

Q3 2017 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, Analyst
- Alex J. Zukin, Analyst
- Brent Thill, Analyst
- Heather Bellini, Analyst
- J. Derrick Wood, Analyst
- Jay Vleeschhouwer, Analyst
- Kash Rangan, Analyst
- Keith Eric Weiss, Analyst
- Keith Frances Bachman, Analyst
- Nate Cunningham, 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 Third Quarter Fiscal Year 2017 Quarterly Earnings 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.

I would now like to turn the call over to Mr. Mike Savage, 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 third quarter fiscal year 2017 financial results. By now, you should have a copy of our earnings press release, which crossed the wire approximately one hour ago. We have also posted PDFs of our earnings call prepared remarks and slides, financial targets and an updated investor data sheet 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 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, September 19, 2017, and contains forward-looking statements that involve risks and uncertainty. Actual results may differ materially from those set forth in such statements.

For discussion of these risks and uncertainties, you should review the Forward-Looking Statements Disclosure in the earnings press release we issued today, as well 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 data sheet 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 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.

Adobe had another record quarter with revenue of \$1.84 billion, representing 26% year-over-year growth. GAAP earnings per share in Q3 was \$0.84, and non-GAAP earnings per share was \$1.10. We continue to deliver strong top-line and bottom-line growth with expanding operating margins and strong cash flow from operations.

Digital transformation has become the top agenda item for C-suites across the globe; and Adobe's Cloud offerings are mission-critical for CMOs, CIOs, CTOs and CEOs charged with modernizing their businesses and the way they engage with their customers.

At the same time, we are significantly growing our footprint in the creative space well beyond our loyal base of creative professional customers. Whether it's designing the user experience for a personal blog or editing a short film, Creative Cloud's capabilities are expanding to address the needs of today's youth, social media mavens and creative enthusiasts while continuing to push the technology boundaries for our most demanding creative pros.

In addition to delivering continuous product innovation, we are investing deeply in Adobe Sensei to dramatically improve the accessibility, design and delivery of digital experiences. Adobe Sensei leverages Adobe's massive volume of content and data assets, as well as our deep domain expertise in the Creative, Document and Marketing segments. We are making the Adobe Sensei framework and intelligence services available to our ecosystem of partners, ISVs and developers who will deliver additional magic.

Central to our strong performance this quarter was record revenue in our Digital Media business. We achieved \$1.27 billion in Digital Media revenue in Q3, a 28% year-over-year increase. We exited the quarter with over \$4.87 billion of Digital Media Annualized Recurring Revenue, or ARR. The net ARR increase in Q3 was \$308 million and was driven by continued strength in our Creative Cloud and Adobe Document Cloud businesses.

Creative Cloud is the one-stop shop for creativity and we increased revenue 33% year-over-year in Q3. Creative Cloud growth was driven by net new subscriptions, continued focus on customer value that fuels retention, adoption of enterprise services and focus on high-potential segments like education.

The video category is exploding, and we continue to drive strong growth with our market-leading Creative Cloud video solutions. At the IBC Conference in Amsterdam, we highlighted our latest innovations in virtual reality, animation, motion graphics, editing, collaboration and Adobe Stock video. We unveiled new premium features in Adobe Spark, a family of easy-to-use services for creating high-quality social graphics, Web pages and video stories. Spark with premium features is now available as a standalone subscription and is also included in our Creative Cloud All Apps subscription.

In addition to Adobe XD for Experience Design and Project Felix for 2D to 3D photo-realistic rendering, we're driving innovation to enable authoring for emerging media types such as AR and VR. We recently acquired best-in-class 360-degree and virtual reality software from Mettle. The acquisition complements Adobe Creative Cloud's existing 360/VR cinematic production technology, and we will integrate this functionality natively into future releases of Premiere Pro and After Effects.

Next month's MAX in Las Vegas will be the world's largest creativity conference. At MAX, we will outline our expanding vision for creators, release new Creative Cloud apps and services and showcase amazing new technology that our brilliant scientists are working on in our labs.

The world's leading digital document service, Adobe Document Cloud, is enabling businesses to automate their paper-based processes. In Q3, Document Cloud revenue was \$206 million, a year-over-year increase of 10%, and we grew Document Cloud ARR to \$556 million exiting the quarter. We drove strong uptake of Acrobat across both Creative Cloud and Adobe Document Cloud.

Adobe Sign is helping drive Adobe Document Cloud ARR growth. Earlier this month, we announced Adobe Sign is now Microsoft's preferred e-signature solution across the

company's portfolio, including the 100 million monthly commercial active users of Microsoft Office 365.

Adobe Scan is at the heart of our mobile PDF creation strategy. Adobe Scan has had over 2.7 million downloads across iOS and Android, delivering revolutionary scanning and text-recognition capabilities through integration with Adobe Document Cloud. The leader in the Digital Marketing category, Adobe Experience Cloud, is enabling enterprises to deliver intelligent, intuitive and effective customer experiences. We achieved record Adobe Experience Cloud revenue of \$508 million in Q3, which represents 26% year-over-year revenue growth.

The breadth of Adobe Experience Cloud, which includes Adobe Marketing Cloud, Adobe Analytics Cloud and Adobe Advertising Cloud, is enabling us to address an expanding array of customer experience categories. Central to the differentiation of Adobe Experience Cloud is our data and analytics platform, which provides unique insight into customer behavior and ROI across every digital touchpoint. In the trailing four quarters, we've helped our customers manage more than 150 trillion data transactions across our Experience Cloud solutions.

Adobe Marketing Cloud enables marketers to deliver hyper-personalized content and campaigns to their customers. We announced new capabilities in Adobe Target to further enhance customer recommendations and targeting, optimize experiences and automate the delivery of personalized offers.

In Adobe Campaign, marketers can now predict the highest performing images, forecast likely customer churn and gain real-time insights to adjust their campaigns.

Adobe Analytics Cloud is foundational to the digital enterprise. We announced new voice analytics capabilities that enable brands to deliver personalized customer experiences using voice-based interfaces. Through deep analysis of voice data, brands can gain robust audience insights and recommendations, while automating the traditionally cumbersome manual analysis.

Adobe Advertising Cloud enables marketers to deliver video display and search advertising across any screen in any format. We announced the addition of digital audio advertising formats on desktop and mobile devices. We added Spotify as a premium inventory source for digital audio, display and video advertising formats. At Advertising Week, we are extending automated buying and data-driven optimization to all TV advertising for the first time in a cross-channel platform.

Last week, we announced new automotive focused analytics, personalization and advertising capabilities in Adobe Experience Cloud that give brands the ability to deliver unique consumer experiences including personalized playlists, on-route recommendations, and audio ads. The 10 largest automakers in the world already use Adobe Experience Cloud and Adobe is working with these brands along with ecosystem players to advance new digital in-car capabilities.

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Our strategic partnership with Microsoft is providing us with an expanded footprint in the enterprise with Microsoft Azure, Dynamics 365 and Power BI, complementing Adobe Experience Cloud. We see a strong pipeline of joint customer opportunities with enterprise customers who are navigating their digital transformation.

Significant customer wins this quarter included Adidas, HSBC, Kellogg's, Marks & Spencer and University of Maryland.

Despite the success with global enterprise customers, we were disappointed with our Experience Cloud bookings in Q3 but remain confident in our ability to execute against this large opportunity.

Two weeks ago, we held our second annual internal Adobe & Women Leadership Summit and announced that we will be at 100% pay parity between women and men in the U.S. by the end of this fiscal year. Achieving pay parity underscores our leadership and commitment to being a diverse and inclusive employer.

In Q3, we were named one of the Best Workplaces for Millennials and one of the top ten Best Places to work in both India and Australia. And for the second year in a row, Adobe has been named to the Dow Jones Sustainability Index World, the gold standard of corporate responsibility reporting for the investment community.

Adobe is the clear leader in creating and delivering digital experiences across all segments and geographies. Our strategy has never been more relevant and we continue to execute well against our plan. No other company empowers every individual to tell their story while enabling businesses to compete more effectively in the digital age. With the world's best employees, partners and customers, we are equipped to continue to deliver on our mission and look forward to a strong close to our fiscal year.

Mark?

Mark S. Garrett {BIO 1407651 <GO>}

Thanks, Shantanu.

In the third quarter of FY 2017, Adobe achieved record revenue of \$1.84 billion, which represents 26% year-over-year growth. GAAP diluted earnings per share in Q3 was \$0.84 and non-GAAP diluted earnings per share was \$1.10. Highlights in Q3 included: record Creative revenue of \$1.06 billion, strong Document Cloud revenue of \$206 million, strong net new Digital Media ARR of \$308 million, record Adobe Experience Cloud revenue of \$508 million, strong year-over-year growth in operating profit and net income, record deferred revenue of \$2.2 billion, more than \$700 million in cash flow from operations, and a record 88% of revenue during the quarter came from recurring sources.

In Digital Media, we grew segment revenue by 28% year-over-year. The addition of \$308 million net new Digital Media ARR during the quarter grew total Digital Media ARR to

\$4.87 billion exiting Q3.

Within Digital Media, we delivered Creative revenue of \$1.06 billion, which represents 33% year-over-year growth. In addition, we increased Creative ARR by \$272 million during Q3 and exited the quarter with \$4.32 billion of Creative ARR.

Driving the momentum with our Creative business was continued strength with Creative Cloud across all segments, including Individual, team and enterprise. Notable Q3 highlights included the achievement of strong net new subscriptions, maintaining or growing ARPU across all key Creative Cloud offerings and strength in Japan.

With Document Cloud, we achieved revenue of \$206 million, and Document Cloud ARR grew to \$556 million exiting Q3. Across Creative Cloud and Document Cloud, Acrobat adoption accelerated again when compared to recent quarters, achieving 19% year-over-year unit growth. In addition, our electronic signature service Adobe Sign continues to show strength. We expect the recent partnership we announced with Microsoft to fuel growth of Adobe Sign moving forward.

In Digital Marketing, we achieved record Adobe Experience Cloud revenue of \$508 million, which represents 26% year-over-year growth. Notable areas of strength include Adobe Audience Manager, Adobe Campaign, and Adobe Advertising Cloud. We now have approximately \$3 billion of annualized ad spend across search, social, display and video. Mobile remains a key driver for our Experience Cloud business; mobile data transactions grew to 57% of total Adobe Analytics transactions in the quarter.

Overall interest in Digital Marketing and Adobe Experience Cloud is strong, and we continue to drive subscription bookings growth. The scale of our engagements is growing with customers increasingly adopting multiple Adobe solutions, which is leading to larger deal sizes but longer sales cycles. As a result, we did not achieve our Q3 bookings goal and are no longer on track to achieve our 30% net new ASV bookings growth target for the year. However, we do expect greater than 20% organic annual growth in FY 2017 on the subscription book of business.

From a quarter-over-quarter currency perspective, FX increased revenue by \$9.6 million. We had \$200,000 in hedge gains in Q3 in FY 2017 versus \$13.3 million in hedge gains in Q2 FY 2017; thus, the net sequential currency decrease to revenue considering hedging gains was \$3.5 million.

From a year-over-year currency perspective, FX decreased revenue by \$11.3 million. We had \$200,000 in hedge gains in Q3 2017 versus \$3.9 million in hedge gains in Q3 FY 2016, thus the net year-over-year currency decrease to revenue considering hedging gains was \$15 million.

In Q3, Adobe's effective tax rate was 22.5% on a GAAP basis and 21% on a non-GAAP basis. The GAAP rate was slightly lower than targeted due to stronger than forecasted profits from outside the U.S. as well as certain tax benefits we were entitled to claim upon filing our U.S. income tax returns.

Our trade DSO was 50 days, which compares to 45 days in the year-ago quarter and 46 days last quarter. Deferred revenue grew to a record \$2.2 billion, up 23% year-over-year, primarily driven by strength in Digital Media.

Our ending cash and short-term investment position exiting Q3 was \$5.4 billion.

Cash flow from operations was \$704 million in the quarter.

In Q3, we repurchased approximately 2.1 million shares at a cost of \$298 million. We have approximately \$2.2 billion remaining of our \$2.5 billion stock repurchase authority granted in January 2017.

I will now provide our financial outlook. In Q4 FY 2017, we are targeting revenue of approximately \$1.950 billion, net new Digital Media ARR of approximately \$330 million, Digital Media segment year-over-year revenue growth of approximately 25%, Adobe Experience Cloud year-over-year revenue growth of approximately 17%. As a reminder, last quarter, we outlined that the Experience Cloud Q4 FY 2017 year-over-year growth rate will be affected by a material amount of perpetual revenue that we achieved in Q4 FY 2016; share count of approximately 500 million shares, net non-operating expense of approximately \$13 million on both a GAAP and non-GAAP basis, tax rate of approximately 24% on a GAAP basis, and 21% on a non-GAAP basis; GAAP earnings per share of approximately \$0.86, and non-GAAP earnings per share of approximately \$1.15.

Our Q4 targets, combined with our year-to-date performance, would yield the following annual FY 2017 revenue results: Total Digital Media segment growth of approximately 26%, total Adobe Experience Cloud growth of approximately 24%, and total Adobe growth of approximately 24%.

Our strong results, coupled with our Q4 targets, demonstrate that FY 2017 will be another record year for Adobe.

Mike?

Mike Savage {BIO 3176226 <GO>}

Thanks, Mark.

As we highlighted last quarter, Adobe MAX is coming up in Las Vegas during the week of October 16. Day One of our conference is Wednesday, October 18, and Adobe management will host a meeting with financial analysts and investors that afternoon. An invitation with registration and discounted MAX pricing information was sent out in August and more details about the conference is available at max.adobe.com. Please contact Adobe Investor Relations with an email to ir@adobe.com if you wish to receive the registration information.

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 77046940. International callers should dial 404-537-3406. The phone playback service will be available beginning at 5:00 PM Pacific Time today and ending at 8:00 PM Pacific Time on September 23, 2017.

We would now be happy to take your questions and we ask that you limit your questions to one number person.

Operator?

Q&A

Operator

Your first question comes from Walter Pritchard from Citi. Walter, your line is open.

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

Hi. Thanks. I'm wondering, Shantanu, on the Digital Marketing performance, I noticed one product that wasn't mentioned as strong in the quarter was Experience Manager. Could you go into some detail as to whether or not weakness in that product was the cause of what you saw? I know what you mentioned on the larger transaction, but was it any sort of product maturity issues you're facing there. And any more detail around sort of steps you're taking to try to resolve some of those challenges you faced in the quarter? Thanks.

A - Shantanu Narayen {BIO 3332391 <GO>}

Sure. I'll talk about that, Walter. I mean, we wanted to be clear in our communication that Q3 subscription bookings were below our expectations, but that in no way diminishes both our excitement around the opportunity and how we're helping companies deal with digital transformation. And when you see the minor impact of that Q3 bookings to our Q4 revenue target, you'll see that we're still targeting 24% revenue growth in fiscal 2017.

So as we think about providing a little bit more color on how we inspect that business, as you know, Walter, there are three components to the Experience Cloud. There's the non-recurring revenue sources including perpetual, and that's now de minimis in this Consulting Services.

The largest part of the business is now represented by our subscription-based model in both Marketing Cloud and Analytics Cloud. And growth there is best described, I think, by net growth on the book of business at the beginning of the year and that's very similar to how we describe Digital Media ARR. That continues to grow, and we're expecting that book of business to grow organically at greater than 20% this year. So the fact that we highlighted revenue in certain categories has nothing to do with an implication that there was revenue weakness in AEM. So wanted to get that out there.

In Advertising Cloud, the business model, again, as you know, is the traditional usage-based model and/or percentage of advertising spend. This includes inorganic compare in FY 2017. But again, that will grow substantially over 30% this year.

And so the way we think about it, the 30% target that we had given was actually based on a different methodology, which was prior to the acquisition of TubeMogul and was blended across both the subscription and the usage-based models and was actually growth on top of last year's growth in the business as opposed to just net growth on the beginning book of business. So the business remains healthy.

There were some large deals that were taking longer, but we expect the traditional year-end strength across Experience Cloud will lead to a substantial increase in sequential bookings from Q3 to Q4, which was the last part of your question, very stringent focus on execution, and we remain excited about the business. We'll probably provide an update to you guys at MAX as well.

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

Thank you.

Operator

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

Q - Brent Thill {BIO 1556691 <GO>}

Thanks. Shantanu, just a follow-up on Experience Cloud. There were some concern that you pulled the target that maybe these larger deals will take longer than Q4 to close. Can you just comment in terms of what you're seeing in the pipeline, or are these just pushing from Q3 to Q4, or do you anticipate a push into the fiscal year?

And then just a quick follow-up. There's been a lot of talk about iOS 11 and the blocking of cookies and ads, as well as the weakness that's been found in some of the ad agencies as of late. Is there anything else going on, maybe outside your control, that you're seeing that's new that we should take into account? Thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

Brent, as it relates to the Q3 pipeline that did not close, it's primarily moved to Q4. It has nothing to do. We still remain the leader in the category, and it's not competitive. So we expect the traditional year-end strength across Experience Cloud will lead, as I said earlier, to the substantial increase in sequential bookings.

But we're also anticipating that as a result of the larger deals, there's a possibility that we'll continue to see an ongoing larger sales cycle that might lead to a phase shift in terms of when the bookings close. And so we don't think that the fundamental opportunity has changed.

With respect to the Advertising Cloud, we had a strong quarter. And as I said, the business is growing substantially over 30% this year. So no impact yet in terms of what we are seeing with respect to cookies or iOS. The advertising spend, I think Mark also spoke to in his prepared remarks, we have a significant amount of dollars under marketing spend.

Operator

Your next question comes from the line of Sterling Auty from JPMorgan. Sterling, your line is open.

Q - Sterling Auty {BIO 2070271 <GO>}

Yeah. Thanks. Just want to continue that line of questions, Shantanu. You mentioned that you don't think it's competitive but still want to try to zero in. Is there any more color as to why the extension or the lengthening of sales cycles, whether it be approval process, rethinking in terms of the direction that the customers are taking, some of their spend? Because I know we're going to get hit with that question a lot, which is why? Why do you think you're seeing the lengthening sales cycle and the spillover in some of these deals?

A - Shantanu Narayen {BIO 3332391 <GO>}

Well, one thing, Sterling, that is happening is given that these are much larger deals, the number of approvals that you need within an enterprise is extending beyond the marketing person who is responsible for this activity. And so as we were targeting the Chief Revenue Officer, the Chief Digital Officer, that was a single point of approval. Now there may be a couple of points of approval. But beyond that, it's just the bigger engagements is resulting in more people in an organization who are responsible for digital transformation, in being involved in the process.

Q - Sterling Auty {BIO 2070271 <GO>}

Got it. Thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah. I think people shouldn't read too much into this as opposed to the fact that we are being as candid and transparent as we always are. The big term opportunity remains exactly the same.

Operator

Your next question comes from Ross MacMillan from RBC. Ross, your line is open.

Q - Ross MacMillan {BIO 1994797 <GO>}

(29:13) Mark, maybe one for you. Just this year has obviously been a really strong year in Digital Media ARR. I think the net add in your forecast is going to be above \$1.2 billion, which is actually higher than we've seen in the past two years. And I know you're not guiding for next year, but just to help us think about the shape of the curve on the net

new ARR because we've been sort of hanging out above \$1 billion now for three years. Is this something you think is sustainable? Or should we start thinking about the potential for the net new ARR to begin to come down? Maybe just help us think about that because there's a lot of factors, obviously, that play into that number.

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

Yeah. We're very pleased with ARR and we're very pleased with the fact, to your point, Ross, that we've been able to continue to add over \$1 billion every year. It, as you know, comes from three big groups, right? So we're still migrating the base over. There's still opportunity there. We continue to attract more and more new users and that remains a very big opportunity and we continue to sell services. So those three growth vectors still play out very nicely. We don't really see any change in that right now.

I mean, we're very pleased with what we've been able to do. And as Shantanu laid out on the marketing side, this billion plus dollars that we're adding every year is an increase to our book of business, which is how we were trying to explain the way we will begin to look at Digital Marketing. So no change to the kind of trajectory from our perspective.

A - Shantanu Narayen {BIO 3332391 <GO>}

And also, Ross, I mean, the more nascent businesses like Adobe Stock and Adobe Sign are continuing to perform really well. International expansion continues to grow and new customer acquisitions, as well as enterprise services. So continued focus on that.

And last but certainly not least, you can see that the impact of Acrobat on that overall business continued to be strong. Acrobat had a strong business in both Document Cloud as well as in the Creative Cloud.

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

And not to pile on, but we also continue to see an opportunity to combat piracy and drive more into education. So there's just a lot of growth vectors left in this business.

Q - Ross MacMillan {BIO 1994797 <GO>}

Yeah, that's very clear. Thank you. And maybe just a quick follow-up on Marketing. The 30% number is a big one, and as you mentioned, that was a kind of combined - sorry for the background noise - combined on the advertising as well as the sort of underlying prior assets. Just as you're thinking about that business, do you think a 20% growth in sort of new ACV is a reasonable way to think about that? Do you think that's high? Do you think that's potentially low? Just maybe a little bit of framework around what you think is sustainable on a kind of new ACV basis, that would be helpful. Thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, I think, first, Ross, the market opportunity continues to be incredibly large. I think we've talked about the \$40 billion TAM. I think you got it exactly when you talked about that was a growth-on-growth number as opposed to just a percentage growth on the book of business.

And so when we look at it as a percentage growth on the book of business, which is similar to what we do in Digital Media, as I said, the Marketing Cloud and Analytics Cloud will grow greater than 20% and the Advertising Cloud is going to be substantially greater than 30%. And so relative to the market opportunity, we continue to think that there's headroom for us, and we continue to be the leader.

Operator

Your next question comes from Saket Kalia from Barclays Capital. Saket, your line is open.

Q - Saket Kalia {BIO 16417197 <GO>}

Sure. Hey, guys. Thanks for taking my question here. Just to change gears a little bit towards Creative, Shantanu or Mark, can you just talk a little bit about Adobe Stock? Realizing you won't give the contribution to ARR, could you maybe talk qualitatively about whether customers are opting for monthly or annual plans, and maybe what price bands are proving to be more popular?

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah. With respect to Adobe Stock, we just continue to think it's a significant opportunity for us. Big picture, we offer it both in conjunction with the Creative Cloud all apps as well as we offer it as a subscription. We have actually tapered down the on-demand part of the Adobe Stock in favor of the subscription so that it becomes a recurring part of the business. I think it's clear when you look at the other stock content services that the growth in that category we are continuing to drive it. We've added new capabilities and video as well. But the business is growing well for us across our offerings, which are primarily subscription-based offerings.

Q - Saket Kalia {BIO 16417197 <GO>}

Got it. Thank you.

Operator

Your next question comes from Heather Bellini from Goldman Sachs. Heather, your line is open.

Q - Heather Bellini {BIO 2268229 <GO>}

Great. Thank you. I was wondering, Shantanu, if you could help share some color with us on the cross-sell and upsell trends you've been seeing in the Creative Cloud community and also wondering if you look forward, what do you see as being a bigger driver of growth? Can you help us think about just directionally net new subs contribution versus cross-sell? Thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, Heather, when we look at the business, I think as we add new categories of products in the authoring space, whether it's Adobe XD or whether it's what we are doing

with Project Felix, and as we think about AR and VR, the first thing that we can continue to do is think about, is it time to also offer another premium Creative Cloud service that can drive and upsell in terms of ARR? We continue to see good adoption of new single apps as was also evident in the Creative Suite business, so called. That's the way in which people enter the platform, and then we move them from single app to the entire Creative Cloud offering.

Services, the ARPU in the enterprise continues to grow as people adopt the services, and we're certainly in the process and have seen success in attaching, whether it's Stock or whether it's Sign to those Creative Cloud Enterprise Term License Agreements. We haven't yet started even looking at pricing, which continues to be a big opportunity for us in terms of optimizing pricing, because we are trying to get more and more people to the platform. So I think net international expansion, Mark talked about education and piracy. The nature of everybody who has a story to tell is just expanding.

I'm excited about Spark and now offering Spark as a premium feature, which we think they should be a significantly larger set of people who would be interested in Spark. So across all of those dimensions, Heather, the cross-sell of people who have the applications to mobile and stock the upsell from individual users to the entire suite, and also from enterprises not only adopting asset management and Creative Cloud ETLAs but also adopting the Marketing Cloud, I think all of those continue to be areas of focus and execution for us.

Q - Heather Bellini {BIO 2268229 <GO>}

Great. Thank you very much.

Operator

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

Q - Kash Rangan {BIO 22095432 <GO>}

Hi. Thanks. A good segue to Heather's question. I was looking to see, given your exceptional track record in being able to lay out longer-term targets and being able to hit that with a lot of panache and style, how should we think about Adobe's growth opportunities ahead? Is it the way you answered Heather's question, the different vectors? Is that the next third chapter, if you will, of your long-term planning that is going to give us the comfort in your ability to sustain this growth?

The reason I ask this because there's not maybe a widely held belief but maybe in some pockets of that investor community that once you hit the full penetration in Creative, whenever that happens, 2018 or 2019 that the growth will decelerate and therefore Adobe is going to have to do something to keep that growth rate. Just curious how we should think about and how you think about it more importantly. Thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

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Well, Kash, I think at our Analyst Meetings we always take it upon ourselves to talk about our long-term growth opportunities, whether they be in Creative, Document or Marketing Cloud, and as we talk about the large TAM available to us, it's clear, actually, that we're executing against all three of those.

And so we'll continue to provide updates at MAX, but from the point of view of your specific question around Creative, we think we're so early in the adoption of our Creative Cloud applications and services and mobile and new forms of offering that any concern associated with sort of migration being the only fuel of the business, we should have put that to bed a long time ago in terms of the new customer acquisition and the new services that are driving the growth. So multiple opportunities. I hope you're coming to MAX, where you'll see a lot of the tremendous innovation, and we'll, again, outline all of the growth vectors that are available for us.

Q - Kash Rangan {BIO 22095432 <GO>}

MAX and Vegas, tough combination to beat. We'll be there.

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

I was going to say, Kash, we both touched on it separately, but if you just list out all the different opportunities in Creative to grow the business, whether it's people coming from the base, new users or services, and then pricing opportunity, international opportunity, piracy opportunity, education opportunity, international opportunity – I said that one – and there's just a lot of different opportunities to continue to grow this business for quite a while from our perspective.

Q - Kash Rangan {BIO 22095432 <GO>}

You guys sound excited. Thank you so much. It's good to hear.

Operator

Your next question comes from Adam Holt from MoffettNathanson. Adam, your line is open.

Q - Adam Holt {BIO 1814951 <GO>}

Hi, guys. Thank you for taking my question. A very good quarter from a cash flow perspective, and I was hoping maybe you could detail a little bit what drove that specifically around the deferred revenue line and I wanted to know, are you seeing any benefit or are you making any changes with respect to your billings duration and trying to move folks to more of an annual cadence from a monthly and quarterly?

And just secondly, given what you talked about...

A - Shantanu Narayen {BIO 3332391 <GO>}

Adam, you're fading. Can you be just a little bit closer to the mic, please?

Q - Adam Holt {BIO 1814951 <GO>}

Sure, sorry about that. Can you hear me now?

A - Mike Saviage {BIO 3176226 <GO>}

Yeah.

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

Yeah.

Q - Adam Holt {BIO 1814951 <GO>}

Okay. So very good quarter from a cash flow perspective, and I wanted to drill down on what's driving deferred revenue. And specifically, have you started to see any impact of maybe better durations from your billings, moving people from monthly and quarterly to annual? And how do you think that plays out going forward?

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

As it relates to the Creative business – oh, so, first of all, Adam, congrats on the new job. Welcome back.

Q - Adam Holt {BIO 1814951 <GO>}

Thank you.

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

As it relates to the creative business, most people are on an annual plan already. So that gets factored into deferred revenue already. You know, the beauty of our business, and you guys all know this, but the beauty of our business, overall, is that you've got two businesses, three businesses growing very nicely and two of which just our amazingly profitable businesses that drive a lot of cash flow and that's going to continue. So we're thrilled with the cash flow. That is one of the beautiful parts of our business and that will continue. But as it relates to deferred, most people are already on an annual plan on the Creative side. So it's really factored in there.

Q - Adam Holt {BIO 1814951 <GO>}

And if I could just ask a quick follow-up, given what you talked about on bookings earlier, would you expect the relationship between billings and bookings to change going forward?

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

To the extent that we, in a quarter, come up a little short on bookings, like we did this quarter, you're going to come up a little short on invoicing and you're going to come up a little short on deferred, and that's why we said in the deferred, most of what you saw there was Digital Media related. So there's definitely a correlation there. But again, none of the fundamentals of the business have changed, none of the opportunity has changed. This

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is, from our perspective, just a short-term change to drive larger transactions in the enterprise.

Q - Adam Holt {BIO 1814951 <GO>}

Terrific. Thank you, guys. (42:22)

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

Thanks.

Operator

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

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Got it. Thank you. Good evening. Shantanu, Mark, without meaning to suggest anything about the new customer acquisition, I'd like to ask about your various opportunities in upgrading and migrating several large bases. Specifically, if you could comment on, for instance, the opportunity to upgrade or migrate CC Team to CCE, by our calculation, about a quarter of the CC subscriber base is using the full product on teams. That would seem to suggest a pretty substantial base upgrade opportunity.

Similarly, even in the years after you grew AEM after the acquisition of Day, you still sold a substantial amount of the old LiveCycle business, we calculate roughly half a billion or more over a period of half a decade even as AEM was growing. So again, there, too, would seem to be a substantial migration opportunity.

And then lastly, with respect to Doc Cloud, which has always been your biggest base, do you think that the new PDF 2.0 spec could engender a new growth cycle for Acrobat either within the base or for new customers?

A - Shantanu Narayen {BIO 3332391 <GO>}

So, Jay, I'll go third, backwards. And so first on Acrobat, I think we've said in the past, we've had over 30 million installation of Acrobat, so clearly that represents a larger opportunity. I think mobile PDF creation with what we've done with Adobe Scan and the ability for all of those assets to be in the cloud and to use Adobe Sensei to do things like OCR, clearly we see a large opportunity. That business has migrated faster than we would have thought to subscription base business while we are growing the overall base. So large opportunity, continue to be focused on it, and clearly I think to your point we are much earlier in the cycle in terms of migrating.

I think as – for the second one that you talked about within the enterprise, the opportunity associated with how people move from traditional lifecycle to new forms capabilities in the AEM stack, absolutely, that continues to be a large opportunity as people are moving from paper to digital, the ability to now have electronic signatures, which completes the

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last mile of that workflow is again an opportunity whether that's in government or whether that's in enterprises that are regulated continues to be a larger opportunity.

And on the CC Team versus CCE, we look at that a little bit more honestly as a buying preference that people have where some people are buying CC Team and they're getting that fulfilled through the channel and others are buying CC Enterprise and want the direct relationship with the customer and with Adobe in that particular case. In both those scenarios, we're focused on upselling services as opposed to migrating them from one buying vehicle to another buying vehicle.

So on that one, I would say, the focus is more on how do we get both of those categories to buy more of the services rather than necessarily transition them if their preference is buying through the channel or Adobe.com to having that CC Enterprise relationship with Adobe.

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Thanks very much.

Operator

Your next question comes from Keith Weiss from Morgan Stanley. Keith, your line is open.

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

Excellent. Thank you, guys, for taking the question and nice quarter. I wanted to ask a couple of sort of bigger picture questions. One is on Sensei. We're starting to hear back some positive feedback on Sensei, particularly in the broader Experience Cloud. Could you guys talk to us a little bit about sort of what you're hearing back from customers and also remind us kind of how the monetization strategy around Sensei is going to be evolving as we move forward?

A - Shantanu Narayen {BIO 3332391 <GO>}

Sure, Keith. I mean, as it relates to Sensei, we've had, as we've outlined on many occasions, decades of significant expertise, whether it's in understanding video, understanding images, understanding the semantic, meaning of documents and on the Experience Cloud side, everything to do with predicting based on these large data sets behavior that will drive optimization of business outcomes on behalf of our customers.

And as we embed more and more of that intelligence, that people have access to directly in how they use their products, I think the aha moment is growing. I think people have that more and more on the Creative side when they saw the magic that they saw within our products.

And now what we are doing is actually ensuring that the ability for them to action all of the insights that we're getting is far more within the hands of the users. So as you point out, the feedback that we're getting on Sensei across all of our offerings is very positive.

I do want to clarify one issue as it relates to the question around monetization of intelligence in our applications. If there are other companies that are saying we're going to monetize the intelligence separately, does that mean that their other applications are dumb and don't have actually the functionality? So for us, we just look at all of the technology that we're putting in, and it's making our existing products that are already world-class better.

So that's the way I look at it. We're not going to go and say, you can buy the non-intelligent product for a dollar and you can buy the additional intelligent product for an additional dollar amount. That makes no sense whatsoever, Keith. But the intelligence is being appreciated. We're investing very deeply in it, and from our point of view, the best is getting better.

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

Excellent. And perhaps one follow-up on distribution. We heard about a sort of an expansion of the ETLA program, trying to sort of make it, so we could put more customers into it. Could you talk a little bit about that extension of ETLAs, and whether sort of the initial feedback has been and whether you've been successful in getting more customers onto that program?

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, Keith. I think we've had tremendous success with actually migrating people from the traditional way of procuring the Creative applications from us into ETLAs. And I think we've described in the past how the first version of that ETLA was, in effect, mimicking the sort of different solutions that they got in Creative Suite.

In other words, Creative Suite was available as a design collection or as a master collection or as a video collection. And the first versions of ETLAs, in terms of doing no harm, we were just providing an equivalent way for them to license the Creative Cloud applications.

The second wave of that, as they're rolling off to three years, we have been very active in upselling them into the Creative Cloud complete application, which is an increase in ARPU for us, as well as selling them new services like Stock and Sign, which is additional revenue. And so the way we measure the business, and I look at this all the time, is migrating all ETLA customers first to Creative Cloud, then to Creative Cloud Complete and then monitoring usage of, not just Creative Cloud, all of our applications but also monitoring Stock as well as Sign. And so we're well on that way to the journey, which is leading to better satisfaction on the part of our customers and clearly increase revenue and ARPU to us here at Adobe.

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

Excellent. Thank you very much, guys.

Operator

Your next question comes from Derrick Wood from Cowen & Co. Derrick, your line is open.

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

Great, thanks. Back on the marketing side. And I mean, it seems like there's more companies forming a position for the Chief Data Officer. I know you guys have always had the ear (50:31) of the Chief Marketing Officer, but I would think as data is becoming more important in the marketing investments, you guys started to have more engagement with the CDO. So I guess what I'm trying to get at is, do you think that may be an element of longer sale cycles? And if so, do you think you need to change or expand your account coverage capacity to sell into a different approval point, or do you feel like you're entrenched enough with large accounts that the rate of investment doesn't need to change much?

A - Shantanu Narayen {BIO 3332391 <GO>}

Good question, Derrick. I think we are definitely entrenched in the accounts where the selling motion or process doesn't have to change as a result of what we are seeing because they know about us. The cycle may take a little bit longer.

With respect to your second question, there's no doubt that there's additional scrutiny on ensuring whatever the frameworks are to protect the data appropriately. If you go to our website, you'll see we're a leader and whether it's FedRAMP and the government are looking at it as HIPAA for health care and ensuring that all of those standards as part of Adobe's security framework and our data privacy framework that we have taken the lead on that.

I think the third part of your question associated with, are we then finding ways that enable our customers to monetize the insight associated with that data? That's clearly something that we've been doing for a while including with the Data Co-Op (sic) [Device Co-Op] in terms of being able to monetize their data. So at all three levels we feel confident; namely, we have the right people on the table. We deal with all of the checklist items that are important for them to feel comfortable with our solutions. And we are providing business value and business outcome.

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

Okay. Great. Thanks.

Operator

Your next question comes from Kirk Materne from Evercore. Kirk, your line is open.

Hi. This is Tom AI (52:29) calling in for Kirk. Just from the product side, can you talk about some of the updates to your 360 VR technology acquired from Mettler? What kind of impact can we start to see in 2018, and how do you think about the TAM of those segments today?

A - Shantanu Narayen {BIO 3332391 <GO>}

Within the Creative Cloud, I think we've touched on the fact that video is clearly the most explosive category that we are seeing. IBC was another great opportunity for us. Within video, we had already added some 360 VR capabilities.

The technology that we've acquired also is available as plug-ins to some of our applications, but as we have done traditionally, we take those plug-ins and apply that natively, because then the performance is significantly better and the usability of that functionality is better.

So big picture, we look at it as saying video is certainly exploding. We're the leaders in that video as Apple and other companies do a lot more innovation on things as AR and VR, extending our existing applications and continuously looking at new opportunities like we did with Project Felix to enable people to author those. There's no question that that's going to lead to both an increased set of new users as well as establish users asking from Adobe Support for all of those new media types. So both represent long-term opportunities for us, and we're pleased with the performance.

Q - Operator

And just a quick-follow up, it looks like your sales and marketing expense grew 14% year-over-year. Can you talk about where you are in terms of adding sales capacity on Digital Marketing side, and how we should think about that initiative as we head into 2018?

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

Yes. It's Mark. We've said for a while now that our incremental spend, if you look at it quarter to quarter or year to year, is going to be primarily in sales and marketing and R&D. And we're going to need to continue to invest in sales and marketing to drive both awareness on the Creative Cloud side and sales capacity on the Digital Marketing side. So I don't foresee that changing, especially as you look out and we continue to drive growth in both of those businesses.

Q - Operator

Great. Thanks.

Your next question comes from Nate Cunningham from Guggenheim. Nate, your line is open.

Q - Nate Cunningham {BIO 19997057 <GO>}

Hi, guys. Thanks for taking my question. Shantanu, on the market side of the business, what do you see as the strategic gaps in your portfolio and what are some areas where we could see you either partnering or making acquisitions in the future?

A - Shantanu Narayen {BIO 3332391 <GO>}

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Well, I'll start with the partnering. We clearly see an opportunity with Microsoft to partner. That's far more than a press release. We're open for business on that particular front, both with AEM and with Campaign in terms of a managed service implementation on Azure and integration with Dynamics as well as integration with Power BI is certainly an opportunity. That pipeline is growing very healthily. We will be in Microsoft Events. I think they have been participating the Adobe Events. So on partnership, while we have a platform that enables a number of small startups to also benefit from and leverage our data assets, that's the one that I would highlight first and foremost.

With respect M&A, I'm certainly not going to highlight, for the smaller companies that may be on our radar what we are interested in to drive up price, but we feel really good about the overall portfolio that we have and in terms of the available market and growth opportunities for what we already have, we feel really good. We will continuously look at adjacencies in order to continue to extend our lead, but nothing stands out as a weakness or gap in our portfolio.

Q - Nate Cunningham {BIO 19997057 <GO>}

Okay. Thank you.

A - Mike Saviage {BIO 3176226 <GO>}

Operator, we're coming up in the top of the hour, why don't we take two more questions, please?

Operator

Certainly. Your next question comes from Keith Bachman from Bank of Montreal. Keith, your line is open.

Q - Keith Frances Bachman {BIO 3018411 <GO>}

Hi. Many thanks. Shantanu, I want to try this for you. Going back to the Marketing Cloud and you commented in your formal remarks of Experience Cloud that you expect FY 2017 to be better than 20% organic bookings growth. And yet I'm trying to understand how to reconcile that, because there's clearly some degradation in the Q4 guidance.

I understand it's a tough comp where you're talking about 17%, but that still includes TubeMogul, which is mostly in the quarter. And so as we think about the business, as you look out beyond this quarter, can the Experience Cloud grow on an organic basis more - is 20% the message that we should be thinking about as we look at next fiscal year for the growth of the Experience Cloud?

A - Shantanu Narayen {BIO 3332391 <GO>}

I think those are two separate issues and we want to make sure, Keith, that we separate the two separate issues, because when we started the second half of the year and provided targets for the remainder of the year for the Digital Marketing revenue segment even at that point we had talked about while we were targeting 25%, which is now 24%,

we expected sequentially Q3 to be higher from a year-over-year growth perspective than Q4. So there is nothing that you should read into the 17%, because that's something that we had outlined at the beginning of the second half of the year. So I wanted to make sure we clarified that.

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

And the reason, Keith, that we had a 25% target as opposed to what used to be a 20% target for revenue...

Q - Keith Frances Bachman {BIO 3018411 <GO>}

Right, right.

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

...was specifically because of TUBE, so that was factored into both the quarter and the year.

A - Shantanu Narayen {BIO 3332391 <GO>}

Right.

Q - Keith Frances Bachman {BIO 3018411 <GO>}

Okay.

A - Shantanu Narayen {BIO 3332391 <GO>}

And as it relates to the long-term growth prospects, I think we've outlined how large this opportunity is. We're not providing FY 2018 targets right now, but nothing has changed as it relates to the substantial opportunity that exists for the offerings that we have as people embark on digital transformation.

Q - Keith Frances Bachman {BIO 3018411 <GO>}

Okay. Will you provide some specific context associated with the upcoming analyst event?

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

At analyst day, yes, we will provide much more context.

Q - Keith Frances Bachman {BIO 3018411 <GO>}

Okay. Thank you.

Operator

Your last question comes from Alex Zukin from Piper Jaffray. Alex, your line is open.

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

Hey, guys. Thanks for taking my question. So maybe the first question on Marketing Cloud; specifically: were there any changes to sales teams or sales leadership, or do you anticipate making them on the Digital Marketing side?

And then, Shantanu, maybe big picture question kind of along the same lines; not necessarily what a gap you have in your marketing portfolio. But if you stacked rank your ability to parlay your success and continued market leadership in B2C marketing into B2B, or do you need a customer record or a customer data set to be able to do that, and/or do you look at maybe going down market as the easier pathway to continued growth? So just big picture and then small, more specific commentary.

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah. I think on the first question, I mean, there's nothing that we are outlining except continued focus on execution with respect to sales execution. So that one's an easy one.

As it relates to the stacked ranking, I think you're right in saying that B2C clearly represented the first beachhead in terms of people who are embarking on digital transformation. However, there are a number of customers who are already in the B2B space who are adopting our solutions because they are going through absolutely the same scenarios. And they have been using our solutions in order to deliver digital transformation whether it's B2B or B2C. So while the first beachhead was B2C, we've already made traction and continue to see opportunity in B2B.

As it relates to your question around going down market and the existence of a customer record, I think the big differentiation in our particular product is not about the customer record as much as it's the ability to in real time deliver the customer experience. And I think over time, the existence of what's on disk as a customer record is far less important than what is in memory in terms of being able to deliver the digital experience.

So I think the game is completely changing to an in-memory, how do you action based on all the data that you have, the behavior, the demographics, rather than an existence of a flat file or a record associated with it. And that's really what we are focused on. We talked about it as the last millisecond in the Experience Cloud. And big picture, I think that's where we will continue to across all digital touch points where a customer engages with an enterprise, ensure that we deliver the best possible customer experience.

And given that was the last question, I - in close, we're absolutely proud of the strong financial results we reported in Q3, and I think you're clearly seeing the leverage that exists in our business model. We remain excited about the growth opportunities, clear that the strategy, whether it's empowering people to bring their creativity to life or enabling businesses to transform, continues to resonate with customers from individuals to the larger enterprises. We have a strong portfolio of products, and this represents multiple multiyear growth opportunities. And we continue to be one of the only companies that's delivering stellar top-line and bottom-line financial results.

We hope you're going to join us at MAX because we're going to tremendous innovation, and we will provide an update at our analyst meeting in conjunction with MAX.

With that, thank you for joining us today.

A - Mike Saviage {BIO 3176226 <GO>}

And this concludes our call. Thanks, everyone.

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