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Q2 2018 Earnings Call

Company Participants

- John Francis Murphy, Chief Financial Officer & Executive Vice President
- Mike Saviage, Vice President of Investor Relations
- Shantanu Narayen, Chairman, President & Chief Executive Officer

Other Participants

- Alex J. Zukin, Analyst
- Brad Alan Zelnick, Analyst
- Brent Thill, Analyst
- Brian W. Wieser, Analyst
- Heather Bellini, Analyst
- J. Derrick Wood, Analyst
- Jay Vleeschhouwer, Analyst
- Jennifer Swanson Lowe, Analyst
- Kash Rangan, Analyst
- Keith Eric Weiss, Analyst
- Kirk Materne, Analyst
- Mark L. Moerdler, Analyst
- Pat D. Walravens, Analyst
- Ross MacMillan, Analyst
- Saket Kalia, Analyst
- Sterling Auty, Analyst
- Walter H. Pritchard, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

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

I would like to now 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 John Murphy, Executive Vice President and CFO.

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

Before we get started, we want to emphasize that some of the information discussed in this call, particularly our revenue and operating model targets, and our forward-looking product plans, is based on information as of today, June 14, 2018, and contains forward-looking statements that involve risk and uncertainty. Actual results may differ materially from those set forth in such statements. For a discussion of these risks and uncertainties, you should review the Forward-Looking Statements Disclosure in the earnings press release we issued today, as well as Adobe's SEC filings.

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

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

I will now turn the call over to Shantanu.

Shantanu Narayen {BIO 3332391 <GO>}

Thanks, Mike and good afternoon. Adobe delivered record revenue in our second quarter with strong financial results. Q2 revenue was $2.20 billion, which represents 24% year-over-year growth. GAAP earnings per share for the quarter was $1.33 and non-GAAP earnings per share was $1.66.

Adobe enables individuals, companies, governments and educational institutions to design and deliver transformative digital experiences, immersive, intelligent experiences that inspire, entertain, and drive loyalty and growth. The breadth of our product portfolio, the deep science embedded in our Adobe Cloud platform, the insights derived from the trillions of data transactions we process every year on behalf of our customers and our global ecosystem of partners and developers have made Adobe the leader in enabling great customer experiences.

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In our Digital Media business, we achieved strong growth in both Creative and Document Cloud revenue in Q2. We added net new Digital Media annualized recurring revenue, or ARR of $343 million, which grew total Digital Media ARR exiting Q2 to $6.06 billion.

We continue to drive steady adoption of Creative Cloud subscriptions and services by individuals, teams and enterprises across all segments and geographies. This resulted in another strong quarter for Creative Cloud, with Creative revenue growing to $1.3 billion.

At Adobe, we believe everyone has a story to tell. Our strategy to empower more of the world's storytellers to express themselves depends on our ability to make our tools more accessible, enjoyable and invaluable to a broader set of creative customers, from creative pros, to hobbyists, to young creatives.

Experience design is one of our fastest growing creative segments and we recently introduced a new starter plan for Adobe XD, our all-in-one UX/UI design platform. Adobe XD is the most modern, cloud-based solution available for designing, prototyping and collaborating with colleagues across multiple platforms.

We recently announced several new integrations between XD and designers' existing workflows inside of tools such as Photoshop and Illustrator. We launched a $10 million design investment fund to support designers and developers who innovate and push the boundaries of experience design.

Enabling creativity in the Education segment remains a passion for Adobe. Adobe Spark premium, our application for everyday communicators to transform their ideas into beautiful visual stories, is now available to every student globally. We've achieved strong adoption of Spark in school districts across the nation.

To further bolster our commitment to K-12 students, we introduced a new offering that gives students more affordable access to applications including Photoshop, Illustrator, Premiere Pro, and XD. These actions are part of our commitment to partner with educators, promote STEAM, and ensure art and creativity remain an essential part of education and professional development.

Adobe's video editing and production tools, including Adobe Premiere Pro and After Effects, are the gold standard for creating films and video from the silver screen to the mobile screen. At NAB, Adobe unveiled innovative updates to Creative Cloud's digital video tools. In addition, partners, including Canon, RED CAMERAs, AMD, and Sony, announced tools and updates that allow users to work in an integrated, collaborative production environment.

Our mission is to push the limits of creativity and storytelling while supporting exciting new mediums. We provided a sneak peek of Project Aero, a powerful new augmented reality, or AR authoring tool at Apple's WWDC last week. Project Aero is a system that makes it easier for designers and developers to create immersive content and bridge the gap between the physical and digital worlds. With close to one billion AR-enabled

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devices expected to be in market next year, AR can drive a new wave of digital transformation and creativity.

In addition to the world's best desktop and mobile tools, Creative Cloud services are driving growth in our business while offering new ways to inspire our customers and accelerate their creative process. Adobe Stock achieved record revenue in the quarter, with greater than 25% year-over-year growth. Adobe Stock now has a library of more than 100 million images, videos and creative assets including new curated HD and 4K videos, as well as Motion Graphics templates.

Adobe Document Cloud is the world's leading digital document service, enabling individuals and businesses to digitize inefficient paper-based processes. In Q2 we achieved record revenue for Document Cloud of $243 million. Document Cloud subscriptions and Acrobat perpetual licensing drove 22% year-over-year revenue growth, and $47 million in net new Document Cloud ARR.

This week marks the 25th anniversary of Acrobat and PDF, the innovation that ushered in the era of digital documents. Twenty-five years later, the pace at which we're innovating with Document Cloud has only accelerated as digital documents become more collaborative and mobile. More than 800 million PDFs are opened in Adobe Acrobat Reader on mobile devices each month. Adobe Scan, our mobile PDF creation app powered by Adobe Sensei that turns your phone or tablet into a scanning and text recognition tool, has been downloaded more than 10 million times.

Adobe Sign, our digital signature solution for Document Cloud, continues to have strong momentum. Today, over half of Fortune 100 companies use Adobe Sign. Last September, we teamed up with Microsoft to integrate Adobe Sign into Microsoft Office 365. Next week we'll be unveiling industry-first innovations in Adobe Sign focused on delivering superior digital document experiences to millions of customers.

Adobe Experience Cloud is the most comprehensive, integrated, and actionable set of solutions in the market, designed to help companies deliver consistent, continuous and compelling experiences across every touch point and channel. In Q2, we achieved Experience Cloud revenue of $586 million and strong bookings across Adobe Marketing Cloud, Adobe Analytics Cloud and Adobe Advertising Cloud. Key customer deals in the quarter included Audible, Intuit, Shell, H&R Block, Japan Airlines, PNC Bank and Samsung.

In May, we announced our intent to acquire Magento, a leading commerce platform. Commerce is an integral part of an end-to-end customer experience as consumers and businesses now expect every interaction to be shoppable. The addition of Magento Commerce will enable commerce to be seamlessly integrated into Adobe Experience Cloud, delivering a single platform that serves both B2B and B2C customers globally while providing the flexibility to scale to serve mid-market and large enterprise customers.

The Magento Platform is supported by a robust community of more than 300,000 developers and a partner ecosystem that provides thousands of pre-built extensions,

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including payment, shipping, tax and logistics.

The acquisition of Magento will make Adobe the only company with leadership in content creation, marketing, advertising, analytics and now commerce, enabling real-time personalized experiences across the entire customer journey, whether on the web, mobile, social, in-product or in-store. We believe the addition of Magento expands our available market opportunity, builds out our product portfolio, and addresses a key underserved customer need.

When combined with our world-class content and data platform and leveraging our Sensei machine learning and AI framework, this latest capability will further differentiate Adobe Experience Cloud as the leading platform for experience businesses. We expect the acquisition to close next week.

We continue to host successful customer Summits across the globe where we roll out new innovations across Adobe Experience Cloud, including major enhancements to the Adobe Cloud Platform. Recent advancements include a new unified customer profile that combines data across an enterprise, intelligent services, and General Data Protection Regulation, or GDPR readiness, all aimed at solving key challenges facing marketers, data scientists and developers.

Adobe was once again recognized for our leadership in technology segments that help to deliver and orchestrate experiences across the entire customer journey. We were named a leader in the Forrester Wave: Digital Asset Management for Customer Experience, achieving the highest score for current offering of the vendor leaders. Adobe was positioned as a leader in the Gartner Magic Quadrant for Multichannel Marketing Hubs. In this inaugural report, Adobe had the strongest ranking for Completeness of Vision among the 21 vendors evaluated.

Adobe Sensei, our artificial intelligence and machine learning framework, forms the foundation of the innovative Adobe Magic across Creative Cloud, Document Cloud and Experience Cloud. We were pleased to be recognized again as one of the World's Most Innovative Companies by Forbes for 2018.

The talent and passion of our more than 18,000 employees worldwide continues to be the catalyst for Adobe's success. We take pride in making Adobe one of the world's best workplaces and cultivating a diverse and innovative team of global employees. This summer we're pleased to welcome over 1,000 interns and university graduates to Adobe, the largest such group in company history.

Adobe has the right strategy, partners, products and people in place to win. We look forward to building on the momentum we're driving across our entire business and expect a strong second half of the year.

John?

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John Francis Murphy {BIO 16018871 <GO>}

Thanks, Shantanu. In the second quarter of FY 2018, Adobe's momentum continued with record revenue of $2.2 billion, which represents 24% year-over-year growth. GAAP diluted earnings per share in Q2 was $1.33 and non-GAAP diluted earnings per share was $1.66. We drove strong performance across our product offerings and geographies during the quarter.

Highlights in Q2 included, record Digital Media revenue, including Creative revenue of $1.30 billion and Adobe Document Cloud revenue of $243 million; record Adobe Experience Cloud revenue of $586 million; net new Digital Media ARR of $343 million, and exiting Q2 with $5.37 billion of Creative ARR; deferred revenue growth of 27% year-over-year; cash flow from operations of $976 million; returning $589 million of cash to our stockholders through stock buyback; and approximately 89% of our revenue in Q2 was from recurring sources.

In Digital Media, we grew segment revenue by 28% year-over-year. The addition of $343 million net new Digital Media ARR during the quarter grew the total to $6.06 billion exiting Q2.

Within Digital Media, we achieved another record quarter with our Creative business. Creative revenue grew 29% year-over-year in Q2 and we increased Creative ARR by $296 million. Several key factors helped drive this growth including strong net new subscriptions across user segments and geographies, helped by robust traffic and conversion on adobe.com; continued momentum with Creative Cloud adoption in emerging markets; stable or increasing ARPU across key offerings, which continues to be driven by retention of users on promotional prices migrating to standard prices, as well as attachment of services in the enterprise and the recently introduced price increase in North America; and strong growth with Adobe Stock.

With Document Cloud, we achieved record revenue of $243 million, which represents 22% year-over-year growth. The performance in Q2 was driven by continued momentum with Acrobat subscription adoption as well as strength in the enterprise with Acrobat and Document Cloud services.

In our Digital Experience segment, we achieved record Adobe Experience Cloud revenue of $586 million, which represents 18% year-over-year revenue growth. Subscription revenue grew 24% year-over year.

Experience Cloud performance in Q2 was driven by success across our Analytics Cloud, Marketing Cloud and Advertising Cloud offerings. Experience Cloud data transactions grew to 97 trillion in the quarter, with 60% of Analytics transactions driven by mobile device usage.

From a quarter-over-quarter currency perspective, FX increased revenue by $15.2 million. We had $0.3 million in hedge gains in Q2 FY 2018, versus $1 million in hedge gains in Q1 of FY 2018; thus, the net sequential currency increase to revenue considering hedging gains was $14.5 million.

From a year-over-year currency perspective, FX increased revenue by $51.3 million. We had $0.3 million in hedge gains in Q2 FY 2018, versus $13.3 million in hedge gains in Q2 of FY 2017; thus, the net year-over-year currency increase to revenue considering hedging gains was $38.3 million.

In Q2, Adobe's effective tax rate was 4% on a GAAP-basis and 5% on a non-GAAP basis. These rates are below the targets we provided due to a structural change we made during Q2 in how we serve foreign customers based on the new U.S. Tax Act. Our recent international tax structure change will benefit our tax rates for the remainder of FY 2018 as well as next year.

Our trade DSO was 44 days, which compares to 46 days in the year-ago quarter, and 47 days last quarter. Deferred revenue grew to a record $2.63 billion, up 27% year-over-year. Our ending cash and short-term investment position exiting Q2 was $6.33 billion.

Cash flow from operations was $976 million in the quarter.

In Q2, we repurchased approximately 2.6 million shares at a cost of $589 million. We currently have $900 million remaining of our $2.5 billion authority granted in January 2017. We expect this authorization to be exhausted by the end of this fiscal year. On May 21st we announced that our board had authorized an incremental $8 billion stock repurchase program through fiscal year 2021, which will be funded from future cash flow generation.

Now, I'll provide our financial outlook. In January, we updated our financial targets to reflect provisions of the new U.S. Tax Act which became law during our fiscal Q1. The Tax Act affords companies like Adobe the ability to make changes to the way we serve our foreign customers with our international corporate structure. During Q2, we made a structural change and the effect of it results in even lower tax rates than we discussed previously for both this year and subsequent fiscal years.

In fiscal 2018, we anticipate an incremental 6-percentage-point reduction in our GAAP and non-GAAP tax rates when compared to the rates we provided in January. We are now expecting a GAAP tax rate of approximately 7% in Q3 and Q4 of fiscal 2018; and a non-GAAP tax rate of approximately 5% in Q3 and Q4 of fiscal 2018.

Our November fiscal year calendar and the timing of certain Tax Act provisions make our FY 2018 a unique year from a tax rate perspective. We indicated in January that we anticipated our tax rates would stabilize at a new rate of approximately 18% on both a GAAP and a non-GAAP basis in FY 2019. Based on the structural change we made in Q2, we now estimate our tax rates in FY 2019 will stabilize at GAAP and non-GAAP rates of approximately 14%.

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Turning to Q3 FY 2018, we are targeting revenue of approximately $2.240 billion. Digital Media segment year-over-year revenue growth of approximately 25%; Digital Experience segment year-over-year revenue growth of approximately 15%; tax rate of approximately 7% on a GAAP basis, and 5% on a non-GAAP basis; share count of approximately 498 million shares; GAAP earnings per share of approximately $1.27; non-GAAP earnings per share of approximately $1.68; and net new Digital Media ARR of approximately $310 million.

Our Q3 targets do not reflect our pending acquisition of Magento Commerce. We have received regulatory clearance and anticipate closing the acquisition next week. For the second half of calendar year 2018, Magento's internal plan projected achieving approximately $100 million in revenue.

After the transition to Adobe's November fiscal calendar and the write-down of deferred revenue due to purchase accounting rules, we anticipate Adobe will report approximately $40 million of Magento revenue in the second half of Adobe's fiscal 2018, with approximately $10 million of it in our fiscal Q3.

We expect the closing of Magento to be slightly dilutive to our Q3 GAAP earnings per share target. We do not expect the closing to impact our non-GAAP Q3 earnings per share target. In Q4, we anticipate normal seasonal strength and a strong finish to the year.

I'll now turn the call back over to Mike.

Mike Saviage {BIO 3176226 <GO>}

Thanks, John. Adobe MAX returns to Los Angeles this fall and day one of our user conference is Monday October 15th. We plan to host a financial analyst meeting on the afternoon of the 15th, and an invitation with registration information will be sent out in early July. More details about MAX are available at max.adobe.com.

If you wish to listen to a playback of today's conference call, a web-based archive of the call will be available on our IR site later today. Alternatively, you can listen to a phone replay by calling 855-859-2056; use conference ID number 4599054. 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 June 20, 2018.

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

Q&A

Operator

And your first question comes from the line of Sterling Auty from JPMorgan. Your line is open.

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Q - Sterling Auty {BIO 2070271 <GO>}

Yeah. Thanks. Hi, guys. Looking at the results the revenue in Digital Media both in the quarter and for the outlook is better than expected despite the Digital Media ARR coming in line. I'm wondering if there's something that's improving the revenue conversion in the quarters or some other factor that's allowing that to happen.

A - Shantanu Narayen {BIO 3332391 <GO>}

Sterling, I'll take that. I think as we look at Digital Media, as you pointed out, ARR was again strong across all different segments. Retention continues to be in line with expect. Acrobat perpetual had a good quarter. So Acrobat as it related to both licensing and perpetual was strong as well as Stock. So I think across the board we continue to focus on converting ARR to revenue.

Q - Sterling Auty {BIO 2070271 <GO>}

Got it. Thank you.

Operator

Your next question comes from the line of Alex Zukin from Piper Jaffray. Your line is open.

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

Hey, guys. Thanks for taking my question. I wanted to ask on the Experience Cloud business, clearly showed some really nice acceleration in the quarter on a much tougher comp from last year. So I wanted to ask kind of what changes have you observed? What's strengthening renewal activity and upsell, any comments would be helpful and then how sustainable do you expect some of these trends to be?

A - Shantanu Narayen {BIO 3332391 <GO>}

Alex, big picture, I think we were very pleased with our performance in the Experience business. I think the metric that we look at a lot was the subscription revenue growth. If you look at the subscription revenue growth in the quarter that was 24% year-over-year. I think in the prepared remarks, we said it was across the Marketing Cloud, Analytics Cloud as well as the Advertising Cloud.

Again, digital transformation is front and center as an imperative for every single organization. Without a doubt we have the clear leadership position in that. The value proposition is very unique. We're getting larger deals. We've talked about the multi-solution opportunities that we have. I would say, particularly, in the quarter as well with the two summits that we organized and the interest that we have in summits as closing opportunities for us.

And last but not least the partnership with Microsoft, where we're jointly going in and engaging with customers at higher levels. So, I'll just point to continued leadership on the product and vision side and focus on execution in the quarter.

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

Thank you, guys.

Operator

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

Q - Brent Thill {BIO 1556691 <GO>}

Thanks. Shantanu, just following-up on Digital Experience. The first half of the year, you actually outpaced your year-end growth rate target and you have easier comps in the back half of this year. So I'm just curious in terms of why not take up your aspirations there? Is there something that's worrying you in the second half? Obviously, you'll have Magento layer in as well. So are you just kind of waiting for that to layer in before you update your aspirations there?

A - Shantanu Narayen {BIO 3332391 <GO>}

I think in terms of overall, as you know Brent, we do not update our full-year guidance at this point, we are coming into what has been the Q3 seasonal quarter in Europe. But the interest and the excitement or aspirations haven't diminished in any way.

As you point out, it was a strong quarter. We have, with Magento, even more of a comprehensive offering and so continue to remain excited. But it's – I wouldn't read anything into it except for the fact that we – we did touch on the fact that Q4 will continue to be seasonally strong, so should proceed as expected.

Q - Brent Thill {BIO 1556691 <GO>}

And just a quick follow-up for John on ARPU. I think last quarter you said ARPU was kind of up across the board. I think now you're saying flat to up. Given the price increases, can you just maybe parse that? I know we're probably digging in on a metric that we're probably going too deep into, but any color there, why that won't be up and up like we saw in Q1?

A - John Francis Murphy {BIO 16018871 <GO>}

Yeah. No, I think what we've said is that it's stable and that we expect it to remain stable to up. So I think it's really kind of for our perspective a healthy metric. We don't guide to that or target externally, but it certainly contributes to our ARR.

A - Shantanu Narayen {BIO 3332391 <GO>}

Maybe just adding color, Brent, on that, as it relates to the enterprise licensing nothing has changed as we enterprise licensing. We're certainly seeing good adoption of the full offering from the customized versions that we had said. As it relates to the price, since you asked that question, we always expected it to be marginal in terms of the impact associated with that.

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We are pleased with what we have seen so far in terms of whether its people buying new subscriptions or renewal where people see the price increase. I think that's very much in line with the additional value that we provided. So on Digital Media, we continue to be excited about the opportunity.

Q - Brent Thill {BIO 1556691 <GO>}

Thank you.

Operator

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

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

Great, thank you. I wanted to follow up a little bit on subscription growth that you're seeing with Creative Cloud outside of the U.S. and in particular by – in geographies outside of the U.S. And I guess maybe in two pieces; first, I think last year one of the talking points was that Japan and Germany were still relatively early in the transition from on-prem to cloud. So I'm curious if we sort of have any update on the rate of the base migration there. And then related as you think about subscriber growth in emerging markets, I'm curious if you have sort of an update on how much of that sort of piracy conversion versus net new users to the base.

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, Jennifer, I think globally when you look at the demand for the Creative solutions and specifically the cloud offerings, I think we've stated that Japan and Germany and the other emerging markets were phase shifted from the United States and Australia where we first introduced the offerings. All the learnings that we've had about how to acquire customers and convert them whether they be new customers to the platform, or as you point out, former pirates, we have certainly learned from that.

We continue to think that the differential pricing that we have in countries like China as well as Southeast Asia is helping us. There's more creativity in those markets. So Japan and Germany, net-net, continue to be good areas of growth for us moving forward. The emerging markets both the piracy as well as the attractive upfront pricing are reasons why people are adopting the platform.

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

Great, thank you.

Operator

Your next question comes from the line of Brad Zelnick from Credit Suisse. Your line is open.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

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Thank you very much and congrats on a great quarter. Shantanu, can you share with us what the learnings have been from the price increase you introduced in North America this quarter and your observations on elasticity?

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, I think Brad, it's early. I would actually point to the learnings that we've had from the foreign exchange changes that have happened in other countries and as a result of that what we have done with respect to pricing. Our strategy continues to be how do we get more and more people on the platform. And so we continue to attract new customers with attractive pricing.

And during the first year, the more engagement that we have with them the more they are likely to add the standard pricing continue and renewal. And so renewal continues to be an area of focus for us. And again, the goal for us right now is attracting new customers to the platform. Everything we've done with respect to price changes has not impacted retention. And so we continue to focus on that blend, if that makes sense.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

It does. Excellent. Thank you.

Operator

Your next question comes from the line of Saket Kalia from Barclays Capital. Your line is open.

Q - Saket Kalia {BIO 16417197 <GO>}

Hi guys. Thanks for taking my question here. Shantanu, realizing that it still has to close, can you just talk about initial customer feedback on Magento? It's been a few weeks. And any early ideas broad brushes that you can share with us on how the business can look different as part of the Adobe family, post-closing?

A - Shantanu Narayen {BIO 3332391 <GO>}

Sure, Saket. I mean, I think despite the fact that we already had integrations with commerce systems, we had clear ask for our customers for a complete Adobe solution from content creation, to delivery, to analytics and now all the way out to commerce.

What we're particularly excited about is the investment that we've made in the Adobe Cloud Platform provides a clear architecture and a playbook for us to integrate new acquisitions like Magento seamlessly. We were attracted by a few things when we looked at Magento, great people, great technology, but I think what's unique was that they targeted both digital and physical goods as well as B2B and B2C in terms of the customer segments. And Mark, who is their CEO, did a great job of leading them after they transitioned out of eBay.

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While their traditional strength has been in the midmarket and departments or single geographies where large enterprises use them for commerce in one geography and then translate it, I think that will continue to be an area of good opportunity for us. And what we will bring to that is the enterprise relationships that we have with larger enterprise. So like all our acquisitions, we look at it from the point of view of can we accelerate their growth? Does it fill out our offering? Do we have a unique and differentiated solution? And the good news was Magento, I think, checked all of those boxes. And so we're excited about it. As we said, hopefully, it closes next week and we've given you some transparency into the size of their business.

Q - Saket Kalia {BIO 16417197 <GO>}

That's helpful. Thanks, Shantanu.

A - Shantanu Narayen {BIO 3332391 <GO>}

Thanks.

Operator

Your next question comes from the line of Mark Moerdler from Bernstein Research. Your line is open.

Q - Mark L. Moerdler {BIO 16855032 <GO>}

Congrats on the quarter and thanks for taking my question. So I'm going to follow up on the questions on Magento. You discussed how Magento has had strength in selling of the physical goods, Adobe's Digital Marketing is all about digital marketing, but of both digital and electronic. How big a nuance, how big a difference is there or how big an opportunity is there, the fact that they are so strong in selling the physical goods? And how does that play into the existing customer base that Adobe has in digital marketing?

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, Mark, I think from our point of view we just want a very comprehensive solution. When you go into a retail customer, for example with Digital Experience, who is making available for sale physical goods, we say yes, we have the ability for you to transact and finalize your sale for physical goods that's shipping. That doesn't mean that we are in shipping ourselves, but the ability to have that inventory, the biller materials, the payment methods is clearly an advantage in terms of them taking a non-digital way of transacting commerce and converting it to commerce.

What's also nice about them is for people who want to do rooms or airline reservations or other digital ways of transacting business, the same solution scales from physical goods to digital goods, things like subscriptions. What Adobe offers, I think we would all acknowledge that more and more companies want to get to a subscription mechanism. And so I think I would look at it more as a comprehensive way of dealing with anything that needs to be transacted online, whether the end result was a physical good, a digital good, a subscription, being able to have a comprehensive offering across B2B and B2C is really helpful. And what I mean by B2B is you might have companies whether they're

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consumer goods companies or companies that are actually shipping to other retailers, who also want to use this to transact business electronically. So that's what's exciting for us about what Magento offers.

Q - Mark L. Moerdler {BIO 16855032 <GO>}

That was very helpful. I appreciate it. Thanks and again congrats on the quarter.

A - Shantanu Narayen {BIO 3332391 <GO>}

Thank you.

Operator

Your next question comes from the line of Ross MacMillan from RBC. Your line is open.

Q - Ross MacMillan {BIO 1994797 <GO>}

Thanks so much. Shantanu, congrats on the quarter. You look like you're tracking again this year to something around $1.3 billion of net new Digital Media ARR. And we're just coming up into a period where you're starting to move on price, you have some new product introductions, there's some ARPU effects from Stock. Just philosophically, how do you think about the progress of that net new ARR? As we think about that, not just this year but broadly speaking over the next two or three years. And do you feel like there are levers that you have to manage that number to a sort of target? And I'm just trying to get a sense for sustainability on that line item. Thanks.

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, Ross, I mean, again when we looked at the ARR accomplishment and the entire Digital Media performance in the first half, it's very clear that we continue to have momentum across all of the various offerings as well as geographies. I think if you look at our Q3 and then I'll get to the big picture, we do expect Q3 as seasonally weak and we've said that we expect the traditional strength in Q4.

I mean one of the things that we're just continuing to monitor in Q3 is what's happened with GDPR and the recent privacy law changes is that everybody who's doing business online in Europe will have to make sure that GDPR is not sort of just a checklist item but a new ways of doing business which requires people to tailor their digital marketing. We were ready with that on May 25. We just want to continue to monitor that as we transact business online. We have best-in-class both for ourselves as well as for the service that we deliver for our customers.

And so we look at the $310 million target for ARR, it's the highest we've actually had in a Q3 for Digital Media. To your point, it should result in record ARR addition in this business for FY 2018. But long-term, as you think about new media types, as you think about devices, what we are doing across education, immersive media opportunities with AR and VR, screen design, video and the explosion of video, I think you'll continue to see us

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innovate more, attract new customers to the platform and really drive the addressable opportunity. So that's really the focus for us in that business.

Q - Ross MacMillan {BIO 1994797 <GO>}

And just a quick follow-up if I can for John, welcome. Just on the tax rate, that new run rate of 14%, is that something that in the absence of material geographic revenue mix shift or M&A, is that something that you would view as broadly as sort of stable run rate even beyond fiscal 2019?

A - John Francis Murphy {BIO 16018871 <GO>}

Yeah. Thanks, Ross. I think what – how I would describe it is with the new Tax Act, we've been digesting the different impacts to that. And so, you see us having made this recent change again after just starting in January. So we do feel that this rate is stable but we continue to evaluate opportunities with the provisions of the tax law. And just to remind you, our fiscal year 2018 is a little unique for us. So we don't have the full impacts of the Tax Act until FY 2019. But I think you can rely on those rates at this point to be relatively stable. And then as we continue to evaluate opportunities to take advantage of the provisions, we can update you then.

Q - Ross MacMillan {BIO 1994797 <GO>}

Great. Thank you and congrats again.

Operator

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

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Thank you. Good evening. Shantanu, a technology road map question for you regarding Digital Experience. How much of a role do you think there may ultimately be for you to have a self-serve model in the portfolio in Digital Experience, paralleling what you've done with Digital Media, particularly with adobe.com? The reason I'm asking is was the launch of the Advertising Cloud Creative at Summit for instance perhaps an early sign of a longer term ambition for more comprehensive self-serve capability that you can deliver to customers for Digital Experience. If that's so, would there then be positive incremental margin implications as you've seen on the Digital Media side from that kind of a model?

A - Shantanu Narayen {BIO 3332391 <GO>}

I think Jay there's no question that a focus on time to value and getting more practitioners adopting our Digital Experience solutions sooner rather than later is a priority for us. We've certainly, to your point, done that with Acrobat and CC.

Magento is a really nice addition to that because, if people can create a website, start to engage with their customers through multiple channels and transact business through commerce that opens up new vistas for us. And if you remember, the original Day

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Software as well as what Omniture had actually targeted small and medium businesses. So I look at it as are we focused on continuing to drive time to value and getting more practitioners to be self-serve. That's only a benefit in terms of their NPS with Adobe. And it's clearly an area of focus for us.

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

A quick one for John. Could you talk about the implications for cash flow from the new tax structure both in terms of not just net income, which is obviously going to be affected on the GAAP side, but also perhaps in terms of deferred tax implications within cash flow?

A - John Francis Murphy {BIO 16018871 <GO>}

Yeah. Clearly, we benefit from the tax rate changes. And I think what we've demonstrated is that our business continues to throw off great cash flow strength and growth. So, I think I would say that that trend is pretty consistent.

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Thank you.

Operator

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

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

Thanks. Just a further question around pricing. You've talked about services for some time and Stock, I think continues to do well. Can you help us understand how services are impacting pricing versus some of these other factors, especially the price increase that just started to have an impact this quarter? Maybe stack rank or kind of relative conversation about the drivers of ARPU? Thanks.

A - Shantanu Narayen {BIO 3332391 <GO>}

Sure, Walter. I mean, I think as it relates to Adobe Stock that is a clear service. It makes the entire offering stickier and I think we mentioned in our prepared remarks that Stock had a very strong quarter. I think it continues to make the whole aspect of an on ramp to creativity easier, so that's been good.

I would say in the enterprise, in particular, as people are finding that whether you're interfacing between freelancers and the marketing or graphics departments within enterprises, storing all of these assets so that you can increase content velocity, things like Adobe Sign, all of them are causing us to be able to both deliver better value and charge more to our enterprise customers.

So in the enterprises in particular, we are very maniacally focused on named user deployment, ensuring more people use it within an enterprise, having services be the way in which they can engage more people in the creative process. And that's leading to both greater ARPU as well as new seat deployment within the enterprise.

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

Great. Thank you.

Operator

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

Q - Heather Bellini {BIO 2268229 <GO>}

Great. Thank you so much. I just had a question about – as you look at your revenue targets, Shantanu, and as you look out a few years, is there a reason to think that the pace of expense growth, which we've been seeing, would change at all? You guys have done such a great job kind of growing expenses at such a much lower pace obviously than revenue. And I'm just wondering is there any reason to think that kind of the pace of what we've seen in terms of expense growth would change based on what your revenue plans might be down the road?

A - Shantanu Narayen {BIO 3332391 <GO>}

That's a great question, Heather, in terms of how we think about it. And I think as a company, we're just being ruthlessly focused on both top-line and bottom-line growth. I mean when you are driving 24% year-over-year growth in revenue, but driving 60-plus-percent growth in non-GAAP EPS, I think it shows that we are really focused on both of those. We just have some very significant opportunities and I think as you think about Q2 may be there were a couple of investments in the Adobe Cloud Platform as well as in preparation for GDPR that were factored in.

But I think long-term we just continue to ensure that we are driving great top-line growth at a very profitable margin. And we're going to continue as we did in Q1, for example, all revenue overachievement will result in greater earnings and that continues to be our focus.

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Q - Heather Bellini {BIO 2268229 <GO>}

Great. Thank you very much.

Operator

Your next question comes from the line of Kirk Materne from Evercore ISI. Your line is open.

Q - Kirk Materne {BIO 5771115 <GO>}

Hi. Yes, thanks very much. Shantanu, I was wondering if you could just – I want to go back to Magento again and can you just walk us through I guess how you're thinking about the integration I assume given the time of your fiscal year will operate generally on a standalone basis? But is this a product that Adobe sales force can start taking to market once the deal closes? I guess just how are you thinking about sort of integrating I guess

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mainly from a go-to-market perspective once the deal closes over the next couple of quarters? Thanks.

A - Shantanu Narayen {BIO 3332391 <GO>}

Well, Kirk, I think the sales force is already chomping at the bits in terms of saying how do we – once the deal is closed have Magento in our bag, it's such a natural extension. But I think to your point our focus has always been with acquisitions do no harm, really make sure that we can continue to bring to bear the Adobe brand, bring to bear the customer relationships that we have and truly understand the magic sauce that makes them so special.

So certainly in terms of from day one when we are closing being able to expand our story of how we can serve customers, looking at some of the customers and I think we pointed that out in the introductory call in terms of who they already have as customers. So I think we will start to deliver it to enterprises, but we will be a little cautious because we just want to make sure that we have a discipline on ramp to that particular product.

Q - Kirk Materne {BIO 5771115 <GO>}

Thanks very much.

Operator

Your next question comes from the line of Derrick Wood from Cowen & Company. Your line is open.

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

Great. Thanks. I wanted to touch drill in on GDPR. And one could argue it could have some mixed impact for you guys. The regulation focuses on data minimization in terms of the amount of content companies should be storing about their end consumers and e-mail lists have to be more scrutinized. And I guess that could weigh on capacity, subscription sales. But at the same time companies are needing to put more governance and workflow around their digital engagements and you could see more standardization and more usage on the Adobe platform. You clearly had a good quarter, but how do you see these dynamics around GDPR working out and impacting the demand trajectory on Experience Cloud?

A - Shantanu Narayen {BIO 3332391 <GO>}

When I take a step back, Derrick, the trend towards online businesses and digital spend and the desire on the part of enterprises to understand attribution is only going to increase. More money is going to be spent digitally, but the bar of how that's being spent and the understanding and effectiveness of that marketing and spend is only going to increase. And I think big picture we look at that as a big opportunity for Advertising Cloud, because not only are we a channel for the major online marketing platforms like search, social, display and TV, but we're unique in that we have sort of the broadest perspective of efficacy across all marketing spends.

On the second side, all companies will need to balance the customer acquisition where this third-party data plays an important role. And the more important issue for all companies is going to be customer engagement to your question around e-mail lists and how you engage with them. And there I think leveraging the first-party data is going to become even more crucial. And so we look at it and say we have the best of both worlds. The Advertising Cloud will continue to focus on helping customer acquisition, but really the energy is going to be spent by companies more on Marketing Cloud, where engagement is going to be even more critical in this world of GDPR. So that you don't, in any way, impact the trust that you've built with companies.

And I actually think Analytics also, across both acquisition and engagement, will become even more critical in this new environment. So you're right in that, we have to help our companies navigate it and you're right and I think long-term it just continues to be a tailwind as the leader in this business.

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

Great. Thanks for the color.

A - Shantanu Narayen {BIO 3332391 <GO>}

Thank you.

Operator

Your next question comes from the line of Keith Weiss from Morgan Stanley. Your line is open.

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

Excellent. Thank you, guys and a very nice quarter. I just had a clarification question around the guidance. I think last quarter Mark Garrett was talking about Digital Media ARR and in talking about Q3 and Q4, he expected the seasonality of Q3 and Q4 to follow similar to what it was achieved in FY 2017. And when I look at the ARR from last year Q2 to Q3 was pretty sort of flat seasonality. It looks like we're looking for closer to like down 9% to 10% this year. Did something change between sort of Mark Garrett's comments in sort of how we're thinking about ARR into Q3 this quarter?

A - Shantanu Narayen {BIO 3332391 <GO>}

No, Keith. I think as I mentioned a little bit earlier when you look at from an absolute perspective the Q3 target that we provided for ARR will still be the largest that we have. I think we continue to see strength in the business, so nothing's changed from that particular quarter. I mentioned briefly that we want to just make sure that we get a little bit more experience with what's happening with GDPR to Derrick and other people's questions associated with what's happening online, but in no way reflects a change in how we see the business. And Q4 again, we expect the traditional strength in the business.

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

Got it. So some caution perhaps around GDPR potentially pushing some Digital Media business from Q3 into Q4?

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, I think we look at it from a first half, second half and we still continue to model it. But you can look at it as we just want to make sure that we understand GDPR in more detail across Q3, yes.

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

Got it. That's helpful. Thank you very much.

A - Shantanu Narayen {BIO 3332391 <GO>}

Thank you.

Operator

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

Q - Kash Rangan {BIO 22095432 <GO>}

Hi, thank you very much. Shantanu, I'm just curious if you look at companies like in your peer group just Microsoft, Intuit they have had revenue growth in some of the key businesses outpace unit growth. So obviously pricing and ARPU growth has been a key trend in the industry. I'm curious how you think about that. Are you at a point where it's more so ARPU growth versus unit growth? If so what is driving that? Or if you on the contrary believe what you said on the previous earnings conference call that the TAM is a multiple of the previous cycle, I'm curious to hear you elaborate on why you believe the TAM is a multiple of the prior cycle. That's it for me. Thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, sure. I mean when we look at the two businesses where we have a B2C business, when you look at the Acrobat and units growth for Acrobat, all the strength in the Document Cloud business is being driven by unit growth rather than what you would call ARPU growth. When we look at customer acquisition and Creative Cloud, we have been pretty forthcoming about how it's really been driven by new people coming to our platform. And so I can't comment on what Microsoft and Intuit are saying, but from our point of view, it's certainly been driven a lot more by new customer acquisitions and focused on that.

And so as we think about big picture what we are focused on in Creative, the first is, let's just continue to drive net new subscriptions focused on retention. The pool is becoming larger and larger. So this is in emerging markets. I would say a little bit more of adjacent markets what we've done with education and hobbyists. We continue to make sure that

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ARPUs are increasing as people go into renewals. But price is not on that first list of things that we are focused on given where we are in the cycle.

Q - Kash Rangan {BIO 22095432 <GO>}

Brilliant. Thank you so much.

Operator

Your next question comes from the line of Pat Walravens from JMP Securities. Your line is open.

Q - Pat D. Walravens {BIO 3241364 <GO>}

Oh, great. Thank you. Shantanu, I'm going to step back a little bit and I'm curious how far on sort of the artificial intelligence side of things, how far away are we from having Sensei help customers search video content with a high degree of accuracy? So Sensei find all the footage that has Brad Pitt in it.

A - Shantanu Narayen {BIO 3332391 <GO>}

Well, Pat, I think if you look at what we already have with respect to Adobe Stock, the two things that I would call Adobe Magic that Sensei has provided is first auto tagging. So you can actually get thousands of pictures and we have the ability based on the prior data set to be able to tag it and infer intent and so you can search. And the canonical example we give is fire engine truck versus being it called different things in different countries. And so we already have that. With video as well I think we have the ability across frames to do searching. And so it's only going to get better and better with the data sets, but that data is not far in terms of being able to find across video. And in fact we have already demonstrated abilities to do search on video.

Q - Pat D. Walravens {BIO 3241364 <GO>}

Great. Thank you.

A - Mike Saviage {BIO 3176226 <GO>}

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

Operator

And your last question comes from the line of Brian Wieser from Pivotal. Your line is open.

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

Thanks for taking the question. I was wondering if you could offer a little bit more color on what you're seeing with Advertising Cloud. You called it out certainly as supporting some of the growth there and we see some of the peers to that business Trade Desk, in particular, doing phenomenally well. And related to GDPR, as we're seeing something of a shake out with much of the ad tech sector, I'm wondering if you see opportunities for

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deeper investment. It seems like anyone with deep pockets in the long time horizon is maybe well positioned to take advantage of just growing organically or by picking up businesses that are now available.

A - Shantanu Narayen {BIO 3332391 <GO>}

We had a good strong revenue quarter for Advertising Cloud in Q2. I think if you looked at our overall revenue growth of 18%, it was certainly higher than what we had guided to Advertising Cloud played a role in that. I think to your point, we are one of the few companies that has the breadth to have the ability for people to invest across search, social, display and all forms of TV. And so I think we're pretty uniquely positioned.

I think what's even more unique about our offering is the tie-in to the segmentation that we have with Audience Manager and the Analytics that we provide on the efficacy of the spend. So we continue to be excited about the opportunity that we have both in Advertising Cloud as a separate cloud and opportunity and the integration of that across the entire Experience Cloud.

And since Brian that was the last question, in close the momentum in our business clearly continued into Q2. We continue to be excited about the product road map that we will deliver in the second half and the innovation agenda. Big picture, the strategy of empowering people to create as well as helping businesses transform continue to be large addressable markets with good tailwinds. And we'll continue to focus on driving both top-line and bottom-line growth with significant margins while we invest in technology as a long-term differentiator for Adobe. Thank you for joining us today.

A - Mike Saviage {BIO 3176226 <GO>}

Thanks everyone. This concludes our call.

Operator

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

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