APPLE INC (AAPL) Earnings Report: Q1 2016 Conference Call Transcript

The following APPLE INC conference call took place on January 26, 2016, 05:00 PM ET. This is a transcript of that earnings call:

Company Participants

- Nancy Paxton; Apple; Investor Relations
- Tim Cook; Apple; CEO
- Luca Maestri; Apple; CFO

Other Participants

- Simona Jankowski; Goldman Sachs; Analyst
- Gene Munster; Piper Jaffray; Analyst
- Katy Huberty; Morgan Stanley; Analyst
- Toni Sacconaghi; Bernstein; Analyst
- Shannon Cross; Cross Research; Analyst
- Brian White; Drexel Hamilton; Analyst
- Kulbinder Garcha; Credit Suisse; Analyst
- Mark Moskowitz; JP Morgan; Analyst
- Jim Suva; Citigroup; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

Welcome to this Apple Incorporated first-quarter FY16 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 (Investor Relations):

Thank you. Good afternoon, and thanks for joining us.

Before we begin, we want you to know that in addition to our press release and summary data schedule, we've published some supplemental material that we'll be referring to in our remarks today; and you can find a link to this supplemental material on our Investor Relations website, at Apple.com/Investor. And it's also included as an exhibit in the Form 8-K we filed with the SEC earlier today.

Speaking first today is Apple 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 margin, operating expenses, other income and expense, taxes and future business outlook. Actual results or trends could differ materially from our forecasts.

For more information, please refer to the Risk Factors discussed in Apple's Form 10-K for 2015 and the Form 8-K filed with the SEC today that I mentioned earlier, along with today's 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 for introductory remarks.

Tim Cook (CEO):

Thanks, Nancy, and good afternoon, everyone, and thank you very much for joining us.

Today we are reporting Apple's strongest financial results ever. We generated all-time record quarterly revenue of $75.9 billion in the December quarter, in line with our expectations and up 2% over last year's blockbuster results.

This is a huge accomplishment for our Company, especially given the turbulent world around us. In constant currency, our growth rate would have been 8%. Our record revenue and continued strong operating performance also led to an all-time record quarterly net income of $18.4 billion.

We sold 74.8 million iPhones in the December quarter, an all-time high. To put that volume into perspective, it's an average of over 34,000 iPhones an hour, 24 hours a day, seven days a week for 13 straight weeks. It's almost 50% more than our Q1 volume just two years ago and more than four times our volume five years ago. 74.8 million iPhones is an incredible number, and it speaks to both the immense popularity of iPhone and the phenomenal execution of our teams to deliver a massive number of devices in such a short period of time.

Our results are particularly impressive, given the challenging global macroeconomic environment. We're seeing extreme conditions, unlike anything we've experienced before just about everywhere we look. Major markets, including Brazil, Russia, Japan, Canada, Southeast Asia, Australia, Turkey and the eurozone, have been impacted by slowing economic growth, falling commodity prices and weakening currencies. Since the end of FY14, for instance, the euro and British pound are down double digits, and major currencies such as the Canadian dollar, Australian dollar, Mexican peso, and Turkish lira have declined 20% or more. The Brazilian real is down more than 40% and the Russian ruble has declined more than 50%.

66% of Apple's revenue is now generated outside the United States, so foreign currency fluctuations have a very meaningful impact on our results. Page 1 of our supplemental material illustrates this point. $100 of Apple's non-US dollar revenue in Q4 of 2014 translated to only $85 last quarter due to the weakening currencies in our international markets.

As you can see, the movement has been dramatic. Last quarter alone, the currency impact has been very large. Page 2 of our supplemental material illustrates our Q1 revenue and growth rates expressed in constant currency. The 8% growth rate I spoke about earlier translates to $80.8 billion in constant currency revenue, which is $5 billion more than our reported revenue. For perspective, that difference is about the size of the annual revenue of a Fortune 500 company.

We know the conditions in China have been a source of concern for many investors. Last summer, while many companies were experiencing weakness in their China-based results, we were seeing just the opposite, with incredible momentum for iPhone, Mac and the App Store, in particular. In the December quarter, despite the turbulent environment, we produced our best results ever in Greater China, with revenue growing 14% over last year, 47% sequentially, and 17% year-over-year in constant currency. These great results were fueled by our highest ever quarterly iPhone sales and record App Store performance.

Notwithstanding these record results, we began to see some signs of economic softness in Greater China earlier this month, most notably in Hong Kong. Beyond the short-term volatility, we remain very confident about the long-term potential of the China market and the large opportunities ahead of us and we are maintaining our investment plans.

Despite the economic challenges all over the world, Apple remains incredibly strong. We have a very satisfied and loyal customer base. We saw a greater number of switchers from Android to iPhone than ever in Q1, and we are very optimistic about our Business over the long term.

Innovation has always been the reason behind our success, and we remain committed to making the best products in the world and expanding the Apple experience to change our customer's lives in better and more meaningful ways. We've invested through economic uncertainty in the past and we've always come out stronger on the other side.

In fact, some of the most important breakthrough products in Apple's history were born as a result of investing through the downturn. We've also seen these times as opportunities to invest in new markets, just as we're doing now in areas such as India and other emerging markets.

Getting back to our record Q1 performance, let me give you some highlights of what we've accomplished since our last quarterly call together. We shipped the amazing new iPad Pro, which has been extremely well received by customers along with a new smart keyboard and revolutionary Apple pencil.

We launched the all-new Apple TV with its own App Store, laying the foundation for the future of television. We had our best quarter by far for Apple TV sales and the number of apps developed for Apple TV is growing rapidly. Today there are over 3,600 apps delivering everything from games to entertainment to educational programming.

We expanded distribution of Apple Watch to almost 12,000 locations in 48 countries during the quarter. As we expected, we set a new quarterly record for Apple Watch sales, with especially strong sales in the month of December.

We released OS X El Capitan, refining the experience and improving performance for our Mac customers. We also updated the entire iMac family with stunning new retina displays and introduced a new line up of wireless accessories. We launched Apple Pay in Canada and Australia with American Express and announced plans to bring this amazingly convenient, private, and secure mobile payment experience to China, Hong Kong, Spain and Singapore in the coming year.

Consumers have spent billions of dollars with Apple Pay. In the second half of 2015, we saw a significant acceleration in usage, with a growth rate 10 times higher than in the first half of the year. There are now over 5 million contactless payment ready locations in the countries where Apple Pay is live today and it's soon to be accepted at thousands of Exxon- and Mobil-branded stations across the US via their Speedpass Plus app. Finally, we also shared the incredible Apple Music experience with even more listeners, with over 10 million paying subscribers less than four months since customers began paying for the service.

Our financial position has never been stronger. We had the mother of all balance sheets, with almost $216 billion in cash, which translates to nearly $39 per diluted share of Apple stock. We continue to invest confidently in our future and we also continue to return capital to our shareholders at a rapid pace.

Our investors have been asking for a while about the recurring nature of our Business. Especially during a period of economic uncertainty, we believe it is important to appreciate that a significant portion of Apple's revenue recurs over time.

First and foremost, our customer satisfaction and retention rates are second to none and provide us with a long lasting foundation. For example, recent consumer surveys by 451 Research, formerly known as Change Wave, measured an incredible 99% customer satisfaction rate for iPhone 6S and 6S Plus and an equally impressive 97% rate for the iPad Air 2. They also indicate that our iPhone loyalty rate is almost twice as strong as the next highest brand.

In addition, a growing portion of our revenue is directly driven by our existing install base. Because our customers are very satisfied and engaged, they spend a lot of time on their devices and purchase apps, content and other services. They also are very likely to buy other Apple products or replace the one that they own. And because of the enduring value of the device, their replacing is likely higher to be given or sold to someone who will also love and use it often.

So as a result, our installed base has been growing very fast and has recently reached a major milestone, crossing 1 billion active devices for the first time. This is an unbelievable asset for us. Because our installed base has grown quickly, we have also seen an acceleration in the growth of our services business, another large and important source of recurring revenues. Now that we have reached this milestone of 1 billion active devices, we thought this would be a great opportunity to share more information on what has become one of the largest service businesses in the world.

So now, I'd like to turn the call to Luca, who will provide more insight into how our platform has grown, followed by details on our record quarterly results.

Luca Maestri (CFO):

Thank you, Tim, and good afternoon, everyone.

Each quarter, we report results for our Services category, which includes revenue from iTunes, the App Store, Apple Care, iCloud, Apple Pay, licensing, and some other items. Today, we would like to highlight the major drivers of growth in this category, which we have summarized on page 3 of our supplemental material.

The vast majority of the services we provide to our customers, for instance, apps, movies and TV shows, are tied to our installed base of devices, rather than to current quarter sales. For some of these services, such as content, we recognize revenue based on transaction value. For some of the services, such as the App Store, we share a portion of the value of each transaction with the app developer and only recognize revenue on the portion that we keep.

To fully comprehend the scale of the services that we are delivering to our installed base and how fast this business is growing, we look at purchases in addition to revenue. When we aggregate the purchase value of services tied to our installed base during FY15, it adds up to more than $31 billion. That's an increase of 23% over FY14. In the recent December quarter, purchases of installed base services reached $8.9 billion, which is a growth rate of 24% year-over-year.

The size and growth of these services tied to our installed base compare favorably to other services companies you're familiar with. Our installed base services are also quite profitable, with gross margins that, on a purchase value basis, are similar to our company average.

Also, we're very excited by the scale and growth of our active installed base, as we indicate on page 4. We define an active device as one that has been engaged with our services within the past 90 days. Our active installed base has recently past 1 billion devices, with year-over-year growth of more than 25%.

Apple is in a unique position of strength. We have world class scales in hardware, software and services all under one roof, which lets us innovate in ways that other companies can't. We have built a huge installed base around four platforms, iOS, Mac OS, Watch OS and TV OS. We have tremendously satisfied and loyal customers who are engaged with our services at a fast growing rate. All of this provides us with an unparalleled foundation for the future of Apple business.

Let me now turn to the details of our record breaking December quarter. As Tim said, revenue was $75.9 billion, an increase of $1.3 billion, or 2% year-over-year. Our growth was driven by all-time record iPhone sales, all-time record revenue from Services, the expanded availability of Apple Watch, and the successful launch of the new Apple TV.

We achieved this record revenue performance despite a very large negative impact from the weakness of foreign currency. And in constant currency, our revenue growth rate was 8%. We once again achieved very impressive results in Greater China, with revenue growing 14% year-over-year and 47% sequentially to an all-time record of $18.4 billion. Emerging markets performance was strong overall, up 11% year-over-year and representing 34% of total company revenue for the quarter.

Company gross margin was 40.1%, up sequentially and better than our expectations, mainly due to favorable commodity costs and product mix. Operating margin was 31.9% of revenue and net income was $18.4 billion, a new all-time record. Diluted earnings per share was $3.28, a 7% year-over-year increase over our previous all-time record; and cash flow from operations was very strong, at $27.5 billion.

For details by product, I will start with iPhone. We sold 74.8 million iPhones in the quarter, an increase of 300,000 compared to last December quarter's sensational results. Total iPhone sales grew 76% in India and more than 45% in Korea, Middle East and Africa. Sales were also up 20% or more in many Western European countries and grew 18% in Mainland China. iPhone ASP was $691 compared to $687 in the year-ago quarter, in spite of a very unfavorable foreign exchange impact.

We continue to see very strong interest in iPhone, not only with consumers but also with business users. Among corporate buyers planning to purchase smartphones in the March quarter, 451 Research found that 79% planned to purchase iPhones. That is the highest iPhone purchase intent in the eight-year history of the survey.

We started the quarter below our channel inventory target range and, thanks to an extremely successful manufacturing ramp, we were able to exit the quarter slightly above the low end of our target range of five to seven weeks of iPhone channel inventory.

Next, I'd like to talk about the Mac. We sold 5.3 million Macs compared to 5.5 million last year, a decline of 4%. We continued our long running trend of PC market share gains, based on IDC's latest estimate of an 11% global market contraction, and we were especially happy with 27% year-over-year Mac sales growth in Mainland China. We ended the quarter within our four- to five-week target range for Mac channel inventory.

Turning to iPad, we sold 16.1 million, compared to 21.4 million in the year-ago quarter, and we exited the quarter within our five- to seven-week target range of iPad channel inventory. In the segments of the tablet market where we compete, we continue to be highly successful. Recent data from NPD indicates that iPad has 85% share of the US market for tablets priced above $200; and the latest data published by IDC indicates that iPad accounts for 67% of the US commercial tablet market, comprising enterprise, government and education.

iPad customer metrics are also extremely positive. In November, 451 Research measured a 97% consumer satisfaction rate for iPad Air 2; and among consumers planning to purchase a tablet within the next six months, 65% plan to purchase an iPad. Corporate buyers reported a 95% satisfaction rate for iPad and a March quarter purchase intent of 73%.

Our enterprise initiatives continue to expand. IBM released 48 new IBM MobileFirst for iOS apps in the December quarter, and there are now over 100 apps in the IBM MobileFirst for iOS catalog for iPhone, iPad and Apple Watch. Our partnership with Cisco has gained significant momentum since we announced it at the end of August. Our engineering teams are on track to deliver exciting new capabilities that create a fast lane for iOS business users by optimizing Cisco networks for iOS devices and apps, integrate iPhone with Cisco enterprise environments, and provide unique collaboration opportunities on iPhone and iPad.

We are also continuing to grow our mobility partner program. We added more than 25 partners in the December quarter, bringing the total to over 90. One great example of our progress in the enterprise is Eli Lilly , who boosted sales productivity by equipping 15,000 field based personnel across the world with iPad. A leader in mobile technology, Lilly has eliminated laptops in the field and is upgrading its US field sales teams to iPad Pro.

Turning to Services, we generated almost $6.1 billion in revenue, including $548 million we received from a patent infringement dispute. Excluding that amount, our services revenue was $5.5 billion, a new all-time record and an increase of 15% over last year, thanks in large part to strong growth from apps. Revenue from the App Store increased 27% and the number of transacting customers grew 18%, also setting an all-time record. Among our customers who purchased apps and content from our iTunes stores, the average amount spent per customer reached an all-time high in the December quarter.

Revenue from other products grew strongly, up 62% over last year, thanks to the growing contribution from Apple Watch, as well as the successful launch of the new Apple TV, both of which established new all-time quarterly records. We expanded Apple Watch distribution significantly over the course of the quarter and we experienced especially strong results during the holiday buying season.

Let me now turn to our cash position. We ended the quarter with $215.7 billion in cash plus marketable securities, a sequential increase of $10.1 billion. $200 billion of this cash, or 93% of the total, was outside the United States.

We returned over $9 billion to investors during the quarter. We paid $3 billion in dividends and equivalents, and we spent $3 billion to repurchase 26 million Apple shares through open market transactions. We also launched our sixth accelerated share repurchase program, spending $3 billion and receiving an initial delivery of 20.4 million shares.

We have now completed over $153 billion of our $200 billion program, including $110 billion in share repurchases. As we have done in the past, we plan to provide an update on our capital return program when we report our second quarter results in April. We also plan to be very active in the US and international debt markets in 2016, in order to fund our capital return activities. Also today, our Board of Directors has declared a cash dividend of $0.52 per share of common stock payable on February 11, 2016, to shareholders of record as of February 8, 2016.

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 $50 billion and $53 billion. We are providing a wider range for revenue than usual for the second quarter because of the volatility we are seeing in the economy and in the financial and currency markets.

We expect gross margin to be between 39% and 39.5%. We believe these are extremely strong margins in light of the headwinds we face from foreign exchange and the sequential loss of leverage. We expect OpEx to be between $6 billion and $6.1 billion. We expect OI&E to be about $325 million, and we expect the tax rate to be about 25.5%.

As you know, we don't provide guidance beyond the current quarter and it's difficult for us to forecast economic and foreign exchange factors; however, at this point, we believe the March quarter faces the most difficult year-over-year compare relative to the rest of the year.

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

Nancy Paxton (Investor Relations):

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

QUESTIONS & ANSWERS

Operator:

(Operator Instructions)

Simona Jankowski with Goldman Sachs .

Simona Jankowski (Analyst - Goldman Sachs):

Hello. Thank you very much.

Just in terms of your March quarter guidance, it does imply a double-digit decline at the midpoint. Maybe if you can just clarify, first of all, what FX headwind is embedded in that?

And then just going to the fundamental underpinning reasons for that, how much of it do you think has to do with international markets in terms of weakening demand and how much of that do you think is comps versus any other factors you might identify, such as a response to higher prices for the iPhone in certain overseas markets?

Luca Maestri (CFO):

Thank you, Simona. Let me take this one.

In constant currency, when you look at it for the March quarter, revenue would be down between 5% and 10%. So we are looking at a 400 basis point impact from foreign exchange for the March quarter.

You talked about a number of issues that are, in fact, included in this guidance. In addition to lapping, of course, a very strong year ago quarter -- just remind you that revenue growth a year ago was up 27% -- there's a number of things that we're facing. The macroeconomic environment is weakening. When you think about all the -- particularly all the commodity-driven economies, Brazil and Russia and emerging markets, but also Canada, Australia in developed markets -- clearly, the economy is significantly weaker than a year ago. We talked about the unfavorable FX, which again is 400 basis points.

One of the things that we've done to respond to the foreign exchange situation has been to increase the price of some of our products in certain international markets. That has had the effect of protecting our margins, which you've seen have been very strong, both in the December quarter and in the guidance that we provide for the March quarter.

But inevitably over time, higher prices affect demand and so we are capturing that in our guidance. So I would say these are the major reasons and the drivers for the guidance on revenue.

Simona Jankowski (Analyst - Goldman Sachs):

Thank you.

Nancy Paxton (Investor Relations):

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

Operator:

Next from Piper Jaffray, we'll hear from Gene Munster.

Gene Munster (Analyst - Piper Jaffray):

Good afternoon. Tim, could you talk a little bit about the iPhone upgrade program and the theme of iPhone as a subscription? In particular, do you believe that this could have a measurable impact on the December quarter once we anniversary this? And then any thoughts on rolled outside the US when that program would.

And my follow-up question would be, I know you can't talk about new products, but any high level thoughts on the virtual reality theme. Do you think this is more of a geeky niche or something that could go mainstream?

Tim Cook (CEO):

On your first question about iPhone, I think the most important thing, Gene, as you know for us, will always be the product and the experience. And so that's first and foremost. Secondly, I would say we were blown away by the level of Android switchers that we had last quarter. It was the highest ever by far. And so we see that as a huge opportunity.

Thirdly, the markets, sort of the emerging markets broader than BRIC, but including all of emerging, when I look at our share in these markets and the LTE penetration, I see huge opportunities.

In terms of the upgrade program itself, I think over time, it will be meaningful as customers get into a different pattern. How much of that plays out in the Q1 of 2017 range is difficult to say. My own sense would be that the other items I've mentioned are probably more important, but I am optimistic about the upgrade program, as well.

Gene Munster (Analyst - Piper Jaffray):

And then virtual reality?

Tim Cook (CEO):

In terms of virtual reality, no, I don't think it's a niche. I think it can be -- it's really cool and has some interesting applications.

Nancy Paxton (Investor Relations):

Thank you, Gene.

Gene Munster (Analyst - Piper Jaffray):

Thank you.

Nancy Paxton (Investor Relations):

Could we have the next question, please?

Operator:

From Morgan Stanley , Katy Huberty.

Katy Huberty (Analyst - Morgan Stanley):

Yes, thanks. I appreciate the macro comments as it relates to guidance, but can you talk a little bit about how you're thinking consumers might react from an ASP perspective? Do you expect consumers to move down the product line, given the macro environment?

And then also, how is channel inventory influencing guidance? Do you feel like channel inventory needs to come down, given the demand trends? And then I have a follow-up.

Luca Maestri (CFO):

Couple of points here, Katy. Our iPhone ASP was $691 during the December quarter. We couldn't be happier with the level of ASP that we generated in the December quarter.

Keep in mind that the foreign exchange impact on that number was $49. So obviously, the mix of products was very strong. We had great reception for the new iPhones that we launched at the end of September.

Of course, we have a very strong mid tier this year in the portfolio, with 6 and 6 Plus. But overall, when you look at the outcome during the December quarter, it was very, very strong. So we feel very good about that and we feel that we have a very, very strong portfolio for iPhone.

On the question around channel inventory, we entered the quarter, the December quarter -- and we mentioned it back in October -- below our target range of five to seven weeks. We have built a bit of inventory during the course of the December quarter. But we have exited at the low end of the five to seven weeks, so we feel that we are in good shape there. And we've exited the quarter also on iPad and Mac well within the ranges that we want to have.

Katy Huberty (Analyst - Morgan Stanley):

And then as a follow-up, back in October you guided FY16 CapEx up over 30%. What's driving that growth? Can you rank it between equipment purchases, data center and real estate? And given the slowdown that you started to see in December, are you still comfortable with that level of investment growth? Thanks.

Luca Maestri (CFO):

Yes. So that is kind of the ranking, Katy. It starts always for us with our tooling and manufacturing process equipment, and that is up a bit year-over-year.

Then we've got data centers. And data centers is a growing expenditure for us, because, as we mentioned in our prepared remarks, our installed base of customers ands devices is growing, and is growing very significantly. And the data center capacity that we put in place is to provide the services that are tied to the installed base. So that type of expenditure goes together with the installed base.

And then around facilities, you probably know that we are nearing completion of our new campus here in Cupertino, and so this is the year where we've got our peak requirements in terms of capital.

Nancy Paxton (Investor Relations):

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

Operator:

From Bernstein, we'll hear from Toni Sacconaghi.

Toni Sacconaghi (Analyst - Bernstein):

Yes. Thank you. I have a question, a follow-up, please. To start, just on iPhones, it looks like your guidance implies about a 15% to 20% unit decline in iPhones for fiscal Q2, which I think, unless you really see a change in demand profile in the second half, suggests that iPhone units will decline year-over-year for FY16.

And I'd like you to address that question, because the obvious follow-up questions are is that because you believe the smartphone market won't grow or because Apple may be reaching saturation in the market? Is that because Apple's replacement cycle accelerated last year and is decelerating this year and that's why we'll see a decline in units?

Or is there something about Apple's ability to gain share in a market where the market is moving to much lower price points? But I'm wondering, and Tim, maybe you're best to answer it, if you can address what appears likely to be a decline in iPhone units and how we put that in the context of how we should think about that, given some healthy data around switchers that you highlighted.

Tim Cook (CEO):

Toni, we do think that iPhone units will decline in the quarter. We don't think that they will decline to the levels that you're talking about. We aren't projecting beyond the quarter, as Luca mentioned earlier; but at this point in time, we see that Q2 is the toughest compare.

We believe it's the toughest compare because of the year ago quarter also had catch up in it from Q1. If you recall, we were heavily supply constrained throughout the whole of Q1, and so some of that demand moved into Q2. Plus, we are in an environment now that is dramatically different from a macroeconomic point of view than last Q2, from a currency point of view, from the level of which we've had to adjust pricing in several of these markets, and the overall melees in virtually every country in the world. And so it's really all of those factors that play in there and it's difficult to sort out how much is due to which one.

Toni Sacconaghi (Analyst - Bernstein):

Right. Can you speak to any of the points around your expectation for the smartphone market or whether you think your replacement cycle has changed or whether your ability to gain share has changed?

Tim Cook (CEO):

The market itself, we don't spend a lot of time on predicting. Our view has always been that if we do -- if we make a great product and have a great experience, that we ought to be able to convince enough people to move over. And so as I look at maybe your broader umbrella point about a question on saturation, the metrics I see would strongly suggest otherwise.

For example, almost half of the iPhones that we sold in China last quarter were to people who were buying their first iPhone. And certainly if you go outside of China into the other emerging markets, our share is much lower and the LTE penetration is so low -- in some cases, it's zero -- that it indicates to me that there's still a lot of people, a tremendous number of people in the world, that will buy smartphones and we ought to be able to win over our fair share of those.

Toni Sacconaghi (Analyst - Bernstein):

Okay. And I just have clarifications, I don't really have a follow-up question. Luca, you had talked about channel inventory increasing. It was 18.4 million for iPhone last quarter. Can you tell us how many more units you had this quarter?

And then I'm not sure if I misheard you, but I think you said your total installed base grew 25% year-over-year. Can you confirm that? Because if Services grew at 13% and your installed base grew at 25%, it almost implies your penetration of your installed base, in terms of your ability to sell services, is going down.

Luca Maestri (CFO):

Maybe I'm going to start with Services, Toni. The reason why we added this -- I think it's page 3 of our supplemental material -- is to try and explain that a couple of steps. The first one is that of the services that we report, there's a portion, about 85% of all of the services that we report is directly tied to the installed base. There is a smaller portion of our services business that is not related to installed base and more related to when we sell a device. A perfect example would be an Apple Care agreement that you purchase at the time of the sale of the device.

And then we are showing that on that portion of installed base-driven services business, there is a part that is related to -- where we recognize revenue in terms of the full transaction value. And then there are transactions, like for example, App Store sales, where a portion of the transaction does not get recognized by Apple , but it goes to the developer.

So when you look at it from a purchase value standpoint, actually in the December quarter, we grew 24%, and for the FY15, we grew at 23%. So we are growing at very, very healthy levels. And to reconfirm the growth of the installed base, yes, it was over 25%.

To the question around the channel inventory for iPhone, we grew channel inventory by 3.3 million units during the course of the December quarter. Keep in mind, we started in acquisition where we were below our targeted range. We were significantly short at the beginning of the quarter.

Toni Sacconaghi (Analyst - Bernstein):

Thank you.

Nancy Paxton (Investor Relations):

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

Operator:

From Cross Research, Shannon Cross.

Shannon Cross (Analyst - Cross Research):

Thank you very much. I had a question about gross margin. Luca, you got gross margins of 39% to 39.5% in your guidance, and that includes hedging. So I'm curious about the puts or takes in there.

And then can you clarify if within the gross margin this quarter, that had the IP licensing contribution, as well? Any color you can give, both on this quarter's gross margin puts and takes, and then also the March quarter. And then I have a follow-up.

Luca Maestri (CFO):

Yes. So Shannon, let me start with Q1. I think when you say IP licensing, you mean this patent dispute that was resolved. Yes, it was included in the gross margins. And it was worth 40 basis points in the 40.1% that we reported for Q1.

For the second quarter, the puts and takes are actually quite simple. From an FX standpoint, the negative impact on a sequential basis from the December quarter is 50 basis points.

Then of course, I would say by far the largest impact on margins for the quarter is the loss of leverage, because that's part of our seasonal pattern, which gets offset by a favorable commodity environment that we've seen for a number of quarters now. And in a way, it's the other side of the coin of the foreign exchange situation.

Shannon Cross (Analyst - Cross Research):

Okay. Thanks. And then Tim, can you talk a bit about -- and I apologize, I sort of lost my voice here -- can you talk a bit about leverage within the model? I know you said you want to invest while there's great opportunity in China and all of that. But given some of the pressures you're seeing, how do you think about where you spend that incremental SG&A dollar and that R&D dollar, and how should we think about it, given you're running $6 billion a quarter?

Tim Cook (CEO):

Yes, on the R&D, Shannon, we're continuing to invest without pause. We have some great things in the pipeline and we very much believe strongly in investing through downturns, such as the one that everyone is going through.

In terms of SG&A, we obviously seek to throttle expenditures in SG&A to the business level, with the exception of where we're investing in new stores and, for example, our expansion plans in China have not changed. We are maintaining our investment profile and plans there. We are also continuing to invest in markets where we believe they are great places for Apple for the long term, like India, as an example of that one.

And finally, even in the markets where today, grantedly, it looks fairly bleak, from Russia and Brazil and some of the other economies that are very much tied to our oil-based economies. We do believe that this, too, shall pass and that these countries will be great places and we want to serve customers in there, and so we're not retrenching. That's not -- we don't believe in that. We are fortunately strong enough to continue investing, and we think it's in Apple's best long-term interest to do so.

Obviously, from a cost point of view, the downside of economic stress is that some asset prices get cheaper, commodity prices get cheaper, and that sort of thing. And so I think this is exactly the period that you want to invest and do so confidently.

Shannon Cross (Analyst - Cross Research):

Thank you.

Nancy Paxton (Investor Relations):

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

Operator:

We'll hear from Steve Milunovich with UBS.

Nancy Paxton (Investor Relations):

Steve, are you there?

Tim Cook (CEO):

Steve?

Nancy Paxton (Investor Relations):

Let's go on to the next question, please.

Operator:

And we'll hear from Brian White with Drexel.

Brian White (Analyst - Drexel Hamilton):

Tim, could you talk a little bit about the next leg of growth in China? Obviously, Apple's done a phenomenal job there. But where do we see the next leg coming from?

And also, you mentioned investing in India. Where do you see that over the next two to three years? I think there's 1 billion mobile subscribers there, almost the size of China. Thank you.

Tim Cook (CEO):

Brian, good question. In terms of China, the LTE penetration as of the end of last October, which is the last data I've got, was in the mid 20s. And so there's an enormous upgrade cycle there for people that are still running on 3G handsets.

Also, I've talked about this before, but I think it's worth mentioning again, because it's easy to lose perspective with some of the things you read every day, is that the middle class in China was less than 50 million people in 2010, and by 2020, it's projected to be about half a billion. And so there's just an enormous number of people moving into the middle class. And we think this provides us a great opportunity to win over some of those customers into the Apple ecosystem.

And so I think the demographics are great. We're continuing to invest in retail stores. Angela and her team have been on this very aggressive rollout plan. We now have 28 stores in Greater China and we are on target to have 40 in the summertime of this year. And so we're continuing on distribution.

Obviously, we've got product things in mind and are crafting our products and services with China heavily in mind. We remain very bullish on China and don't subscribe to the doom and gloom kind of predictions, frankly.

In India, India is also incredibly exciting. India's growth, as you know, is very good. It's quickly becoming the fastest growing BRIC country. It's the third largest smartphone market in the world, behind China and the United States.

The population of India is incredibly young. The median age there is 27. I think of the China age being young, at 36, 37. And so 27 is unbelievable. Almost half the people in India are below 25. And so I see the demographics there also being incredibly great for a consumer brand and for people that really want the best products.

And as you know, we've been putting increasingly more energy in India. India revenue for us in Q1 was up 38%. We also had currency issues in India, as everybody else did. Constant currency growth was 48%. And so it's a very rapidly expanding country. And I think the government there is very interested economic reforms and so forth that I think all speak to a really good business environment for the future.

Brian White (Analyst - Drexel Hamilton):

Okay. Great. Thank you.

Nancy Paxton (Investor Relations):

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

Operator:

We'll hear from Kulbinder Garcha with Credit Suisse.

Kulbinder Garcha (Analyst - Credit Suisse):

Thank you. My question's for Tim on the iPhone business. You talk a lot about the macroeconomic weakness weighing on units, but is some of the issue just that last year replacement got accelerated and this year it's kind of normalizing, and that's kind of a one-time headwind in terms of the unit growth that you see in that business. Is any of that going on, or is that not material, in your view?

And the other follow-up I had was that you've mentioned in recent calls, helpfully, the percent of the base, prior to when the 6 came out, that were now on the larger screen phones. Can you give us an update on what that number is? I think the last time it was in the low 30s. Thanks.

Tim Cook (CEO):

Last question first. The number of people who had an iPhone prior to the iPhone 6 and 6 Plus announcements -- and so this was in September of 2014 -- that have not yet upgraded to a 6, 6 Plus or 6s or 6s Plus is now 60%. So another way to think about that is 40% have, 60% have not.

In terms of your initial question about is there some of the compare issue that are people that ran out quickly to buy a 6 and 6 Plus and sort of accelerated? There is no doubt that we had an unbelievable year last year, and the Q2 was particularly really, really strong because of the pent-up demand that left from Q1 in addition to Q2. And so there's no doubt about that.

However, I think you can tell from the numbers that Luca is talking about just on the currency side, and that's before thinking through the affect that price increases can sometimes have on the business over a period of time, it's clear that the economic piece is large.

Kulbinder Garcha (Analyst - Credit Suisse):

Thank you.

Nancy Paxton (Investor Relations):

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

Operator:

And next we'll hear from Steve Milunovich with UBS. Mr. Milunovich, you may want to check your mute button.

Tim Cook (CEO):

Steve, are you there?

Nancy Paxton (Investor Relations):

Okay. Let's try the next question, please.

Operator:

And we'll hear from Mark Moskowitz with JP Morgan.

Mark Moskowitz (Analyst - JP Morgan):

Yes. Thank you. Good afternoon. A question and a follow-up. As far as the question, Tim, I wanted to get a better sense from you in terms of what is the overarching message of introducing a little more details here around services. Is this really to just reinforce the power of the franchise or the platform at Apple in terms of to really navigate tougher macro times in terms of the higher level recurring revenue, or is it a stepping stone to much more in terms of Apple service, i.e. I think of all the stuff you do on the data center side. Could we eventually have seen, with the help of IBM and Cisco , that you eventually move more into the cloud services for the enterprise?

Tim Cook (CEO):

So good question. We started breaking out Services, as you know, in the beginning of FY15. And as that business has grown and as it became clear to us that the investors and analysts wanted more visibility into that business, we've now elected to break it out and show the full size, scope, growth, and make comments on the profitability of it from a transparency point of view.

I do think that the assets that we have in this area are huge, and I do think that it's probably something that the investment community would want to and should focus more on. In terms of our future plans, I wouldn't want to comment about any particular thing, but obviously, with breaking this out, we wouldn't be breaking it out if it wasn't an area that was very important to us in the future.

Mark Moskowitz (Analyst - JP Morgan):

Okay. Thank you. And I wanted to follow-up on the upgrade advance program dynamics. Can you talk a little more about what you're seeing in terms of in-store at the Apple Stores? Are you seeing any sort of dislocation in terms of folks who are moving to the upgrade or finance program, are they moving more toward Apple versus maybe the in-store percentage that used to be related to the carriers? In other words, are folks just going with Apple now, instead of the carriers, when they buy their phone, as part of these upgrade programs?

Tim Cook (CEO):

Honestly, this has nothing to do with wanting to move customers from one person to another. This has to do with wanting to provide customers a very simple way to upgrade. Because we serve a significant number of customers in the Apple Store who want the iPhone when it's new and when it comes out, and so we've designed a program that made it simple and easy to do that. I have no idea over time how the percentage of the sales will vary between carriers and the Apple retail store, but that's not our overriding objective.

Mark Moskowitz (Analyst - JP Morgan):

Okay. Thank you. Good afternoon.

Nancy Paxton (Investor Relations):

Thank you, Mark. We have time for one more question.

Operator:

And your final question will come from Jim Suva with Citi.

Jim Suva (Analyst - Citigroup):

Thank you very much. A question for Tim and then a detail follow-up for Luca. Tim, with the macro situation changing, a lot of CEOs view that and their strategy is very different go-to-market strategy. Some change the way they go to market. Some change their products.

In the past, Apple's been very known in always having a premium product. With the slowdown in the macro FX and also GDP revision, is Apple's strategy go-to-market still always at premium product, or is there a need to go to more also a middle market or lower price point to attract more customers? Just because it seems like growing that installed base and services, as you pointed out, really economically could really help out Apple in the long term.

And then the financial question for Luca is on that patent litigation, Luca, when you gave guidance three months ago, did you have a view that that was coming in? And if so, was that included in the guidance or not, or was that post the quarter guidance? And I assume it's all one-time this quarter you recorded it, it's all gross margin, and we don't cause that to reoccur again going forward. Thank you very much.

Tim Cook (CEO):

Our strategy is always to make the best products. And that, for the smartphone market, that we are able to provide, though, several different price points for our customers. We have the premium part of our line is the 6s and the 6s Plus. We also have a mid price point, with the iPhone 6 and the iPhone 6 Plus. And we continue to offer the iPhone 5s in the market and it continues to do quite well. And so we offer all of those, and I don't see us deviating from that approach.

We always want to offer somebody the -- we don't design to a certain price point. We design a great product and we make it priced at a great value. And today, we're able to offer all three of those different iPhone options.

Luca Maestri (CFO):

And Jim, on the patent question, yes, obviously this is a one-off item that affected the December quarter. As I said earlier, it's worth 40 basis points. So without it, our gross margin would have been 39.7%. It will not repeat going forward.

To your question around was it included in the guidance, yes, the probability of receiving the amount was incorporated in the development of the guidance range. If you remember, we guided to 39% to 40%, and that number was included within the range.

Jim Suva (Analyst - Citigroup):

Thank you very much, gentlemen.

Nancy Paxton (Investor Relations):

Thank you, Jim. A replay of today's call will be available for two weeks, podcast on the iTunes store, webcast on Apple.com/Investor, and via telephone. And the numbers for the telephone replay are 888-203-1112 or 719-457-0820 and please enter confirmation code 7349088. These replays will be available by approximately 5:00 PM Pacific Time today. And members of the press with additional questions can contact Kristin Huget at 408-974-2414. Financial analysts can contact Joan Hooper or me with additional questions. Joan is at 408-974-4570, and I'm at 408-974-5420. Thanks again for joining us.

Operator:

Ladies and gentlemen, that does conclude today's presentation.