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Smartphone sales' growth to drive the technology sector

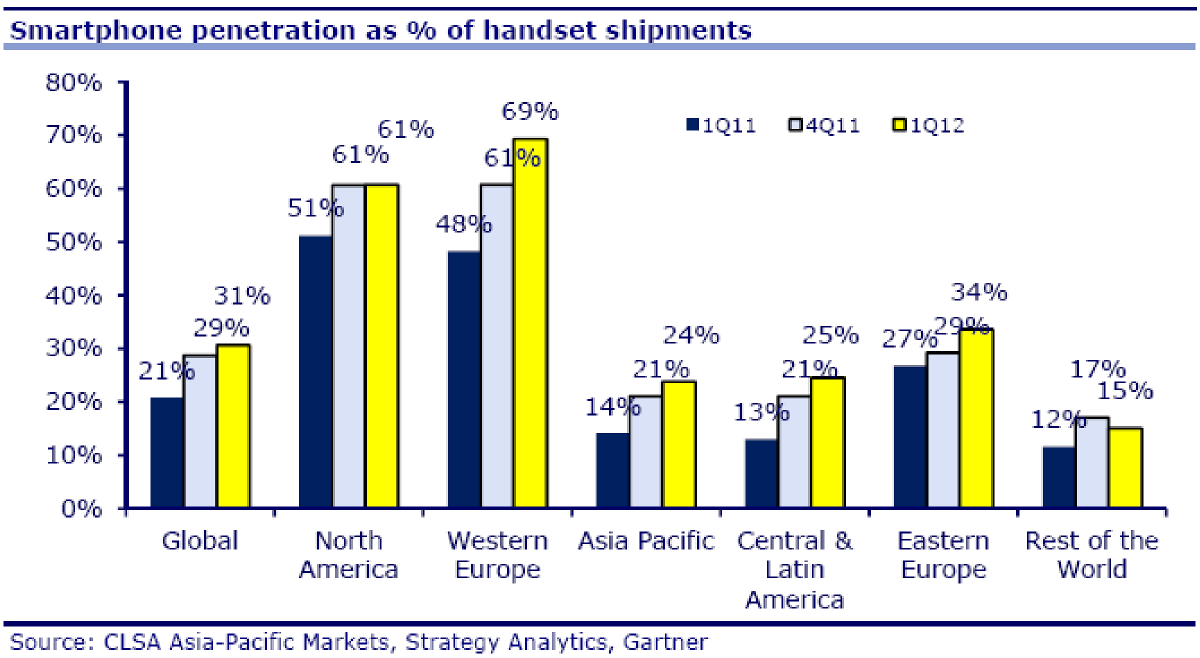
The launch of the new iPhone 5 and the legal battles between Apple and Samsung are dominating the headlines in the technology sector, which is increasingly dependent upon the rapid sales growth of smartphones. Global smartphone shipments grew by 43% yoy in Q1 alone to reach 147m.

Moreover, we believe that this rapid pace can be maintained. For despite the rapid sales growth already seen, the handset market retains substantial untapped potential for further expansion because global effective smartphone penetration remains relatively low at 31%.

However, global sales may disappoint in the near term. Estimates for 2Q12 handset shipments are being revised down, with some downside to current expectations of 160m units. Forecasts that the total market size could reach 1bn units by 2013 are now also looking overly optimistic. Recent downgrades reflect eurozone weakness, tighter US carrier subsidies and a likely delay in new product launches by Apple.

These factors will offset the continuing robust growth of emerging markets as the arrival of lower cost handsets at attractive price points drives an increased propensity to upgrade from traditional feature phones. However, while overall emerging market demand remains strong, the Chinese market presents both an opportunity and a threat to mainstream vendors. The development of sub-US$300 phones in China is driving significant growth in smartphone shipment volumes as consumers migrate away from legacy feature phones. Highly-fragmented competition, however, is likely to hinder profitability as hundreds of "white-box" local brands enter this segment. Consequently, even large scale vendors such as Huawei and ZTE could struggle to see a single model breach the 1m unit breakeven threshold.

Figure1: The potential of the emerging world



"We can see considerable potential in the handset market given still low global penetration"

Apple and Samsung's growing market dominance

The benefits of the market's overall expansion will not be evenly spread as Apple and Samsung extend their dominion over a "squeezed middle", which consists of second tier manufacturers, such as HTC, Nokia and Research In Motion Limited (RIMM), who are additionally pressured from below by emerging Chinese competitors such as the aforementioned Huawei and ZTE.

Interestingly, Apple and Samsung are pursuing significantly different business models. Samsung is now the market leader with a market share of overall shipments of around 30% and it may take up to 50% of incremental volume in 2012 on the back of its successful Galaxy series. Less well appreciated is Samsung's success in low-end handsets with 70% of shipments now coming from emerging markets. Samsung has integrated vertically into the component chain (memory, application processors, and display), enhancing cost competitiveness and reducing time to market. These are important considerations in an industry where average product cycles may only extend over 12 -18 months.

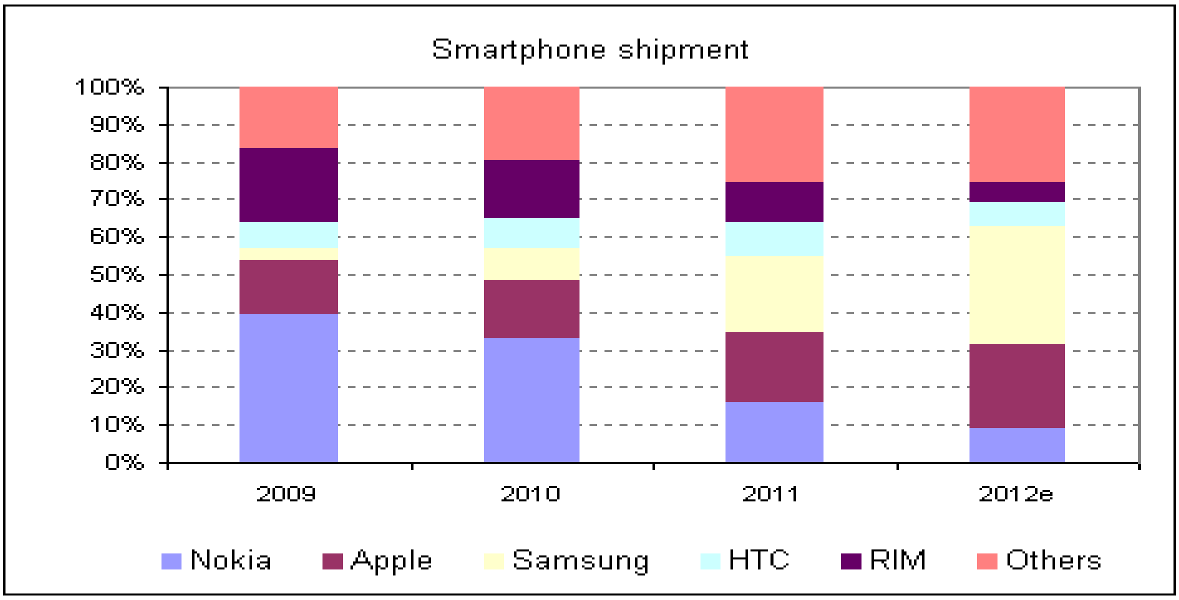
By contrast, Apple pursues a completely outsourced business model but uses its largest scale per single device to maintain cost bargaining power versus its mainly Taiwanese component suppliers. With less than 8% of the overall handset market and a relatively sticky user base, Apple shipments should accelerate into 4Q12, assuming a timely transition to iPhone5 once yield issues with the new in-cell display technology are resolved.

Apple remains favoured stock despite disappointing Q3 figures

In late July, Apple released Q3 figures that missed consensus sales and profits estimates and the shares reacted negatively. However, it is important to keep the data in perspective:

- **Total sales grew by 23% on a year over year basis**, a very respectable rate given how many companies are struggling to deliver meaningful growth in the current economic environment.
- **No iPads were sold in China in Q3 due to trademark issue, which have now been resolved.** This factor will prove incrementally positive for Q4.
- **Apple is heading into another big product cycle, with a stream of new products likely to be released later this calendar year.** Apart from the IPhone 5, an iPad mini, a new Macbook line-up and a new operating system (iOs6) are rumoured to be heading for the launchpad. As a result, consumers are waiting for the new products to upgrade their hardware and this has temporarily depressed demand. Hence the Q4/September quarter guidance is conservative.
- **Apple has $117bn of cash on its balance sheet – up $7bn over the past quarter – and is starting to return this cash to shareholders** (increased shareholder returns is a theme that we favour in our US and global strategies), having initiated a $2.65 dividend. It will also start a $10bn buy-back in October.
- **We are not paying for the growth already delivered by the company**: ex the cash, the firm is trading on c. 10x FY'12 earnings i.e. investors are not willing to assume that the growth delivered over the past years is repeatable - we disagree.

Figure 2: A smartphone duopoly?



Mid-tier vendors struggle to compete

Meanwhile, mid-tier vendors, such as Nokia, RIMM, HTC and LG, now account for less than 20% of total smartphone shipments. This mirrors the experience of 2G where tier 1 manufacturers, then ironically including Nokia, prospered at the expense of Siemens and Motorola. We continue to avoid Nokia due to an uncompetitive cost base (75,000 staff versus 25,000 at Apple) and a redundant operating system. For HTC, the problem is one of a lack of scale as the advantage of being an early mover in Android adoption fades. We anticipate further risk to this mid-tier group as a result of a non-competitive cost structure, inadequate scale and limited content differentiation.

Intellectual property is the new battleground

Longer-term the change in US carrier policy on smartphone subsidies could prove negative for high-end handset vendors since it will extend the replacement cycle for handsets. In addition, vendors are starting to find it harder to differentiate purely on the basis of hardware, with most phones now offering 4.5-5" displays, dual/quad core CPU and ~2500mAh battery. Apple seems better placed compared to other suppliers as content becomes the focus of differentiation. Intellectual Property has also become a marketing weapon with corporates content to spend millions of dollars in patent challenges as a way of delaying rival launches. In early September, for example, Apple added the best-selling Samsung Galaxy S3 handset to a list of products it says infringe its patents. The Galaxy Note tablet is also included in a new list of 21 gadgets submitted to a court in California. It is not the same court that last month awarded Apple $1.05bn (£644m) after finding Samsung guilty of "wilful" infringement. If the new court initially finds infringement, it has the power to halt Galaxy sales in the US before trial.