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Quick Thoughts: Apple Watch – All About the Benjamins

- The Apple Watch lacks a compelling use case at launch, but critics are gun shy after missing on iPad. Demand driven by fashion, not function, with 10% max penetration into iPhone base
- \$349 is the bare bones price – fancy bands and luxury materials will take blended ASPs \$750 or more, with very strong margins. CY2015 sales of \$15-20B possible
- Without subsidies or unique high value applications, replacement cycle should be much longer than iPhone. As such, growth curve could peak quickly after a quick early ramp.
- Universal ID for payments, locks, tickets, etc. could be the killer app, but necessary standards, infrastructure and ecosystem many years away and will see fierce competition

Toward the end of Apple's annual September iPhone launch extravaganza, Tim Cook borrowed Steve Jobs' signature tagline and offered up "one more thing". That thing was, of course, the Apple Watch – hotly anticipated for more than a year with more fevered speculation than any previous piece of consumer electronics, other than, perhaps, the still mythical Apple Television set. The unveiling spurred a standing ovation from the carefully selected live crowd, and rapturous "first impressions" posts from the attending journo and bloggers once they were able to get a clear enough WiFi signal to upload.

From a traditionalist perspective, the Apple Watch is beautiful, with classic (although possibly a bit thick) proportions and impressive craftsmanship. It will be available in three tiers – the \$349 anodized aluminum Apple Watch Sport with its plastic band, the stainless steel Apple Watch with a sapphire crystal and a slew of luxe bracelets to choose from, and the solid gold Apple Watch Edition. The price points for the two luxury lines have yet to be revealed, and I agree with "The Daring Fireball's" Jon Gruber, who was first out of the gate with the suggestion that they could start at \$1000 and go up from there. The bill of materials is pretty upscale and Apple has never been shy about asking for a premium. I suspect that it will tag 18K gold with the kind of mark-up that it has historically attached to Flash memory. With the unassailable power of the brand behind it and the penchant for conspicuous consumption amongst the wealthy in many parts of the world, there is clearly a market for \$5-10K Apple wrist bling.

This turn to luxury gives clear context to the company's recent executive raids on Burberry, Tag Heuer, and other brands of the 1%, and could be an omen of similar up market moves in other categories – why should Nokia spinoff Vertu be the only one selling a \$10K gold smartphone? Still, there are some risks to the high end strategy. Intrinsically, high price points mean fewer people are able to afford the product. Even \$349 is a hefty charge for an Apple devotee who just dropped \$199 (or more) to get an iPhone 6.

This is doubly true given the shaky use cases for the Apple Watch. Fitness bands have been with us for quite a while and have built a devoted, but tiny, market of the health obsessed and the dangerously ill. Most of

these products sell for less than a third of the Apple Watch entry point and those that go for similar prices are waterproof and have GPS and phone-independent maps on board. Moreover, Endeavor Partners estimates that despite good intentions by purchasers, 50% of all fitness trackers are no longer used after the first 6 months. While Apple has devoted a good deal of energy to promoting its HealthKit API for collecting health-oriented apps to a single iOS umbrella, the design of the Apple Watch, even in its Sport configuration and with its battery of biometric sensors, is a bit impractical for the heavy duty athlete. The other supposedly killer app talked about at the Apple Fest was payments, but Apple Pay won't even fly on an Apple Watch unless it has a TouchID capable iPhone linked to it. I wrote about Apple Pay in depth last week (<http://www.sector-sovereign.com/2014/09/september-15-2014-apple-pay-friend-and-potential-foe-to-the-payments-industry-status-quo/>) and, cutting to the chase, I don't think that is likely to pull through a lot of Watch sales in the foreseeable future. If there is a killer app, I'm fairly confident it won't be HealthKit or ApplePay.

But what WILL it be? The Apple Watch interface seems clever, repurposing the traditional crown of the watch from winding to navigating and populating a home page with cute little bubbles that are scrolled through a la Blackberry rather than swiped. Still, the zeitgeist has clearly moved past wrist watches – only one in three millennials wears a watch now, most relying on their smartphones instead. The input mechanisms are clumsy – scrolling is limited, keyboard input is impossible and voice commands are imperfect and, frankly, more than a bit dorky, particularly when used to converse with one's wrist. The much heralded Siri voice command system is used by just 7% of iOS 7 users. Nonetheless, maybe some smart developer out there has a real killer app for those 1.89 inches of display real estate, and maybe the new bigger screen iPhones leave a hole for a smaller lighter alternative to fishing the 4.7 inch mother ship out of pocket or purse.

The best vision that I've heard involves the Apple Watch as a ubiquitous token of secure identity, akin to the electronic bracelets provided to guests of Disney Resorts (or prisoners on house arrest). In this world, a flick of the wrist unlocks your door and controls your home or hotel room. The same flick executes a transaction in a store, confirms your boarding pass at the airport gate, and lets you through the turnstiles at the ball game. While this utopian world will be extraordinarily cool, it is also extraordinarily far away. Necessary standards for wireless connectivity – N.B. NFC and its 12 inch transmission radius won't cut it for most of this – are the subject of fierce partisan debate that is nowhere near settled. Infrastructure investment has hardly started. If Apple Pay is a few years early, and I think it is, the broader vision of a wrist-based EZ Pass for life is at least a decade before its time and a LOT of other companies will have their say in it before it is a reality.

Of course, the history of the iPhone and iPad hangs in the air as a painful reminder to many of us not to underestimate those folks in Cupertino. Many analysts doubted the appeal of both of these revolutionary products at their birth. It took the original iPhone six months to get 3rd party apps on the virtual shelves and it was derided as a toy by many of the industry execs that later lost their jobs as a result of their blasé take on game changing innovation. iPad would have caught even more people flatfooted if they hadn't been already humbled by the iPhone experience. Nonetheless, the launch was greeted with skepticism and dismissed as a solution looking for a problem just before Apple started selling 10s of millions of units to consumers who quickly figured out that they were supposed to use them to consume media and surf the



web. In a similar vein, applications for the Apple Watch will trickle in after it becomes available sometime in early 2015.

My best take is that no more than 10% of the installed base of around 200M iPhone users will spring for an Apple Watch. Only about 35% of those users sprung for the flagship iPhone 5S, and most of those received a \$450 subsidy from their carriers, which took the acquisition price below \$200. No one will be subsidizing that \$349 for the entry level Apple Watch Sport. Without a really compelling use case, object lust will only take demand so far. That's the bad news.

The good news is that by segmenting the market into expensive, really expensive, and really, really expensive, Apple can skim a lot of cream off of the top of the market. While I suspect Apple will sell 10-15M units in the first year of availability, there will be enough ~\$1000 stainless steel models and ~\$5K solid gold models to take the blended average selling price to more than double that price floor. Total Apple Watch 12 month sales are likely to be more than \$10B, a nice 7-8% bump to Apple revenues and, likely, an even bigger bump to profits and cash flows. The upward revisions will be forthcoming.

Still, once the fanboys and plutocrats have gotten theirs, what will happen to demand? I don't think that you can expect Apple Watch owners to upgrade on the same 2 year cycle with which they swap out their phones – the price is too high and the marginal utility of a new model seems low. More likely, they'll be in the market for a new strap to update the look. The iPad peaked a year ago, three years after its initial launch. Given that the high end segment has crept even closer to overall saturation, the Apple Watch may have even less of a run as a growth engine. That means that Apple will just have to find another \$10B in new annual product revenues somewhere else just to make up for flat Watch sales.

Apple delivered a lot on September 9. I'm pretty convinced that the new big screen iPhone 6 and 6 Plus will pull ahead a lot of replacement demand and take incremental share from Android. Apple Watch will kick in sometime in early 2015 and keep the party going for a while. Apple should easily beat consensus expectations over the next 3-4 quarters and deliver the best top line growth that they have had in a couple of years. Regardless of investor skepticism, strong results should beget strong stock performance for a while. Next year, they'll have to do it again, even bigger. Good luck with that.