Investment Research

Apple and Netbooks

Securities Analyst: Lisa R. Thompson
Industry Analyst: Caroline Gabriel, Rethink Research
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It is better to know what a firm's customers are doing than what its management was saying.

Investment Summary/Ramifications

We continue to have a Favorable Opinion on Apple based on its innovation and new revenues streams for future products including iPhones and computers. IPhones continue to be a heavily wished for Christmas item and the continued world wide roll out should keep revenues strong. While competition continues to increase, we look to the company to leapfrog others. At 17xs 9/09 EPS, and 16Xs cash flow with $21 billion in cash ($23 a share) Apple stock is attractively priced.

The computer world and the cell phone world are expanding into each others territory as subsidized netbooks sold through carriers proliferate. Apple has a foot firmly in each camp.

Apple is believed to be negotiating a pilot with **O2 in the UK to sell a subsidized laptop (probably the new $999 MacBook)**. While this is not an official netbook with embedded 3G, it may be used to test the waters. Netbooks are being sold subsidized by carriers in Europe well ahead of the U.S. Logically it is there that they are pushing to get Apple product. If this were to happen, it should happen in Q1 or Q2 of next year. But then again, Apple may not choose to go the carrier route at all. If they do, the business model would look much like that for the iPhone rather than a computer sale. Given that Apple does not yet have a 3G embedded netbook, let alone a cheap computer, we do not expect any meaningful revenues for a computer sold through carriers this year or for 2009.

While a low-cost netbook from Apple could cannabalize higher end MacBooks we believe that Apple would increase rather than decrease profits much as they did introducing nanos and shuffle at lower capabilities and lower prices. Additionally, as Apple has shown with its cost reduced 3G phone, it is adept at making money even with lower priced products.

Netbook low-end computers are the fastest growing sub-category for the PC market. In fact, Rethink notes that Acer netbooks are so hot at T-Mobile in the UK and Germany that they sold out of all the they could get their hands on. In the third quarter, In EMEA about two million netbooks shipped in Q3 and Rethink believes that could go up by 50% or even more in Q4. Worldwide, Rethink estimates the figure around 5m for the quarter. Most of these were sold standalone, not through carriers although this is a growing trend. Most carriers only started selling netbook in the current quarter. Netbooks are 5% of the total US PC market now. In Europe, Acer and Asus account for 80% of the market according to IDC.

Rethink: Apple launches sub-$1,000 MacBook, but is netbook wave all positive?

Apple duly launched its sub-$1,000 MacBook notebook, **fuelling speculation that it would soon sign up with one or more cellular carriers to offer a low end, web-optimized PC through the new cellco channe**l, emulating many PC makers of 'netbooks', from specialists like Asus to mainstream vendors like Dell.

The surge in sales of low cost netbooks – which have fewer features and less performance than standard laptops, but are highly geared to on-the-move internet access – have proved a major boost to the PC sector this year. Especially as the mobile world continues to wait for a really usable mobile web device, despite the best efforts of smartphone and MID suppliers.

Overall, worldwide PC shipments rose to 80.6m units during the third quarter this year, a 15% increase over a year ago, according to Gartner. However, the netbook phenomenon may be masking the real picture, especially in the US, and the **low end PCs may be starting to cannibalize sales of their more fully featured cousins.**

The surge in third quarter unit sales was dominated by sub-$500 models, **boosted further by the addition of a new channel, the cellco offering subsidized notebooks. W**hile the carrier takes most of the burden of the subsidy, this pricing can still depress the perceived value attached to a notebook still further. The first two vendors to enter the netbook market, Asus and Acer, saw the highest Q3 growth in the sector.

Despite cannibalization fears, PC makers have recently been busily mining this rich new revenue stream, selling via the cellular operators. They hope the 'netbooks' will be clearly differentiated from higher margin, media-heavy laptops and so create new sales – as second machines or among people who would not otherwise invest in a laptop. **Carriers, especially in Europe, are starting to offer them at very low prices, bundled with mobile broadband contracts in the same way as smartphones**.

Meanwhile, analysts took Apple's decision to make its notebooks "far more affordable" as a sign that even this vendor, which traditionally trades on its premium brand rather than pricing, is under pressure from the consumer spending downturn. As with the lower cost iPhones, the company seems to be chasing new market share and seeking new channels, possibly including cellcos. The first sub-$1,000 MacBook is the 13-inch white model for $999, but though this is $700 cheaper than high-end models, it still does not take Apple up against the netbooks or budget PC laptops, and may dilute perceived value without being cheap enough to woo budget conscious users and so drive major new volume.

The area of highest demand for laptops is currently for models priced between $750 and $900, which means Apple, must be valuing its brand at a premium of $100 to target that band of consumers – which in a downturn may prove optimistic.

Will O2 in the UK be the first with an Apple netbook?

However, it was inevitable that Apple would consider tapping into the netbook market, given its newfound relationships with cellcos via iPhone and indeed, **O2 UK has been widely reported to be readying a MacBook offer to go alongside its iPhone exclusive.** In the quarter ended in June, Apple's computer revenue grew 43% year-on-year to $3.6bn. Notebook sales accounted for 61% of that, growing 42% from a year earlier.

In the third quarter,

The netbook market played an important role in Intel's third quarter figures. The mobile sector buoyed Intel's third quarter results as sales of its Atom product for ultra-mobile PCs and mobile internet devices started to have full impact. Intel gave much of the credit for the third quarter numbers to strength in the company's Mobility product group. Net revenue from this group came in at nearly $4.7bn, up from about $4bn a year earlier. Atom and other chips for the netbook segment recorded Q3 revenue of $200m, though fears remain that Atom would cannibalize the market for higher margin products. Intel said its average microprocessor ASPs declined sequentially, but would have been flat excluding Atom products. CFO Stacy Smith noted that the Atom product has a good profit margin, higher than the Celeron product.

T-Mobile runs out of netbooks for 'free' offer

Mobile operators across Europe are now offering heavily subsidized laptops to encourage hefty broadband contract commitments. So popular are some of these 'free' deals for low end, mobile optimized PCs, or 'netbooks', that **T-Mobile has even sold out of its Acer devices**.

The operator is being forced to look for an alternative notebook supplier since Acer cannot provide sufficient numbers of its Travel 5320 model at the price T-Mobile requires. This has been offered in **Germany and the UK in a bundle that includes the laptop, 200 minutes, unlimited texts and a USB modem dongle, for around €30 per month over a two-year contract.**

It is not clear whether Acer is trying to push up the unit price while negotiating the extension of its T-Mobile contract, or whether it really cannot get hold of netbooks at a more rapid rate. The PC maker expects to sell 5m netbooks this year, and shipped over one million in September alone. It is working with several carriers, including Taiwan Mobile, and is putting pressure on netbook specialists like Asustek with its Eee range.

JRPG Investment Research

JRPG, LLC
679 Littleton Blvd.
Suite 201
Littleton, CO 80120
Voice: 303-954-4207
Fax: 516-452-5840

www.JRPG.com

Peter White
Analyst, Research Principal
303-954-4207
peter@jrpg.com

Caroline Gabriel
Analyst, Research Principal
303-954-4207
caroline@jrpg.com

Jamie Townsend
Managing Partner
516-624-2612
jamie@jrpg.com
IM's Jamie@jrpg.com

Gerard Hallaren, CFA
Managing Partner, Director of Research
303-954-4207
gerard@jrpg.com
IM's (AIM, Yahoo, Skype): gerard6656

Geoffrey Knapp
Senior Vice President - Sales
203-856-8755
gknapp@jrpg.com
AIM: gbknapper; SKYPE: gknapp1

Lisa Thompson
Analyst, Research Principal
203-648-9409
lrt@jrpg.com
IM's (AIM, Yahoo, Skype): LRT256