

Apple receives mobile wake-up call

Analysis: Vendor finds out just how tough the market is

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WASHINGTON (MarketWatch) -- A chastened Apple Inc. has now learned one fundamental truth about the wireless-phone market. It will soon discover another.

The first lesson Apple is learning -- the hard way -- is that most consumers are not willing to pay a pirate's booty for a mobile phone.

The company admitted as much this week when it slashed the price of its top-end iPhone to \$399 from \$599, a move that shaved 9% off the value of Apple stock in the past three days.

A whiff of panic also was evident in Apple's hasty decision on Thursday to give previous iPhone buyers a \$100 credit. The handset went on sale in late June.

Although Apple had planned to gradually reduce the price, the speed of the decision and size of the cut shocked industry observers. The abrupt shift suggests demand was flagging after a burst of sales in July and early August.

"It's unusual to cut the price so dramatically so soon after the introduction," said Ross Rubin, a consumer-electronics analyst at the market-research firm NPD Group.

Yet mobile handsets are unlike any product -- and wireless is unlike any market -- in which Apple has gotten involved. Customers have come to expect ultra-low prices on even the most feature-packed phones, and the competition is brutal.

"It's a tough market," said wireless consultant Jane Zweig, who runs The Shosteck Group. "Apple is learning."

Would-be market entrants such as Hewlett-Packard Co. and Google Inc. should pay heed. H-P has already produced some smart phones and rumors abound about a pending Google phone.

"Cell phones are very complicated to design and build properly," said Ed Snyder, a former engineer and longtime mobile analyst at Charter Research. "Google doesn't want this. Neither does H-P."

Huge market, low prices

What's attracted Apple to the mobile market is the market's sheer size: several billion people and growing. Every adult in the world -- and most kids -- eventually are expected to own a wireless phone.

Over the years, however, consumers have grown used to falling prices, even in wealthier regions such as the United States and Western Europe. Phone companies are even willing to give phones away for free to keep their customers paying their monthly bills.

NPD, for example, has found that 28% of the mobile phones purchased in the second quarter by U.S. consumers were obtained for free after special promotions. Another 28% sold for under \$50.

As a veteran salesman at one Sprint Nextel retail store put it, "the most popular phone is always the cheapest one."

By contrast, only 4% of the phones sold in the U.S. in the second quarter cost more than \$250. That's the market Apple is dabbling in.

Smart money?

These premium-priced handsets fall into a category known as smart phones. Such devices have full keyboards, the ability to send email and surf the Internet, and even play music and videos.

Apple clearly achieved big success in that segment in the third quarter. The market-research firm iSupply said the iPhone was the top-selling smart phone in July, outstripping BlackBerry and Palm devices.

What's more, iSupply found that the iPhone represented 1.8% of all U.S. handset purchases during that month, tying LG's far-less expensive Chocolate for the No. 1 position.

After a hot start, though, rumors were rife that the iPhone's momentum was slowing. Apple's sharp price cut appears to support the speculation despite denials by Chief Executive Steve Jobs.

In any case, Apple also recognized it was failing to reach its intended audience. Smart phones accounted for just 80 million of the 1.02 billion handsets shipped worldwide in 2006, according to the research firm IDC.

Yet Apple doesn't want to position itself merely as a niche supplier of pricy smart phones for elite customers. It sees the iPhone more like the iPod than the Mac. The company wants to position the device to capture a much larger slice of the mobile market.

To accomplish that goal, however, the company will have to further reduce the price of the iPhone. And that means the company has to slash the cost of producing the device, which iSupply has estimated at \$265 before marketing expenses.

Those are big challenges in an industry in which margins for most handset makers -- Nokia Corp. and Research In Motion Ltd. excepted -- are thin. Even long-established mobile vendors such as Motorola Inc. have not mastered the art.

"Low cost always wins," new Motorola Chief Financial Officer Tom Meredith stressed to investors Thursday at a Citigroup conference in New York. "Let me repeat: Low cost always wins."

Here comes the competition

Of course, Apple is not inexperienced in the art of financial management. The company is extremely well run, better than most of the mobile-handset makers. Its famous technological prowess is also on full display in the beautiful design of the iPhone, some of whose features are sure to be copied by competitors.

And that leads to the second truth Apple is soon to discover. The older mobile-handset business is not like the young MP3-player market, where Apple quickly seized a dominant position and benefited from repeated mistakes by weaker or less savvy rivals.

Top vendors in the handset business are well established, much larger and financially secure, with greater economies of scale. They respond quickly and intelligently to innovative designs by their rivals -- and they'll do the same with Apple.

Just a few years ago, for instance, Motorola's then-expensive Razr was the thinnest phone on the market and it became the industry's all-time best seller. Nowadays almost every handset is cheap and thin, some much thinner than the original Razr, and Motorola is struggling to return its handset unit to profitability.

By early next year, if not sooner, handset makers are likely to adopt the features of the Apple to which consumers prove most receptive. The likely result is a vicious cycle: more pressure on Apple to reduce prices and hence to reduce manufacturing costs.

"Apple's move into the phone business is like going from the Little Leagues to the Major Leagues," said Snyder, one of the few early skeptics of the iPhone. "I think Apple has bitten off more than it can chew." ■

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