

Operator

Please standby, we are about to begin. Good day, everyone, and welcome to this Apple Incorporated Fourth Quarter Fiscal Year 2013 Earnings Release Conference Call. Today's call is being recorded. At this time for opening remarks and introductions, I'd like to turn the call over to Nancy Paxton, Senior Director of Investor Relations. Please go ahead.

Nancy Paxton

Thank you. Good afternoon, and thanks to everyone for joining us. Speaking first today are Apple's CEO, Tim Cook; and CFO, Peter Oppenheimer and they will be joined by Vice President and Corporate Controller, Luca Maestri for Q&A session with 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, stock-based compensation 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 2012, the Form 10-Q for the first three quarters of 2013 and the Form 8-K filed with the SEC today along with the associated press release. Apple assumes no obligation to update any forward-looking statements or information, which speak as of their respective dates.

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

Tim Cook

Thanks, Nancy. Good afternoon, everyone and thank you very much for joining us. We are eager to share with you the results of the final quarter of Apple's fiscal 2013 with a strong finish to an amazing year and Peter will provide details about the September quarter shortly.

But first I'm happy to tell you that Apple's business is stronger than ever. We are in a unique position of having world class hardware, software and service skills under one roof, which enables us to provide an unparalleled user experience to 100s of millions of customers. And working with our vibrant developer community, we've built a large and thriving ecosystem.

We are winning with our products in all the ways that are most important to us, in customer satisfaction, in product usage and in customer loyalty. Our relentless focus on providing innovation that enhances our customer's lives

is evident in extraordinary list of products that we've launched in just the last couple of months.

From the colorful iPhone 5c and forward thinking iPhone 5s to the powerful new iMac, MacBook Pro and Mac Pro to the stunning iPad Mini with Retina display and the dramatically thinner, lighter and more powerful iPad Air.

Thanks to a deep collaboration between our design and engineering teams. We also launched iOS 7 with a stunning new redesign, powerful new features and a great new service called iTunes Radio. We introduced OS X Mavericks bringing new core technologies for breakthrough power efficiency and performance to our Mac and we introduced next generation iLife and iWork apps for iOS and OS X. And we're making all of this incredible software free because we want our customers to have access to the greatest new features. All of these are products that only Apple could have delivered and most companies would be proud to just have one of them.

Looking back, we're very pleased with Apple's many accomplishments during fiscal 2013. Our customers had an incredible response to our product line up, buying a 150 million iPhone, 71 million iPads and 16 million Macs across the fiscal year.

We expanded the breadth and depth of our ecosystem and we generated over \$16 billion revenue from iTunes software and services. We also welcomed almost 400 million visitors to our retail stores and opened or remodeled 49 new stores and for the second year in a row we produced over \$50 million in revenue per store.

We generated record total company revenue of \$171 billion, earnings of \$37 billion and operating cash flow of \$54 billion. We paid over \$8 billion in capital expenditures to both to our supply chain, expand our infrastructure and increased our retail footprint. We also completed 15 strategic acquisitions. That's an average of one acquisition every three to four weeks.

We more than doubled the size of our capital return program to a \$100 billion, including the largest share repurchase authorization in history and we become one of the largest dividend payers in the world.

In fact, we returned over \$36 billion to shareholders to dividend and share repurchases in the last five quarters alone. We remain firmly committed to our objective of delivering attractive returns to shareholders through both our business performance and a return of capital. We review our capital program regularly and our orders engaged in the discussion of capital allocation on an ongoing basis.

We have solicited feedback on our capital return program from shareholders in the past. We greatly appreciated their suggestions and we will actively seek their input again this year. As we've in the past, the Board and the Management team will consider a wide range of issues and be thoughtful and deliberate and we will announce any changes to our current program in the first part of the new calendar year.

We are off to a great start in fiscal year '14. We continue to be very confident in Apple's future and we see significant opportunities ahead of us and both current product categories and new ones. We are participating in large and growing markets. Today smartphone penetration of the global handset market is only a little over 50%.

The smartphone category is expected to grow significantly in the next few years from about 1 billion units per year this year to over 1.7 billion in 2017. And the tablet market is growing at an even faster way from about 225 billion units this year to over 400 million in 2017. We are continuing to invest in R&D and distribution, we're expanding our geographic coverage and we're building upon a phenomenal, but still very young retail store presence.

We are also proud to be a force for good in the world beyond our products, whether its improving working conditions of the environment, standing up for human rights, helping eliminate AIDS or reinventing education, Apple is making substantial contributions to society.

I would like to thank all of our customers and our long-term shareholders for their loyalty and I'd also like to thank Apple's many talented employees who have worked tirelessly to bring us this far and who are passionately focused on making great products that enrich people's lives.

I'd now turn the call over to Peter to discuss the details of the most recent quarter. Peter?

Peter Oppenheimer

Thank you, Tim.

We are pleased to report the results of the final quarter of Apple's fiscal year '13 with record four quarter iPhone sales, driving our highest September quarter revenue ever.

Revenue for the quarter was \$37.5 billion, up \$1.5 billion or 4% from the year-ago quarter, and slightly above the high end of the guidance range. Gross margin was 37% at the high end of our guidance range, and operating

margin was \$10 billion, representing 26.8% of revenue. Net income was \$7.5 billion translating to diluted earnings per share of \$8.26.

As for the details of the quarter, I would like to begin with iPhone. We sold 33.8 million iPhones compared to 26.9 million in the year-ago quarter, an increase of 6.9 million or 26% and a new September quarter record. iPhone sales were ahead of our expectations and grew stronger year-over-year in each of our geographic segments.

We were particularly pleased with growth in a number of developing markets with unit sales up sharply year-over-year in Latin America, the Middle East, Russia and India. We were also very happy to add NTT Docomo to our carrier line up in Japan, a country where demand to iPhone has been especially strong.

iPhone sales remain very robust in the U.S with comScore estimating that Apple was the leading smartphone manufacture with a 40.7% smartphone subscribership for the three months ending in August. And among North American customers polled by ChangeWave late last month, we plan to purchase the smartphone with a 90 days, 63% indicated they plan to purchase an iPhone.

We exited the quarter with about 14.3 million total iPhones in channel inventory, which represented a sequential increase of 3.3 million from the June quarter and placed us at the low end of our target range of 4 to 6 weeks of iPhone channel inventory on a look forward basis.

Customers are loving their iPhones. Based on the most recently published research, ChangeWave measured a 96% customer satisfaction rate among iPhone users and Kantar measured a 92% customer loyalty rate, significantly higher than the competition. And we believe that a great customer experience translates to much higher usage. In fact, Experian reported that iPhone users spend an average of 53% more time each day on their phone than android phone users.

iPhone continues to be a key productivity tool for organizations around the world aided by apps from the app store as well as those custom built for internal use. In fact, nearly 35,000 companies representing millions of employees worldwide are building custom apps that address specific workflow improvements with their iPhones and iPad users.

In the U.S., over 14,000 employees of Johnson Controls are using iPhones for work. The company has created in-house apps that have enhanced field technician service delivery and customer communications. In China, AVIC International, a unit of Aviation Industry Corporation of China has equipped 27,000 employees with iPhones to access internally developed apps for

office, administrative documentation, approval processes in key business intelligent systems.

Turning to iPad, we sold 14.1 million iPads during the quarter compared to 14 million in the year-ago quarter. iPad sales exceeded our expectations in the September quarter as we approach our new product introductions. We experienced robust year-over-year sales growth in Japan, Russia, the Middle East and we were pleased with strong back-to-school demand for iPad in the U.S. and Canada. iPad sell-through was roughly equal to sell-in, so we exited the quarter with about 4.1 million units of iPad channel inventory within our target range of four to six weeks on a look-back basis.

Interest in iPad remains incredibly strong. In an August survey by ChangeWave, consumers who intend to purchase tablets within 90 days, 55% indicated they find the purchase of iPads more than four times the rate of the next most popular alternative. And of those who already own iPads, the survey measured a 99% customer satisfaction rate. The momentum of iOS devices in enterprise also remains incredibly strong.

In its latest Mobility Index Report, Good Technology indicated that the iOS platform accounted for 95% of enterprise mobile app activations and 72% of all mobile device activations in the September quarter while iPad accounted for 90% of total tablet activations. Companies around the world are using iPads with custom apps to reinvent their legacy business processes; improving efficiencies across organizations and job sections.

For example, direct store delivery reps at Dr Pepper Snapple Group uses iPads to facilitate communications and streamline the product delivery process. East Japan Railway personnel use iPad Minis to stay informed about schedule changes and access conductor manual. And Swedish manufacturer SKS uses a custom iPad app to calculate the life of their ball bearing products saving 10 to 15 minutes per calculation for every engineer several times per day.

Schools around the world continue to adopt iPad to transform teaching and learning in the classroom. In the U.K. the number of iPads sold to K-12 schools has more than doubled year-over-year and in Latin America; over 70,000 iPads are being used by systemic learner students [ph] across 800 schools to improve their learning experience.

Here in the U.S., school districts continue to rollout large iPad initiatives to students. The Coachella Valley School District in California is currently distributing over 19,000 iPads to its entire student body. In South Carolina every one of the Horry County School District's 10,000 middle school students will receive an iPad this year. These broad deployments are in part

driven by the great educational content available on iPad and we're pleased to report that iBooks textbooks are now available across the U.S., U.K. and Australian national high school curricula.

Last week we were thrilled to introduce new iPads featuring the A7 chip with 64-bit desktop-class architecture, ultrafast wireless and expanded LTE connectivity. The new iPad Air features a beautiful retina display in an elegant unit body design that is 20% thinner and 28% lighter than the fourth generation iPad and the iPad Mini with retina display packs all the pixels of the iPad Air into its stunning 7.9 inch display and runs over 475,000 iPad apps available in the app store.

Turning to Mac, sales with 4.6 million Macs were above our expectations, which is a 7% decline from the year-ago quarter. IDC estimates that the global personal computer market contracted by 10% during the September quarter indicating that Macs continues to gain share just as they have with 29 of the last 30 quarters. We were especially pleased with strong year-over-year growth in sales of MacBook Air which we updated in June. In late September we updated iMac with fourth generation Intel quad-core processors, new graphics, next generation Wi-Fi and faster PCIe flash storage options.

Last week we launched new versions of MacBook Pro with retina display featuring fourth generation Intel core processors, faster graphics, long rate battery life and a more affordable price. Also last week we launched Mavericks, the 10th major release of OS X with more than 200 new features. Mavericks brings iBooks and Maps to the Mac, includes the new version Safari, enhances multi-display support, introduces Finder Tabs and Tags and delivers core technologies for breakthrough power efficiency and performance and is now free. We ended the quarter with Mac channel inventory that was just below our four to five week target range.

We continue to be very pleased with the growth of iTunes software and services in the strength of the Apple ecosystem. Our iTunes Stores generated record billings of \$4.4 billion in the September quarter thanks to continued strong growth in sales of apps. The quarter's iTunes billings translated quarterly iTunes revenue \$2.4 billion, up 15% from the year-ago quarter. The strong iTunes sales combined with other software and service revenue resulted in total quarterly revenue 4.3 billion from iTunes software and services, an increase of 22% year-over-year.

Cumulative app downloads have reached 60 billion and our app developers have now earned 13 billion from sales to the App Store, half of which they've earned in the last year. We had a tremendously successful launch of iOS 7 last month with hundreds of millions of downloads in the first few days

alone, making it the fastest software upgrade ever. Last week we reported nearly two-thirds of iOS devices were already running iOS 7; that's significantly higher than the percentage of users running the latest versions of other mobile operating systems. This rapid transition to the latest version of iOS not only means that more customers are having the most advanced experience possible but it also enables developers to offer their latest app innovations to hundreds of billions of users in a single software release.

iOS offers something now for everyone with its great new design and features such as control center, AirDrop and iTunes Radio. In fact the number of unique listeners who have tried iTunes Radio is now 20 million and growing. iOS 7 also includes significant features that make iPhones and iPads more secure in users to manage in corporate environments, offering new ways to configure and deploy devices at scale.

New device management capabilities include control sharing of documents and attachments, App Store license management, wireless managed app setup and streamline mobile device management and enrollment. In terms of security, iOS 7 offers enterprise single sign-on, default third party app data protection and per app VPNs automatically connect stored corporate apps to the network without the need for users to change complicated settings.

I'd now like to turn to the Apple retail stores. The revenue for the quarter was 4.5 billion, up 6% from the year-ago quarter. The stores produced very strong iPhone sales with unit growth of 36% per store per week compared to the September quarter last year. We completed the remodels of two stores and opened eight new stores during the quarter ending with a total of 416 stores including 162 outside the United States. We are projecting a total of approximately 30 new store openings in fiscal year '14, about two-thirds of which will be outside U.S.

We also plan to remodel about 20 stores over the course of fiscal year '14. With an average of 411 stores opened in the September quarter, average revenue per store was 10.9 million compared to 11.2 million in the year-ago quarter. Retail segment income was 709 million. We hosted 99 million visitors to stores during the quarter which translates to 18,500 visitors per store per week. Operating expenses were 3.8 billion and included 467 million in stock-based compensation expense. OI&E was 113 million and the tax rate for the quarter was 25.9%.

Turning to our cash, we ended the quarter with 146.8 billion in cash plus short term and long term marketable securities, a sequential increase of \$100 million from the June quarter. Our domestic cash was 35.5 billion at the end of the September quarter, a sequential decline of 5.2 billion largely

attributable to our share repurchase activity. \$111.3 billion or 76% of our total cash was offshore at the end of the September quarter, and cash flow from operations was \$9.9 billion.

We paid \$2.8 billion in dividends in the quarter and we executed an additional \$5 billion in repurchases up 10.4 million shares of Apple stock during the quarter. This brings us to a cumulative total of \$36 billion in payments for dividends and share repurchases over the last five quarters of which share buybacks were \$23 billion. This has resulted in cumulative retirement of almost 47 million shares and represents 5% of the total shares outstanding prior to the launch of our repurchase program. More than 44 million of these shares have been retired in the past two quarters alone.

Finally given that our capital return program must be funded from domestic cash, and as a result of our payments to date, the cash that we can net domestically and return to shareholders to stop accumulating. In fact we give return to shareholders who invested essentially all of the increase in available net cash generated since the beginning of our capital return program in 2012. Our Board of Directors has declared a dividend of \$3.05 for common share payable on November 14, 2013 to shareholders of record as in the close of this on November 11, 2013.

Now, as we move ahead into the December quarter, I would like to review our outlook which includes the types of forward-looking information that Nancy referred to in the beginning of the call. First, I was to explain a bit about revenue deferrals. We believe that our software and services play a tremendous role in delivering an overall experience that our customers have come to know and love. Over the last few years we have added significantly to the offering that we provide our customers a no incremental charge from operating system upgrade rights to non-software services such as Siri and iCloud.

So, iLife and iWork has become as essential for the user experience as mail, messages and calendar. So we're now making iPhoto, iMovie, Pages, Numbers and Keynotes available as free downloads to customers who purchase new iOS devices and we're also making Mavericks and future OS X upgrades as well as iLife and iWork free to our Mac customers. As a result of the traditional rights and features we are deferring a greater portion of the sale of each iOS device in Mac sold. We anticipate that the additional deferral per device sold coupled with our sequentially greater unit volume expectations in the December quarter will result in about a \$900 million sequential increase in the net amount of revenue deferred for software upgrade rights and non-software services.

In total we expect revenue to be between \$55 billion and \$58 billion compared to \$54.5 billion in the year ago quarter. We expect gross margins to be between 36.5% and 37.5% reflecting approximately a \$105 million related to stock-based compensation expense. We expect OpEx to be between \$4.4 billion and \$4.5 billion including about \$585 million related to stock-based compensation expense. We expect OI&E to be about \$200 million and we expect the tax rate to be about 26.25%.

In closing, we are very pleased with the results of the final quarter of our fiscal year '13. We enter fiscal year '14 with an incredible lineup of products including our amazing new iPhones and iPads. We remain committed to delivering great innovative products and services that delight our customers and enhance their lives, and we're very confident in our new product pipelines.

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

Nancy Paxton

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

Question-and-Answer Session

Operator

(Operator Instructions) First we'll go to Katy Huberty of Morgan Stanley.

Katy Huberty – Morgan Stanley & Co. LLC

Thanks. Peter, I'm a little surprised your December quarter gross margin guidance isn't even better given the increased total iPhone mix and also iPhone 5s within the iPhone line. I imagine there's a lot of offsetting factors given the products that were launched last week. So, I just wonder if you can walk through some of the gross margin headwinds that you see in the December quarter.

Peter Oppenheimer

Sure. We expect, as I said in my prepared remarks our gross margins to be between 36.5% and 37.5%. So, essentially inline with the September quarter we're pleased to be guiding gross margin about flat sequentially given all the new products that we have launched in the last few weeks. During the quarter we expect gross margin to benefit from the leverage on the substantial sequential increase in revenue. Offsetting these benefits we see a few factors including the higher deferred revenue relating to the

software that I talked about in my prepared remarks. And as I said we expect the sequential increase in our deferral which is not only revenue but affects margin as well to be \$900 million. Second, a richer mix of new iPad's with higher cost structures and lower pricing. Third, FX headwinds primarily from the Yen and fourth, the new lower priced MacBook Pro and iMac which have higher cost structures and credit structures. So those are four things that I would point out Katy.

Katy Huberty – Morgan Stanley & Co. LLC

Okay, very helpful. Tim, the press and even some of your competitors are quite complementary of the innovation in iPhone 5s. But it seems like investors are looking or glancing over the 64-bit ARM processor, the fingerprint sensor, the M7 processor and part of this is that they're not exactly sure what those technologies enable, i.e. why do you need a 64-bit ARM processor in a phone. So, just hoping you could enlighten us a little bit on that question.

Tim Cook

Well, I think everything that you mentioned Katy is the front end of a long road map and so we have the first 64-bit smartphone as you mentioned and this is our first use of the fingerprint sensor and if you've used it thus far you know that it's pretty profound to -- use it from a security point of view and use it also to purchase apps or music or movies et cetera. And so, both of these I think are the most important person here obviously is what our customers think and these new innovations on the 5s and the 5c combined led us to have our best iPhone launch ever with selling about nine million units through the weekend. So it was -- we're off to a great start.

Nancy Paxton

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

Operator

We'll go to Bill Shope with Goldman Sachs.

Bill Shope - Goldman Sachs

Okay, great, thanks. Looking at the iPhone business as well, for the 5c there was some anticipation that the price point would be lower and there was obviously some debate around that when you launched it. Now that you had the device out there for a while, a few weeks; what type of response are you seeing from the most cost sensitive regions and can you remind us of some

of the things you are doing to make the products increasingly affordable for the emerging regions in particular?

Tim Cook

Bill, its Tim. If you look at what we've done with our iPhone line, we're selling the iPhone 4s as our entry offer. We're selling the iPhone 5c as sort of a mid-tier offer and then of course the iPhone 5s. And our goal is to overall have growth worth for total iPhone, but also within that we want to have each of those categories grow as compared to the -- what we were doing previously. And so, if you take look at the total offers that we're making and low-end space and mid-tier and high-end, the sum of all the price points we offer there we'd like to grow in each one of those and we're really pleased that we did that, and so that's how we measure partly measure success, because the most important thing for us is to make a great product, but we do need growth and we're happy that we've seen that. I realize that some people were reading rumors about that the entry phone would be the 5c, but that was never our intent obviously. Our entry iPhone is the iPhone 4s and as you know from comments that I've made previously we were selling the iPhone 4 in very good volumes and as we began to experiment in different regions at somewhat lower price points we saw a fair amount of price elasticity and so we're hoping and thinking that, that will continue with the 4s.

Bill Shope - Goldman Sachs

Okay. And then related to that somewhat looking at the iPhone ASP's overall, last quarter you reminded us that the iPhone ASP and mix tends to be at its highest levels in the first few months of a product cycle and then tends to trend downward throughout the product cycle. Do you think we should assume similar patterns hold for this cycle or there is some unique factors we should consider particularly given the change in the product line?

Tim Cook

All things being equal what we would normally see on our products is that you have a large number of people that are early adopter related that come into the market right after we announced and buy our very best product. So other things being equal that's what we would expect to see.

Bill Shope - Goldman Sachs

Okay, great. Thank you.

Tim Cook

Yes.

Nancy Paxton

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

Operator

Next, we'll go to Tony Sacconaghi with Sanford Bernstein.

Antonio Sacconaghi - Sanford C. Bernstein

Yes. Thank you. Tim, you commented in your initial remarks about new product categories. I think this was also something you were explicit about in your April quarterly conference call where you said that consumers and investors should expect new products, including new product categories in the second half of this year and first half of 2014. So can you reiterate that we should have that expectation? And when you talk about new product categories, I presume that since you made the statement in April, there have been none? I just want to make sure I understand the semantics of what you referred to as a new category?

Tim Cook

Tony, I didn't say in April that you would see them in this year and the first half of next year just to be clear on that. But what I have said is – I have said that you would see some exciting new products from us in the fall of this year and across 2014. And I obviously stand by that and you've seen a lot of things over the last couple of months. In terms of new product categories, specifically if you look at the skills that Apple has from hardware, software and services and at incredible app ecosystems, these set of things are very, very unique. I think no one has a set of skills like us and we obviously believe that we can use our skills in building other great products that are in categories that represent areas where we do not participate today. So we're pretty confident about that.

Antonio Sacconaghi - Sanford C. Bernstein

Okay. As a follow-up I wanted to revisit the question your pricing strategy. Last quarter you spoke very buoyantly about elasticity that you experienced on the iPhone 4 and you had lowered the price in many emerging markets to about \$400. Yet when the new products came out, the 4s was actually at a notably higher price than the 4 had been the previous quarter. The 5c was obviously in line with what we had seen before with the 4s and 5s was in line with the 5. So if anything one of the common themes that came out on last earnings call was the desire to embrace the elasticity of the iPhone, but as

best I can tell price points across the board seem to be a little bit higher than they were three months ago despite the significant success you had there. So I'm wondering how we should think about what lessons you learned from the 4 pricing changes, why you didn't choose to keep the 4 given that it was an extraordinary strong seller as best we could tell last quarter and how you proceed – how you expect to try and continue to address the lower priced segments of the smartphone market?

Tim Cook

Tony, the 400 number just to clarify your number not mine, what we did with our lineup this time was the 4s is replacing the 4 and so if you look at the U.S. as an example, the 4s is now 3, the 4 previously was 3. When you translate that out of the U.S., it depends on the market as to what specifically is happening. As you know currency changes and the strength of the dollar doesn't play in our favor in some geos from that perspective. But generally we see the 4s as our entry iPhone offer that gives somebody the ability to access the entire ecosystem with a fantastic product. And we clearly understand that there is elasticity in that market and we'll move accordingly.

Nancy Paxton

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

Operator

We'll hear from Ben Reitzes with Barclays.

Ben Reitzes - Barclays Capital

Hi. Thanks a lot. First question is on China. Tim, congrats on being I think the only company in my sector that grew in China this quarter. I'd have to check that but got to be one of them. You returned to growth I believe at 6%, if my math is right. What happened and do you see that growth rate accelerating? We're hoping you have new partnerships there and how can you expand distribution?

Tim Cook

Yes. Ben we had a pretty good quarter in China. We obviously want to do better. But if you look at the quarter, we did grow by 6%. Underneath that, iPhone units were up 25% year-over-year despite significant constraints on iPhone 5s that affected the whole company [ph]. However, we were able to launch in our first round this time in China and that was a big change in the result of a close work relationship with the carriers in China and the

government. And so we feel really good about that. We are able to do that on the iPad as well as we announced last week. For the full year, the Greater China region generated over \$27 billion in sales for us, up 14% year-over-year. So we have a reasonable sized business there. In the year-ago quarter, iPad launched. It launched late in China and so that pressure, the 6% down some otherwise it would have been I think even a stronger quarter given the strength of iPhone. So we are continuing to invest in stores. We opened one additional store in Greater China in the last few weeks. We're investing in indirect distribution. Our point-of-sales are up by about 50% year-over-year on the iPhone and we're continuing to go out to more cities. Initially we were very focused on just the large cities and so we're working on both coverage on launching earlier and execution and continuing to build on our retail practice there.

Ben Reitzes - Barclays Capital

Okay. And I guess nothing to announce more but my second question is for Peter. There's some confusion around the revenue deferral and I was just hoping you could clarify it for gross margins. The \$900 million is about – I don't know I guess 160 basis points if I have that right on gross margins. How much of that should we say is pressuring gross margin down in your guidance? I mean do we take about – would your gross margin guidance had been about half the difference there higher if it weren't for this revenue deferral? And then when do we recoup that margin? How many quarters does it take to recoup and how will that flow back to the model? Thanks.

Peter Oppenheimer

Sure, Ben. We have been deferring revenues for the sale of each iOS device and Mac given that we have been providing updates to software. Given the announcements that we made last week and that I went through it in my prepared remarks, we have actually increased those deferrals. iPhone and iPad, we are differing between \$15 and \$25. That's up as much as \$5 per device and Mac has been some \$20 to \$40, so up an additional \$20. On a sequential basis, given the increased deferral rates that we have as a result of increase in the software that we are providing to customers for free coupled with our sequential unit increases, we will defer we think about \$900 million more in revenue in the December quarter than we deferred in the September quarter. So you can calculate the impact to gross margin on that. We will also and that goes straight through the margin, its revenue and a dollar-for-dollar reduction in gross margin. We will then record that revenue that we've deferred for iOS devices across a two year period of time ratably and for Mac over a four year period of time. So, Ben just to summarize, we happen to frame revenue on both iOS devices and Mac for a number of years given the software that we have been giving away for free.

We have increased those rates beginning in September for the iOS devices and in October for the Max, and it will come back into those products over two and four years as I said.

Ben Reitzes - Barclays Capital

Great, thanks. That's a pretty good guide for gross margin if you take that out -- if you're leaving that out. Thanks.

Peter Oppenheimer

Ben, I'd just add on to that, thank you for saying it and I agree; and I would also say that we're really happy to be guiding gross margin flat not only because of the deferral but in addition to all of the new products that we've introduced with higher cost structures and lower prices and we'll -- no hard and fast commitments, but we're going to work really hard to get down the cost curves as we have successfully in the past.

Ben Reitzes - Barclays Capital

Thanks a lot. I appreciate it.

Nancy Paxton

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

Operator

From Piper Jaffray, we'll go to Gene Munster.

Gene Munster - Piper Jaffray

Hey, good afternoon and just to make sure this is crystal clear here on the gross margin. It would have been about 38.5% would have been the mid point of the guide excluding the change to deferral, is that correct Peter?

Peter Oppenheimer

Probably in that range, Gene. I didn't do it precisely, but you can take the \$900 million that we're deferring across the revenue range as we did the math.

Gene Munster - Piper Jaffray

Okay, great. And then beyond the December quarter in terms of structural elements around the iPhone gross margin, a couple of years ago with the 4s we saw the launch and then we saw the margins ramp kind of nicely after the launch. I know you're not giving guidance beyond the December quarter,

but are there some structural things that have changed the profitability of the iPhone it would be good to know as we think about our models in 2014.

Peter Oppenheimer

I don't know if there's any structural difference's, but I'll make a couple of comments and I'm not giving guidance beyond the December quarter but just a couple of things to think about. We're benefiting this quarter as I talked about in answering Katy's question from the benefits of leverage given the very big sequential increase in revenue. Leverage cut both ways, so presumably that would go against us in the March quarter. However we would expect to defer less for the software deferrals in the March quarter as well. And as I noted at the end of Ben's question, we will endeavor to work very hard to get down cost curves as we have in the past, no change.

Gene Munster - Piper Jaffray

Okay. And then my follow-up question, in terms of the iPad and the Mini price change I guess just broader thinking around the iPad we've seen some fluctuations in the growth rate. How do you think about that segment in terms of growing at or above or below market growth rates around tablets? And separately is there any differences in terms of how often people are upgrading their iPad's versus the iPhone's, it feels like they're upgrading them every three years versus a little bit over every two years for the iPhone, is that accurate. So, the size of the opportunity and then maybe just any sort of nuances and the upgrade behaviors between the iPhone and the iPad.

Tim Cook

Gene, its Tim. We continue to view the tablet market as huge. We see it as a large opportunity for us. We are not solely focused on unit share as I've said many times, but we're focused on usage in customer's side, the loyalty and other things that are very important to us. We do believe that this has been or the announcement last week was our largest iPad announcement ever and we're confident we're going to grow year-over-year, and if you look back we had a very, very strong quarter a year ago. We get off to a great start this weekend with iPad Air. And then later in the months we'll begin shipping the new Mini. We do feel that we wanted to reduce the price of the iPad Mini and so we did that and now we're coming in at \$299 which is an incredible value to get access to the whole of the ecosystem and so forth. And iPad Air is just, it's absolutely incredible product, the best iPad we have ever done. And so, I think all of these are -- [ph] thus these products are going to do really well. I think it's going to be an iPad Christmas and -- but

we will see, we will report the numbers back to you in January how we did, but we are pretty confident.

Nancy Paxton

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

Operator

From Cross Research, we will go to Shannon Cross.

Shannon Cross - Cross Research

Thank you very much. Tim, can you talk a bit more about your decision to offer the Mac OS for free and provide iWork and iLife with new device purchases? How are you thinking about it vis-à-vis some of the competition?

Tim Cook

Our primary reason for doing it Shannon was that we wanted it to become a part of what it meant to own a Mac and what it meant to own an iOS device. We saw iWork had become the best selling productivity app on a mobile device. We wanted all of our customers to have access to our very latest software, so they would have access to our best features. And so we decided to make the bold move of making it free and I know some other folks charge a \$199 or so for each of these actually for the OS and the productivity apps. But we really wanted to make it a part of the experience and so we are making it free and we are going back all the way to Snow Leopard on the OS side and iWork is free for all new Macs and so I think it's a very strong offer, I think it's just another reason that everyone should buy Mac and we think it was great decision to do so, but most importantly we think it's great for customers.

Shannon Cross - Cross Research

Great. And then -- I just had a question on education which somewhat ties into this since iWork and iLife I think are some of these operating systems run through that, I'm curious with the -- what your thoughts are with regard to Chromebook Google apps, any kind of foothold that we are seeing with Google taking share in education because as we've seen some of the price points for the devices are pretty low, but clearly you guys are able to sell into education as well. So I'm kind of curious as to how you view the competition and how you position your products vis-à-vis some of the things that are fairly low priced?

Tim Cook

It's a good question. We had our best education quarter ever. We went over a \$1 billion in revenues for the first time ever. We were up strongly year-over-year up 8%. iPad was up 22% year-over-year and the Mac was up 8% and as you know the PC market was down 10% in the aggregate and likely down even more in education. And so we feel like we're doing great on both fronts, both in the iPad space and in the Mac space for people wanting to buy Mac. And we do see Chromebook's in some places, but the vast majority of people are buying PC/Mac or an iPad. Our share of tablet in education is 94%. I mean it's -- yeah, it's sort of unheard of. I have never seen a market share that high before. So we feel like we are doing really well here and are great to be making -- feel great to be making a contribution to education.

Shannon Cross - Cross Research

Thank you.

Nancy Paxton

Thank you, Shannon. The next question please.

Operator

Next from UBS, we will go to Steve Milunovich.

Steve Milunovich - UBS Securities

Thanks. Could you talk a little bit about the supply side? There has been some thoughts that the fingerprint technology has been a little bit hard to manufacture and you indicated that the Retina mini would be out later in November. So kind of curious, if you're going to be able to lead the demand for the holidays with the mini that you would like to or may be some general supply comments and also comments on component cost.

Tim Cook

Sure. Steve it's Tim. In terms of supply, iPhone 5s into the quarter with a very significant backlog. We are still -- we still have a significant backlog. However, our supply is building each week and we're -- we've been -- and we're very confident of our ability to keep ramping and so we rolled out 30 more countries with the iPhone 5s and 5c as of last Friday and we'll roll out another 16 this week. And so we're right on where we would like to be in terms of achieving 100 countries by the end of the calendar year. In terms of the retina or the iPad Mini with the retina display, we'll start shipping later in November. It's unclear whether we will have enough for the quarter or not. We now have mini -- we will have but you really don't know the demand until after you start shipping and so we'll see how that goes. But I think we'll

do fairly well with iPad as I had mentioned before. We felt like it's going to be a really great holiday season. On terms of component cost, both DRAM and NAND were up last quarter from the previous quarter. DRAM we believe will continue to be up in this quarter. We think NAND will be flat and other commodities will fall sequentially.

Steve Milunovich - UBS Securities

Okay. And then Peter, about a year ago you indicated that the December quarter would benefit by about 200 basis points in gross margin due to a combination of mix shift toward phones and higher volume. Is that the sort of uplift you would expect from those factories this December quarter?

Peter Oppenheimer

Steve, I don't want to put a precise amount on it but we – I see us benefiting from a couple of things in the quarter; the leverage on the higher revenue by far being the biggest. As Tim mentioned, we expect to have a positive commodity environment and selling iPhones is never a bad thing from the margin perspective.

Steve Milunovich - UBS Securities

Thanks.

Nancy Paxton

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

Operator

We'll go to Mark Moskowitz with JPMorgan.

Mark Moskowitz - JPMorgan

Yes. Thanks. Good afternoon. The first question for Tim just regarding the channel inventory levels of 14.3 million for the iPhone, much higher than we've seen in the quarters past. Is there similar sort of message there in terms of you not having much broader coverage in terms of incremental coverage or is there a much bigger incremental upgrade cycle from your installed base or both?

Tim Cook

I think the way – the number one thing to know on the channel inventory is that our range as you know for iPhone is four to six weeks and we were at the low end of our range. And so that to me is the most – that's the most

important thing I look at anyway I should say. You can choose to look at the thing that's most important to you. In terms of a changing from where it's been in the past, the things that you should consider are the – China was in wave one this year, so there was a lot more point-of-sales there. We added DOCOMO in Japan. And so that's a large carrier to add. And what probably were not in the opening comments was that of the 14 million, 1.8 million of those were iPhones that were in transit and therefore not available to sale in the channel. And we always count those in channel inventory because they are in our sales line. And so that's how I look at the iPhone inventory.

Mark Moskowitz - JPMorgan

Okay. And then just a follow-up, if I could. A year ago you had a very ambitious multi-product ramp in terms of new products coming out. At the same time you did have some impacts related to supply constraints. Just to kind of follow up on Steve's question. Do you feel that four months later, fast forward to the future now that you're in a much better shape to kind of avert or navigate some of these big supply constraints that inflicted some problems on you last year or can we see a similar situation as we move to the quarter?

Tim Cook

As I mentioned on the iPhone 5s I feel like we're doing really well on supply. The demand is very robust. And so we are in backlog right now. But I feel confident about us continuing to ramp and do quite well for the quarter. On the iPad Mini we'll start shipping later this month and it's very difficult to forecast exactly when supply and demand will balance there. We'll also see about the iPad Air as we go out this week. I think we'll have a really good weekend. It may be that not everyone can find what they want more [ph]. I think versus last year I think one key difference is we announced one of our key Macs, the iMac but we didn't begin shipping until the end of December. And so we went for more than two months with minimal iMac sales and therefore from a Mac point of view year-over-year last year, we had – our only down a quarter, down versus the market that is in the last 30 quarters. And so I don't envision that happening this year. I feel really good about the way the MacBook Pros have gotten off last week. They've gotten off to a huge start. I feel great about Mac growing year-over-year this quarter. I feel great about iPad growing year-over-year this quarter as well. You can tell that from the strong guidance numbers that Peter gave earlier.

Nancy Paxton

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

Operator

We'll go to Chris Whitmore with Deutsche Bank.

Chris Whitmore - Deutsche Bank

Thanks very much. I wanted to ask about iPhone ASPs. They were down about 7% year-on-year in the quarter and down sequentially. Last year they were up sequentially on the launch. Was that a product supply availability issue? And how do you think about ASPs going forward?

Peter Oppenheimer

Chris, it's Peter. Sequentially we were relatively flat, so I'll comment on a year-over-year basis. They were down 7% as you indicated and this was primarily due to a significant increase in the sales of our entry SKUs where we had made them more affordable to attract more first-time smart buyers. We've also encouraged some FX headwinds from the yen, the Australian dollar and a number of the emerging markets which impacted us as well. I don't want to forecast ASPs for the December quarter. We'll report to you in January what they were. But the FX headwinds will likely continue given where exchange rates are today.

Chris Whitmore - Deutsche Bank

And just to follow-up on Mark's earlier question around channel inventories, that 14 million unit number was I think higher than a lot of people expected. Was that also SKU-ed [ph] towards the low end of the product stack given the 5s was short exiting the quarter?

Tim Cook

The 5s was in huge backlog and so any kind of 5s that was in the channel was a transitional kind of move – maybe perhaps in transit and so forth. We did have as I mentioned before, we had 1.8 million units of total iPhone units in transit at the end of the quarter. So that's a pretty substantial number.

Chris Whitmore - Deutsche Bank

And just lastly I wanted to ask about subsidies. That wasn't mentioned as a potential impact to phone margins but can you comment on carrier subsidies more generally? How sustainable are they given the competitive environment and how are carriers responding to the pricing stack of your phone line? Thanks a lot.

Peter Oppenheimer

I think carriers like to sell as many units as they can and get as many people in their service. And in most regions walk into the un-serviced contracts and so they're very predictable and reliable and I don't really see that changing. I think the carriers have come up with some different or some carriers have come up with different sales programs that might appeal to someone who wants to upgrade their phone annually instead of every other year. I think those programs in general probably reduce the subsidy somewhat in the aggregate for people that take these up. But customers may due to such a fair exchange for getting the upgrade more often, so there's a customer proposition for it. Other than that I think we have great relationships with the carriers. I think they were as we were very happy with the iPhone rollout.