, and also availability? Are you calling up on the 6 Plus?

**Tim Cook**

Steve, its Tim. We don't report out the precise mix. But what I can tell you is that iPhone 6 was the most popular iPhone last quarter, but I just believe to sell 74.5 million they were really all popular. And all did well. There is clearly a geographic difference where some geos would skew much higher on their preference to iPhone 6 Plus than other geos. And so it's something that is not consistent around the world. But both did incredibly well, and we're really proud of them, along with the iPhone 5S and 5C as well, which continues to in the lineup.

**Steve Milunovich**

Okay. And then could you update us in terms of the sell through relative to the reported numbers for the Phone, the Pad and your biggest plans to increase by roughly a week of channel inventory?

**Tim Cook**

From an iPhone point of view, as I think Luca covered, our channel inventory decreased from the beginning of the quarter by 200,000 units, and that left us outside of our target range on the low -- outside the low end of the range to be specific. Just recently we became in supply demand balance on the 6

and 6 Plus in January. We were not able to reach a balanced state during our fiscal Q1.

On iPad, we increased channel inventory by 1.1 million units from beginning of the quarter to end of the quarter. That compares to the previous year where we're increased to 2.1 million. Obviously, that inventory was required because of all the new products that we announced on iPad with the iPad Air 2 and the iPad Mini 3 in the October timeframe during the quarter.

At the end of the quarter, we were within the target range of channel inventory on iPad. In terms of growing channel inventory, in particular on iPhone where we're outside of it, we wouldn't expect to see a large step function increase. We would expect it to occur more gradually over time than sort of all at once type of thing. But we don't guide to channel inventory specifically as you know.

**Nancy Paxton**

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

**Operator**

From Morgan Stanley we'll go to Katy Huberty.

**Katy Huberty**

So not to dilute the fantastic performance in December, but can you talk a little bit about how you think about the sustainability of this very strong iPhone demand into 2015, particularly given that most carriers had access to that product during the quarter? And then I have a follow up on margin?

**Tim Cook**

Sure Katy. It's Tim. You can see from the March guidance that we've given, that we are incredibly bullish about iPhone going forward. We believe that it's the best smartphone in the world. Our customers are telling us that. The market is telling us that. We're doing well in virtually every corner of the world. And so we're very bullish that it does have legs. I would point out that only a small fraction of the installed base has upgraded. And so there is a lot more people within the installed base. But I would also point out that we had the highest number of customers new to iPhone last quarter than in any prior launch. And also that the current iPhone line up experienced the highest Android switcher rate in any of the last three launches in the three previous years. And we didn't look back to the other years. So I don't know about those.

And so we see that we're appealing to new customers, both new to smartphone and new to iPhone and people switching. We're very bullish on the product and getting great feedback about the quality of the products we're shipping. And so we're very, very bullish. The emerging markets which has been a source to great questions over time, the growth was absolutely stunning, in Brazil and Mainland China more than doubling year-over-year which is 3x to 4x what those markets were doing according to IDC. And so we enter the quarter with quite a bit of momentum.

**Katy Huberty**

And Luca as you know, you typically enjoy component cost downs and yield improvements as you move through a product cycle. Is there anything other than currency that keeps you from potentially locking the gross margins higher over the course of the year? Thank you.

**Luca Maestri**

Katy, you're right. I mean on both fronts. We certainly expect more favorable cost in the March quarter than we've seen in the December quarter. It goes with our product cycle. The foreign exchange headwinds as I was explaining to Shannon, they will be on a sequential basis a headwind of more than 100 basis points. So if you were to exclude that foreign exchange impact, we would actually be guiding to sequential increase in margins.

The other element that is there and it's very seasonal, it's always there, it's the loss of leverage that we got from Q1 to Q2. When you look at our revenue guidance, we are guiding to a sequential decline between 26% and 30%. So you obviously have that loss of leverage, but without a doubt the biggest headwind that we got right now is foreign exchange. Having said all that guiding 38.5% to 39.5%, we feel slightly very good about where we are right now in the cycle.

**Nancy Paxton**

Katie could we have the next question please?

**Operator**

We'll go to Benjamin Reitzes, Barclays.

**Benjamin Reitzes**

And Tim obviously a lot of good questions about the great iPhone number but I wanted to ask about the Apple Watch. Shifting in April, month or two later than I think you said originally obviously, probably not that big a deal,

but what's going on with that product in a little more detail in terms of the timing and your excitement for it and maybe a little more color on other apps that could be available at launch? And any expectations you have for it would be great.

### **Tim Cook**

My expectations are very high on it. I'm using it every day and love it and I can't live without it. So I see that we're making great progress on the development of it. The number of developers that are writing apps more for it are impressive and we're seeing some incredible innovation coming out there. And just to clarify, what we had been saying was early 2015, and we sort of look at the year and think of early as the first four months, mid is the next four months and late is the final four months. And so to us it's sort of within the range and it's basically when we thought. We're going to -- but most importantly we're going to be thrilled to start shipping it, because we got a lot of customers that are wanting to get one.

### **Benjamin Reitzes**

And then just a follow-up in terms of China. How do you feel the momentum there is in terms of sustainability versus some of the local competition, and as you navigate that market specifically going forward?

### **Tim Cook**

The local competition was obviously there this quarter and has been there for many quarters before. And so the local competition is not new. I think we did really well there. I'm very proud of how we're doing. I was there right after the launch in October. And the excitement around the iPhone 6, iPhone 6 Plus were absolutely phenomenal. And you can see that in the results with Mainland China being up 100% year-on-year, despite not having a full quarter of sales since we launched in the second half of October.

You can tell by that we're a big believer in China. We're looking at our investment. We're growing the number of stores. We'll hit 20 soon and we're doubling that by mid-2016 as Angela has said earlier and Luca said in his prepared comments as well. We're also growing the channel there. Our online store has expanded to over 350 cities now, and in fact our online revenues in China last quarter were more than the sum of the previous five years. And so it's an incredible market. I think people love Apple products and we are going to do our best to serve the market.

### **Nancy Paxton**

Could we have the next question please?

## **Operator**

From Bernstein we'll hear from Toni Sacconaghi.

## **Toni Sacconaghi**

I was wondering if you could comment on your revenue guidance. Luca you mentioned the range as down 26% to 30% sequentially. I think if you look back over the last three or four Q1 to Q2s, revenues declined more in the 15% to 20% range. As you noted, your iPhone channel inventory is below your target range as well. So if anything, that might be going up. So I'm wondering if you could just discuss a little bit what factors are contributing to this steeper than normal decline this quarter, particularly given your ongoing enthusiasm for the phone.

## **Luca Maestri**

First of all, it's a 20% year-over-year growth that we're guiding at the top end of the range. So we obviously feel good about a 20% growth. As we look at it on a sequential basis, there's a couple of things that I think is important to point out. I mentioned the foreign exchange headwinds. They are there. We need to deal with them, but they obviously are a negative to revenue. Those are headwinds that we had this year and were not there a year ago. So that's one factor.

We've also said the manufacturing ramp that we've had this year in the December quarter has been the fastest that we've ever had. And so that's also a factor that impacts the sequential compare. And then there's a couple of specific events that happened last year in the March quarter which are not going to repeat this year. One of them is the fact that last year in January we launched China Mobile and we had the subsequent channel sale for China Mobile. That of course is not going to repeat this year. And we also had a very, very strong quarter in Japan in the March quarter a year ago, which was driven by very significant carrier promotional activities, and a pull forward of sales into the March quarter in anticipation of a consumption tax increase that took place on April 1, and again that is not going to repeat. So when you take those factors into account, I think that explains the sequential decline that we see this year. Again I want to point out to the 20% year-over-year growth.

## **Toni Sacconaghi**

Luca just to confirm, sequentially my math is saying it's about two point incremental revenue headwind. Is that the right way to think about it?

## **Luca Maestri**

From FX?

**Toni Sacconaghi**

Yes. Currency.

**Luca Maestri**

Right.

**Toni Sacconaghi**

Sequentially, okay. Tim, I was wondering if I could have my -- direct my follow-up to you, which is the iPad. You've spoken on prior calls about your enthusiasm for the product on a go forward basis. Over the last year it's down double-digits from a unit perspective and ASP has also been declining. So I was wondering if you could comment on whether your bullishness about the iPad persists and is it really -- do you believe it's a replacement cycle, that we will ultimately see that will start to drive growth or is there really innovation in product that is both necessary and forthcoming that's going to drive that growth?

**Tim Cook**

Toni, I am still very optimistic and bullish on iPad over the long run, as I've indicated before. When you measure it in these 90-day clips, as we do in the short run, I don't think you're going to see a miraculous change in the -- or an improvement in the year-over-year. But here is what I see when I look at it and the reason that I'm so optimistic. I see that the first time buyer rates are very high. And so by very high, I mean that if you look in some of the developed market like the U.S., Japan, the UK, you would find that 50% of the people are buying an iPad for the first time. If you look in China, it's over 70%. And so that -- when you have that kind of first time buyer rates, you don't have a saturated market.

When I look at the customer stat on iPad, it's literally off the charts, in some cases a 100%, which is unheard of in surveys to get these kind of customer stat ratings. When I look at the usage, the usage is six times our nearest competitor. The usage is defined as measured in web browsing is like 71% of total tablets, as I think Luca covered earlier. Also the commerce taking place across the iPad is enormous. Essentially over 80% of the commerce on tablets are taking place on iPad. And so when I back up and look at all of these, and I believe that over the long arc of time that the iPad is the great business, I also have visibility obviously of what's in the pipeline and feel very, very good about that. That said, I'm not projecting -- to be clear with

everyone, I'm not projecting something very different next quarter or the next. I'm thinking over the long run.

In terms of what I think is going on, I think what you said is absolutely true, that the upgrade cycle is longer. It's longer than an iPhone, probably between an iPhone and a PC. We haven't been in the business long enough to say that with certainty, but that's what we think. There is probably some level of cannibalization that's going on with the Mac on one side and the Phone on the other. And so you probably have a little bit of that that is shaking out. How much, very hard to tell on the early going, particularly since we just shipped the new phones a few months ago.

And so I think there's some things like that are going on. On the other side I think the partnership with IBM and the work that we have going on in the Enterprise is profound. I think we're really going to change the way people work. I'm really excited about the apps that are coming out and how fast the partnership is getting up and running.

And so I think that can move the dial there. And so I'm not predicting the 90-day clips and so forth, but over long arc of time I really believe that iPad is a great space, a great product and with -- also coupled with the product innovation we've got, I think there is a very, very bright future for it.

## **Operator**

We'll go to Gene Munster with Piper Jaffray.

## **Gene Munster**

A couple of questions for Tim. First, any updates on Apple TV or your broader biz in the living room? And second a high level question about Apple Pay and some of the successes at point-of-sales. Can you talk a little bit about if in app is important or how important that is? And potentially how the product could evolve over time? Could you see this becoming more consumer to consumer or more just kind of a broader payment platform? Thank you.

## **Tim Cook**

Gene, on Apple TV, we had a solid quarter with existing product. We've sold 25 million Apple TVs now which at the sake of repeating myself, it's something that we continue to look at and work on and find a way that we can make even greater contribution than what we're doing. On Apple Pay, both the contactless payment and the in app are both important. I think they are both huge opportunities. I think they'll play out differently in different geographic regions as to which one is larger than the other and well



likely -- the mix of those things will change over time as more and more commerce flows across apps and so forth.

In terms of how it evolves, I think we're in the first inning on it. I'm not -- we haven't even completed the first inning yet. There's tons of things on our roadmap of adding functionality to it. We're obviously -- we're just in the U.S. right now and so there's tons of countries to go to and there is not a day that goes by that I don't get notes from many businesses outside U.S. running Apple Pay and banks and merchants.

And of course we still have a lot of merchants left in the U.S. But I have to tell you that given that we've launched in October, I'm actually unbelievably shocked, positively shocked at how many merchants were able to implement Apple Pay in the heart of their holiday season, because generally most people sort of lock down and don't do very much. But we were able to get this in a lot of different merchants and I give them a lot of credit for that. But I think we're just on the front end. And I think that this is the year of Apple Pay. And some of the things you mentioned and others are all things that we're looking at and in many cases working on in terms of where it can take us.

## **Nancy Paxton**

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

## **Operator**

From JPMorgan we'll go to Rod Hall.

## **Rod Hall**

So I wanted to start off Tim. You talked about the smaller of the user base who have upgraded to iPhone 6 or 6 Plus. And I wonder if you could give us a little bit more color on that, maybe even go as far as quantifying how many of the base you think have upgraded and also talk a little bit about the pattern of upgrades? Are they all tending to be over iPhones or is there are good spread? Can you give us any further color on that? Thanks.

## **Tim Cook**

It's a small fraction. It's a number that's in the mid-teens or barely in the teens. And so when I look at that I say that there is an enormous amount left. And given there are fair amount of Android units out there, there is also an enormous amount of Android customers that could switch. And I'd also remind you that there is a lot of people that have not yet bought a smartphone. And I know it doesn't feel like that when you're sitting in the

United States, but from a worldwide point of view there's still lots of them. And so I see all three of those groups there and I'm very excited about all of them, and serving all of them.

**Rod Hall**

And then my follow up I'd like to direct at Luca. Luca, I wonder, could you talk a little bit about the duration of the hedge contracts and the renewal pattern that we should expect to see this year? Just kind of remind us what your typical renewal pattern is and will you be accelerating that this year given all the currency movement?

**Luca Maestri**

Yes Rod. Typically, I think, we have clearly active hedging programs of winning the market almost every day, but we tend to hedge three to 12 months out. There are cases where maybe we've had to go a bit longer, if we feel that we have a strong conviction about certain currencies. Otherwise again the typical period is three to 12 months. And as hedges roll off, we replace them with new hedges. We take into account the exposures that we have around the world, taking into account our most recent forecast and we hedge accordingly. We feel very good about our hedging position and the decisions that we've made particularly during the summer when we felt that maybe we needed to hedge a bit more than we have done historically.

**Tim Cook**

It's probably worth pointing out too that there is some markets where we can't economically hedge.

**Luca Maestri**

Yes. There are some exposures where the cost of hedging is prohibitive or the financial instruments are not there to hedge. And in those cases of course that's where you get the full impact of the volatility.

**Nancy Paxton**

Thanks Rod. Could we have the next question please?

**Operator**

From RBC Capital Markets we'll go to Amit Daryanani.

**Amit Daryanani**

I just have two questions. One maybe just on the gross margin side. I want to understand, the 100 basis points of headwind that you're talking about in the March quarter, is that sort of is -- there is some still protection on the hedges or is that a raw number with no hedges in place?

**Luca Maestri**

That's correct. I think its good clarification. I was talking about the net impact after the hedges. The impact without hedges would be higher. And again this is sequentially right. Because on a year-over-year basis actually the impact is larger, given the fact that currencies have moved during the last 12 months. But the 100 basis points that I quoted includes the mitigating impact of the hedging program.

**Amit Daryanani**

And just, when you think about the iPad and you talked about the IBM partnership where you're seeing some traction. Could you just talk about what sort of penetration do you guys think iPads have on an enterprise side right now and how do you see that improve over the next few quarters as you roll out the MobileFirst modules with IBM.

**Tim Cook**

We think that what we know, that if you look at the Fortune 500 as an example, we're in essentially all of the Fortune 500 companies. So the issue is not that, and it's not a market share number, because our market share is extremely high. The issue is that enterprises, generally speaking are only deploying iPads to a small percentage of their workforce. And so the real opportunity is to bring mobility into the enterprises and change how people work. In order to do that, you obviously need apps that are written to specific jobs, not just apps that are general productivity apps like work processors and spreadsheets and presentation tools et cetera.

And so that's one of the things that working with IBM provides us, is both that and the knowledge of the verticals, which they bring a significant amount of knowledge on all of the verticals that I mentioned earlier. And so where can we take that to? I think if we can really change the way people work, I think the opportunity is enormous. We're not hanging numbers out there to be measured on at this point, but we don't do a lot of big partnerships as you probably know. And so when we do one, it is significant and it's because we really believe in it, and we really believe in this one and what it can do for customers.

**Nancy Paxton**

Thank you Amit. Can we have the next question please?

**Operator**

From Deutsche Bank we'll hear from Sherri Scribner.

**Sherri Scribner**

Luca, I was hoping you can give us some detail on your expectations for operating expenses going forward. I know you've been investing pretty significantly in new products, but wanted to see how we should think about those trending over the next couple of quarters?

**Luca Maestri**

Sherry, as you know, we provide guidance just for the upcoming quarter. And from what you've seen from our guidance for the March quarter, we're guiding to a growth in OpEx on a year-over-year basis that is similar to what we've experienced during the course of the December quarter. We obviously feel good about the business during the December quarter. Our revenue exceeded in terms of growth, our growth in operating expenses. There's going to be quarters where the opposite is going to happen. Our expense to revenue ratio during the December quarter was that 7.4%. It was the lowest that we've had in two years. It's among the lowest ratios that we've ever had. But obviously we are investing in the business and we will never under invest in the business.

The majority of the increase will continue to come from R&D, given the fact that we've expanded our product portfolio and we're making investments all the time ahead of the revenue that would be generated in the future. We also expect to continue to invest in marketing and advertising. We're expanding distribution all over the world. We've taken our brand to more places and we continue to open new retail stores around the world. And so the idea for us is to continue to invest in the business, making the right trade-offs and the results from the December quarter give us very good confidence for the future.

**Nancy Paxton**

Could we have the next question please?

**Operator**

We'll go to Bill Shope with Goldman Sachs.

**Bill Shope**

I wanted to follow up on your previous comments on the iPhone and the customer composition for the quarter. Considering the iPhone 6 Plus brought you into entirely new segment of smartphone market, can you give us a bit more color on that customer composition for this device? Specifically you mentioned the differences in geographic adoption, but how about on the Android switcher comments you made earlier, and first time adopters relative to the traditional iPhone 6 and your other iPhone models in the past. And I guess related to that, what do you think this tells you about your ASP and unit opportunity for growth in 2015?

**Tim Cook**

Bill, at this point, just shortly after the quarter, we don't have all of our research in from all of the people that bought last quarter. But in the aggregate, as I've mentioned before, we saw more new customers to iPhone than we had ever seen before. And we had a higher rate of Android switchers than we had in the three previous launches. And it's not that we had more in the fourth one, and I don't what those numbers are, and whether it's something we're looking at. And so between the switchers and the people that are just new to smartphones and selected an iPhone, and our upgrades, which we're very happy with, but represent a small fraction of our installed base, we feel really great about what's in front of us.

**Bill Shope**

Makes sense. And then a follow up on your Apple Pay commentary. When we look at the opportunity outside of the U.S. are there unique hurdles we should consider as we think about the timing of the rollouts in Europe and Asia, or is it really just about following partnerships together?

**Tim Cook**

Each has a different implementation. And so in some ways, like there is a different set of carriers in every country, there is a different set of banks. In a lot of the countries, some of the processes with the merchants are different. And so it's an area where there is quite a bit of difference country to country to country and so there's clearly heavy lifting involved to scale. However it's not something that scares us or that's preventing us from viewing it as a big opportunity.