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California State University, Fullerton

NASDAQ:ADBE

Recommendation: **Buy**

Last Close (Feb. 22): \$119.47

Price Target: \$172.03

ADOBE SYSTEMS INC. FINANCIAL ANALYSIS

Adobe Systems Inc. (NASDAQ:ADBE) is one of the largest software companies in the world. The company offers digital media and marketing solutions which provide platforms to businesses, schools, freelance photographers, and professionals to uniquely enhance digital media and streamline marketing campaigns. Adobe has two major business segments. Digital media remains Adobe's most valuable software. However, the digital marketing service has become a valuable part of their business as well. Document Cloud, which offers products like Adobe Acrobat for document editing and sharing, is a small subset of Adobe's operations. Adobe rents all of its software online, for subscriptions lasting from one month to one year.

Adobe Inc. is an established corporation with a strong brand entering a new phase of growth. It is uniquely immersed across the computer software industry as the leader in digital media software. More recently, Adobe has made access to its products more affordable and easier to use. The worldwide popularity of Photoshop is monumentally advantageous for a company that would otherwise fiercely compete for sales. Adobe Acrobat and Adobe Reader are used extensively worldwide for document viewing, editing, and sharing. Adobe has over 20 software applications in the digital media cloud alone.

FISCAL 2016 PERFORMANCE

In fiscal 2016, Adobe's revenue was 5.85 billion dollars, a 22% year over year increase. Sales have seen accelerating growth in the past two years because of the increased affordability of Adobe software. Adobe has offered all of their products almost exclusively on a subscription basis since 2013, effectively renting expensive software like Photoshop monthly or yearly. Immediately after this switch, sales fell 8%, about 350 million dollars, in fiscal 2013. However, Adobe more than retained customers fragmented by the switch to the subscription cloud platform. Now, subscription revenue accounts for 80% of all sales. Since 2013, sales increased 44%. The successful overhaul of Adobe's revenue structure and affordability provided for a new cycle of growth. Adobe realized a net income of 1.17 billion, spending the most on sales and

marketing as well as research and development. In Fiscal 2014, Adobe's net income was only 268 million dollars.

Adobe reported earnings per share of \$2.32 in fiscal 2017. For two years, Adobe has not missed a single earning consensus forecast.

73% of all subscription sales were from the Digital Media segment, and 25% came from Digital Marketing Cloud. Licensing of proprietary software has been sharply declining as Adobe braces for a full cloud based subscription platform. Adobe hopes to provide easily forecastable revenues with measurable growth metrics once the subscription platform is fully implemented.

LOOKING FORWARD

Adobe's established brand and Photoshop's strong reputation in digital media, combined with consistent outstanding financial performances, helps dilute some of the risk associated with the company's aggressive marketing segment campaign. Essentially, owning shares of Adobe is a portfolio of two large profitable segments of the company. Digital Marketing Cloud will require more costs associated with sales; and although this segment is profitable, it is too young to gauge effectiveness. Digital Marketing Cloud will be competing with other software solutions in a market with a lot of specialized talent. The metrics must show that this product will be productive enough for businesses to employ. However risky this campaign may be, it may have a good payoff. The market adapted to Adobe Reader and Acrobat. The Industry adapted to Adobe Photoshop. Adobe Marketing Cloud is already headed in the right direction with the right company.

Adobe's stock price has posted very strong gains as well, up over 40% year to date and over 200% since 2012.

Adobe no longer reports subscription metrics for cloud services. The company hopes the subscription platform can provide reasonable future estimates for revenues and cash flows.

SYSTEMIC RISK

The financial data is strong, and matches the optimism market-wide for Adobe.

However, now, more than ever, Adobe's products are a luxury good. Anyone can access Photoshop or Acrobat for as little as twenty dollars or less. If someone is pressured to cut costs, they will begin with Adobe. Moreover, Adobe Marketing Solutions are costly for small businesses. Marketing Cloud can cost over 50 thousand dollars including implementation, conservatively. Small businesses will suffer in recessionary periods while freelance users will be sure to exclude Adobe Services from monthly expenses.

Even in an event of a large recession, Adobe will still likely retain the Digital Media Cloud success in years to come afterwards. However, Adobe's young marketing campaign may not survive a severe recession if it comes too soon.

VALUATION

Adobe Systems. Inc.

NASDAQ:ADBE

| | |
|---------------------|-------|
| Beta (Adobe) | 1.16 |
| Market Risk Premium | 4.50% |

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|----------------------|----------|
| Current Price Feb 22 | \$119.47 |
|----------------------|----------|

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|------------------------|--------------|
| <u>Required Return</u> | <u>5.14%</u> |
|------------------------|--------------|

Market Risk Premium ranges from 3.5% to 5.5% historically

| | |
|--------------------|-----------|
| Shares Outstanding | 504000000 |
| Effective Tax Rate | 19% |

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|--------------------------|-----------------------|
| <u>Market Cap Feb 22</u> | <u>\$60.2 Billion</u> |
|--------------------------|-----------------------|

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|------------------|----|------------------|
| Operating Income | \$ | 1,493,602,000.00 |
| EBITDA | \$ | 1,572,136,000.00 |

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|---------------------|----|----------------|
| Free Cash Flow 2016 | \$ | 744,587,160.00 |
|---------------------|----|----------------|

| | |
|--------------------------------|------------------|
| Free Cash Flow in Fiscal 2016 | \$744,587,160.00 |
| Estimated Earnings Growth Rate | 20% |
| Terminal Growth Rate | 3% |

Adobe Inc. Forecasted Future Cash Flows

| | 2017 | 2018 | 2019 | 2020 | 2021 |
|----------------------------------|------------------|----------|----------|----------|----------|
| Free Cash Flow | \$ 897 | \$ 1,072 | \$ 1,286 | \$ 1,543 | \$ 1,852 |
| Enterprise Value | \$ 86,692 | | | | |
| Terminal Enterprise Value | \$ 104,137 | | | | |
| Price Per Share | \$ 172.03 | | | | |

*All figures in millions, excluding price/share

STRONG BUY RECOMMENDATION

Adobe's revenue and income have both more than doubled in the past 2 years. Consensus estimates of Yahoo Financial Analysts expect next year's revenue to be over 8 billion. This year's revenue was 4.5 billion. A growth rate of 20% is a conservative estimate for future free cash flows. Adobe operating expenses have grown only 12 percent in the last year compared to revenue growth of 42 percent in revenue. Historically, the stock has posted a 200% gain in the last five years. Subscription growth, although accelerating, will inevitably grow terminally along with the company. The cash flows from the next five years imply the stock is underpriced.

Adobe's subscription platform, which includes Photoshop and Acrobat, continues to dominate the market. Analysts are underestimating the value of Adobe's business. Growth will ultimately decelerate, but fiscal 2017 will be the prime timeframe for the height of Adobe's expansion. What remains after terminal growth inevitability is yet to be seen, but the risk associated with long term success concerns primarily the Marketing Cloud segment. Adobe's media solutions, on the other hand, are a serious established platform for businesses, schools, and professionals. A price of \$172 by fiscal 2017's end should not be a surprise.

RESOURCES

Adobe's 10-K Report was released in December 2016. Marketwatch and Yahoo Finance were also consulted for qualitative research.

Consensus estimates of earnings growth were as high as 25% for the next year. Valuations in this report were estimated with a conservative estimated growth rate of 20%.