

PERSPECTIVES

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Smart Watch Market Opportunity

2015 will be the Year of the Smart Watch, but will it be a successful market?

Whether or not the smart watch category is a global success or just another moderately sized category, 2015 will mark the year the category begins to take off. Our estimates for total smart watches sold to date are in the ~1.7-1.9 m unit range. We believe the number in active use to be well below the total sales figure.

The smart watch market in general, and even the Apple Watch specifically, has been panned by many investors and pundits who claim they fail to see a need or a value proposition. I believe this view is shortsighted and, while it is a valid criticism of the current crop of smart watches, it is unfair to make such a claim without spending time with the Apple Watch once it is released.



The Current Wrist Watch Market

- Approximately **1.2 billion** wrist watches sold annually worldwide
- Number of Swiss-made watches sold: **29,200,000**
- Number of watches produced by China annually: **663,000,000**
- Number of watches produced by Hong Kong annually: **354,000,000**
- Average cost of a Swiss-made watch: **\$739 ASP**
- Average cost of a Chinese-made watch: **\$3 ASP**
- Mechanical analog watches make up **77% of watches sold**
- Digital/electronic watches make up **23% of watches sold**

Watch Market Leaders by Sales Revenue

Swatch / Omega annual sales	\$8,880,000,000
Rolex Annual sales	\$4,500,000,000
*Consensus Apple Watch FY15 revenue estimate	\$10,000,000,000

Several key points to make on the previous data. 1.2 billion watches a year sold is a good sized market. However, the average price of the vast majority of those units is \$3. Swiss-made watches make up less than 3% of the total unit volumes. These Swiss manufacturers are the vast majority of the high end/luxury segment of the watch market and they control the vast majority of market share of the high end.

In terms of revenue leaders (listed above), if Apple does near or above Wall St. consensus revenue of about \$10 billion dollars, they will be near the top if not the leading vendor by watch market revenue.

“Research data indicates actual watch ownership among consumers in many developed markets is quite high.”

Research data indicates actual watch ownership among consumers in many developed markets is quite high. A UBS survey of over 4,000 people in major markets such as China, US, the UK, and other parts of Europe found 70% of respondents said they owned a watch.

Our product purchase intent survey data of ~5,700 people showed 37% of respondents intend to purchase a wrist watch in the next six months. Demographics with the greatest purchase intent were highest among those in the top 25% income bracket and males and females between the age of 25-34.

From Fashion to Utility

An important observation of today's watch market is to understand the fashion over utility of existing watches. In the wrist watch's early days, the product was more utility than fashion. Today, they serve more of a fashion/status role than one of utility. Very few wear a watch today just to tell time. Most wear them as fashion or jewelry.

The utility nature of the original watch is an interesting angle to explore. Some very early use cases included in the military. It was a glance-able time display to help keep troops in sync with their orders. Similarly, during the days of the railroad, an accurate time piece was essential in helping people make their

trains. Missing a train could mean being late for work or to an appointment. From a utility standpoint, the early days of the wrist watch added a level of increased functionality and convenience that did not exist before.

What makes the smart watch category interesting is to think through some of the ways technology can bring modern day utility back to a fashion-centric wrist worn object. The upside of the smart watch, in our view, is to expand the category of a wrist worn display beyond those who buy and wear watches today. To do this, the product must be fashionable but also go beyond in order to appeal to those for whom fashion alone is not a good enough reason to buy a watch.



The Job of the Smart Watch

While there was certainly a fashion-centric element of the original growth of wrist watches, most used the watch in order to help them manage their time and be on time. Given the diversity in applications a smart piece of glass on your wrist can assume, we believe the upside opportunity of the smart watch is because the software, apps, services, etc., will allow it to fulfill a variety of jobs. It can be both a fashion object and a health and fitness monitor.

It can be fashionable and a way to receive relevant or communication alerts. The big opportunity for the smart watch is to bring convenience and utility back

to the watch using modern technology — the same way early wrist watches served a more productivity centered use case.

The smart phone is the computer we always have with us. The smart watch is the computer that is visible at all times. As the job for the smart watch gets defined by the ecosystem, it is the “display that is always visible” premise that will define what additional computing utility is most valuable.



Starting off in the Enterprise

I believe some of the first mainstream applications for smart watches will quickly attract a business audience. Much of the utility in receiving notifications on the wrist today have a more “productivity” based value proposition. Email notifications, calendar alerts, reminders, messages via text or other corporate communications platform (assuming it gets supported on the smart watch platform), and more are all valuable use cases for smart watches.

In fact, our research consistently shows the most positive response of smart watch owners today comes from those who are regularly in a business context. It also bends toward those who are more mobile in their jobs. In other words, moving from meeting to meeting, out in the field doing sales, delivery, maintenance, etc.

A smart watch provides this audience a convenient way to get timely and important notifications at a glance that help them be productive and add a layer of convenience to their job that a phone in the pocket doesn't necessarily

provide. Our early research with the enterprise work force and smart watches give us confidence the category will gain steam with the business market. Given iOS's dominance in the enterprise, we believe this angle gives the Apple Watch a strong edge in business.

Broader Consumer Appeal

Growing beyond a business/enterprise angle for smart watches is key for the category. Certainly, a percentage of consumers and those who are early adopters/gadget/tech enthusiasts will likely adopt smart watches. But breaking beyond these is essential if the total addressable market is to be near or larger than the existing analog watch market.

Identifying the utility of the smart watch in more business use cases seems clear. Identifying the true mass market ones is more difficult at the present. Perhaps the utility/productivity angles that will likely draw corporate customers have parallels with communication in pure consumer markets. Communication/social use cases are central in mainstream consumer smart phone applications — perhaps elements of those use cases extend to the wrist to add value in ways a pocket or purse based smart phone can not.

We expect health and fitness based applications to also have more mass market appeal which adds another element of utility to the product. Driving the value proposition of the smart watch to the broader consumer market requires software developers capitalizing on the potential of the wrist worn display that is visible at all times.

A popular saying surrounding smart devices is: the most convenient screen is the one we have with us at all times. The screen we have with us at all times is the smart phone. However, perhaps the smart watch evolves this to say: the most convenient screen is the one we can see at all times. Cracking this value proposition is key for the categories upside.

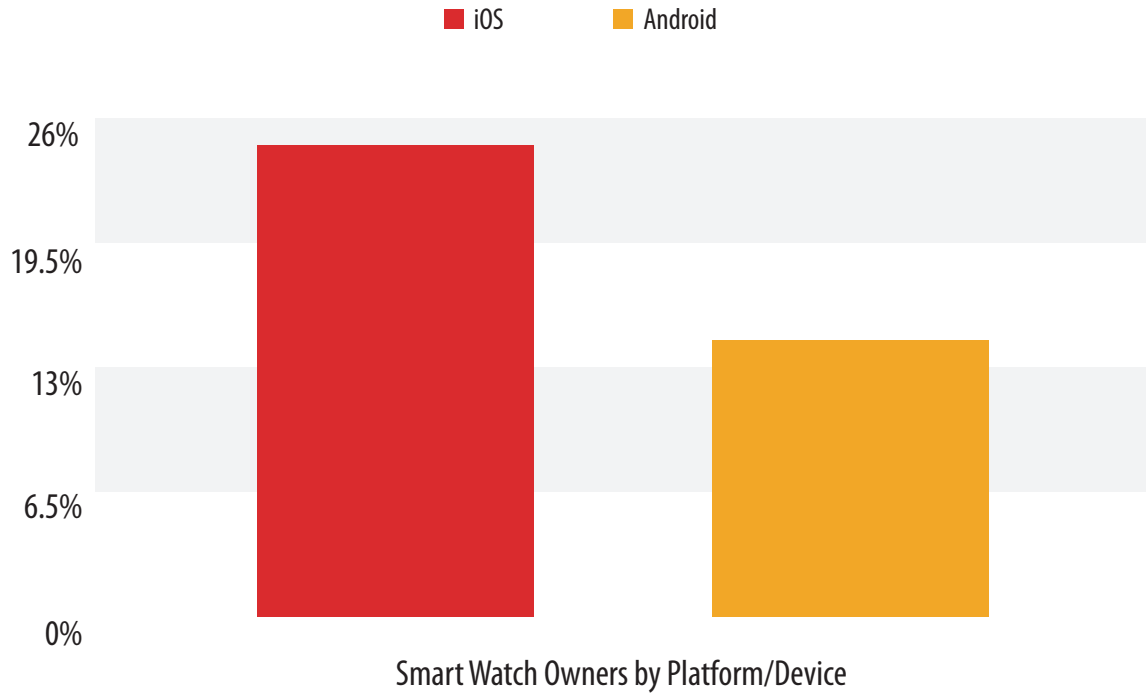
Deals Not Advertising

An example of this could be something TapSense showed recently. The idea of hyper-local notifications to the watch is a use case worth exploring. TapSense is working to build this kind of hyper-local, contextual, push-based notification to allow marketers to take advantage of a person's context. The quick example they showed was, as you walk by a Starbucks, you may be pushed an "offer".



Here we need to make an important distinction. I don't believe consumers want advertising pushed to their smart phones or smart watches. I believe they want deals. There is a significant difference. In the Starbucks example, this would clearly have to be an opt-in program. But if you love Starbucks, who would not want a deal offered to them? This is the driving force of retail and it is extremely successful for a reason. Emails from a consumer's favorite retailer offering them coupons, which expire, but incentivize them to come in store are hugely valued.

Taking this even further, what if your smart watch was smart enough to know you will be passing a Starbucks on your way to your next meeting and you have 30 min to spare before the meeting starts. It also knows it's 20 degrees outside and that you may like to stop for a warm beverage to kill time — so it offers you a coupon at Starbucks. If done right, this could have huge consumer appeal.



Data on Smart watch Ownership / Intention to Purchase

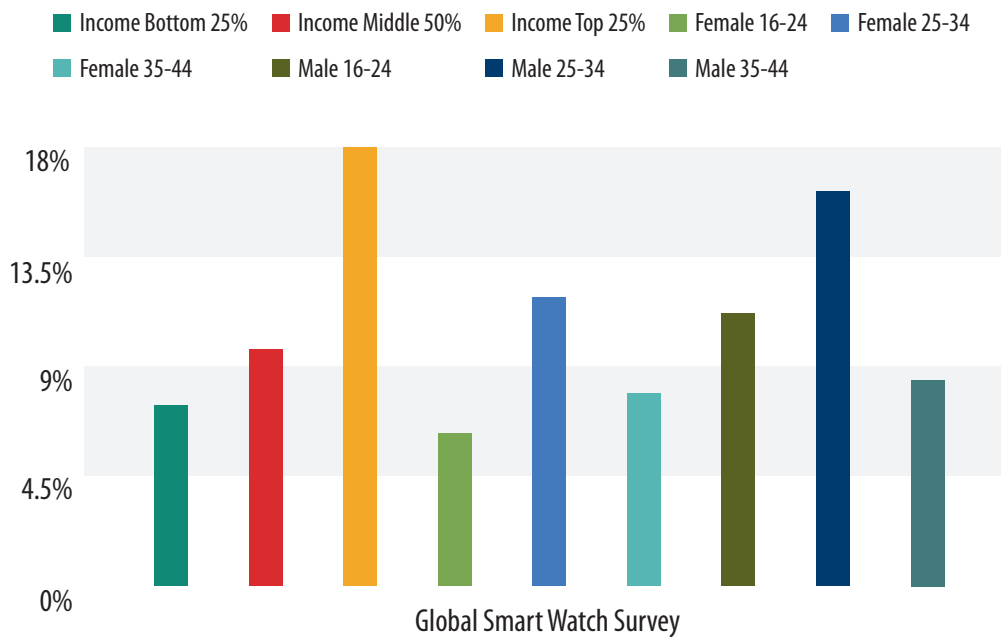
Although the market is still quite young, we've attempted to gather as much data on those who own smart watches currently along with the demographic trends that make up the existing smart watch market. Below is what we have found.

The chart above is made up of responses from those who said they owned a smart watch. I've broken out the respondents who said they owned a smart watch by platform.



The vast majority of consumers from the panel who indicated they owned a smart watch were iPhone owners. Of the Android respondents who indicated they owned a smart watch, most were Samsung Galaxy owners at 62% and Motorola at 20%.

From a demographic standpoint, a few things stand out regarding the current market from our surveys. Perhaps unsurprisingly, of all income brackets polled, the top 25% ranked the highest in smart watch ownership. By age group, men aged 25-34 ranked the highest in smart watch ownership.



* Demographics of respondents who said they owned a smart watch

† Question: What tech products do you personally own?

• Smart watch (example Samsung Galaxy Gear, Moto 360, Pebble, etc.)

Keeping in mind the smart watch market is small, with total sales to date of less than two million, it is still useful to get a picture of who owns them today and whom the interest thus far has been from. One interesting point from this survey panel was the ownership of smart watches among the younger demographics. The knock on smart watches is “young people don’t wear watches”, but both the watch ownership data and this smart watch data seem to suggest the younger generation is a valid segment of the market. This may just be because the younger generation is tech savvy and bends toward tech enthusiasm, but even then it makes a strong case for increased interest levels in the smart watch category with this demographic.

Scenarios

With the market being so new, it is difficult to make forecasts or predictions about what will happen. Instead, we present a number of scenarios we can see occurring over the next five years.

#1 - Apple Dominates The Category

Apple will easily strongly influence the smart watch category in 2015 and 2016. It is hard to argue against Apple's vertical advantage and tight control of their entire ecosystem. This advantage undoubtedly will give them a dominance in the early stages of a category. If a number of things play out, we can see them command the category for the long term.

Apple had a near monopoly on the iPod/MP3 market. We can see a similar scenario playing out where Apple effectively "iPods" the smart watch category, maintaining dominant share over the next five to seven years. While the early success of the iPod was driven by Apple releasing iTunes for Windows, we don't see the need for Apple to support other platforms in order to hold sway over the smart watch category. Apple's existing iPhone customer base is large enough to keep it the foremost smart watch vendor and their smart watch platform as the reigning one in the smart watch category.

Apple is blessed by their developers and always has been. Developers for the Apple Watch will make or break the product. To dominate the category, Apple's developers will tightly integrate the Apple Watch experiences with their apps and drive compelling use cases into the mass market. Apple's developers are a large part of their competitive advantage for iOS and this extends to the Apple Watch making it very difficult for other smart watch platforms to commit and attract developers or build an ecosystem. I believe, for the smart watch to go mainstream, it will take an ecosystem and Apple has history in their corner when it comes to building for a category.

Key assumptions for this scenario:

- Competing analog watch vendors like Swatch, Omega, Seiko, Citizen, and many other brands selling watches below \$700 avoid making a smart watch of their own as they fear it simply becomes a race to the bottom. Instead, they choose to simply maintain course and focus on analog watch products.
- Smart watch platforms become fragmented. Should some higher end

watch brands decide to make smart watches, they decide to try and create their own platform in order to maintain stronger differentiation and avoid a race to the bottom.

- Android's ecosystem and customer base is not profitable enough to make it worthwhile for companies to support and develop for Android Wear.
- Google or any other smart watch platform OS (like Tizen for Samsung) succeeds at building a smart watch ecosystem for developers and core services.



#1 - Android Wear (or something else) Dominates Market Share

Another possible scenario is the smart watch category shapes up very much like the smart phone category. Apple succeeds at their goal to acquire the top 20% of the market and rake in the majority of the profits. While Android Wear, or another third party licensable smart watch OS, provides the software platform to the vast majority of hardware companies making smart watches.

In this scenario, the vast majority of Chinese and Hong Kong produced smart watches adopt Android Wear (or something else) and flood the market with very low cost smart watches. Also in this scenario, Swiss watch makers competing in the sub \$1000 watch market start making smart watches because Apple Watch cannibalized nearly all the sales of Swiss-made watches in that price range.

Android Wear, or another third party, becomes the standard smart watch platform for the vast majority of watch makers and technology companies starting to make watches.

Key assumptions for this scenario:

- The vast majority of watches sold today go “smart” over the next five years and run Android Wear or another third party smart watch platform.
- Watch makers standardize on a smart watch platform and there is little to no smart watch platform fragmentation.
- Google or a third party standard platform is genuinely competitive with Apple’s.

It seems a safe assumption Apple will have the advantage in the early stages of the smart watch category. Like the iPhone, they have a five to seven year advantage on the competition. It is logical that Apple maintains an advantage in this market for at least two years, if not longer, and we feel scenario #1 is how the market will look for at least the first three to five years if not longer.

While there is a strong case to be made for scenario #2 simply because it is logical the competition will need to contend at some point with Apple and will have to choose a platform to use or create their own and the market may likely flood with low cost Android (or another third party) smart watches. It is unclear if these products will stick or be competitive.

A mix of both scenarios is possible as well. Apple may not be destined to be the only dominant vendor in the top 20% of the smart watch market but poised to have much higher market share even if not the total majority starting to make watches.

Size of the Market Opportunity

While any true attempt at market sizing will need to be more formally done after the Apple Watch is launched, there are at least a few logical assumptions we can make today.

I do believe we will see a vast number of watches made and sold below \$1000 dollars go “smart” and do so quickly. If that is the case, then annual numbers



can easily be in the 600,000–700,000 a year range. Even if we assume all watches go smart some day, we know that the “watch” market is a 1.2 billion a year one that sees some moderate growth and decline here and there. The key observation today about the watch market is it is not growing and all the profits are essentially consumed by the Swiss makers comprised of around ~30m in units sales annually.

The smart watch market dynamics seem very similar to that of the mobile phone market. The profit is mostly made by Apple in the high end and the variety of Android OEMs make very little. This is likely one reason Apple is attracted to this market. It fits their business model of focusing on areas where there is true value in the high end.

Assuming that, if we just look at the watch market today as a basis for the size of the smart watch opportunity, we can roughly assume its max potential is 1.2 billion shipments per year. Not a bad size at all. However, the interesting question is to think through ways smart watches can make the category much larger and perhaps return to growth. This is where the return to adding valuable and convenient functionality back to the wrist worn display will come in. I believe there is more upside potential to the smart watch category than just the size of the watch market today. After seeing and analyzing the Apple Watch, we will develop some models that will try to estimate the true upside in terms of size.

Conclusion

Overall we are bullish on this market. We think smart watches are an interesting new platform and it is our sense that any of its future success will lie, not with the hardware, but rather the apps and services that may be created around this platform over the next few years. Historically speaking, we know this was a critical component for the success of PCs, tablets, and smart phones that dominate the computing market today. In each case, the people behind the operating systems for these products created an OS and built software developer kits and OS extensions that ultimately gave the software community the tools to be very creative in the apps they make for these platforms.

We have to look at smart watches in the same way we looked at PCs and smart phones in the early days. None of us in 1981 could have predicted the PC would be huge hit. In fact, IBM's own business plan called for the sale of only 400,000 IBM PCs during the total life of the product. Since 1981, we have shipped over 1 billion PCs. When the first smart phones hit the market in the early 2000's, nobody could have predicted we would be selling close to 2.5 billion a year in 2014. All of these products ended up having killer apps that ultimately allowed them to take off and impact the market in ways none of us could have dreamed of when they first came out.

That is why I, nor anyone else, can predict if a smart watch will go mainstream at this stage of the game. Many of us believe there is something here but not sure exactly what.

However, that is where the role of an SDK and smart watch platform comes in. I have learned to never underestimate the genius of the software developer community to create innovative software that could drive this smart watch platform forward.