Q1 2017 Earnings Call

Company Participants

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

Other Participants

- Alex J. Zukin, Analyst
- Brent Bracelin, Analyst
- Derrick Wood, Analyst
- Heather Bellini, Analyst
- Jay Vleeschhouwer, Analyst
- Kash Rangan, Analyst
- Keith Eric Weiss, Analyst
- Kirk Materne, Analyst
- Pat D. Walravens, Analyst
- Richard Hugh Davis, Analyst
- Ross MacMillan, Analyst
- Samad Samana, Analyst
- Sterling Auty, Analyst
- Walter H. Pritchard, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, ladies and gentlemen. I would like to welcome you to Adobe Systems' First Quarter Fiscal 2017 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session.

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

Mike Saviage {BIO 3176226 <GO>}

Good afternoon, and thank you for joining us today. Joining me on the call are Adobe's President and CEO, Shantanu Narayen; and Mark Garrett, Executive Vice President and CFO. In the call today, we will discuss Adobe's first quarter fiscal year 2017 financial results. By now, you should have a copy of our earnings press release which crossed the wire approximately one hour ago. We've also posted PDFs of our earnings call prepared remarks and slides, financial targets and an updated investor datasheet on adobe.com. If you'd like a copy of these documents, you can go to Adobe's Investor Relations page and find them listed under Quick Links.

Before we get started, we want to emphasize that some of the information discussed in this call, particularly our revenue and operating model targets and our forward-looking product plans, is based on information as of today, March 16, 2017, and contains forward-looking statements that involve risk and uncertainty. Actual results may differ materially from those set forth in such statements. For a discussion of these risks and uncertainties, you should review the Forward-Looking Statements Disclosure in the earnings press release we issued today, as well as Adobe's SEC filings.

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

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

I will now turn the call over to Shantanu.

Shantanu Narayen {BIO 3332391 <GO>}

Thanks, Mike, and good afternoon.

Adobe had an outstanding first quarter with record revenue of $1.68 billion and record profit. GAAP earnings per share in Q1 was $0.80, and non-GAAP earnings per share was $0.94. We continue to execute well against our strategy and are driving momentum across our entire business. Digital transformation has created a tailwind for Adobe among a diverse spectrum of customers in a broad number of industries, from students to designers to the public sector and the world's largest brands.

Once the domain solely of professionals, today everyone is a creator, from the teenager doing a school photography project to the small business owner prototyping her website to the filmmaker working on his first documentary. And design has become a critical element in the fabric of our lives. Design is the starting point for every connection we make, and great design requires innovative technology. At the same time, massive amounts of data, the proliferation of devices and skyrocketing customer expectations are forcing enterprises to completely rethink their business strategies. To forge stronger customer connections that lead to brand loyalty and growth, forward-looking enterprises are reimagining the experience they provide to their customers.

At Adobe, we've always known that a great customer experience is the differentiator that separates market leaders from the pack. At the center of every great experience are customer intelligence and amazing design, and these are Adobe's core competencies. Our mission to help our customers design and deliver great experiences has never been more relevant as is reflected in our outstanding Q1 results.

In Digital Media, we continue to be the undisputed leader in helping customers inject creativity into their jobs, schoolwork, and their daily lives. We achieved a record $1.14 billion in Digital Media revenue in Q1 and exited the quarter with over $4.25 billion of Digital Media annualized recurring revenue or ARR. The net ARR increase in Q1 was $265 million and was driven by continued strength in our Creative Cloud business. Creative Cloud is the one-stop shop for creatives the world over and we continue to execute against our strategy of migrating CS customers, expanding into new market segments, and adding value through new services. In Q1, Creative Cloud ARR growth was driven by strong performance in the SMB segment with our Creative Cloud teams offering and international growth, as well as strong retention of existing subscribers.

This year, two of Adobe's iconic creative apps are celebrating anniversaries. In March, Adobe Illustrator, the industry-standard vector graphics app that lets you create logos, typography and complex illustrations for print, web, video and mobile celebrated its 30th anniversary. Thirty years of Illustrator projects are visible everywhere across the world from billboards on US highways to magazine covers in Tokyo. More than 180 million graphics are created monthly with Illustrator.

Earlier this week, we celebrated Premiere Pro's 25th anniversary. Premiere Pro is the world's leading video production solution and continues to grow its footprint across every video segment. Premiere Pro was the official editing tool of the 2017 Sundance Film Festival in January. Premiere Pro's virtual reality workflows are seeing strong adoption with the majority of the films in the Virtual Reality category at Sundance having used it in their creative process.

As part of our year-long celebration, we are partnering with the Grammy-award-winning band, Imagine Dragons, who just released a music video for its newest song, Believer. Earlier this week we announced that creatives in 27 countries will have the chance to take the raw video footage from the original video and cut their own version.

Our Adobe Stock service business continues to accelerate. In the past year, we have grown Adobe Stock assets to more than $60 million, and in January we announced a partnership with 500px, a global online photography community which expands Adobe Stock's Premium collection.

The world's leading digital document service, Adobe Document Cloud, enables businesses to reinvent inefficient paper-based processes. In Q1, Document Cloud revenue was $196 million and we grew Document Cloud ARR to $493 million. Acrobat units across Creative Cloud and Adobe Document Cloud combined again grew double digits year-over-year. This achievement was driven by new customer acquisition with our subscription model and the funnel of users created by the broad use of PDF and the proliferation of Adobe Reader across mobile devices.

In February, in conjunction with the Cloud Signature Consortium, we unveiled the world's first open, cloud-based digital signature standard available in any browser and on any device. We announced new functionality in Adobe Sign that enables users to create end-to-end business workflows such as advanced document routing, online collaboration and Microsoft SharePoint integration. Adobe Sign now includes mobile tools powered by Adobe Sensei for scanning, reading, routing and signing documents.

Deep intelligence, fueled by trillions of data transactions, are the foundation of our Digital Marketing business. We drove a record $477 million in Adobe Marketing Cloud revenue in Q1 which was 26% year-over-year revenue growth. Adobe Marketing Cloud continues to lead the category and be the most comprehensive offering for global brands, government agencies and institutions that need to deliver personal, consistent and relevant experiences to their audiences everywhere and every time they connect with them. Adobe Marketing Cloud features best-in-class solutions in analytics, content management, cross-channel campaign management and media optimization. We managed more than 100 trillion data transactions on behalf of our customers over the past year across our Adobe Marketing Cloud solutions.

In February, Gartner recognized Adobe as a leader in its 2017 Magic Quadrant for Digital Marketing Hubs research report. For the third consecutive time, Adobe was ranked the highest in completeness of vision axis among the 22 companies that were evaluated. Also in Q1, Adobe was recognized as a Leader in the Forrester Wave report on Web Content Management systems, receiving the highest score. Thanks to the completeness of our offering, our continued innovation and our growing partner network, we continue to see strong market momentum with major customer wins this quarter at DICK'S Sporting Goods, Mercy Health, Hutchison UK, AutoTrader.com, Computer Sciences Corporation, ADT and the University of Michigan.

In December, we completed our acquisition of TubeMogul, a leader in demand-side video advertising. We achieved strong Q1 TubeMogul revenue, and we are hard at work integrating TubeMogul with our current Adobe Media Optimizer solution. As a combined advertising solution, we will enable Adobe's customers to optimize their video, search and display advertising investments across desktop, mobile, streaming devices and TV.

Next week in Las Vegas, we will conduct our largest Adobe Summit ever with more than 12,000 attendees including more than 1,000 of our global partners. Executives from top brands including the NBA, National Geographic, T-Mobile and Facebook will take the stage and we'll give an update on our strategic partnership with Microsoft.

We're continuing to aggressively invest in the Adobe Cloud Platform and Adobe Sensei, our unified artificial intelligence and machine learning framework and intelligent services. Our trillions of content and data assets, along with our deep category expertise in the markets we serve, give Adobe Sensei a unique ability to help customers tackle complex experience challenges. We plan to unveil new Adobe Sensei capabilities at Adobe

Summit. We will also provide an update on our adobe.io capabilities for partners, ISVs and developers who can utilize our open platform to develop their own applications. This level of innovation can only come from talented, creative and dedicated employees. Last month we held our internal Tech Summit where we announced our commitment to train every one of our technical employees in artificial intelligence fundamentals. We also demonstrated the incredible work happening across the company.

Last month we were included on Fast Company's Most Innovative Companies list, and last week we were honored to be named to the Fortune Best Places to Work list for the 17th year. Adobe would not be the company it is today without our rich diversity of employees and that continued diversity is vital to our future. I would like to thank all our employees for the role they play in our continued success.

To create an exceptional customer experience, you need a potent combination of deep intelligence and amazing design. These are our unique capabilities and our opportunity has never been greater. We have the technology leadership, partner ecosystem and customer relationships to fundamentally reshape how individuals, brands and institutions transform themselves in the 21st century. Q1 was a great start to what we believe will be another great year for Adobe.

Mark?

Mark S. Garrett {BIO 1407651 <GO>}

Thanks, Shantanu. In the first quarter of FY 2017, Adobe achieved record revenue of $1.68 billion, which represents 22% year-over-year growth. GAAP diluted earnings per share in Q1 was $0.80 and non-GAAP diluted earnings per share was $0.94. When comparing Q1 FY 2017 and Q1 FY 2016 results, it is helpful to remember that our year-ago quarter had an extra week due to Adobe's 52 to 53 week fiscal year calendar. Factoring in the extra week a year ago in Q1 FY 2016, year-over-year revenue growth in the quarter was greater than 25%.

Highlights in Q1 included achieving $265 million of net new Digital Media ARR; record Creative revenue of $942 million; record Adobe Marketing Cloud revenue of $477 million; strong year-over-year growth in operating income and net income; record cash flow from operations and deferred revenue; and 85% of Q1 revenue came from recurring sources.

In Digital Media, we grew segment revenue by 22% year-over-year. The addition of $265 million net new Digital Media ARR during the quarter grew total Digital Media ARR to $4.25 billion exiting Q1. Within Digital Media, we delivered Creative revenue of $942 million which represents 29% year-over-year growth. In addition, we increased Creative ARR by $244 million during Q1 and exited the quarter with 3.76 billion of Creative ARR.

Driving the momentum with our Creative business was continued demand for Creative Cloud across all offerings and routes to market during the quarter. Q1 ARR performance was driven by strong subscription adoption and retention, strength with Creative Cloud for teams, particularly in Europe, and continued growth with Adobe Stock. Creative Cloud ARPU was either steady or grew quarter-over-quarter across all offerings in Q1.

With Document Cloud, we achieved revenue of $196 million. Document Cloud ARR grew to $493 million exiting Q1. Driving this growth was continued 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 Adobe Marketing Cloud revenue of $477 million, which represents 26% year-over-year growth. TubeMogul added $32 million of revenue in Q1, which was $13 million above our target of $19 million. Approximately $10 million of the upside was due to some of the TubeMogul revenue being recognized on a gross basis in the quarter rather than on a net basis. Excluding the extra 10 million of gross TubeMogul revenue, year-over-year Adobe Marketing Cloud revenue growth was 24%, which was in line with our Q1 target. As we discussed on our TubeMogul conference call in January, we intend to recognize TubeMogul revenue on a net basis. Due to some ongoing contractual commitments, there will be some small gross revenue amounts through year end.

Mobile remains a key driver for our Marketing Cloud business. Mobile data transactions grew to 56% of total Adobe Analytics transactions in the quarter. Total data transactions in Q1 grew to 41.3 trillion and in the trailing four quarters, data transactions with our Marketing Cloud solutions exceeded 100 trillion.

From a quarter-over-quarter currency perspective, FX decreased revenue by $14.8 million. We had $18.3 million in hedge gains in Q1 FY 2017, versus $8.1 million in hedge gains in Q4 FY 2016, thus the net sequential currency decrease to revenue considering hedging gains was $4.7 million. From a year-over-year currency perspective, FX decreased revenue by $11.9 million. We had $18.3 million in hedge gains in Q1 FY 2017, versus $3.2 million in hedge gains in Q1 FY 2016, thus the net year-over-year currency increase to revenue considering hedging gains was $3.2 million.

We experienced stable demand across all major geographies during the quarter. In Q1, Adobe's effective tax rate was 13.5% on a GAAP-basis and 21% on a non-GAAP basis. The Q1 GAAP rate was slightly lower than targeted due to Adobe's adoption of the new accounting standard affecting taxes related to equity-based costs.

Our trade DSO was 46 days, which compares to 42 days in the year-ago quarter and 47 days last quarter. Deferred revenue grew to a record $2.06 billion, up 28% year-over-year. Our ending cash and short-term investment position exiting Q1 was $4.65 billion. Cash flow from operations was a record $730 million in the quarter. In Q1, we repurchased approximately 2.2 million shares at a cost of $238 million. We have $300 million remaining under the January 2015 authority, after which we will begin repurchases under our new $2.5 billion authority granted in January 2017.

Now I'll provide our financial outlook. In the second quarter of fiscal year 2017, we are targeting revenue of approximately $1.73 billion. We expect to achieve approximately $290 million of net new Digital Media ARR in Q2, which represents both sequential and year-over-year growth in net new ARR achievement. We expect Digital Media Q2 segment year-over-year revenue growth of approximately 24%, and Adobe Marketing Cloud year-over-year revenue growth of approximately 26%.

We are targeting our Q2 share count to be approximately 499 million shares. We expect net non-operating expense to be approximately $15 million on both a GAAP and non-GAAP basis. We are targeting a Q2 tax rate of approximately 24% on a GAAP basis and 21% on a non-GAAP basis. These targets yield a Q2 GAAP earnings per share target of approximately $0.66 and a Q2 non-GAAP earnings per share of approximately $.094. In summary, Q1 was an amazing start to what we believe will be another record year for Adobe. We remain bullish about our prospects for the rest of the year and beyond.

Mike?

Mike Saviage {BIO 3176226 <GO>}

Thanks, Mark. Next week Adobe will host its annual Digital Marketing Summit in Las Vegas, with the opening day keynote on the morning of Tuesday, March 21. We are also hosting an informal Q&A session for financial analysts and investors in attendance on Tuesday afternoon. If you'd like to attend the Summit, please send an email to ir@adobe.com for registration information. If you are unable to attend in person, keynote sessions on Tuesday and Wednesday, as well as the Q&A session for financial analysts and investors will be webcast live and we will send out webcast access information tomorrow.

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 70709434. International callers should dial 404-537-3406. The phone playback service will be available beginning at 5 PM Pacific Time today and ending at 5 PM Pacific Time on March 22, 2017.

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 Kash Rangan with Bank of America Merrill Lynch. Your line is now open.

Q - Kash Rangan {BIO 22095432 <GO>}

Congratulations on a great start for the year. Mark, I hate to bring this up, but AAC 606 (23:10), a lot of companies are starting to give it a little thought. I'm wondering if you could give us your perspective on how it would change the revenue recognition, the marketing flow and also the expense recognition. Thank you so much.

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

Yeah, thanks, Kash. You'll see that we've written some disclosure in our SEC filings on this. The standard, as you know, is effective for Adobe in the first quarter of 2019, so we have quite a bit of time until it goes effective for us. We don't plan to early adopt and we haven't selected a transition method yet. We're clearly evaluating the effect of the standard and what it will do to revenue for us. We expect that revenue related to professional services in our Cloud offerings for enterprises, individual and teams would remain substantially unchanged but again we're in the process of evaluating that.

And as it relates to what we would call more of an ETLA, a term-based license where software and maintenance are bundled together, those are the arrangements that will likely have some impact from the standard. But again, we have until 2019 to work through that. And as you know, we're now selling the full Cloud solution to the enterprise. So that's where we stand as of today. But clearly more work to do and lots more time.

A - Mike Saviage {BIO 3176226 <GO>}

Next question, please.

Operator

And your next question comes from the line of Sterling Auty with JPMorgan. Your line is now open.

Q - Sterling Auty {BIO 2070271 <GO>}

Yeah, thanks. Hi, guys. On the Creative Cloud side, the growth and momentum continues to be strong. But can you give us a little bit more at least qualitative color as to the drivers of it? How much of it might be stuff that you're doing on price and managing promotions? How much is adding new customers ad how much of it is deeper penetration into existing customers?

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, Sterling. I'll take that question. I mean, I think we're continuing to see good strength across each of the groups, particularly as it relates to Q1. We saw some good SMB, small and medium business demand that continues to do well. As you know, that's the team offering, which is a higher price point offering. And especially in EMEA, we had a good quarter. I would say Acrobat had a strong unit quarter. That's reflected both in Creative Cloud as well as in Document Cloud. In addition to that, we continue to see good progress on retention. And so as people migrate off the performance or the promotional pricing and get on to the full plans.

And then new unit adoption as well for the new offerings, especially the photography solution and international continue to do well. And also there's no question that we're combating piracy as the ability to get boxes in most countries diminishes. So I would say across the spectrum of the different offerings. And from an ARPU point of view as well, Sterling, I think Mark mentioned that in his prepared remarks. That continues to be strong as well.

Q - Sterling Auty {BIO 2070271 <GO>}

Thank you.

Operator

And your next question comes from the line of Alex Zukin with Piper Jaffray. Your line is now open.

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

Hey, guys. Congrats on another great quarter. Thanks for taking my question. Shantanu, I wanted to ask a bigger picture question for you about what you're seeing in terms of the growth of front office budgets and maybe what change you've observed this year, at least start of this year from maybe the last year and the year before that? And how is that driving a change in kind of – is that accelerating your vision in any way because it seems like this shift of the digital transformation budget to the importance at the CEO level has really accelerated? So just curious to hear your thoughts on that.

A - Shantanu Narayen {BIO 3332391 <GO>}

You're absolutely right. I think big picture, the conversations that we're having day in and day out are enterprises recognizing that digital is transforming their agenda. And then they decompose that into what are the key things that they have to do in order to use that as an opportunity rather than a challenge. And clearly from our point of view, the engagement that they do with their customers or how they deliver their experience continues to be, we think, one of the key ways in which people make digital tailwind rather than a headwind and we're part of all of those conversations.

I think if you talk to also the consulting companies, they're being brought in to aspirationally help all of these companies rethink their business model, processes and people. But top of the agenda for even the CEO and the CIO and CFO is what are we doing with respect to delivering a better, engaging customer experience. Next week at Summit, we'll talk a little bit more about how that expands on our vision of what we can do and what people are asking us to step up and do. But I think the way it manifests itself in the business is people are saying, if this is so key to my future I want to bet and standardize on companies that have a comprehensive platform, which is why we're always pleased to see us being rated as the number one platform that exists for this kind of technology solution.

A - Mike Saviage {BIO 3176226 <GO>}

Next question?

Operator

And your next question comes from the line of Walter Pritchard with Citigroup. Your line is now open.

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

Hi. Thanks. Mark, I heard your response or I guess Shantanu on the question around demand drivers. I'm wondering if you could just talk about ARPU specifically as a driver in fiscal 2017 and beyond. It did feel like your commentary around Stock suggested that you were seeing more of an uptick there. And you have things like Sensei and so forth that are incremental to the product that you're delivering in the market. Can you help us understand how much more of a driver ARPU is versus what it's been over the last several years in this transition?

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, Walter. Maybe I'll give you some color, which we didn't touch on as another demand driver, which is in the enterprise. As you know, we are coming up on the anniversary, a lot of the three-year ETLAs. And the first time when we did the three-year ETLAs, Creative Cloud was relatively new. And so what we were doing was, in effect, providing them with a subscription model that mirrored their – what I would call custom way of buying CS in the past. As those are all rolling off the first three-year milestone, we are clearly selling them both on the CC complete solution as well as on Services. So the number of people who are contracting for Services right now, people have to get an exception to not contract for Services. And so that clearly represents an increase in ARPU as well.

To your point, Stock had a good quarter. We continue to see growth both in terms of the demand as well as in terms of the inventory. Sign had a good quarter. All of them are adding. And I think what's on your minds as well as investors is, hey is there leverage and room for price increases. We still think we're in new customer acquisition growth. We're helping people deliver value and so that's really what's still driving a lot of the upside in ARR with the potential to look at optimizing further out as well.

Operator

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

Q - Heather Bellini {BIO 2268229 <GO>}

Great. Thank you so much. Shantanu, I was wondering if you could share with us how you've seen the success of Creative Cloud impact the adoption of the marketing suites? And I know that's been one of your goals that one could help drive the other, but have you seen any change in the ability for you being the industry standard for Creative start to impact the Marketing Cloud side of the business? And has the messaging with customers and the receptivity started to – have you seen any noticeable difference over the last 12 months? Thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

It's a really good question, Heather, and there's no question actually in our mind that where Creative Cloud was first the door opener for us to have conversations with the enterprise. There is an increased expectation from customers that the content lifecycle that we talk about, namely the ability for them to accelerate how they deliver campaigns or how they personalize the experience that they wish to deliver across all of these different channels is predicated on making sure that that content from – content all the way from creation through asset management and all the way out to delivery is more seamless than it's ever been. So I would say three years ago, two years ago we were talking about that as one of the benefits. I would say today, every conversation with the enterprise is they see that as a differentiator for us, and the expectation is that's how they will accelerate both the campaigns and how they will ensure personalized delivery. So we're seeing that whether it's in financial services, whether we're seeing retail, travel, hospitality, automotive, it's a key part of our differentiator and one that we will continue to innovate in

Q - Heather Bellini {BIO 2268229 <GO>}

Great. Thank you very much.

Operator

And your next question comes from the line of Ross MacMillan with RBC Market. Your line is now open.

Q - Ross MacMillan {BIO 1994797 <GO>}

Thanks so much and congratulations from me as well. Mark, I didn't see any commentary on fiscal 2017 guidance. I'm just curious, I guess, specifically about how you're thinking of the $1 billion ARR target given the strength in Q1 and your guide for Q2, which is certainly above our number.

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

Yeah. Sure, Ross. Clearly from our perspective, the business is performing exceptionally well. We had a great Q1 across all the key metrics. And to your point, we provided what we think are strong Q2 targets. If you remember back, we guided FY 2017 the first time at Analyst Day back in November of last year. We updated it again in December with Q4 earnings. We updated it once more in January for TubeMogul and we just don't want to get in the habit of updating annual guidance so frequently. So we're very happy with the first quarter. We're very pleased with what we were able to do from a guidance perspective on Q2. Clearly, we've got momentum, we just don't want to get in the habit of updating annual guidance that frequently.

Q - Ross MacMillan {BIO 1994797 <GO>}

Understood. Thank you. And then one just quick one, just looking at Q2 guide, it implies that, at least I think in our model, that operating margins maybe you're down a little bit sequentially. And I know we have a little bit of an extra three weeks, I think from Tube, but are there any other factors for us to think about in terms of OpEx this quarter? Summit or anything else that's unusual? Thanks.

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

Our salary increases kick in for the company and that has an effect on Q2 from a cost perspective, you'll see that every year. We continue to hire and invest in the company. Again, we feel great about our performance in Q1 and our ability to drive leverage in the model going forward.

Q - Ross MacMillan {BIO 1994797 <GO>}

Understood. Congratulations again. Thank you.

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

Thanks, Ross.

A - Mike Saviage {BIO 3176226 <GO>}

Thanks, Ross.

Operator

And your next question comes from the line of Keith Weiss with Morgan Stanley. Your line is now open.

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

Thanks. And thank you guys for taking the question and congrats on a really nice quarter. On the Marketing Cloud side of the equation, you talked about this Gartner Magic Quadrants that came out during the quarter, I think in the Forrester Wave. Are you seeing any change in the competitive environment? Are any of the sort of the CRM guys or any of the big guys like the Microsofts or the Oracles of the world getting more competitive in that Marketing Cloud field for you guys? And then as a follow-up, any initial sort of gains or any initial benefits you guys are seeing from the Microsoft relationship in FY 2017?

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah/ Let me take the second one first, which as you'll get an update as well at Summit so we are hoping a lot of you will be at Summit. I think you'll be pleased with how quickly we've been able to integrate the products. And from my point of view, the benefit for the Microsoft relationship is really customer-driven. Customers are asking for integration with Azure, Power BI, as well as Dynamics and I think the team has done a great job. But next week, we'll give you a little bit of an update on that.

On the first question as it relates to the competitor, I think we've talked about this is a $40 billion TAM. Clearly, there are other players that you're alluding to that are also seeing this as a market opportunity. But our track record and our winning percentage record in the areas that we're strong continues to be excellent. I think we have a differentiated solution. And I think our vision, the way we want to take this, and how we want to continue to expand it, I think it still makes us a unique leader, but certainly there are other players in this market as well, Keith.

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

Excellent. Thank you very much.

Operator

And your next question comes from the line of Jay Vleeschhouwer with Griffin Securities. Your line is now open.

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Thank you. A question for Mark. As you know, I'm particularly interested in your growth margin structure and the various components of that. You had a couple of dichotomous outcomes in Q1 with respect to cost of revenue that perhaps you can address. You had an unusually large sequential increase in Digital Marketing cost of revenue, where before you'd been seeing some good margin expansion there. Was that tied somehow into the TubeMogul revenue upside given the way they were recording their cost of revenues versus their gross revenue recognition?

On the other hand, you had a pretty material sequential decrease in Digital Media COGS. Was that anomalous, or is that something that you think is sustainable? And lastly, you had a pretty significant increase in Services cost of revenue even though your revenues were down materially from Q4 to Q1. So lots of moving pieces and COGS, but maybe you could address those?

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

Yeah. I mean, the single biggest thing probably worth mentioning, Jay, is you're exactly right. If you look at digital marketing this quarter, that $10 million of gross revenue recognition would flow right into COGS, so you'd have $10 million of revenue and $10 million of COGS. If you back that $10 million of COGS out of digital marketing, the gross profit would be exactly the same as last quarter. So there's really no change to digital marketing cost of service. It's been pretty consistent and you're exactly right, it was really driven by Tube.

On the Digital Media side, I think what you saw this quarter is some of the upside that you see in our revenue relative to our guidance was from a bit more perpetual product, especially on the Acrobat side, and that comes, as you know, with very, very high gross margins. So that's why you would have seen Digital Media gross margin better this quarter.

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Okay. And the Services piece?

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

Services. I can't remember what your question was. It was back to Q...?

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Okay. Sorry. Yeah, so Services revenue were down sequentially but you had a pretty meaningful sequential increase in Services COGS. Yeah.

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

Yeah, the revenue's down sequentially mainly because in Q4 it's a very difficult time for the teams to deliver Services with holidays and year end. So typically, Q1 revenue is going to be a little bit lighter on the Services side, and the cost of services doesn't change that much so that's why you see a little bit less on the gross margin side

Q - Jay Vleeschhouwer {BIO 1498201 <GO>}

Okay. Got it. Thank you.

Operator

And your next question comes from the line of Samad Samana with Stephens, Inc. Your line is now open.

Q - Samad Samana {BIO 17883999 <GO>}

Hi, thanks for taking my question. So we saw that in early February the company pushed out price increases in some international or outside of the U.S. in some countries where FX is a particular headwind. I'm curious if you learned any lessons from those price increases and whether it shows you what the appetite for customers is to accept those and how it impacts your thoughts on raising prices in the U.S.?

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

Yeah, this is Mark. We did push out some price increases around the world in various markets because of FX to stay FX neutral, if you will. And the good news there is we really did not see an impact to ARR. So that does give us confidence that down the road, we're able to tweak pricing a bit. We're not taking advantage of that yet other than FX, but that was a very good sign.

Q - Samad Samana {BIO 17883999 <GO>}

Maybe just a quick follow-up. Could you give us what the Marketing Cloud revenue growth would have grown year-over-year excluding the extra week and the revenue contribution from TubeMogul just for an apples-to-apples compare? Thanks.

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

With the week, I would have to get back to you. The TubeMogul gross, you just take out $10 million, and instead of $26 million it would've been $24 million. But I don't have the week broken out between the different businesses. It was about $75 million we said a year ago, but we didn't split it between the businesses. I don't think it's very...

Q - Samad Samana {BIO 17883999 <GO>}

Great. Thanks for that

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

I don't think it's very material for digital marketing, to be honest with you. It's more material on the media side, that extra week. Because you think about it as recognizing revenue from subscribers, it doesn't change that much from an enterprise perspective.

Q - Samad Samana {BIO 17883999 <GO>}

Great, thanks. That's very helpful. Thank you.

Operator

And your next question comes from the line of Derrick Wood with Cowen and Company. Your line is now open.

Q - Derrick Wood {BIO 4963641 <GO>}

Great. Thanks. And congrats on the quarter. Shantanu, you mentioned Adobe Stock has 60 million assets now. And I don't really know how this compares to other offerings, but I know you guys announced a partnership with Reuters a few months ago. And I guess I'm just curious how impactful it is when you onboard new content into the service. I mean, specifically, do you think these partnerships kind of move the needle and increase the tax rate or getting people to subscribe to the monthly version? And would you say growth is tied to bringing more content on board or are you really at kind of full scale?

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah. The way I would answer that is sort of strategically as we look at that business, there are three things that we think we continue to have to execute on to ensure that we capitalize on the opportunity that we've talked about. The first is integration within the products. I think you've seen us make some good integration with products like Photoshop. So the ability for people to contribute and to acquire assets is built into the product. So that's one area that we're continuing to make sure we invest.

The second one that tends to be a way in which you compete effectively is the inventory. So I think having the inventory and having the inventory across different kinds of assets including Premium and including partnerships with some of the people that you're talking about, that also helps us ensure that we're competitively either ahead of the market or at least in line with the market.

And the third one that we think about when we think about Stock is how good is our technology to find the right asset based on the intelligence that we can provide. And that's where I think we will demonstrate superior advantage to anything else that's out there because our ability to understand these assets and irrespective of what keyword is being used to search for a particular asset, return the right. So in other words, search relevance in search is going to be a key part of it. And I think in all three of those, we're continuing to make great progress. And I think at MAX, we showed you a lot of really cool ways in which we will make that more relevant. It's an area we'll continue to invest in so we feel good about it, Derrick.

Q - Derrick Wood {BIO 4963641 <GO>}

Good. Thank you.

Operator

And your next question comes from the line of Richard Davis with Canaccord Genuity. Your line is now open.

Q - Richard Hugh Davis {BIO 1497599 <GO>}

Hey, great. Thanks. Just a real quick question. So it seems to me, and you've touched on this, that you're becoming a lot more critical to your customers. And typically that means larger deals, but larger deals have a different selling motion and cadence and staff dynamics. Could you just talk a little bit about what you believe you need to do to evolve and position yourself to kind of move to larger deals? I mean, you obviously keep up with the small stuff, too, but that'd be helpful. Thanks.

A - Shantanu Narayen {BIO 3332391 <GO>}

You're absolutely right. The good news is we're absolutely mission critical to our customers so the level of engagement that we have with these enterprises is at multiple levels all the way from the C-Suite to all of the practitioners who are using our products. I would say actually on the field side and on the partner side, we have evolved that over many years where we think we have a world class organization that does that because it's not just what you do internally, it's ensuring that the thousand partners that I talked about who are also partners to the companies that we're working with are evangelizing and are promoting our products and are educated on our products. So I actually feel good about all of those. In some cases, you have those deals, the larger the size, the time taken can increase. But that's why we want to build a healthy pipeline and continue to execute against that. So I feel very good about it. And that is without a doubt one of the areas where we've invested in over the last few years.

Q - Richard Hugh Davis {BIO 1497599 <GO>}

Super. Thank you.

A - Shantanu Narayen {BIO 3332391 <GO>}

Thank you.

Operator

And your next question comes from the line of Brent Bracelin with Pacific Crest Securities. Your line is now open.

Q - Brent Bracelin {BIO 2447337 <GO>}

Thank you for taking the question. Mark, I wanted to go back to the non-GAAP operating margins of 36% this quarter, certainly above where we had thought they'd be. If I go back the last two years, Q1 was the low point and then you saw basically improvement throughout the year. Is there something different about this year or different that we should think about relative to the additional kind of expenses or hiring plans that might be a different sequence? And then as a follow-up to that, if I go back and look at where op margins could go, I think the peak was back in 2008 at 40%. How are you thinking about kind of the op margin trajectory longer term?

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

Sure. There's no difference on the cost side than what you've seen in prior years. As I just mentioned a few minutes ago on the revenue side in Q1, we did have a little bit of the upside coming from some increased perpetual revenue on the Acrobat side of the business, on the Toolbar distribution deal and that revenue upside can typically drop down to the bottom line pretty readily. So that's where you saw a bit more margin than we had guided to in the first quarter. Expense-wise, there's no real change to our trajectory and there hasn't been for quite some time.

In terms of long term margins, the best I can do for you right now is two things. One is we're very focused on margin. You see that in any given quarter. You see that when we overachieve on revenue like we did in Q1. And we gave a three-year model a little while back that shows what margins could look like through at least 2018. And if you looked at that model and looked at it back when we gave it to you, you would see margins up above 35%. Beyond that, we'll see.

Q - Brent Bracelin {BIO 2447337 <GO>}

Fair enough. Thank you.

A - Mike Saviage {BIO 3176226 <GO>}

Operator, we'll take two more questions please.

Operator

Certainly. Your next request question comes from the line of Pat Walravens with JMP Securities. Your line is now open.

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

Oh, great. Thank you. Shantanu, probably for you, what key points would you make to investors at this point about your acquisition strategy going forward and sort of what you're looking for?

A - Shantanu Narayen {BIO 3332391 <GO>}

Well we actually feel really good about all of the technology that we have. I mean, we're always on the lookout for small innovative companies. And I think both Mark and I have always talked about we look for – is it bringing us strategic advantage? What is the culture of the companies that we're looking at? Because we're very, very thoughtful about making sure that we continue to expand on the vision of what people want. And the third is financially whether it makes sense. And so we've done some when they make sense but we feel really good about the core value that we have and we'll continue to be on the lookout for things that meet our criteria in all of those, namely continuing to expand strategically what we can do, ensuring that the culture fit is right and financially making sense.

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

Okay. Thank you.

Operator

And your final question comes from the line of Kirk Materne with Evercore. Your line is now open.

Q - Kirk Materne {BIO 5771115 <GO>}

Thanks very much and thanks for squeezing me in. Shantanu, I was wondering if you could talk a bit about how the up sell of Stock in the Marketing Cloud customers is going relative to the Creative Cloud as that seem to be somewhat of the untapped opportunity that we don't talk perhaps as much about? I was just kind of curious how should we think about that as another step forward in terms of Stock. Thanks.

A - Shantanu Narayen {BIO 3332391 <GO>}

Yeah, I think, Kirk, from our point of view, as we are going more and more to these large enterprises with solutions across the Creative Cloud, Document Cloud and the Marketing Cloud, we have a quarterback model, and the named account model with this quarterback is that they're clearly bringing to bear opportunities like the ones that you're talking about. If you're in there primarily with Marketing Cloud, ensuring that we sell more solutions, sell Stock, sell Sign, and continue to drive the CC DLAs (50:08).

And so I think the model that we have in the field is really one of how do we comprehensively to these larger accounts ensure that they're getting the benefit of the breadth of our solutions. And to your point in CC, when we think about the CC enterprise opportunity and conversation that we're having with those customers, we're very much moving them from custom to complete, and we're moving them from complete to complete plus services. And the service that is top of mind for us is Stock. So a good question and it's clearly one of the areas that we're focused on.

And since that was the last question, I think in summary, we were really pleased with the strong start to Q1. It was an outstanding quarter and I think the Q2 targets that we gave reflect the continued momentum in the business. But in addition to the great quarterly performance, we're really excited about the long-term opportunities that we've outlined, namely the ability to empower people to create the things they want to create and to enable businesses to transform themselves. And I think we're continuing to be unique in that we're one of the only companies that's delivering great top line growth and bottom line earnings. We're looking forward to next week's Adobe Summit. It's our largest ever. We really hope you'll join us to hear about our vision for the future and demonstrate both product and partner progress against that vision. But thank you for joining us today.

A - Mike Saviage {BIO 3176226 <GO>}

And this concludes our call. Thanks, everyone.