Q1 2018 Earnings Call

Company Participants

- Mark S. Garrett, Executive Vice President & Chief Financial Officer
- Mike Saviage, Vice President of Investor Relations
- Shantanu Narayen, Chairman, President & Chief Executive Officer

Other Participants

- Adam Holt, Investment Banker & Research Analyst
- Alex J. Zukin, Analyst
- Brent Thill, Analyst
- J. Derrick Wood, Analyst
- Jay Vleeschhouwer, Analyst
- Jennifer Swanson Lowe, Analyst
- Kash Rangan, Analyst
- Keith Eric Weiss, Analyst
- Mark Grant, Analyst
- Ross MacMillan, Analyst
- Saket Kalia, Analyst
- Sterling Auty, Analyst
- Walter H. Pritchard, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, ladies and gentlemen. I would like to welcome you to Adobe Systems First Quarter Fiscal Year 2018 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. Thank you.

I would now like to turn the call over to Mr. Mike Saviage, Vice President of Investor Relations. Please go ahead, sir.

Mike Saviage {BIO 3176226 <GO>}

Good afternoon, and thank you for joining us today. Joining me on the call are Adobe's President and CEO, Shantanu Narayen; and Mark Garrett, Executive Vice President and CFO.

In our call today, we will discuss Adobe's first quarter fiscal year 2018 financial results. By now, you should have a copy of our earnings press release, which crossed the wire approximately one hour ago. We've also posted PDFs of our earnings call prepared remarks and slides, financial targets and an updated investor datasheet on adobe.com. If you'd like a copy of these documents, you can go to Adobe's Investor Relations page and find them listed under Quick Links.

Before we get started, we want to emphasize that some of the information discussed in this call, particularly our revenue and operating model targets, and our forward-looking product plans, is based on information as of today, March 15, 2018, and contains forward-looking statements that involve risk and uncertainty. Actual results may differ materially from those set forth in such statements. For a discussion of these risks and uncertainties, you should review the Forward-Looking Statements Disclosure in the earnings press release we issued today, as well as Adobe's SEC filings.

During this call, we will discuss GAAP and non-GAAP financial measures. A reconciliation between the two is available in our earnings release and in our updated investor datasheet on Adobe's Investor Relations website.

Call participants are advised that the audio of this conference call is being webcast live in Adobe Connect and is also being recorded for playback purposes. An archive of the webcast will be made available on Adobe's Investor Relations website for approximately 45 days, and is the property of Adobe. The call audio and the webcast archive may not be re-recorded, or otherwise reproduced or distributed without prior written permission from Adobe.

I will now turn the call over to Shantanu.

Shantanu Narayen {BIO 3332391 <GO>}

Thanks, Mike, and good afternoon. FY 2018 is off to a strong start for Adobe as we continue to successfully execute against our strategy. In Q1, we delivered record revenue of $2.08 billion, which represents 24% year-over-year growth. GAAP earnings per share in Q1 was $1.17 and non-GAAP earnings per share was $1.55.

Our strategy to empower people to create and transform how businesses compete is working. Our relentless focus on delivering innovation to our customers is continuing to drive our outstanding performance.

Across the globe, individuals and companies now recognize that great experiences have become the basis of differentiation in an increasingly competitive and complex world. With the world's best digital media and digital experience cloud-based solutions, Adobe has become the go-to company for helping customers develop and deliver transformative digital experiences.

In our Digital Media business, we achieved strong growth in both Creative revenue and Document Cloud revenue for Q1, achieving net new annualized recurring revenue, or

ARR, growth of $336 million. We exited Q1 with Creative ARR of $5.07 billion, marking the first time Creative ARR has surpassed $5 billion.

Across our individual, team and enterprise offerings, we continue to acquire new subscribers through Creative Cloud single app and all app offerings. We focus on retention by driving customer engagements through products, services and community. In addition to strength in our major geographies, emerging markets such as Korea, China and Southeast Asia are beginning to contribute to subscriber growth.

Creative Cloud remains the gold standard for creativity and design. We deliver ongoing value to our subscribers through major feature enhancements in our existing flagship applications across desktop and mobile devices.

In addition, we're attracting a broader set of consumers and creative professionals through innovative new applications like Adobe Character Animator, Spark, Lightroom CC, Dimension and XD.

Adobe XD is an innovative new app for designing experiences across multiple screens. In addition to graphic, mobile and website designers, product managers are adopting this all-in-one solution that combines design, prototyping, and collaboration capabilities. We recently delivered workflow enhancements, tighter integration with Photoshop, and deeper support for new modalities such as pen and touch. Major companies, including Wipro, have standardized on XD as their core design product.

Video continues to be an explosive category and our editing and production products, including Adobe Premiere Pro and After Effects, continue to gain momentum among large production houses, as well as independent film makers. More than half of the films at the recent Sundance Film Festival were edited with Premiere Pro, as were the majority of virtual reality projects.

Adobe Spark makes it easy for everyday communicators to transform their ideas into beautiful visual stories that make an impact with graphics, videos and web pages. Starting next month, Adobe Spark Premium will be accessible to every student globally, and we're already beginning to see strong adoption across school districts in areas like Anaheim in California, Roanoke in Virginia, Burnsville in Minnesota, and Deer Park in Texas.

In addition to the world's best desktop and mobile tools, we continue to focus on community and services to provide inspiration and accelerate the creative process. Adobe Stock now has a library of more than 80 million images, videos and creative assets. Last month, we announced a partnership with the Pantone Color Institute to curate a collection of Adobe Stock Premium images inspired by the top colors in fashion, as well as a gallery of Adobe Stock images that captures the essence of Pantone's always highly anticipated Color of the Year. It's PANTONE 18-3838 Ultra Violet, for those of you who are curious.

Adobe Stock achieved record revenue in the quarter, with greater than 20% year-over-year growth. Adobe Document Cloud is the world's leading digital document service, enabling individuals and businesses to automate inefficient paper-based processes.

Acrobat performance across Creative Cloud and Document Cloud was particularly strong in Q1. Document Cloud subscriptions and Acrobat perpetual licensing drove 18% year-over-year revenue growth and $33 million in net new ARR.

As worldwide PDF adoption continues, we're focused on delivering new services, including Adobe Scan and Adobe Sign. Adobe Scan, our mobile PDF application that leverages Adobe Sensei to capture and create intelligent PDFs, has been downloaded more than 7 million times. Adobe Sign is now the preferred e-signature solution in Office 365, and we closed our first set of joint customers in the quarter.

Digital transformation and the ability to deliver immersive, intelligent and impactful customer experiences is a strategic imperative for businesses and governments worldwide. To drive customer engagement and growth, you need to be an experience business; and the Adobe Experience Cloud is the industry's most complete and integrated offering.

We achieved Experience Cloud revenue of $554 million in Q1, and strong bookings across Adobe Marketing Cloud, Adobe Analytics Cloud, and Adobe Advertising Cloud. Key customer deals included Braun, City National Bank, Expedia, Ford, the NFL, Rakuten, Samsung, and T. Rowe Price.

In Q1, Adobe was once again recognized as a leader by industry analyst firms, achieving top scores among evaluated vendors in The Forrester Wave: Enterprise Marketing Software Suites and The Forrester Wave: Cross-Channel Campaign Management reports. Adobe was positioned as a Major Player in IDC's MarketScape Worldwide AI in Enterprise Marketing Clouds Vendor Assessment, with Adobe Sensei ranking highest in capabilities. In the competitive category of Digital Experiences, Adobe was recognized as a leader in the Gartner Magic Quadrant for Digital Experience Platforms.

We're in a world where businesses are challenged to reach, engage and influence their customers across multiple digital touch points and new interfaces, including voice, augmented reality and virtual reality. Our goal is to be a mission-critical partner to governments and enterprises as they undergo this essential digital transformation. Our success is a result of our comprehensive offering, our deep investment in technology, and a rich ecosystem of partners.

In two weeks, we will be hosting Summit, our annual digital experience conference that brings together the world's biggest brands, agencies, consulting firms and media companies. Leaders from Coca-Cola, the NFL, Mercedes-Benz, Tourism Australia, Marriott and more will share how they're tackling digital transformation and capitalizing on new opportunities in the experience era. We plan to unveil a spectrum of new Experience Cloud capabilities, including new Sensei-powered features that will use new algorithms to simplify complex tasks.

We've long recognized that our Experience Cloud customers need more than just innovative products. They need a partner who can help them navigate the many challenges involved in digital transformation. Adobe has always prided itself on being that trusted partner. And at Summit, we will introduce a broad spectrum of programs that champion and enable our customers.

We made great strides in delivering new magic through Adobe Sensei, our artificial intelligence and machine learning framework across Creative Cloud, Document Cloud, and Experience Cloud. Last month, we were recognized by Fast Company as one of the Most Innovative Companies in Artificial Intelligence.

We're keenly aware that our continued growth as a company is made possible by an innovative and exceptional team of employees around the world. We were recently recognized by Fortune as one of the World's Most Admired Software Companies. Fortune also named Adobe one of its 100 Best Companies to Work For, the 18th year we've been honored with that designation.

Adobe continues to have the right strategy, products and people in place to drive future growth. And we're fortunate to go-to-market with the industry's best partners and serve the world's most innovative customers, across all industries and geographies. 2018 is off to an outstanding start, and we look forward to building on this momentum.

Mark?

Mark S. Garrett {BIO 1407651 <GO>}

Thanks, Shantanu. In the first quarter of FY 2018, Adobe's momentum continued with record revenue of $2.08 billion, which represents 24% year-over-year growth. GAAP diluted earnings per share in Q1 was $1.17 and non-GAAP diluted earnings per share was $1.55. We drove strong performance across our product offerings and geographies during the quarter.

Highlights in Q1 included: record Digital Media revenue, including Creative revenue of $1.23 billion and Adobe Document Cloud revenue of $231 million; record Adobe Experience Cloud revenue of $554 million; net new Digital Media ARR of $336 million, and exiting Q1 with more than $5 billion of Creative ARR; deferred revenue growth of 25% year-over-year; record cash flow from operations of $990 million; returning over $300 million of cash to our stockholders through stock buyback; and a record 88% of our revenue in Q1 was from recurring sources.

In Digital Media, we grew segment revenue by 28% year-over-year. The addition of $336 million net new Digital Media ARR during the quarter grew the total to $5.72 billion exiting Q1. Within Digital Media, Creative revenue grew 30% year-over-year in Q1 and we increased Creative ARR by $303 million. Several key factors helped drive this growth, including: strong net new subscriptions across user segments and geographies, spanning creative professionals to consumers and students; and quarter-over-quarter growth in ARPU across all product categories.

In addition, services are helping to grow Creative ARR and revenue. Adobe Stock had a strong quarter, and Stock and collaboration services helped grow Creative Cloud enterprise ARR. 86% of Creative enterprise agreements signed during Q1 included services, which helps expand the use of Creative Cloud within companies and makes it more mission-critical to content workflows.

During Q1, we finalized a transition on adobe.com from using U.S. dollar estimates from our third-party e-commerce platform in certain emerging markets, to using transactional level data denominated in local currencies. This transition resulted in a one-time catch-up of approximately $20 million to our ending ARR balance, and is reflected in the Q1 ARR increase.

With Document Cloud, we achieved strong revenue with 18% year-over-year growth. The performance in Q1 was driven by continued strength with Acrobat subscription adoption and perpetual licensing of Acrobat through the channel. Acrobat year-over-year unit growth across Creative Cloud and Document Cloud again exceeded 20%; and Adobe Sign contributed with another solid quarter of revenue and ARR growth.

In our Digital Experience segment, we achieved Adobe Experience Cloud revenue of $554 million, which represents 16% year-over-year revenue growth. Subscription revenue grew 22% year-over year. Experience Cloud performance in Q1 was driven by success across our Analytics Cloud, Marketing Cloud and Advertising Cloud offerings, with emerging solutions such as Audience Manager, Campaign, Target and Media Optimizer solutions achieving strong results.

From a quarter-over-quarter currency perspective, FX increased revenue by $12.2 million. We had $1 million in hedge gains in Q1 FY 2018, versus $1 million in hedge gains in Q4 FY 2017. Thus, the net sequential currency increase to revenue, considering hedging gains, was $12.2 million.

From a year-over-year currency perspective, FX increased revenue by $35.6 million. We had $1 million in hedge gains in Q1 FY 2018, versus $18.3 million in hedge gains in Q1 FY 2017. Thus, the net year-over-year currency increase to revenue considering hedging gains was $18.3 million.

In Q1, Adobe's effective tax rate was 17% on a GAAP-basis and 11% on a non-GAAP basis. These rates are consistent with the updated tax rate targets we provided in January, which reflect the impact of the new Tax Act.

Our trade DSO was 47 days, which compares to 46 days in the year-ago quarter and 55 days last quarter. Deferred revenue grew to a record $2.57 billion, up 25% year-over-year. Our ending cash and short-term investment position exiting Q1 was $6.15 billion. Cash flow from operations was a record $990 million in the quarter.

In Q1 FY 2018, we repurchased 1.6 million shares at a cost of $301 million, which lowered our diluted share count to less than 500 million shares. We have approximately $1.6 billion remaining of our $2.5 billion stock repurchase authority granted in January 2017.

I will now provide our financial outlook. In Q2 FY 2018, we are targeting: revenue of approximately $2.150 billion; Digital Media segment year-over-year revenue growth of approximately 25%; Digital Experience segment year-over-year revenue growth of approximately 15%; tax rate of approximately 13% on a GAAP basis and 11% on a non-GAAP basis; share count of approximately 499 million shares; GAAP earnings per share of approximately $1.16; non-GAAP earnings per share of approximately $1.53; and net new Digital Media ARR of approximately $330 million. We expect revenue, earnings per share, and Digital Media ARR results in Q3 and Q4 to follow similar seasonality as was achieved in FY 2017.

Our leadership in the large addressable markets we created, combined with Adobe's leveraged operating model, contributed to another record quarter in Q1. We look forward to seeing you at Summit. Mike?

Mike Saviage {BIO 3176226 <GO>}

Thanks, Mark. Day one of Adobe Summit, the world's largest digital experience conference, is Tuesday, March 27. An invitation with registration and discounted pricing information to attend Summit in Las Vegas was sent out in January to our investor and analyst e-mail list. We will host an informal Q&A session with financial analyst attendees and Adobe management on the afternoon of the 27. Attendees can also attend educational sessions, meet with customers and partners, and learn more about our solutions at the conference. More details about Summit are available at summit.adobe.com.

If you wish to listen to a playback of today's conference call, a web-based archive of the call will be available on our IR site later today. Alternatively, you can listen to a phone replay by calling 855-859-2056. Use conference ID number, 6388567. International callers should dial 404-537-3406. The phone playback service will be available beginning at 5:00 P.M. Pacific Time today, and ending at 5:00 P.M. Pacific Time on March 21, 2018.

We would now be happy to take your questions, and we ask that you limit your questions to one per person. Operator?

Q&A

Operator

Your first question comes from Adam Holt with MoffettNathanson. Your line is open.

Q - Adam Holt {BIO 1814951 <GO>}

Hi, guys. Thanks very much, and congratulations on another spectacular quarter. 60% plus EPS growth, just amazing. I guess my question is for Shantanu. As we head into the Summit event, it's an interesting market, we've been seeing headlines about companies like Procter & Gamble cutting digital media spend. And it sort of seems like a little bit more of a mixed environment, yet you all continue to do well. And I wanted to, A, get your sense for how the end market feels to you, whether things like cut on digital spend trickles down into your market? And, B, just thinking about the growth rates, do you feel like you're at steady state with sort of Digital Experience at 15%? Or can you do better as some of your products get more mature? That's it. Thanks.

A - Shantanu Narayen {BIO 3332391 <GO>}

Thanks, Adam. As it relates to digital transformation and what's happening in the Digital Experience business, it actually feels like the spending environment for digital within enterprises remains unaffected by what you're referring to as marketing spend. And the reason for that is that everybody is trying to engage with their customers digitally across touch points. And as you know, our offering, which is the most comprehensive, actually has everything to do with not just the advertising spend aspect of marketing, but also the delivery of the content, the multi-channel campaign communication, the audience segmentation.

And to give you maybe a little bit more color on that, Adam, it's really about the themes that we hear about are: first, every business is trying to do customer segmentation; every business is trying to do – ensuring that they can personalize the experience they're delivering for their customers; and running the business, frankly, by looking at real-time metrics which correspond clearly to our Audience Manager product, our Analytics product, and our Campaign product.

So it feels like, long-term, the Digital Media spend is only going to increase. People are going to ask for more attribution associated with it. And so, it feels really strong. We had a strong revenue, as well as a bookings quarter.

The last thing I might say in that is, if you look at the underlying business, I think we said in the prepared remarks that the revenue actually grew greater than 20%; and that's as a result of us focusing a lot more on subscription bookings and subscription revenue, rather than focusing on services because we have an incredibly large ecosystem of partners. So feels really good and we expect the momentum to continue.

Q - Adam Holt {BIO 1814951 <GO>}

That's great. Thank you.

Operator

Your next question comes from Ross MacMillan with RBC Capital Markets. Your line is open.

Q - Ross MacMillan {BIO 1994797 <GO>}

Thanks so much, and my congratulations as well. Maybe just actually on Digital Media. I'm curious on the comment on 86% attach of services on Creative Cloud. I'm just curious as to, is there any way to think about how material that is on driving ARPU as you think about that service attach? And then, maybe as a follow-up, to Mark, was there any impact on new ARR from the impending price increase that went into effect on March 1? Was there any sort of shift of renewals, for example, into Q1? Thanks.

A - Shantanu Narayen {BIO 3332391 <GO>}

Ross, with respect to your first question and the environment within the enterprise, we have talked about, during the first time we transition enterprise customers from buying the perpetual product to buying the cloud product that we had, in effect, mirrored the various solutions that we had as part of Creative Suite. As we are now increasingly renewing them, we have been doing, I think, a great job of evangelizing the entire suite of products. So the first thing we see, as it relates to ARPU increases, is people moving from a subset of products to using the entire suite of products.

The other thing that we've been doing with enterprises is continuing to reflect the benefits of adopting Adobe Stock so that they can have access to all of this great content as an on-ramp to accelerate the creativity process, as well as things like Creative libraries which enables an enterprise to globally ensure that they're using the same fonts and colors and as such to ensure consistency and improve what we call as content velocity.

And so, I think the need from enterprises to really standardize across all of our products and with content management and asset management now becoming an increasingly important thing, it's really great to see both the ARPU increase and the increased adoption of our Creative products within enterprises. And that's certainly contributing to the strength in ARR that you saw.

A - Mark S. Garrett {BIO 1407651 <GO>}

And then, Ross, as it relates to the price increase in Creative Cloud, it's a process. We started communication with the channel and customers in March. We're trying to be very diligent about the communication and getting it right. The price changes were not in effect in Q1; they'll take effect in Q2. And as we've said from the very beginning, it won't represent a material impact on ARR in 2018.

A - Shantanu Narayen {BIO 3332391 <GO>}

And the last thing I'd maybe add to that, Ross, is we don't think there was an impact associated with the impending price as it related to Q1 results. And so, when we look at our Q1 results across geographies, it wasn't as if there was an impact of that in Q1.

A - Mark S. Garrett {BIO 1407651 <GO>}

Meaning that people were not buying in advance of the price increase.

Q - Ross MacMillan {BIO 1994797 <GO>}

Yeah, exactly. No, I think that was clear from your guide on ARR for Q2. Thanks again, and congratulations.

A - Mark S. Garrett {BIO 1407651 <GO>}

Thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

Thanks, Ross.

Operator

Your next question comes from Jennifer Lowe with UBS. Your line is open.

Q - Jennifer Swanson Lowe {BIO 6926228 <GO>}

Great. Thank you. Shantanu, maybe a question for you. You've commented in your prepared remarks that you were seeing an increase in demand for Creative Cloud in some emerging markets and you named Korea, China, Southeast Asia. And China, in particular, is an interesting one, given high usage of Creative Suite and maybe low monetization. Can you talk a little bit about what your sense is on how much of that is existing paying customers migrating to Creative Cloud, versus starting to eat into piracy a bit in that market in particular?

A - Shantanu Narayen {BIO 3332391 <GO>}

Sure, Jennifer. I mean, I think what we are seeing in those emerging markets is actually a phase shift in what we've seen in the other major geographies that we have, which is: people love the new innovation that we're providing; people love the comprehensive nature of what we've delivered with Creative Cloud; people who are casual pirates are now finding that the affordability of the upfront price allows them to actually be legitimate customers of Creative Cloud.

And I think the one difference that we have, for the first time, is in those markets we're able to offer differential pricing and not feel like the differential pricing will cause people to take the product, put it in a box and resell it in the United States. And so, I think we've very effectively combated piracy. But I think it just actually reflects with mobile exploding in those particular areas and content creation for mobile being such a large requirement in those emerging markets, it just continues to do well.

In different markets, the last thing I might say is that, there may be different offerings where we are seeing the initial traction. So I would say, in some of those emerging markets, the traction might be more with the team and enterprise, than an individual. But, overall, I think the trend is really positive.

Q - Jennifer Swanson Lowe {BIO 6926228 <GO>}

Great. Thank you.

Operator

Your next question comes from Brent Thill with Jefferies. Your line is open.

Q - Brent Thill {BIO 1556691 <GO>}

Good afternoon. Mark, you mentioned ARPU was up quarter-over-quarter in all categories. I think that's a shift in your tone versus kind of the flat-to-up that you've commented in the past. I'm just curious if going forward you expect that trajectory to continue throughout the year?

A - Mark S. Garrett {BIO 1407651 <GO>}

Well, clearly, we're benefiting from continued people coming off of price promotion. As we said, we're benefiting from services. As we said, Stock's doing really well and we're benefiting from services there. So that's clearly the trajectory that we see. The price increases, like I said, have not taken effect yet, so that will help down the road as well.

Q - Brent Thill {BIO 1556691 <GO>}

Okay. And just a quick follow-up on close to 42% operating margins. One of the questions, I think, that you've gotten is, as it relates to the reinvestment back in the business and at the growth rate you're at and the margin structure, is there a level where you feel that there is a appropriate reinvestment back for the future or do you feel that you are balancing that given where margins are right now?

A - Mark S. Garrett {BIO 1407651 <GO>}

Yeah. I mean, clearly, we think we're balancing it. Q1 strength in margin and earnings though was clearly driven by the revenue upside that you saw. And hiring in the first quarter is lower just based on seasonality with hiring. We expect hiring to pick up the balance of the year. We have Summit. We have MAX. We're definitely going to have increased spending as we go through the rest of the year. So I wouldn't look at that 42% as the new watermark. I would look at the revenue and earnings and information we provided for Q2 and you'll see that operating margin will be a little bit lower in Q2. So that's not kind of the new run rate.

A - Shantanu Narayen {BIO 3332391 <GO>}

And, Brent, we'll continue to be very diligent about the opportunities. There are still tremendous opportunities ahead of us. I think our investment in deep technology; you'll see some of the benefits of that at Summit. And with AI, and us being continued to recognize in terms of what we are doing with AI, expect to see continued investments in that space. And so, we have large opportunities and we're going to continue to focus on driving aggressive growth.

Q - Brent Thill {BIO 1556691 <GO>}

Thank you.

Operator

The next question comes from Alex Zukin with Piper Jaffray. Your line is open.

Q - Alex J. Zukin {BIO 18006605 <GO>}

Hey, guys. Congrats on another great quarter. I guess one question I maybe had and then a follow-up is, just given the upside versus kind of the guide for Digital Media ARR, were you more surprised by the strength in ARPU growth or new subscriber growth? And maybe also just can you help us stack rank the new subscriber growth coming from the lower SKU customers versus the international subscriber growth?

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah. Again, I would look at the success that we had and what we have seen in the past is maybe a little bit of falloff from Q4 to Q1 and the momentum actually continued, which I think just reflects interest in the Creative products. It continues to be across the board. Clearly, a lot of the new customer acquisition we are seeing is as a result of Single App adoption. And we're doing an effective job of completing them to use the entire suite.

So I would say it was the new customer adoption that drove more of the ARR than the ARPU. We're doing a good job, however, of engagement, as we mentioned in our prepared remarks, and as people are coming to their annual cycle of re-upping. And I think as it relates to the specific products, the usual suspects continue to show a lot of strength. Imaging continues to be strong. One interesting thing, we introduced a mobile offering of our product. We're seeing now mobile offering being adopted. And so, we're starting to monetize that. We're monetizing Spark, and Stock continues to feel good.

And last, but certainly not least, as we've said, Acrobat and the strength of Acrobat, both as it relates to what we are seeing on subscriptions across Creative and Document Cloud, as well as licensing – and the licensing tends to be primarily customers who are already using Acrobat and are adding more seats as a result of the strength of their businesses – that was also really encouraging. And all of the Acrobat that's being used as perpetual, that continues to be an opportunity for us down the road to move to subscription. So I feel strong all around.

Q - Alex J. Zukin {BIO 18006605 <GO>}

Got it. And then, Shantanu, maybe just a follow-up on Sensei and AI. Are you seeing that – given the broader adoption of the Suite, rather than specific products, are you seeing any of that being driven by Sensei and maybe the automation of workflows across product lines that you're driving?

A - Shantanu Narayen {BIO 3332391 <GO>}

Without a doubt. I mean, you know what, people come, and whether it's a company like Reliance Telecommunications (sic) [Communications] in India or Loblaw visited us from Canada, or Tourism Australia, Mastercard, what they're asking us is you guys have transitioned your business to be more direct, tell us how you are moving from data collection, to insight, to automation; and whether it's in analytics in what we do with anomaly detection, or whether it's in personalization what we do with recommendations based on data or media attribution in the marketing side. They're clearly expecting, and we're delivering on this automated nature of what AI can bring to it.

Hopefully, you're going to be at Summit and we'll share a little bit more about it. The deep investment that we've also made in our data platform and how you can actually start to get this unified view of a customer, I think a lot of people are finding that very impressive in terms of what that can do for their businesses. So the investment is clearly being recognized and adding value.

Q - Alex J. Zukin {BIO 18006605 <GO>}

Okay. Thank you, guys.

Operator

Your next question comes from Jay Vleeschhouwer with Griffin Securities. Your line is open.

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Thank you. Good evening. One for you, Shantanu, and one for Mark. For Shantanu, we've sometimes spoken of the cohort phenomenon within Creative Cloud; that is the aging or mix of older Digital Media customers that you've been trying to move or migrate to CC. So a similar question regarding Marketing Cloud. When you think back to the deployment of AEM and MO and so forth, four, five, six, seven years ago, what kind of upgrading phenomenon have you been seeing as part of your business recently?

And for Mark, what further gross margin leverage do you think you might still be able to experience? You're at 95% in Digital Media, but might there still be some upside there? And you're at around 63% or so in Digital Marketing, is there some leverage there? Thanks.

A - Shantanu Narayen {BIO 3332391 <GO>}

Jay, as it relates to the Digital Experience business, I think we have always said that with existing customers who adopted one solution, the strategy has been to continuously demonstrate how the integration of our newer solutions can add more value.

I think in the prepared remarks we talked about how some of the emerging solutions showed strength, whether it's Audience Manager, which is being used for customer segmentation and definition. And so, that's clearly how we continue to grow existing accounts, as well as increased usage of our products. And with new accounts, it tends to be a little bit more of adoption of the entire platform that's driving it.

So I would say the earlier cohort, because they had originally adopted one or two solutions because that's what the portfolio had, that cohort we focus more on up-sells. And the newer cohorts, we are focusing more on the entire story in the platform.

A - Mark S. Garrett {BIO 1407651 <GO>}

Jay, on gross margin, a lot of that improvement comes from operating efficiency in our hosted costs, and it comes from better margin on professional services. I would expect that we'll continue to see margin improvement, probably more so on the Digital Experience side than the Digital Media side. You're not going to see a big movement, but you'll see continued improvement in gross margin.

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Great. Thank you.

Operator

Your next question comes from Walter Pritchard with Citi. Your line is open.

Q - Walter H. Pritchard {BIO 4672133 <GO>}

Hi. Thanks. Shantanu, on the Digital Marketing side, I'm wondering – you bought TubeMogul about a year ago. I'm wondering how you're thinking about M&A in that area, it just does seem like that market's moving pretty quickly and acquisitions could be a part of the future. Just curious, and especially anything large that you might be contemplating in that area?

A - Shantanu Narayen {BIO 3332391 <GO>}

Well, Walter, I think with the acquisition of Tube, we became the most comprehensive offering already in the market; and adding the ability to do linear, non-linear and adding TV to the mix of search, social, display, really was good. So we feel good about our opportunity there. And it's unlikely that there's anything large that's going to change. We like what we have organically, Walter.

Q - Walter H. Pritchard {BIO 4672133 <GO>}

Thank you.

Operator

Your next question comes from Kash Rangan with Bank of America Merrill Lynch. Your line is open.

Q - Kash Rangan {BIO 22095432 <GO>}

First of all, congratulations to Mark Garrett on your retirement. Outstanding job at Adobe. Tremendous value creation. I think it'll go down as one of the best. And a question for you, Shantanu. When you look at the old cycle, which ended I think when you gave CS installed base of 12.8 million, I forget how many years back that was. Now, you've got a different word to your point, there's more mobile consumptions, there's more smartphones.

What is your best prognostication as to how the days of the old Creative users will play out in the next cycle? Are we looking at an addressable opportunity in terms of units and job creation that is multiples of what the old base? Because we're used to analyzing Adobe through the lens of this is the old cycle, this is the old base and this is where the company matures, whatnot.

Can you help us understand with some numbers in perspective as to why the addressable market could be, if I'm right, that it could be multiples given mobile and a whole bunch of other factors that just did not exist in the prior cycle? That's it from me. Thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

Well, Kash, you're right about the fact that we look at it as not just a migration opportunity, but a very significant new opportunity as it relates to the importance of creativity. Everything from K-12, which is why we try to give examples of how Spark is used there. This was never really a migration story. And as people like you have recognized that it's been a hugely expansive story in terms of attracting new customers. And what we try and do, and that's probably more appropriate at our analyst call, is to continue to show how big the TAM is, when we talk about the $20 billion TAM and the number of users and the different offerings that we have.

And so, within the company, we're just focused on how do we keep adding more subscribers. The migration is not the first, second or third thing we talk about; we talk about acquisition, we talk about engagement. And a product like XD, every product manager in the world should be using it. When we talk about – everyone has a story to tell and the media types that they are using to tell that story and the devices that they are using to tell that story on and the modalities that they're using to create that story, it has never been more exciting in terms of what we can do for content creation.

And I think our teams are doing an incredible job at innovating. So it's clearly a multiple of what we considered at the peak of the Creative Suite, and it really should be. I'd love to see every single student in K-12, as part of every history project, use our Creative Cloud to tell the story.

Q - Kash Rangan {BIO 22095432 <GO>}

Wow, in the next life I want to be a creative artist. Thank you so much, guys. Congrats.

A - Mark S. Garrett {BIO 1407651 <GO>}

Thanks, Kash.

A - Shantanu Narayen {BIO 3332391 <GO>}

With artificial intelligence, we're going to make that happen right now, Kash.

Q - Kash Rangan {BIO 22095432 <GO>}

Exciting guys. Thank you.

A - Mark S. Garrett {BIO 1407651 <GO>}

Thanks.

Operator

Your next question comes from Saket Kalia with Barclays. Your line is open.

Q - Saket Kalia {BIO 16417197 <GO>}

Hi, guys. Thanks for taking my question here. Mark, I think it was mentioned earlier that in Digital Experience there is more of a focus on subscription versus services, kind of given the ecosystem of partners. And I know we don't talk about segment margins specifically – operating margins, that is. But can you just talk about qualitatively whether we should see a more concerted effort in leveraging the partner ecosystem in Digital Experience and what that can mean for segment margins?

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah. Maybe I'll start off, and then Mark can certainly add. When we talk about ecosystem of partners, the ecosystem of partners is really in three categories. I mean, we have a incredible set of what you would've considered the traditional SI partners, the Accentures, the Deloittes of the world, who have practices built around digital transformation, who are out there not just implementing our solutions, but also certainly co-selling and helping sell our solutions.

We have the media agencies. The media agencies are moving their business to include a technology and strategy component for digital transformation, the WPPs, the Publiciss of the world have become incredibly great partners in that. And then, you have the traditional ISVs, and the partnership with Microsoft allows us to jointly go-to-market with a very integrated offering across what they're doing with dynamics and Power BI and Azure, and what we are doing with Analytics Cloud, Marketing Cloud, and Advertising Cloud.

When the business was starting, we had a consulting organization that enabled people to implement this. I think a lot of the implementation and the running, we have a great ecosystem of partners, and so that results in us not requiring as many consulting resources. And we've shifted our focus there to be more architectural services so that we can ensure that people are getting the best value out of our products.

And so, that reflects itself in terms of when we use those services as part of COGS instead of that being there. And that's why it's more a traditional software sale, which, in your words, would result in better margins. So that's how we tend to think of what's happening in the environment and why we feel well-served by both the super global partners, as well as some regional partners.

A - Mark S. Garrett {BIO 1407651 <GO>}

And the only thing I'd add to that is to the extent that we can leverage that partner ecosystem that Shantanu talked about, we could potentially invest a little bit less in the sales and marketing line that we are currently doing a lot on our own today. So you get leverage both in professional services and in sales and marketing.

Q - Saket Kalia {BIO 16417197 <GO>}

Very helpful. Thanks, guys.

Operator

Your next question comes from the line of Heather Bellini with Goldman Sachs. Your line is open.

Q - Mark Grant {BIO 17608250 <GO>}

Thanks. This is Mark Grant on for Heather. Appreciate you taking the question. You've mentioned a couple of times that there are opportunities that you've taken advantage of within the customer base to look at customers that are single product are using a subset of the product and then moving them to the full suite, obviously, driving some improved ARPS there. Can you give us a sense of the relative size of that opportunity going forward? And then, how much of the base do you think is still in a position to make that shift into a larger ticket?

A - Shantanu Narayen {BIO 3332391 <GO>}

You're referring to the Digital Experience side in terms of single solutions and multiple. I think Brad, at the last analyst call, gave you some update about how we're moving in terms of the top 100 customers and the significant improvement in revenue associated with each of those customers. But as we continue to offer more integration between our products, as they continue to grow their own businesses and the transactions costs, they're significant. I would go back to our big picture of how when we think about Digital Experience, it's a 60-plus-billion-dollar opportunity. And while we are doing well, there still is a significant amount of headroom in that business.

Q - Mark Grant {BIO 17608250 <GO>}

Great. Thank you.

Operator

Your next question comes from Sterling Auty with JPMorgan. Your line is open.

Q - Sterling Auty {BIO 2070271 <GO>}

Yeah. Thanks. Hi, guys. You called out Acrobat and Document Cloud a couple of times. I'm just curious, is there any particular vertical industries that are seeing a bigger uptake or maybe a new use case that's starting to drive that growth?

A - Shantanu Narayen {BIO 3332391 <GO>}

Well, I think the use of both PDF and Adobe Sign to automate paper-based processes across a variety of industries is certainly one of the places that we're seeing it. But I would also point back to mobile and the adoption of PDF on mobile and what's happening there and the ability for that. We've also done a really incredible job I think as a team of leveraging Reader. And so, the fact that we have Reader distributed and when you get one of these documents that has an embedded, whether it's a spreadsheet or something else in it and you want to edit it, the ability for people to now edit PDFs and to use it as a on-ramp as part of their creative process, that's also helping out.

So I think there are three or four horizontal use cases. And as it relates to vertical industries, anybody who is trying to automate paper-based processes and regulated industries like government, financial services, tends to be at the forefront of that. They're certainly seeing the benefits, not just of moving to PDF, but also the benefits of using Adobe Sign.

A - Mike Saviage {BIO 3176226 <GO>}

And this is Mike. Operator, we'll do two more questions. And before we do that, just to build on what Shantanu said, the datasheet that we published has the Excel file built into it as an attachment, just as an example of what Shantanu said. And I say that not only to point that out, but also with the new segment information we published in January, it'd be helpful to look at the updated datasheet for the new segment information that we have moving forward this year. So, operator, two more questions, please.

Operator

Certainly. Your next question comes from Keith Weiss with Morgan Stanley. Your line is open.

Q - Keith Eric Weiss {BIO 6993337 <GO>}

Excellent. Thank you for taking the call, guys, and another outstanding quarter. Just a quick question on sort of Digital Marketing side of the equation. With GDPR really coming onto the horizon, do you guys see any indication or do you have any concerns that there may be some frictions around some of the more sort of customer data type functionalities that that guys are doing in the marketing office with deep personalization of the segmentation? Or is that kind of a non-issue amongst your customer base?

A - Shantanu Narayen {BIO 3332391 <GO>}

I'd point back to what happened when the cloud first came out. When the cloud first came on the horizon, I think a lot of people appropriately talked about what that meant for security. And I think a number of cloud vendors clearly pointed out that the ability for people to update that would actually make systems more secure, which is something that I think most people would look at. I think as people are collecting data, the emphasis and importance of data and privacy continue to be front and center, but I don't think it changes the fundamental trajectory associated with people wanting to have all of this in the cloud.

We just have to make sure that we use it as a tailwind against the competition and step up, like we have done when we collect customer data to enable our customers to do that as well. And so, we'll be ready for GDPR when it comes. But it's not going to change this fundamental move where things are going to move in the cloud, and digital is going to be the way in which enterprises transact with consumers.

Q - Keith Eric Weiss {BIO 6993337 <GO>}

Got it. And then maybe a quick one for Mark. The repurchase activity continues to go on pace and even sort of up the pace a little bit. Are you guys still building up a lot of cash on the balance sheet? Any update on kind of the potential uses for that cash?

A - Mark S. Garrett {BIO 1407651 <GO>}

So there's no change to our current prioritization of capital. We still take excess cash and put it towards M&A and share repurchases. Obviously, we have more excess cash now with the tax reform. We have $1.6 billion remaining on our current authorization, and obviously we're executing against that. When we're ready, of course, we'll come out to you with any change to the current trajectory on that.

Q - Keith Eric Weiss {BIO 6993337 <GO>}

Excellent. Thank you, guys.

Operator

Your last question comes from Derrick Wood from Cowen & Company. Your line is open.

Q - J. Derrick Wood {BIO 4963641 <GO>}

Great, thanks. So we're hearing more and more digital agencies enter the SI market and kind of want to participate in the technology implementation on the marketing side, not just large ones that you talked about, but a lot of mid-market agencies. So I'm just wondering how you're thinking about the mid-market opportunity for Experience Cloud. Is there any new initiatives you could look at to focus more on the mid-market?

A - Shantanu Narayen {BIO 3332391 <GO>}

We've announced a couple of partnerships there, Derrick, with mid-market providers in order to do it. I would say our focus is really more on the larger enterprises right now. That's not to say that we do not partner with regional media agencies and/or SIs. They tend to have, in many countries, very strong relationships with enterprises.

So our partner ecosystem is open to all. But in terms of taking our own solutions and focusing them down market as opposed to focusing our solutions on what we think the largest opportunity is, we're focused a lot more on the large enterprise opportunity.

Since that was the last question, what Mark, Mike and I do is, when we are going through our preparation we try and make sure we address some of the things that may be top of mind. And one of the questions that actually didn't come up was the fact that we haven't updated our annual guidance. And we wanted to sort of proactively ensure that we address that and say, we really don't want to get into updating annual targets across revenue and balance sheet every quarter.

I think for those of you, as you think about how this plays out, the Q1 performance as well as the Q2 targets I think are clear indicators of the strength of the business. And the one thing we might have you continue to focus on is our original second half growth of 20% on revenue as you think about how you want to be prudent about your models.

But having said that, we had an outstanding quarter. The strategy of empowering people to create and helping businesses transform just represent large addressable markets. And we see significant tailwinds. I'm pleased with the relentless execution. And it just continues to, hopefully, demonstrate to you that we're a unique company that's able to drive both top line and bottom line growth with significant operating margins.

We will continue to invest in driving innovation through long-term technology investments in both Digital Media and Digital Marketing. And we're really pleased with how Sensei has continued to be a differentiator. Look forward to those of you who will be able to join us at Summit, and thank you again for joining us today.

A - Mike Saviage {BIO 3176226 <GO>}

And one last thing, we had some connectivity problems on Connect. So for those that are on Connect, the archive will be complete as well as the phone replay. So if you did have some issues listening on the Connect session, we'll have that rectified in the archive. And thanks again for joining us.

Operator

This concludes today's conference call. You may now disconnect.
