

FINANCIAL NOTE

Apple/China Mobile Deal Raises More Questions than Answers

# SUMMARY

Apple’s recent distribution announcement with China Mobile, the world’s largest telecom carrier, was widely expected and the impact was arguably already built into Apple’s stock price. Consensus expectations for increased shipments in 2014 were around 20 million units (nearly a $10B revenue bump based on ASPs just below $500).

On the surface, this all sounds fine and good, but we would argue that the challenge is most people have little understanding of how markets in China really work. At a basic level, it’s critical to understand that China is far from being a homogenous monolithic market. In fact, China is really a grouping of many different types of markets, some of which will be eager and excited to get iPhones and some of which will not even give it a second thought. The big question is, how the Chinese middle class and upper middle class will react to the availability of Apple’s iPhones. In our view, that question sits at the core of how successful Apple will be in China—and it’s a question that does not have a clear answer.

Though there are no “official” standards or definitions, China is commonly broken down into five or six tiers of cities, based on the population, average income and level of infrastructure (among other elements). Tier one cities are the three (or four-depending on whom you ask) big ones most people know: Beijing, Shanghai, Guangzhou (and Shenzhen). Income levels are high in these cities, status symbols are important and multinational brands like Apple do well here. In fact, these are the cities where Apple has built its Apple stores. But as you move down the city tiers, not only do average income levels go down, so does interest in multinational brands.

Though PCs are not a perfect proxy, they can provide some valuable insight into the situation. In tier one cities, multinational brands like Dell, HP (and Apple) have reasonable market share and give stiff competition to China-based Lenovo—the kings of the China PC market overall. But in Tier 3 and 4 cities, the multinationals have almost no market share presence and domestic Chinese brands dominate.

The challenge is, the Tier 1 cities only represent about 5% of total Chinese households, Tier 2 is a bit under 10% and even Tier 3 is in the 20% range. The remaining two-thirds of households fit into the lower tier cities where Apple isn’t likely to have many sales. Domestic Chinese brands like Huawei, ZTE, Lenovo and CoolPad, on the other hand, currently have and will maintain the majority of smartphone market share—particularly if Apple continues to maintain the high price points they currently have even with their “low-end” 5C.

The bottom line is that Apple’s efforts at wooing the potential swing market of the Chinese middle class in Tier 2 and Tier 3 cities—through a combination of attractive hardware, improved price points and an increased supply of native Mandarin applications—are going to be key in determining the success of this new venture. Without strong successful efforts in this area, we believe 2014 shipments into China could be as low as 10 million, but if they are successful, they could even reach 30 million. Only time will tell.

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