

Apple event feedback: Big plans for gaming

Apple held its annual event on Wednesday (9 September) in San Francisco and unveiled, for the most part, what was largely expected and written about in the media over the past few weeks. Not unexpectedly, the company's new iPhone 6s and iPhone 6s Plus look basically like their predecessors on the outside (with a rose gold colour option added for the iPhone). However, in terms of functionality it now has what is called 3D Touch sensors, which allow the user to bring up content/menu options by simply pressing hard on the screen. In addition the iPhone has gained the ability to shoot 4K videos (which has four times the number of pixels of 1080p high-definition video) and a faster processor. Apple introduced an upgrade to its smartwatch OS (due on 16 September), which will allow third-party apps to run on the device without having to rely on a linked smartphone's processor. It also announced its first tie-up with a luxury goods brand with its new \$1,500 smartwatch with French luxury-goods house, Hermès. The new iPad Pro was introduced. It has a larger (32.8cm) display, and is aimed squarely at the business user. Apple no doubt hopes that this new model will reinvigorate sales (iPad sales were down 19% YoY between the start of October 2014 to end June 2015). The iPad Pro will be launched with an optional, magnetically-connected keyboard and a stylus (called the Apple Pencil), with sensors in the pencil's tip to give the user the effect of using a real pencil on paper. According to Apple the iPad Pro offers similar processing power as 80% of portable PCs sold over the past six months.

In our view, however, the most interesting announcement coming from the event was Apple's revamped Apple TV set-top box which will see the iPhone maker for the first time venture into living-room video gaming territory. The new Apple TV features an App Store, a new OS (tvOS), Siri and gaming support, universal content search, and a revamped remote (with a glass touch surface), which doubles as a video-game controller and also boasts motion controls.

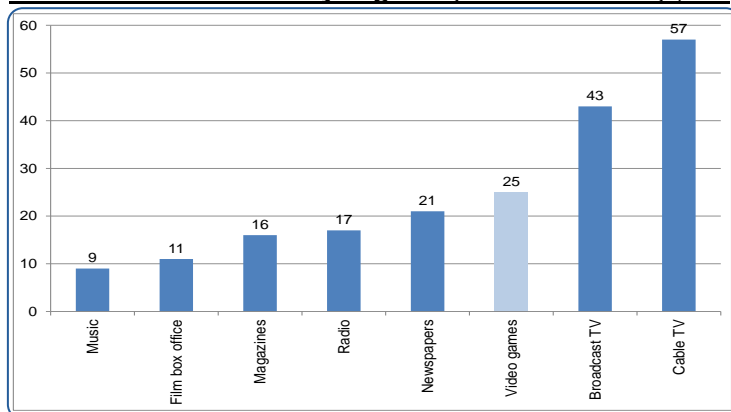
We believe the new Apple TV's ability to (and increased emphasis on) gaming will open up an as-yet untapped market for the company. While it is unlikely to revolutionise the 'living-room' games industry (as the iPhone has the mobile industry over the past decade or so) – at least not over the short-term, it could provide Apple with another revenue stream. While gaming has been possible on the current Apple TV (through the Airplay functionality), this option has

been disappointing (slow, glitches etc.) and never quite lived up to its potential. This is expected to change when the new set-top box launches in October and gamers have a true App Store at their disposal.

Background:

The global gaming industry is huge with a recent report from *SuperData* (which analysed only software sales and did not include hardware) valuing it at \$74.2bn and finding that games revenue will soon outstrip broadcast TV revenues.

Entertainment revenue by segment, 2015 estimates, \$bn:

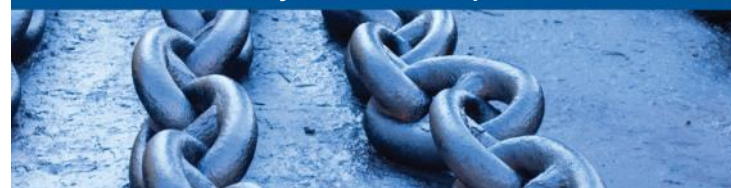


Source: SuperData, Anchor Capital



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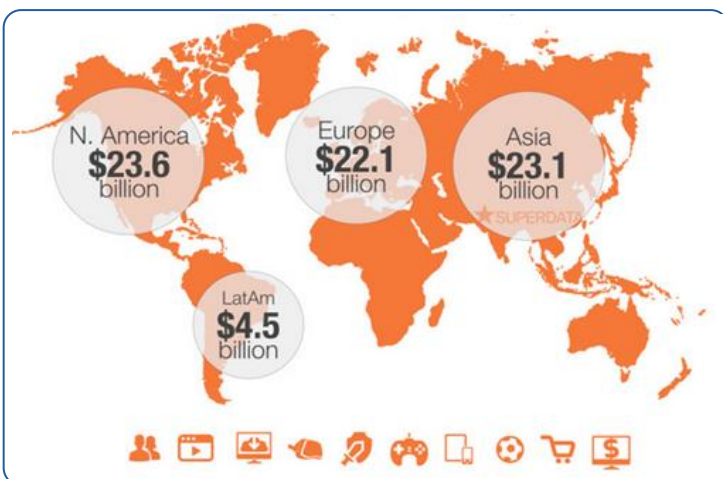
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Apple continued... In its report entitled *Global Games Market Report – 2015*, the market research firm says that gaming video content and competitive gaming such as e-sports “will help push video games past broadcast TV into the No. 2 spot in entertainment market share behind cable TV”. The report shows that games’ share of the total entertainment market has tripled in the past three decades, and while mobile accounts for the largest revenue segment in the study (at \$22.3bn), retail sales follow at \$19.7bn. Free-to-play massively multiplayer online (MMO) games account for c. 50% of that number followed by social games, PC downloadable game content, digital console sales, pay-to-play MMOs, and the rest.

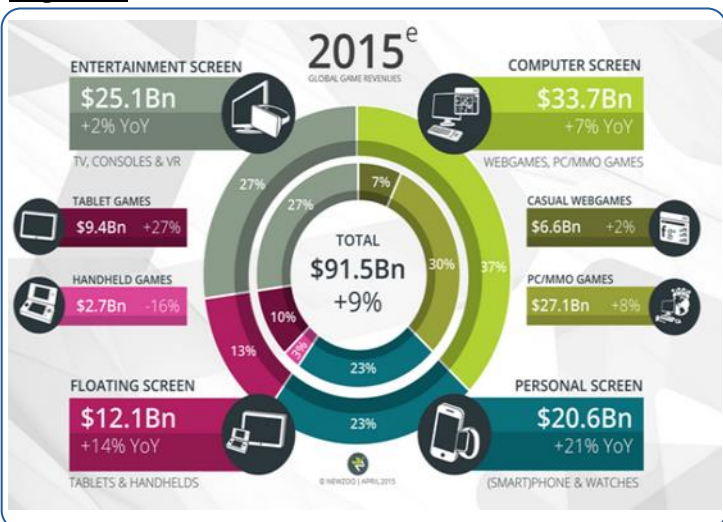
Global games market by region, 2015E:



Source: Newzoo

Another report from *Newzoo* is even more optimistic and expects the global games market to jump to \$91.5bn this year. At the current pace the report says it expects that global revenues will reach \$107bn in 2017. At the same time, the study finds that global mobile game revenues will eclipse console game revenues for the first time this year. *Newzoo* says it expects that mobile games will generate \$30.3bn worldwide; it predicts that console games will take in \$26.4bn. The firm expects sales for the total worldwide gaming market to be \$91.5bn in 2015.

Global games market, 2015E per screen and market segment:



Source: Newzoo

So what does this mean for Apple’s venture into the living-room gaming sphere? By all accounts it does not seem as if Apple is necessarily taking on the big guys (Sony, Microsoft) or going after ‘hardcore’ gamers who are more interested in console-grade games like the ones available on the Xbox or the Playstation (PS4). Instead, from Wednesday’s presentation, the company seems more interested in targeting users who are looking for a mobile-like social gaming experience (a very lucrative user base) that’s already available on the smartphone and tablet. At least that seems to be its initial expectation. However, as Apple has proven in the past it has the ability to revolutionise a market segment it enters and who is to say this will not happen with its venture into living-room gaming. Apple may very well be on the verge of creating a big new category in gaming, different from what others have tried or even failed to create in the past.

There are a number of factors that we view as positive for Apple’s foray into the living-room gaming space and below we highlight a number of these:

- The revamped Apple TV has the potential to **expand the gaming audience** by bringing casual gaming to a user’s living room and thereby serving as an extremely accessible entry point (easy and inexpensive) into games for those who have already been playing these games on their mobiles or tablets.
- By venturing into living-room gaming, Apple has found yet another way to keep established users within the **Apple ecosystem**.
- In general, living-room games have (with few exceptions), become more difficult to access by requiring relatively expensive home consoles or top-of-the-line computers, while newer games are, in most cases, not playable on older-but-still-running systems (for example PS3 games on PS4). So, to a large degree, **barriers to entry** have been high as well as the ease of use. In the case of Apple, games are downloaded from the App store and can be played across its devices as well as on any updated future Apple TV models. Consumers shouldn’t have to pay exorbitant amounts to try out a new game and in the case of Apple TV they won’t have to.
- Starting at \$149 (with anyone who intends to use it for games likely needing the larger \$199 edition for more storage) the Apple TV is **cheaper** and a more practical option when compared to the Wii U, Xbox One, and PS4, which range in price from \$299 to \$399.
- **Relatively inexpensive games** vs other gaming console games: The fact that games downloaded from the iTunes store are relatively inexpensive is another hook for Apple to use. Many users have also already purchased games from the App store that they have been playing on their iPhone or iPad and thus should have a huge catalogue waiting for them at no extra cost, as some (if not all) of those games for iOS will double as the users Apple TV game collection.
- Although not confirmed by Apple, it is likely that at least some, if not all, games will allow for **progress to be synced across devices (i.e. continuity across devices)**. This means a user can start the game on his/her iPhone (or iPad) and finish it using the Apple TV in the living room.

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- While most new gaming consoles launch with a limited number of (expensive) games, Apple will launch with the support of the App Store and the **tens of thousands of games** that are already available.
- Apple has an **established captive user base** and developers tied up in years of investment in the App Store ecosystem and is therefore literally bringing one of the largest bases (and probably the most lucrative existing base) of casual (mobile and tablet) gamers to its new gaming platform. Games (for iPhone and iPad) are already the most popular category on the iOS App Store, accounting for the majority of top spots on App Store charts.
- Apple has a **proven revenue model** in the App store and, in effect, Apple TV now brings the low-cost app sales model from Apple's other devices to a gaming console.
- Apple has a nearly **bottomless war chest** it can use to support the device if initial sales are slow. So, while the gaming market may be crowded, few have Apple's resources with which to take a chance.
- Apple gets a **30% cut of all purchases** on the App store. According to *Fortune* the continued growth of mobile game revenues will put Apple (and Google) in the "top-five public companies by game revenues in 2015, thanks to their 30% commission on all games sold in their app stores".
- *Newzoo* reported recently that Apple's **App Store remains (by a wide margin) the biggest single platform in the mobile industry**, accounting for c. 50% of the mobile games market revenues in 2014 (Google Play came a close second).

So while there are a myriad of reasons why we are positive about Apple's foray into the living-room gaming market, we highlight a few (minor) concerns below:

- *The biggest negative* is that Apple is unlikely to win over hardcore gamers (the Xbox One and PS4 owners). These gamers already have an ecosystem around their particular console or PC and it is improbable that they will move to another operating system and lose all the games, trophies etc. on their existing platform. This means Apple may lose out on a large, established segment of the gaming market (who also spend more on gaming).
- Storage capacity. The Apple TV's maximum storage is 64GB so there is very little space available for single-game file sizes that run into 30GB-40GB.
- Following on from the above point at a cost of \$149-\$199, the Apple TV won't have the graphical horsepower to match an Xbox or PS4 (although it will be significantly cheaper).

Conclusion:

Although there are *caveats*, Apple is bringing one of the largest user bases (and most likely the single most lucrative existing base) of casual gamers as well as the most popular App Store category to the table. Apple's App Store was the key growth driver of its Services segment (which includes revenue from iTunes, AppleCare, Apple Pay, licensing and

other services), with revenue from the App Store growing robustly by c. 24% YoY during 3Q15. *Forbes* estimates that the App Store's current grosses run close to \$5bn a quarter, with 70% going to developers and 30% to Apple. Games account for over 50% of this revenue – already a significant revenue stream for both Apple and its developers.

While the Apple TV is unlikely (at least initially) to challenge its more expensive console competitors from Sony, Microsoft and Nintendo, we also don't believe that is the market Apple is going for at the moment. Instead, by enabling gaming on the new Apple TV, Apple is likely looking at taking console gaming beyond the hardcore gamer and thus dramatically expanding a user base that would otherwise only have played games on their iPhone or iPads. Added to that, with an already healthy library of cheap and free games on the App Store, Apple will be challenging the current gaming industry status quo. If successful, the company could eventually make inroads into territory that has traditionally been dominated by the likes of Sony, Microsoft, and Nintendo.

At Wednesday's announcement CEO Tim Cook said "We believe the future of television is apps," before he unveiled the new Apple TV set-top box, adding that the "... television experience has been virtually standing still while innovation in the mobile space has been racing ahead. Today, we are going to do something about that." Apple TV could end up doing what has already been done but cheaper and, as usual, a little differently – more people will have the opportunity to play video games in their living rooms thereby expanding what is already a very profitable and robust market segment. Ultimately, if Apple is able to do this successfully (which we believe is the most likely outcome), the company will have a huge opportunity to diversify its revenue stream further.

Marco de Matos



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