Q4 2016 Earnings Call

Company Participants

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

Other Participants

- Brent Thill, Analyst
- Brian W. Wieser, Analyst
- Jack Kilgallen, Analyst
- Jay Vleeschhouwer, Analyst
- Michael Nemeroff, Analyst
- Ross MacMillan, Analyst
- Samad Samana, Analyst
- Stan Zlotsky, Analyst
- Sterling Auty, Analyst
- Steve M. Ashley, Analyst
- Stewart Kirk Materne III, Analyst
- Walter H. Pritchard, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, ladies and gentlemen. I would like to welcome you to Adobe Systems Fourth Quarter Fiscal Year 2016 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.

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 the call today, we will discuss Adobe's fourth quarter and fiscal year 2016 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 data sheet on adobe.com. If you'd like a copy of these documents, you can go to the 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, December 15, 2016 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 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 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 the webcast archive cannot be rerecorded or otherwise reproduced or distributed without prior written permission from Adobe.

I'll now turn the call over now to Shantanu.

Shantanu Narayen {BIO 3332391 <GO>}

Thanks, Mike, and good afternoon. FY 2016 was another great year for Adobe. Our record revenue and net income were driven by strong performance in Creative Cloud Annualized Recurring Revenue, continued growth of Adobe Document Cloud subscriptions and strong revenue and bookings for Adobe Marketing Cloud. In Q4 we delivered record revenue of $1.61 billion, which represents 23% year-over-year growth. GAAP earnings per share in Q4 was $0.80 and non-GAAP earnings per share was $0.90. For the year, we grew total revenue to $5.85 billion, which represents 22% annual growth. GAAP earnings per share in FY 2016 was $2.32, and non-GAAP earnings per share was $3.01.

In Digital Media, we're advancing the state-of-the-art for content and setting the standard for creativity and digital documents. We exited the year with over $4 billion of annualized Recurring Revenue or ARR. The net ARR increase in Q4 was $316 million, and was driven by continued adoption and retention of Creative Cloud and Document Cloud across all customer segments. Creative Cloud is the one-stop shop for creativity and design, and in FY 2016 we expanded our customer base while continuing to deliver a rapid stream of product innovations. We achieved record Creative revenue of $886 million in Q4. For the year, we achieved Creative revenue of $3.2 billion, which represents 38% year-over-year growth.

At the heart of the Creative Cloud is the promise of continuous innovation, and the pace at which we are delivering new technology is accelerating. Last month at our MAX

Creativity Conference, we unveiled next-generation desktop, mobile, and cloud services for designers, photographs, and film-makers, as well as sneak previews of creative technologies in the areas of virtual reality, image matching and digital painting. Our creative customers have always counted on us to turn the future into reality. Creative Cloud is the place designers expect to get the best tools and services in emerging categories like Experience Design and 3D.

Earlier this week we released two public betas; Adobe XD for Windows, the first all-in-one tool for designing, prototyping and sharing user experiences for web and mobile apps; and Project Felix, a new application that enables designers to create photo-realistic composites with 2D images and 3D assets. Adobe Stock continues to gain momentum in the multi-billion dollar stock image category. In Q4 we launched the Adobe Stock Contributor Site, a new platform that allows users to upload and sell photos, illustrations, videos and vectors to the world's largest creative community. We also announced a partnership with Reuters that will bring their expansive video and photography library across news, sports, business and entertainment to the Adobe Stock service.

With creativity exploding across the globe, geographic expansion represents a significant growth opportunity. In November, we launched Adobe Creative Cloud for teens in China. China is one of the world's largest digital economies and we can now address its extensive community of designers and creatives. We believe everyone is creative and should have the opportunity to express themselves. Adobe Spark, our consumer-friendly web and mobile solution for creating and sharing professional quality animated videos, web stories and social graphics, is gaining traction with small businesses, social marketers and students. We will continue to invest in Adobe Spark, which we see as a key way to reach a broader consumer audience as part of Creative Cloud.

The world's leading digital document service, Adobe Document Cloud, leverages the PDF standard we pioneered and enables businesses to transform inefficient paper-based processes to digital. In Q4, Document Cloud revenue was $191 million, and we grew Document Cloud ARR to $475 million. Document Cloud represents the modern way for managing digital documents. Core cloud capabilities like mobile and collaboration, as well as services like electronic signatures have become a requirement for our customers. As a result, Document Cloud subscriptions now eclipse licensing of perpetual Acrobat software or Adobe.com, and we expect to see stronger migration among our enterprise customers in the coming year.

As part of the ongoing innovation delivered through Document Cloud, this quarter we rolled out critical new scan functionality in our Adobe Reader mobile apps. In October, we expanded the global footprint for Adobe Document Cloud, with the launch of the Adobe Sign service in Japan. In our Digital Marketing segment, Adobe Marketing Cloud is the leader in enabling brands, government agencies and institutions to deliver great digital experiences across devices and channels. Whether it's financial institutions, retail, travel and entertainment, or automotive, entire industries are experiencing digital disruption and aggressively deploying technology to drive stronger brand loyalty and growth.

Adobe's winning formula is built on a unique foundation of content and data, which enables deep customer insights, development and delivery of consistent personalized experiences, and the ability to monitor and optimize business performance in real time. Adobe Marketing Cloud continues to be the most comprehensive offering in the exploding digital marketing category with best in class solutions in analytics, content management, cross-channel campaigns, and data management, as well as media optimization.

We're seeing strong demand for the Adobe Marketing Cloud across the globe as evidenced by the sold-out crowds at events this quarter in London, Paris, Munich and Tokyo. Major customer wins this quarter included Lufthansa, Pandora, United Healthcare, UPS, U.S. Defense Information Systems Agency and Verizon. In Q4, Adobe managed a record 33.5 trillion data transactions, providing us with an unparalleled view into real-time business and cultural trends. Debuting in 2016, the Adobe Digital Price Index has redefined how inflation and consumer goods prices are tracked and measured, and has received broad support from the world's leading economists.

Leveraging over 20 billion visits to retail websites, Adobe Digital Insights' Holiday Shopping Report accurately predicted online sales for this holiday season within a margin of error of less than 0.5%. Adobe measures 80% of all online transactions from the top 100 U.S. retailers, and $7.50 out of every $10 spent online with the top 500 U.S. retailers go through Adobe Marketing Cloud. This tremendous volume of data puts Adobe in the unique position to deliver highly accurate, census-based online sales totals, pricing and product availability trends each holiday season.

Last month we announced our intention to acquire TubeMogul, a leading demand-side video advertising platform, further strengthening our leadership in digital marketing and ad tech. Adobe is currently a leader in search, display and social advertising planning and delivery with our Adobe Media Optimizer solution. The addition of TubeMogul to our ad tech capabilities will enable Adobe's customers to maximize their video advertising investments across desktop, mobile, streaming devices and TV. Together, Adobe and TubeMogul will enable our customers to identify the right audience segments and plan, execute, and measure paid media performance across any device. We expect the transaction to close in December.

In September, we announced a strategic partnership with Microsoft to help enterprises embrace digital transformation. Adobe announced it will make Microsoft Azure the preferred platform for our cloud services, providing customers with a trusted, enterprise-grade, global platform, and that we will integrate our Adobe Marketing Cloud technology with Microsoft's Dynamics 365 Enterprise and Power BI. Microsoft announced it will make Adobe Marketing Cloud the preferred marketing service for its enterprise customers and its extensive partner and developer ecosystem. Adobe's success has been a result of our ability to predict the future.

While others are jumping on the machine learning and AI bandwagon, these capabilities have been the foundation of our innovation for decades. Our engineers and scientists are squarely focused on harnessing the massive volume of content and data assets captured in our cloud solutions to tackle today's complex experience challenges. Last month we announced Adobe Sensei, a new framework and set of intelligence services for dramatically improving the design and delivery of digital experiences. Adobe Sensei's services address the critical demands of our creative, document and marketing customers from image matching across millions of images, to understanding the meaning and sentiment of digital documents, to finely targeting important audience segments.

Dozens of these intelligence services have been deployed in our products to date, and we are significantly increasing our investment. We also intend to make Adobe Sensei available to our ecosystem of partners, ISVs and developers. Adobe's success over the decades is in no small part due to the unique culture we have created. In October, we were named a Best Multinational Workplace by the Great Places to Work Institute, and this month we were among the top 10 employers on Glassdoor's 2017 list of 50 Best Places to Work. We know that a strong workforce is a diverse workforce, and we are committed to increasing diversity among our employee base.

We have broken new ground in terms of employee benefits, like extended parental leave, and are implementing new programs including youth coding and media-making initiatives to inspire future female technologists. Being a good global citizen is important to our employees, customers and investors. For the first time, Adobe has been selected as a component of the prestigious Dow Jones Sustainability World Index. For the third year in a row, we received a perfect score on the 2017 Corporate Equality Index report from the Human Rights Campaign Foundation. In light of these accomplishments, Adobe's brand momentum has never been stronger, and we were honored to be one of the five fastest growing brands on the 2016 Interbrand Best Global Brands ranking.

FY 2016 was a great year for Adobe. We're driving growth in each of the large categories we have created. With a $64 billion total addressable market by 2019, our opportunity has never been greater. Our mission to change the world through digital experiences has never been more relevant and our strategy, our technology, and our people set us up for continued success. I would like to thank our employees for their dedication and innovation over the past year. We remain incredibly excited about the opportunity ahead.

Mark?

Mark S. Garrett {BIO 1407651 <GO>}

Thanks, Shantanu. Our earnings report today covers both Q4 and fiscal year 2016 results. In FY 2016, Adobe achieved record annual revenue of $5.85 billion, which represents 22% year-over-year growth. GAAP EPS for the year was $2.32 and non-GAAP EPS was $3.01. This performance is the result of strong execution against our strategy and noteworthy achievements including; growing Digital Media ARR by $1.13 billion during the year to exit fiscal 2016 with $4.01 billion, well ahead of our original target of $3.875 billion; achieving 38% year-over-year revenue growth in our Creative business and exiting the year with $3.54 billion of ARR; delivering Document Cloud revenue of $765 million and growing ARR to $475 million, both of which reflect progress against our goal of migrating this to a subscription business; achieving record Adobe Marketing Cloud revenue of $1.63 billion, and 20% annual year-over-year growth; generating $2.2 billion in operating cash flow during the year, which represents 50% year-over-year growth; growing deferred revenue to $2 billion and increasing our unbilled backlog to approximately $3.4 billion exiting the year, together this represents approximately $5.4 billion of contracted revenue that will be recognized over time, and returning over $1 billion in cash to stockholders through our stock repurchase program.

In the fourth quarter of FY 2016, Adobe achieved record revenue of $1.61 billion, which represents 23% year-over-year growth. GAAP diluted earnings per share in Q4 was $0.80 and non-GAAP diluted earnings per share was $0.90. Highlights in the quarter included; achieving $316 million of net new Digital Media ARR; record Creative revenue of $886 million, which represents 33% year-over-year growth; record Adobe Marketing Cloud revenue of $465 million, which represents 32% year-over-year growth; strong growth in operating and net income; record cash flow from operations and deferred revenue; and 82% of Q4 revenue from recurring sources.

In Digital Media, we grew segment revenue by 23% year-over-year. The addition of $316 million net new Digital Media ARR during the quarter grew total Digital Media ARR to $4.01 billion exiting Q4. Within Digital Media, we delivered Creative revenue of $886 million, which represents 33% year-over-year growth. In addition, we increased Creative ARR by $283 million during Q4, and exited the quarter with $3.54 billion of Creative ARR. Driving the momentum with our Creative business was continued strong demand for Creative Cloud across all offerings and routes to market during the quarter, including net-new Creative Cloud subscriptions, and enterprise contract renewals and up sells. Creative Cloud ARPU grew quarter-over-quarter across all offerings in Q4.

As we outlined at our analyst meeting in November, our focus with Creative Cloud continues to be in three key areas; growing our core base of users, including migrating the legacy user base of Creative Suite users, addressing piracy, and growing our installed base in the Education market; driving new customer adoption in adjacent markets with market expansion efforts such as the Photography plan, and using Creative Cloud mobile apps to create awareness and drive new member adoption; and growing ARPU and ARR with value expansion services such as Adobe Stock. Some highlights against these goals during the year include; 53% year-over-year subscription growth outside the U.S.; broadly expanding our base of users by adding more than 1 million Creative Cloud Photography plan subscribers during the year; and growing Adobe Stock revenue by more than 40% year-over-year.

With Document Cloud, we achieved revenue of $191 million. Document Cloud ARR grew to $475 million, the highest sequential quarterly growth this year. Driving this growth was adoption of Acrobat subscriptions and value-add services such as Adobe Sign, both of which are benefiting ARR and building a foundation for revenue growth in the future. In Digital Marketing, we achieved record quarterly and annual Adobe Marketing Cloud revenue. Entering the year, we targeted approximately 20% Adobe Marketing Cloud annual revenue growth, and approximately 30% Annual Subscription Value, or ASV bookings growth. Included in these targets in FY 2016 was an expectation of approximately $45 million of perpetual revenue.

Relative to our expectations at the beginning of the year, we experienced increased demand for on premise, perpetual licensed solutions by some customers. When we combine ASV bookings for the year with an overachievement in first year value of perpetual contracts, we achieved 30% bookings growth. In Q4, we achieved Marketing

Cloud revenue of $465 million, which represents 32% year-over-year growth. With this Q4 performance in FY 2016, we achieved 20% annual revenue growth. Mobile remains a key driver for this business. Mobile data transactions grew to 55% of total Adobe Analytics transactions in the quarter.

From a quarter-over-quarter currency perspective, FX decreased revenue by $4.5 million. We had $8.1 million in hedge gains in Q4 FY 2016, versus $3.9 million in hedge gains in Q3 FY 2016. Thus the net sequential currency decrease to revenue considering hedging gains was $0.3 million. From a year-over-year currency perspective, FX decreased revenue by $9.1 million. We had $8.1 million in hedge gains in Q4 FY 2016, versus $1.3 million in hedge gains in Q4 FY 2015. Thus the net year-over-year currency decrease to revenue considering hedging gains was $2.3 million. We experienced stable demand across all major geographies during the quarter.

In Q4, Adobe's effective tax rate was 12.5% on a GAAP basis, and 21% on a non-GAAP basis. The GAAP rate was lower than targeted due to tax benefits recognized as a result of the completion of certain income tax audits. Our trade DSO was 47 days, which compares to 47 days in the year-ago quarter, and 45 days last quarter. Deferred revenue grew to a record $2 billion, up 36% year-over-year. Our ending cash and short-term investment position was $4.76 billion, compared to $4.45 billion at the end of Q3. Cash flow from operations was a record $696 million in the quarter. During this year, we have been using excess domestic cash to buy back stock and reduce our share count. In Q3, we repurchased approximately 3.2 million shares at a cost of $331 million. We currently have $500 million remaining under our current authority granted in January 2015.

Now, I'll provide our financial outlook. Entering FY 2017, we have great momentum and continue to see strength across our three cloud businesses. We are excited about our large addressable markets, and are uniquely positioned to drive strong top-line and bottom-line growth. At our November 2 financial analyst meeting, we outlined our long-term strategy, and provided long-term growth rates and preliminary FY 2017 financial targets. We remain confident in our ability to operationally execute against those targets, and we are reaffirming our long-term FY 2015 to FY 2018 financial targets today.

Since the analyst meeting, the U.S. dollar has strengthened considerably. Were it not for this currency fluctuation, we would be reaffirming all of the preliminary FY 2017 targets we provided on November 2. Based on today's FX rates, we believe our hedging programs will effectively mitigate the impact of these rate changes in Q1 and Q2, but if they persist, current FX rates will affect our ability to achieve the preliminary annual targets due to the impact in the second half of FY 2017. As a result, we are providing the following FY 2017 targets; we expect total revenue of approximately $6.95 billion, which, factoring in the extra week in FY 2016, represents approximately 21% year-over-year growth; we continue to target Digital Media segment revenue growth of approximately 20%.

As you know, we measure ARR on a constant currency basis during a fiscal year, and if necessary, we revalue ARR at year-end for the current currency rates. FX rate changes have resulted in a $27 million reduction, and an updated Digital Media ARR exiting FY 2016 of $3.99 billion. The effect of this revision is reflected in our updated investor data sheet, and we continue to expect approximately 25% Digital Media ARR growth, which equates to approximately $1 billion of net new ARR in the year, leading to approximately $5 billion of Digital Media ARR exiting FY 2017. By quarter, we expect to add approximately $225 million of net new Digital Media ARR in Q1, followed by sequential growth of net new ARR in Q2. Then in Q3, we anticipate a seasonally driven sequential decline followed by strong seasonal growth in the fourth quarter to achieve the target for the year.

In Digital Marketing, we continue to target Adobe Marketing Cloud revenue growth of approximately 20%, and Adobe Marketing Cloud ASV bookings growth of approximately 30%. Despite the currency impact, we expect to achieve the same FY 2017 EPS targets we provided on November 2, which are a GAAP earnings per share of approximately $2.85 and non-GAAP earnings per share targeted at approximately $3.75. During the year, we expect revenue and earnings per share to grow sequentially each quarter with the largest sequential increase in Q4.

Starting with FY 2017, we are providing quarterly estimates for our most likely results rather than providing targeted ranges, due to the increased predictability in our business. In the first quarter of fiscal year 2017, we are targeting revenue of approximately $1.625 billion. We expect to achieve approximately $225 million of net new Digital Media ARR in Q1. We expect Digital Media Q1 segment year-over-year revenue growth of approximately 19% and Adobe Marketing Cloud year-over-year revenue growth of approximately 20%. When comparing Q1 FY 2017 targets, it is helpful to remember that Q1 FY 2016 had an extra week due to our 52-53-week fiscal year calendar. Factoring the extra week in Q1 FY 2016, all Q1 FY 2017 revenue targets represent greater than 20% year-over-year growth.

We are targeting our Q1 share count to be approximately 501 million shares. We expect net non-operating expense to be approximately $13 million on both a GAAP and non-GAAP basis. We are targeting a Q1 tax rate of approximately 15% on a GAAP basis, and 21% on a non-GAAP basis. These targets yield a Q1 GAAP earnings per share target of approximately $0.71, and Q1 non-GAAP earnings per share of approximately $0.87.

Finally, the targets we are providing today do not reflect our planned acquisition of TubeMogul, which we expect to close in December. We plan to issue updated Q1 and annual FY 2017 financial targets after the acquisition closes. We strongly believe analysts and investors should wait for the close of the acquisition to combine expected results of both companies into an updated model for the coming year. We plan to host a brief call to discuss our strategy and targets that factor in items such as a stub quarter period and accounting implications.

In summary, 2016 was another strong year for Adobe. We are the market leader with all three of our cloud solutions and we are executing well against a large and growing addressable market. We're excited about what lies ahead for Adobe and look forward to sharing more progress with you in the coming year.

Mike?

Mike Saviage {BIO 3176226 <GO>}

Thanks, Mark. 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, 25369759. 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 5:00 PM Pacific Time on December 21, 2016.

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 the line of Steve Ashley with Robert Baird. Please go ahead. Your line is open.

Q - Steve M. Ashley {BIO 1528771 <GO>}

Thanks so much for taking my question. I was going to look at the Creative media business. You're hitting on all cylinders. I mean, the Creative business is strong, you've strengthened Education, Document is coming up the curve. I was going to ask about the consumer opportunity there. Can you remind us what you have today in consumer, and if there's an opportunity to maybe push out and expand how far you push into the consumer market in the future? Thanks.

A - Shantanu Narayen {BIO 3332391 <GO>}

I'm happy to take that Steve, you're right, and thank you for the acknowledgment of how we're executing against the Creative business. From our point of view, Creative Cloud is very much about not just migrating the core customer segment, but significantly through market expansion, making sure that we're targeting new customers. I'd point out two or three different initiatives in that space. The first one clearly is Creative Cloud Photography plan, as you know, we used to have Lightroom and Photoshop elements. We're increasingly seeing those consumers adopt the Creative Cloud Photography plan. That continues to do really well in terms of the new customer acquisition that we have.

A second category that I'll talk about are products like Adobe Spark. We're seeing more and more people who have a story to tell, wanting to use Adobe Spark, and I think in this year you'll see that also start to get integrated and folded into the Creative Cloud much like mobile apps are. They represent a big customer acquisition and adoption and migration opportunity. And the third I'd continue to impress upon Education. Education as a segment does really well in Creative Cloud. It's that next generation of, whether it's K-12 students or higher ed, as they get exposed to our products, clearly as they enter university or the marketplace, they're using our products, all of which we look at as positive trends for the future.

Q - Steve M. Ashley {BIO 1528771 <GO>}

Great. Thanks so much.

Operator

Your next question comes from the line of Kirk Materne with Evercore ISI. Please go ahead. Your line is open.

Q - Stewart Kirk Materne III {BIO 5771115 <GO>}

Thanks very much, and congrats on a great fiscal year to you all. Shantanu, the last time we met you it was right the week before the election, and I think there's a lot of folks sort of wondering what you guys have seen sort of post the results from a macro perspective. I know you guys are sort of operating on sort of your own cadence right now in terms of your products and your strategy. But I was just kind of curious, I guess, especially in the digital marketing world where you guys are obviously talking to a lot of enterprises. Is there any change in tone or projected spend or anything like that? I was just kind of curious if you'd give us a bit of an update on that. Thanks.

A - Shantanu Narayen {BIO 3332391 <GO>}

Sure, Kirk. I have seen a rally in the stock market as well, which I think all of us have certainly experienced. But in addition to that, I would just continue to emphasize this notion of how all enterprises are being transformed by what's happening in digital, and the urgency with which they really need to think about technology that they can leverage to become more of an experienced business. I think that continues to be unabated. As you saw, we had a pretty strong Q4, revenue grew over 30% year-over-year in the Digital Marketing business. And I think the opportunity continues to be one that we're excited about, not just in the U.S. but internationally as well. So nothing that we've seen either just before the election or post-election changes our belief in the large opportunity and our continued execution in that space, Kirk.

Q - Stewart Kirk Materne III {BIO 5771115 <GO>}

Thanks very much.

Operator

Your next question comes from the line of Sterling Auty with JPMorgan. Please go ahead. Your line is open.

Q - Sterling Auty {BIO 2070271 <GO>}

Yeah, thanks. Hi, guys. In your prepared remarks, you mentioned the overage, or the higher than expected demand on premise perpetual in the Digital Marketing side. How much of that happened in the fourth quarter? And if you normalize, how would you kind of characterize the bookings and revenue relative to what your expectations were?

A - Shantanu Narayen {BIO 3332391 <GO>}

Sterling, when we look at the entire year first, let me reflect that we continue to think that we both have the most comprehensive offering, and we're pleased with both the revenue and the bookings growth for the year. I do want to clarify that we think the cloud remains the long-term right offering for our customers, but the fact that we have an on premise solution, we continue to think it's a competitive advantage. And globally, it's hard to predict which option customers might prefer on a quarter-by-quarter basis. But I want to reiterate, it's all from our point of view good revenue.

When we look at the different components of revenue in the Marketing Cloud, and you look at subscription, which we think is the healthiest long-term predictor, and then you look at perpetual and consulting, the subscription bookings revenue grew 29% year-over-year in FY 2016, so stronger than the overall 20%. And if you actually go back to what Mark showed at the SEA Meeting (36:47) and look at the pie chart, it was exactly in line with what we had predicted for Q4.

Relative to the beginning of the year, to your question, we certainly overachieved a little bit in perpetual revenue relative to subscription bookings. However, when you normalize that and you take, given perpetual revenue as a multi-year commitment, and look at just the first-year component, I think it's really small. And so relative to overall growth, we feel good about it. The mix was slightly different relative to what we thought at the beginning of the year.

Q - Sterling Auty {BIO 2070271 <GO>}

Got it. Thank you.

Operator

Your next question comes from the line of Brent Thill with UBS. Please go ahead. Your line is open.

Q - Brent Thill {BIO 1556691 <GO>}

Thanks. Shantanu, the Asian business has been very strong the last couple of quarters, and I was curious if you could just talk through the fall-through that you're seeing there. I know you've also made a bigger push into China, where many software companies have not been successful for a lot of reasons. Can you just talk a little bit about what you're seeing there so far as you push more aggressively to China?

A - Shantanu Narayen {BIO 3332391 <GO>}

Sure, Brent. I think there are two things that we factor in; the first is, as we've always stated when we first released Creative Cloud, adoption of Creative Cloud in Asia lagged adoption of Creative Cloud in the U.S. and UK for example, as Mark said. We now are pleased with the adoption that we're seeing. Australia was always a strong market. Australia continues to be a very strong market. So as it relates to Creative Cloud, as we said, even having it in China right now, it was long overdue. And the fact that we now have Creative Cloud for teams in China I think shows our commitment to the Chinese digital economy, which we continue to think is one of the largest. So we feel good about it.

The other large opportunity, as you know, for us is in Digital Marketing, and that's driven by two different phenomena; the first phenomena is, as we increasingly have global agreements with U.S. multinationals, they expect deployment of our solutions whether it's in retail, financial services or other places, to also be true in China and in India and in Australia and Southeast Asia, so that's continuing to drive some growth. And then even local companies in all of those markets, as they realize mobile in particular there and the digital disruption there, there's excitement around our products. So in Digital Media, it's all about the adoption of Creative Cloud and Digital Marketing, it's both about global adoption of our Digital Marketing solutions, as well as local companies increasingly recognizing that they have to migrate to digital with mobile being the key driver there.

Q - Brent Thill {BIO 1556691 <GO>}

Thank you.

Operator

Your next question comes from the line of Walter Pritchard with Citi. Please go ahead. Your line is open.

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

Thanks. Shantanu, I'm wondering if you can talk about the ETLA performance in the fourth quarter, and your expectations in terms of ETLA as a part of that billion dollars in incremental ARR next year, and specifically trying to figure out if the new ETLA business is still growing. I know you're kind of coming up on some renewals and so forth there. I just wanted to get a sense of the trajectory.

A - Shantanu Narayen {BIO 3332391 <GO>}

In net summary Walter, very strong quarter in Q4, I think driven by two different phenomena; the first is, three years ago when we had first introduced the ETLA program for our customers, it was really more a reflection of what they were licensing for Creative Suite, so I'd call them more of these custom solutions, which reflected what versions of different products they were using. Starting in fiscal 2016, we moved to a more complete solution, which is people were licensing all of the products and the fact that it was integrated. The field organization did a really great job of articulating the benefits of moving to the entire complete solution. And the second thing that actually happened in the year was also true-ups, which is people are finding that as they're deploying more and more of Creative Cloud, they were volunteering doing true-ups. So new logos, as well as moving from what I would say custom to complete, and clearly resulting in an increase in ARPU for the enterprise. And we continue to believe that that represents a large opportunity in the U.S. and internationally for FY 2017.

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

Thank you.

Operator

Your next question comes from the line of Kash Rangan with Bank of America Merrill Lynch. Please go ahead, your line is open.

Hi, this is Shankar on behalf of Kash. I have a question on your overall margin profile as we look into the next few years. You mentioned in your prepared remarks about the increased investment that you're going to make in Sensei and Adobe Spark and whole lot of other products. But if you also look at the large TAM potential, and the potential that Azure partnership that can drive your Marketing Cloud, and also your margins down over time, what's the leverage in them all (42:13), and can we expect like operating margins to be in the 40% to 45% range, say, by end of the decade?

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

Hey, it's Mark. Thanks for the question. I'm glad I got one. I was getting ready to go home. So first, we're extremely proud of our ability to be one of the only, if not the only, cloud companies that can grow significantly on top line and bottom line, and the fact that we got to $3.01 this year, and being well ahead of our guidance is something that we're very proud of. We do have room in the model to invest in the businesses that we need to invest in. And if you look at next year's guidance and you do the P&L based on what we just told you, you're going to come up with operating margins that are increasing by around a point from this year. So from 34% to 35%. We gave you guidance for 2018. You can see that margins continue to improve from there. I'm not going to say at this point that we're going to go back to 40%, which is where we were in 2008, but you can see that there is still tremendous leverage in our model, and we feel very good about that.

Q - Operator

Thank you.

Your next question comes from the line of Keith Weiss with Morgan Stanley. Please go ahead. Your line is open.

Q - Stan Zlotsky {BIO 19183037 <GO>}

Hey, guys. Good afternoon. This is Stan Zlotsky sitting in for Keith Weiss. So I actually wanted to ask a question on Document services business. The ARR that you added in Q4 was very impressive, and you guys mentioned in the prepared remarks the fastest and the most that you've added all year. So what was the driver of that outperformance in the quarter? And more broadly, as you move the Document services business to subscription, how are you thinking about that versus the kind of strategy that you adopted moving the Creative Cloud business to subscription as well? So thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, I think two comments come to mind there. First is, it was a very strong year, and if you'd look at just the Document Cloud segment ARR, it probably under-represents the momentum that we have with the Document Cloud and Acrobat businesses because, as you know, a significant number of people also use Acrobat DC when they're using the

Creative Cloud. So big picture, it was driven by both the Adobe.com, where we have very dramatically made the switch from people buying the perpetual product to people buying the subscription offering, as well as enterprise and the adoption of new services like Adobe Sign.

And so when you look at the ARR, I think the ARR growth was over 20% for the year. And when you think about the unit growth that we're seeing in it, it just reflects that PDF as a standard has continued to be the win which people share it. For those on the call, I would also really recommend you try out our new mobile apps and the scan functionality where it's, I would say, one of the easiest ways for people to create a PDF out of any picture that they might have using the camera. So continued innovation, I think, in that space just reflects as paper to digital is this macro trend we're very uniquely positioned to capitalize on that.

A - Mike Saviage {BIO 3176226 <GO>}

Next question, please.

Operator

Your next question comes from the line of Jay Vleeschhouwer with Griffin Securities. Please go ahead. Your line is open.

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Thank you. Mark, don't go home yet. I have a question for you. So the question concerns cash flow.

A - Mike Saviage {BIO 3176226 <GO>}

Jay, it's Mike. I'm glad you're on our call and not the Oracle call like others. Thanks. Go ahead, Jay.

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Okay. You're very welcome. So you just grew your GAAP operating cash flow by about $800 million in 2016. And the question is, how are you thinking about cash flow in 2017? Do you think you could achieve a similar increment, even considering all the investments, of course, that you're talking about, particularly in terms of geographic expansion in Asia, and of course R&D?

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

Yeah, Jay, thanks for the question. Obviously, we had extremely strong cash flow on the year, really good cash flow in Q4. As I look into next year, I expect very strong cash flow again. I will say I'm glad you asked the question, I will say, just so everybody understands, cash flow from Q4 to Q1 always naturally declines. We have a lot of payments that get made in the first quarter for commissions and bonuses and things like that. So you should expect a pretty substantial decline, just sequentially. But I do fully expect another strong cash flow year next year.

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Okay. Maybe just as a follow up, could you talk about perhaps the non-net income components of that? I mean, how are you thinking in terms, for example, of deferred, in particular?

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

Again, I expect deferred to continue to increase as we drive bookings faster than we're driving revenue.

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Okay. Great. Thanks very much.

Operator

Your next question comes from the line of Ross MacMillan with RBC Capital Markets. Please go ahead. Your line is open.

Q - Ross MacMillan {BIO 1994797 <GO>}

Thanks for taking my question. Mark, when we look at ARR, big picture, I guess, is that we added about $1.1 billion this year, 2016, it's about the same level as fiscal 2015. We're talking about $1 billion in 2017. So there's really very little decay in the rate of new ARR being added. And I know you're not yet talking about the year even further out, but how should we be thinking about that kind of pace of moderation, shall we say, in that ARR increment? And the question really goes to this sort of notion of kind of where we are, both in terms of new user adds and base transition. I'm just curious for your sort of high-level thoughts.

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

Yeah, I mean, like you say, we've been consistently adding around $1 billion and we feel very good about that number. We continue to attract new users. We continue to drive higher ARPU. We're getting people off of promotions onto full price. We're adding value add services like Stock. All of those things help drive that ARR number. Retention helps drive that ARR number. So there's lots of different ways that we can do that. And as you know, we're addressing a much bigger TAM than we were addressing a number of years ago. So all of that plays into our ability, we believe, to continue to drive that kind of net new ARR.

Q - Ross MacMillan {BIO 1994797 <GO>}

And then just one other, just follow up quickly, just on the seasonality of ARR this year. I think, this will be the first year where we actually see a decline in fiscal Q3. Is that just the base effect, like the numbers are getting bigger, or are there any particular things this year we should think about as we transition Q2 to Q3 that maybe we didn't see last year or the prior year?

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

No, yeah, there's nothing new. We're just trying to make sure we incorporate seasonality. I mean, Q3 is a slower seasonal quarter for buying for us, and we just want to factor that in.

Q - Ross MacMillan {BIO 1994797 <GO>}

Okay. Thanks again. Congratulations.

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

Thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

Thanks, Ross.

Operator

Your next question comes from the line of Brian Wieser with Pivotal Research. Please go ahead. Your line is open.

Q - Brian W. Wieser {BIO 16451167 <GO>}

Thanks for taking the question. Following the TubeMogul acquisition, I was just wondering if you could talk a bit about any other aspects of ad tech (50:28) you think you may be emphasizing investment in, whether internal or external? And maybe relatedly, Tube made a pretty strong focus, as an independent company, on its demand side orientation, given the business you have on Primetime, I'm wondering if you expect it will have some supply side orientation, as well.

A - Shantanu Narayen {BIO 3332391 <GO>}

I think at this point, Brian, what I would say is we're excited about the TubeMogul acquisition, and we are excited about the long-term video as well as data opportunity. Just to highlight, from our point of view, TubeMogul enables – it's more heft in our ad tech platform, which is a key part as we're targeting the CMO, or the Chief Revenue Officer, the Chief Digital Officer in an enterprise, and adding to what we have in display, search and social, so that's good. To your point, we do have now more end-to-end capabilities all the way from video delivery to monetization for our publisher as well as our advertiser customers.

And I think what's perhaps most strategic, the integration between their DSP offering and our DMP. We're seeing more and more people wanting to integrate with our industrial-leading Audience Manager DMP. That has really become, in fiscal 2016, a driver of the adoption of the platform. And so I think our goal when this closes will be to share more about what we are planning to do strategically. But big picture, it just enables us to be more of a trusted platform for the Chief Marketing Officers and Chief Revenue Officers, and to enable both personalization in terms of delivery, and better segmentation, and deriving value from all of the data that they have. So excited about it, and we'll say more about that after we close.

Q - Brian W. Wieser {BIO 16451167 <GO>}

Okay. Thank you very much.

Operator

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

Q - Jack Kilgallen

Thanks. It's Jack Kilgallen filling in for Heather. So you mentioned Creative Cloud ARPU continues to grow sequentially. I just wondered if you could rank order the drivers behind this. I know you mentioned that users on promo pricing renewing at full price, new offerings like Stock. Maybe if you could just put into context what sort of the biggest drivers are, and how long we should expect a tailwind like the promo users renewing at full price to exist? Thanks.

A - Shantanu Narayen {BIO 3332391 <GO>}

All of them are clearly driving the transition of the business to ARR. I would say people are migrating off of the promotional pricing, and as long as they continue to retain to full price, that's certainly one of the large drivers. I think we talked about enterprise as one of the large drivers. The mix, as it moves from single app to complete is another driver. So hopefully that gives you a little bit of color. And that's why our strategy of getting more and more people on to the platform, we actually did fewer promotions in the quarter, there were more targeted promotions, so they were successful. And that gives you some color, I think. Stock and Sign are starting to become reasonable ARR, and we expect continued growth in both those areas as well.

Q - Jack Kilgallen

Thank you.

Operator

Your next question comes from the line of Michael Nemeroff with Credit Suisse. Please go ahead. Your line is open.

Q - Michael Nemeroff {BIO 6355446 <GO>}

Hi, guys. Thanks for taking my question. Just building on the last one, some recent survey work that we've done suggested that the majority of enterprises have yet to upgrade to Windows 10, but they plan to do so within the next 12 months to 24 months. So I'm just curious, how much of the as-yet converted suite base is running Windows versus iOS, and do you expect, because I didn't hear you mention in the last answer, that those Windows 10 upgrades would drive some of the ARR growth in fiscal 2017?

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, I think, big picture, what I would say in that particular space is, whenever there are hardware transitions or software transitions with significant new functionality, they always represent opportunities for us to accelerate migration. When people look at Windows in particular, I think what's most exciting to them is in addition to the incredible hardware that Microsoft and other companies are doing, the fact that it's touch-enabled has really made a very significant difference. Video capabilities also in that platform are just so powerful that there's clearly migration from the high-end proprietary video systems into PCs. So that hopefully gives you some color. I think Apple continues to innovate. But with Windows 10 as people migrate, it always is an opportunity for us to work with that transition team to make sure that they also migrate to Creative Cloud.

Q - Michael Nemeroff {BIO 6355446 <GO>}

Thank you very much.

A - Mike Saviage {BIO 3176226 <GO>}

Operator, we're coming up on the top of the hour. Why don't we take one more question?

Operator

Your last question comes from the line of Samad Samana with Stephens, Inc. Please go ahead. Your line is open.

Q - Samad Samana {BIO 17883999 <GO>}

Hi. Thanks for taking my question, squeezing me in. I'll apologize if I'm asking something that's already been asked. I jumped on late. But could you give us any idea, you gave the 1 million new Photoshop subs that you added on Photography package, maybe any color on just what the full year trend looks like for full Creative Cloud ads, and if there's any change in either the retention rate that you saw there, or the add-on rates for the Adobe Stock package, or the Creative Cloud package that included Stock? Thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

I think with respect to both the addition of subs as well as the migration of the business, all of them just continued to be really powerful. If I had to give you a little bit of color as it relates to what happened in retention, I think in 2011, when we first outlined the opportunities, we estimated at that point that even at 80% retention rates for the core Creative, it would be great for the business. Clearly, retention for the core Creative is really higher than that. And when you think about it for the entire base that includes consumers, it's also higher than 80%. And so as we look at retention, it's actually a very good indicator of the core health of the business, and we're pleased with that. With respect to the Creative Cloud Photography plan, it just continues to be a very vibrant way for us to attract new customers to our particular platform.

And since that was the last question, for me, my summary remarks would be, while FY 2016 was clearly a great year, in many ways I'm even more excited about the long-term opportunities that we have created for ourselves as a company. When we think about the two big areas of focus for Adobe, empowering people to create and transforming how businesses compete, it just represents massive opportunities in our content and data platform, really allow us to uniquely address this need. On the Creative business, just continuing to enable any individual who has a story to tell, to tell them across any medium, any device. And on the enterprise side, enabling them to leverage technology to reinvent themselves as an experienced business, represent large unmet needs. I feel good that we're innovating while staying in an extremely select group of people and companies that are delivering impressive both top line and bottom line growth. I'd like to thank our customers, partners, employees and investors, and wish you all a Happy Holiday season. Thank you for joining us.

A - Mike Saviage {BIO 3176226 <GO>}

And this concludes our call. Thanks, everyone.

Operator

You may now disconnect.