Company

16 February 2010 | 34 pages

Adobe Systems Inc. (ADBE)

Equity
Initiation of coverage

Looking for Upward Estimate Revisions From CS5 Product Cycle and Macro Recovery

- **Initiating Coverage with Buy** — We are initiating coverage on Adobe Systems with a Buy / Medium Risk (1M) rating and a $39 target price.
- **We are expecting strong CS5 release** — Driven by some pent-up demand, an improving macro-economic backdrop and strengthening PC and Mac hardware, we believe Adobe shares are poised for upward revisions to estimates post the April 2010 launch of CS5. Our FY10E EPS of $1.84 and FY11E EPS of $2.14 compare to consensus $1.80 and $2.08, respectively.
- **There is room for multiple expansion** — We are not counting on a return to the 30x P/E the stock achieved in each of the last five Creative product cycles. However, we believe the history of multiple expansion into cycles will continue and drive multiple above current 17x 2010 EPS. Our $39 price target is based on 21x 2010 EPS of $1.84.
- **High macro correlation a positive** — Adobe's business suffered more than peers through the downturn as the company sells a more discretionary product and lacks a stable maintenance stream in our view. Our analysis shows high correlation to macro-economic and advertising industry indicators. The acquired Omniture business is also levered to a recovery in online trends.
- **Steve Jobs has given you an entry point** — We believe recent controversy surrounding the impact of HTML 5 on Adobe's Flash platform are overdone. While long-term forces trend to standards, HTML 5 lacks consensus on video implementation, leaving Flash as the de-facto standard in video for the foreseeable future.

Buy/Medium Risk	1M
Price (12 Feb 10)	US$31.45
Target price	US$39.00
Expected share price return	24.0%
Expected dividend yield	0.0%
Expected total return	**24.0%**
Market Cap	US$16,484M

Price Performance (RIC: ADBE.O, BB: ADBE US)

EPS	Q1	Q2	Q3	Q4	FY	FC Cons
2009A	0.45A	0.35A	0.35A	0.39A	1.54A	1.54A
2010E	**0.37E**	**0.42E**	**0.49E**	**0.55E**	**1.84E**	**1.79E**
Previous	na	na	na	na	na	na
2011E	**0.52E**	**0.53E**	**0.53E**	**0.56E**	**2.14E**	**2.05E**
Previous	na	na	na	na	na	na
2012E	**0.54E**	**0.57E**	**0.57E**	**0.61E**	**2.29E**	**2.27E**
Previous	na	na	na	na	na	na

Source: Company Reports and dataCentral, CIR. FC Cons: First Call Consensus.

Walter H Pritchard
+1-415-951-1770
walter.h.pritchard@citi.com

Kenneth Wong
kenneth.wong@citi.com

See Appendix A-1 for Analyst Certification and important disclosures.

Fiscal year end 30-Nov	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	15.2	20.5	17.1	14.7	13.7
EV/EBITDA adjusted (x)	8.5	11.4	9.2	8.2	7.6
P/BV (x)	3.8	3.4	3.0	2.7	2.4
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Per Share Data (US$)					
EPS adjusted	2.07	1.54	1.84	2.14	2.29
EPS reported	1.59	0.73	1.33	1.69	1.92
BVPS	8.38	9.29	10.34	11.67	13.22
DPS	0.00	0.00	0.00	0.00	0.00
Profit & Loss (US$M)					
Net sales	3,580	2,946	3,609	3,932	4,093
Operating expenses	-2,520	-2,214	-2,689	-2,786	-2,827
EBIT	**1,060**	**732**	**920**	**1,146**	**1,265**
Net interest expense	34	28	2	8	15
Non-operating/exceptionals	-16	-58	0	0	0
Pre-tax profit	**1,079**	**702**	**922**	**1,155**	**1,280**
Tax	-207	-315	-221	-277	-307
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**872**	**386**	**700**	**877**	**973**
Adjusted earnings	1,136	815	968	1,105	1,161
Adjusted EBITDA	1,706	1,317	1,628	1,721	1,744
Growth Rates (%)					
Sales	13.4	-17.7	22.5	8.9	4.1
EBIT adjusted	18.7	-27.9	22.9	13.7	4.6
EBITDA adjusted	11.9	-22.8	23.6	5.7	1.3
EPS adjusted	28.3	-25.8	19.5	16.3	7.3
Cash Flow (US$M)					
Operating cash flow	**1,281**	**1,118**	**1,373**	**1,412**	**1,472**
Depreciation/amortization	270	282	357	275	231
Net working capital	-126	183	146	79	98
Investing cash flow	**-305**	**-1,497**	**-120**	**-140**	**-160**
Capital expenditure	-112	-120	-120	-140	-160
Acquisitions/disposals	-4	-1,583	0	0	0
Financing cash flow	**-1,022**	**478**	**-400**	**-500**	**-500**
Borrowings	350	636	0	0	0
Dividends paid	0	0	0	0	0
Change in cash	**-60**	**113**	**853**	**772**	**812**
Balance Sheet (US$M)					
Total assets	**5,822**	**7,256**	**7,903**	**8,525**	**9,344**
Cash & cash equivalent	2,019	1,904	2,758	3,530	4,342
Accounts receivable	467	411	442	427	505
Net fixed assets	313	388	333	316	323
Total liabilities	**1,411**	**2,392**	**2,568**	**2,632**	**2,808**
Accounts payable	56	59	67	72	74
Total Debt	350	1,000	1,000	1,000	1,000
Shareholders' funds	**4,410**	**4,864**	**5,335**	**5,893**	**6,536**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	47.6	44.7	45.1	43.8	42.6
ROE adjusted	25.1	17.6	19.0	19.7	18.7
ROIC adjusted	44.7	20.2	25.5	30.6	33.1
Net debt to equity	-37.8	-18.6	-32.9	-42.9	-51.1
Total debt to capital	7.4	17.1	15.8	14.5	13.3

For further data queries on Citi's full coverage universe please contact CIR Data Services Americas at CIRDataServicesAmericas@citi.com or +1-212-816-5336

Powered by: dataCentral

Contents

Investment Thesis

We expect the release to drive significant top line growth and generate upside to earnings.

We are initiating coverage of Adobe Systems with a Buy rating (1M) and a $39. price target. Adobe is the largest provider of software used in the creative design and development process. The company is nearing the release of its highly anticipated Creative Suite 5, which is easily the most important short and medium term driver of the stock. We expect the release to drive significant top line growth and generate upside to earnings. Robust product cycles, usually lasting 18-24 months have consistently resulted in earnings growth and substantial multiple expansion. Past product cycle saw the earnings multiple peak at 30x. Trading at 17x FY10 earnings, we believe there is room for multiple expansion and our $39 price target is based on 21x. Beyond this, the company is among the most highly levered to macroeconomic trends. With an inevitable recovery in these trends (although certainly questions about the magnitude of a recovery), Adobe has a tailwind over the next several years. Beyond the Creative business, we expect to see macro benefit to the acquired Omniture (10% of expected revenue) business and some improvement in enterprise (~25% of expected revenue). We recommend investors take advantage of recent weakness in the shares (down 4% since the Jan. 27th iPad announcement). The highly anticipated announcement of Apple's (AAPL.O; US$200.38; 1H) iPad (without Flash support) and Steve's Job's comments regarding the future viability of Flash have caused significant investor concern that we believe is unwarranted. Our estimates are above consensus for 2010 and 2011 with an upward bias as we gain better visibility into specifics around the CS5 launch in April.

Steve's Job's comments regarding the future viability of Flash have caused significant investor concern that we believe is unwarranted.

Five Reasons We Are Bullish on Adobe Shares

1) **Creative Suite 5 product cycle will likely generate upside to numbers.** Few software vendors depend on a single product as much as Adobe and even fewer have little or no annuity revenue. As a result, Adobe's financial results are highly levered to performance of the Creative Suite products, which contribute 60% of revenue. Our analysis suggests many dynamics working in Adobe's favor during the upcoming CS5 cycle including pent-up demand, a reversal in the macro environment and strong growth in Mac and PC hardware. As a result, we conclude that revenue in the cycle will likely approach levels seen during CS3 (our base case) and could exceed CS3 (our upside case). As a result, our FY10 $1.84 and FY11 $2.14 in EPS is ahead of consensus ($1.80 and $2.08, respectively). If the more aggressive upside case comes to fruition, our earnings estimates would be $1.98 and $2.23.

2) **Room for multiple expansion.** Robust product cycles, which usually last 18-24 months have consistently resulted in an acceleration in earnings growth and substantial multiple expansion for Adobe shares. This was the case with CS1 and CS3. Currently trading at 17x FY10 earnings, we believe there is room for multiple expansion as shares have 30x in prior cycles. Relative to the S&P 500 at 1.3x, shares are trading at considerable discount (25%) to its 5 year average 1.6x and range of 1-2x the market. Given the economic backdrop, we have taken a conservative approach applying a multiple of 21x roughly 70% of the typical level. At 21x our $1.84 FY10 earnings estimate we arrive at a value of $39.

3) **With one of the highest correlations to macroeconomic trends in software, Adobe is a good recovery play.** Adobe's customer base of print and online media have business models directly tied to advertising spending and thus overall GDP. As such Adobe's business is perhaps the most levered to the macro climate.

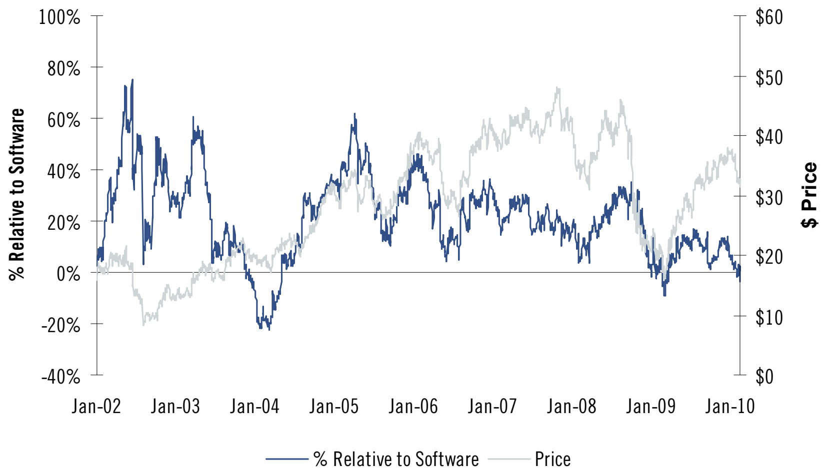
4) **Steve Jobs has given you an entry point.** The announcement by Apple to exclude the Flash player from its highly anticipated tablet device, the iPad, led investors question the long-term viability of Flash. Many believe the dynamic media functionality native to HTML 5 will render Flash obsolete. We believe with industry leaders still debating over some of the basic standards, including in the area of video, there is little near term risk to the Flash platform.

We believe with industry leaders still debating over some of the basic standards, including in the area of video, there is little near term risk to the Flash platform.

5) **Omniture business levered to recovery in online trends and also boosts long-term growth rate.** As business models shift from brick and mortar establishments to the web, the need to track and process user behavior will grow in importance. Ecommerce vendors and online advertisers such as Google (GOOG.O; US$533.09; 1H) and Yahoo! (YHOO.O; US$15.17; 1H) have already indicated an up-tick in Internet spending trends. The eventual resurgence of online trends should provide Adobe with a long term growth engine to supplement its core graphics business.

Where could we be wrong? The most likely area where our analysis could be wrong is in the up-take of CS5. While it appears there is pent-up demand in the customer base and general economic indicators are improving (two important drivers), worldwide macroeconomic conditions are still fragile and customers may continue to defer purchases of new product in favor of continuing to use “good enough” existing versions of the Creative Suite.

Figure 1. Adobe Share Performance Relative to Software Peers



Source: FactSet, Citi Investment Research and Analysis

Figure 2. CIRA Estimates vs. Consensus ($ millions except per-share data and where noted)

	Revenue		
	CIRA	Consensus	% Diff
Feb-10	$825	$824	0.1%
May-10	874	865	1.0%
FY 2010	3,609	3,597	0.3%
FY 2011	3,932	3,973	-1.0%
	EPS		
	CIRA	Consensus	% Diff
Feb-10	$0.37	$0.37	-1.9%
May-10	0.42	0.41	2.2%
FY 2010	1.84	1.80	1.8%
FY 2011	2.14	2.08	2.6%

Source: dataCentral, CIRA

Point #1: Creative Suite 5 Product Cycle Will Likely Generate Upside To Numbers

Investors remain very focused on playing the cyclical aspects of Adobe's Creative Solutions business (nearly 60% of revenue and majority of profits). We'd argue that ultimately this behavior is likely to change as CS matures. However, with a new Creative Suite slated for launch in the company's May quarter, we expect the dynamics of the Creative Solutions business to be the primary driver of the stock for 2010.

At the end of the day, the key question is how earnings will compare to current expectations ($1.80 FY10 consensus) and earnings during prior cycles ($1.54 in CS4 cycle vs. $2.07 in CS3).

Investors spend considerable time comparing current or upcoming cycles to prior cycles in order to understand the magnitude of growth that will be driven by upgrades, new customers, suite up-take, pricing and other drivers. At the end of the day, the key question is how earnings will compare to current expectations ($1.80 FY10 consensus) and earnings during prior cycles ($1.54 in CS4 cycle vs. $2.07 in CS3).

Figure 3. Sources of Growth

Product release	CS1	CS2 (1)	CS3	CS4	CS5
Release date	10/27/03	4/27/05	4/16/07	10/15/08	4/26/10
Total cycle revenue	$1,564	$2.2 / $3B	$3,165	$2,609	$3,041
Avg quarterly revenue	$261	$278 / $372M	$527	$435	$507
Peak quarterly EPS (3)	$0.25	$0.33	$0.50	$0.45	
Cycle / cycle growth %	**+38%**	**+7% (2)**	**+42% (2)**	**-17%**	**+16%**
Growth breakdown:					
Pricing (total)	**+20-25%**	**+10-15%**	**+20-25%**	**(-1-1%)**	**+3-8%**
Price change estimates	+12%	+4%	+15%	+2%	+3%
Suite migration	+10%	+8%	+7%	0%	+2%
+ = Positive / – = Negative					
Secular	+ + +	++	+	–	– –
Macro	+ +	+ + +	+ +	– – –	+
Apple Mac	+		+ + +		+
Pent up demand	+ +	–	+ + +	– –	+ + +
Addition of acquired tech.		+	+ + +		+
Units	**+12-17%**	**(-3-8%)**	**+13-18%**	**(-20-25%)**	**+5-15%**
Currency	**+2%**	**0%**	**+4%**	**+3%**	**0%**

(1) Multiple CS2 revenue estimates reflect: 1. Complete exclusion of MACR 2. MACR included in past results
(2) CS2 growth rate excludes MACR / CS3 growth rate compared to CS2 incl. MACR
(3) Does not include quarters where 2 releases overlap

Source: Citi Investment Research and Analysis

We believe that there are a variety of reasons why the CS5 cycle will be a strong one. This includes a broadly improving macro environment, pent-up demand from a weak CS4 cycle, a strong PC and Mac hardware cycle and the addition of at least some acquired technology (Omniture).

The company provides minimal insight into the unit and price dynamics of their Creative business making precise modeling more difficult. We've attempted to break down the various cycle-to-cycle growth drivers in the Creative business since Photoshop 7 (the last non-suite release, dating back to April 2002). We have taken a broader view of the "Units x Price" framework which allows for a high level examination of the inputs that factor into cycle over cycle growth. Starting with cumulative cycle revenue, we are able to determine average quarterly revenue which we use as the basis for cycle over cycle growth. Then we breakdown growth into three sources: 1) Price 2) Units 3) Currency fluctuations. Price generated growth is the byproduct of SKU price increases and suite upsell from point products. We combine the weighted average change in retail pricing (adjusted for our product mix assumptions and new/renewal ratio) with change in suite as a % of revenue (assuming units flat) metric given by the company to derive the price component of our analysis. We then adjust for currency fluctuations using the Euro and the Yen as a proxy for the European and Asian Pacific markets. We attribute the unaccounted for source of growth is driven by unit growth. While not exact, we believe our analysis can be useful to determine directionally how a product cycle will compare as well as relative strength of a cycle. Our base case assumes moderate cumulative price/suite growth of 5%, flat FX and 5% unit growth. Looking at CS1 and CS3 unit growth, we believe 5-15% unit growth is well within reach. Given our belief that units significantly eroded during the CS4 cycle we believe it is more likely than not that unit growth will be biased to the upside. Our upside case assumes 18% unit growth which implies a cycle/cycle growth rate of 23% and $3.2B in cumulative cycle revenue. We assume profit margins of 75% on incremental revenue which generates $71M and $47M of after tax profits in FY10 and FY11 respectively which translate into $0.13 and $0.09 in EPS upside.

Figure 4. Creative Product Cycle Comparison

	Pro-forma CS2/Studio 8 (2Q05 - 1Q07)	CS3 (2Q07 - 3Q08)	CS4 (4Q08 - 1Q10)	CS5 [1] (2Q10 - 3Q11)	CS5 [1] (2Q10 - 3Q11)	CS5 [1] (2Q10 - 3Q11)
				Base	Upside	Downside
Cumulative cycle revenue	$2,978	$3,165	$2,613	$3,043	$3,206	$2,833
Length of cycle (quarters)	8	6	6	6	6	6
Avg quarterly revenue	$372	$527	$436	$507	$534	$472
Avg quarterly growth vs last cycle	N/A	42%	-17%	16%	23%	8%
Peak quarter	4Q05	4Q07	4Q08	4Q10	4Q10	4Q10
Peak from last trough	17%	72%	3%	35%	43%	30%
Exit quarter from peak	-12%	-13%	-15%	11%	11%	21%
Peak quarterly EPS during cycle [2]	$0.33	$0.50	$0.45	$0.56	$0.59	$0.53

[1] CS5 growth estimates based on Citi CS4 forecast.

[2] Does not include quarters where 2 releases overlap

Source: Citi Investment Research and Analysis; Company reports

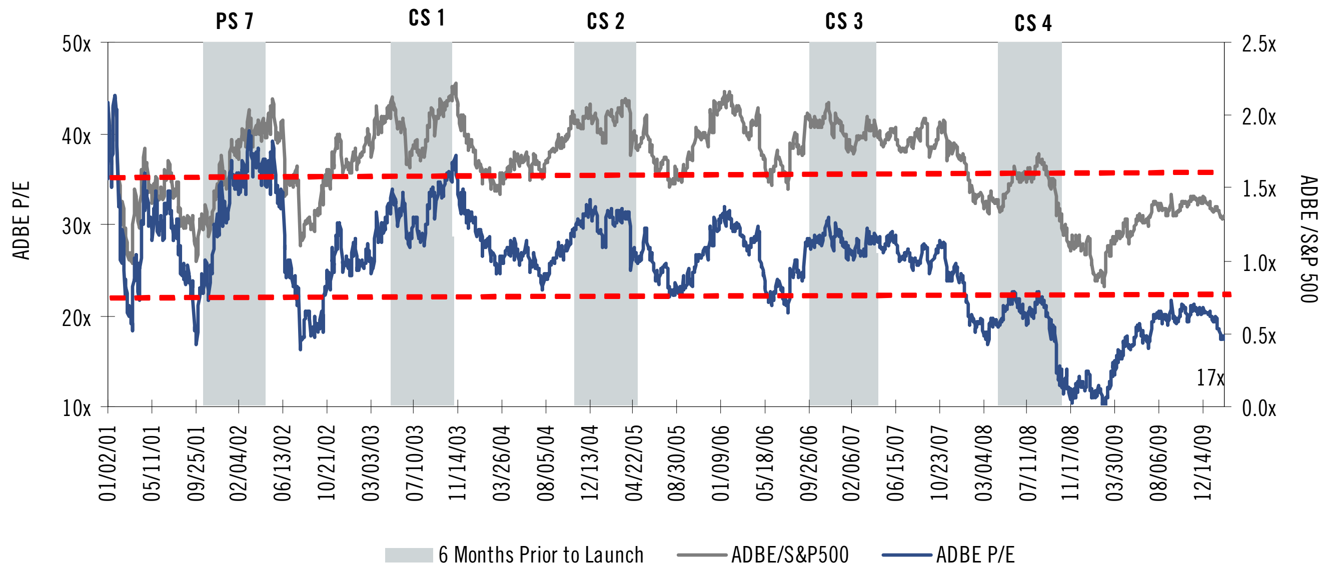
Point #2: Earnings multiple remains well below historical average; Should expand as CS5 results drive numbers higher

While we have attempted to bring some structure when analyzing Creative growth and the resulting earnings, understanding what multiple investors will apply to these earnings is much more difficult. Figure 5 below shows Adobe's forward 12-month P/E history with CS product releases overlaid. With the

With the stock currently trading at 17x earnings and 1.3x the market we believe there is still sufficient headroom for multiple expansion.

exception of CS4 which was released mid-recession, shares typically trade at 30x earnings and 2x relative to the S&P 500 in the months leading up to the product launch. Like much of the market, Adobe's P/E has rebounded from a trough multiple of 10x at the beginning of 2009. With the stock currently trading at 17x earnings and 1.3x the market we believe there is still sufficient headroom for multiple expansion.

Figure 5. Adobe P/E and Relative P/E Prior to CS Product release

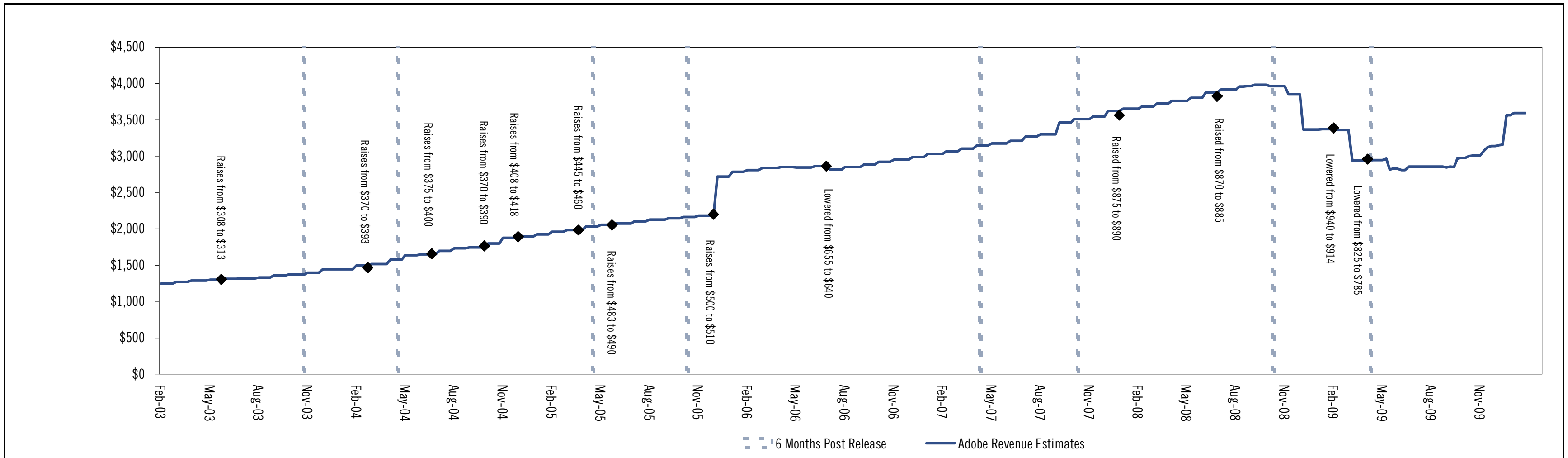


Source: Factset, Citi Investment Research and Analysis

Adobe stock fluctuates with greater frequency than most large cap peers. Looking into historical movements, we've isolated several factors that cause these swings. The stock is positively correlated to general market movements and earnings results. Following a product cycle, the stock generally experiences contraction of its absolute multiple and its premium relative to the market as investors participating in the cycle upside take profits.

Beyond playing the cycle sentiment, the magnitude of a Creative Suite release presents the potential for significant upside to numbers. Figure 6 demonstrates the upside history of each cycle looking at consensus NTM revenue estimates relative to mid-quarter revenue revisions by management. During the CS1 and CS3 releases, the company raised guidance 7 times and reported revenue above the mid point of guidance in every quarter of the cycle by an average of $36M or 6%. Conversely, underperforming release cycles, CS2 and CS4 fell short of guidance in 4 of the cumulative 13 quarter thus far and only beat guidance by an average of $4M per quarter. We strongly anticipate CS5 results to mirror the former and expect upside to numbers to stimulate multiple expansion deeper into the cycle.

Figure 6. Adobe Revenue Revisions vs. Consensus NTM Revenue Estimates



Product	1Q03	2Q03	3Q03	4Q03	1Q04	2Q04	3Q04	4Q04	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06
(International releases in gray lettering)														
Adobe Acrobat		6.0							7.0				3D	
Acrobat Connect														
Creative Suite				1.0						2.0				
FrameMaker											7.2			
Illustrator				CS						CS2				
InDesign™				CS						CS2				
Lightroom														
Photoshop Elements								3.0				4.0		
Photoshop				CS						CS2				
Premiere														
Premiere Elements								1.0				2.0		
Premiere Pro			1.0			1.5							2.0	
Soundbooth														
	Reaffirm	Raise	Reaffirm	Reaffirm	Raise	Raise	Raise	Raise	Raise	High End	Reaffirm	High End	Reaffirm	Low End
	Feb '03	May '03	Aug '03	Nov '03	Feb '04	May '04	Aug '04	Nov '04	Feb '05	May '05	Aug '05	Nov '05	Feb '06	May '06
Guided Q revenue	$283	$308	$308	$340	$370	$375	$370	$408	$445	$483	$480	$500	$645	$655
Revised Q revenue	$283	$313	$308	$340	$393	$400	$390	$418	$460	$490	$480	$510	$645	$640
Reported Q revenue	$303	$326	$326	$366	$431	$418	$412	$439	$483	$506	$498	$510	$655	$635
Guided Y revenue	NA	NA	NA	$1,425	$1,488	1.488+	NA	$1,875	$1,925	NA	NA	$2,700	$2,700	$2,570

Product	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09
(International releases in gray lettering)														
Adobe Acrobat		8.0							9.0					
Acrobat Connect		6.0						Pro						
Creative Suite				CS3	CS3				CS3.3	CS4				
FrameMaker					8.0						9.0			
Illustrator				CS3						CS4				
InDesign™				CS3						CS4				
Lightroom			1.0											
Photoshop Elements		5.0				6.0				7.0				
Photoshop				CS3						CS4				8.0
Premiere				CS3						CS4				8.0
Premiere Elements		3.0				4.0				7.0				
Premiere Pro				CS3						CS4				
Soundbooth				CS3						CS4				
	Reaffirm	Reaffirm	NA	NA	NA	High End	NA	High End	NA	Reduce	Reduce	NA	NA	Reaffirm
	Aug '06	Nov '06	Feb '07	May '07	Aug '07	Nov '07	Feb '08	May '08	Aug '08	Nov '08	Feb '09	May '09	Aug '09	Nov '09
Guided Q revenue	$595	$670	$655	$720	$780	$875	$870	$870	$870	$940	$825	$700	$690	$715
Revised Q revenue	$595	$670	NA	NA	NA	$890	NA	$885	--	$914	$785	--	--	$715
Reported Q revenue	$602	$682	$649	$746	$852	$911	$890	$887	$887	$915	$786	$705	$698	$757
Guided Y revenue	$2,562	$2,961	$2,961	$2,961	$2,961	$3,122	$3,569	$3,569	$3,569	NA	NA	NA	NA	NA

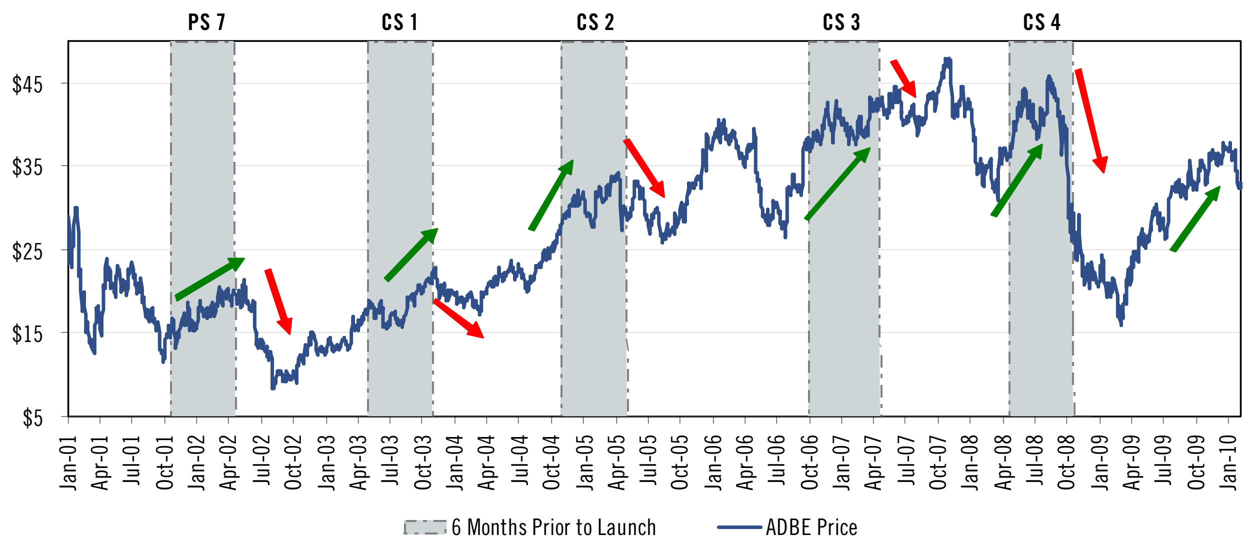
Source: Citi Investment Research and Analysis

Profit Taking After Mid-April Launch, But Likely To Be Short-Lived

We believe that CS5 will mirror the results of CS1 and CS3 rising into the cycle followed by a brief drop with strong results driving upside after the post-release drop.

The stock historically builds up momentum in the 9-12 months heading into a product cycle, peaking in the first full month of the release, which is then typically followed by a "sell the news" decline in the 6 months after the product launch. While stronger cycles such as CS1 and CS3 also follow the pattern, stock declines following the release are much shorter as strong results drive positive earnings surprise offering investors upside deeper into the cycle. We believe that CS5 will mirror the results of CS1 and CS3 rising into the cycle followed by a brief drop with strong results driving upside after the post-release drop. As we have a high degree of confidence in the prospects and positive impact on numbers of the CS5 release, we believe this decline will be shallow (like in CS1 and CS3) and represent another good entry point.

Figure 7. Product Cycle Impact on Stock Price



Source: Factset, Citi Investment Research and Analysis

Point #3: Significant leverage to the economy; Should outperform software peers broadly in a recovery

Adobe's Creative Revenue (~60% of total and therefore its overall revenue) has a high degree of correlation with macroeconomic indicators. Given the economy has just been through what some would consider to be the worst downturn since the 1930's Great Depression, the coming years are likely to see at least some reversal of these negative trends. While we believe short and medium term revenue acceleration driven by the release of CS5 is likely to be a more important driver, this positive macro leverage should be a tailwind as well.

The inevitable turnaround in ad spending suggests Adobe is a clear cyclical beneficiary.

We found meaningful correlation (r > 0.5), between Creative revenue and several key macroeconomic and business indicators. These include nominal GDP (0.59), magazine advertising (0.67), direct mail (0.64), Internet advertising (0.54) and total advertising (0.57). Furthermore, in the areas where Adobe has little exposure (newspaper, radio and television ad spending), there appears to be very little correlation. As a control group, we looked at the correlation of overall software spending (BEA Data) with the same indicators, and with the exception of Internet advertising, only moderate correlation was detected. The inevitable turnaround in ad spending suggests Adobe is a clear cyclical beneficiary.

Figure 8. Adobe Correlation with macroeconomic Drivers

	Software Revenue	Adobe Revenue	Creative Revenue	Real GDP	Nominal GDP	Newspaper	Magazines	Total TV	Radio	Yellow Pages	Direct Mail	Internet Media	Total U.S. Advertising
1989	23%	31%	--	3.6%	7.5%	4%	11%	5%	7%	7%	4%	--	5%
1990	14%	11%	--	1.9%	5.8%	0%	1%	7%	5%	7%	6%	--	4%
1991	13%	18%	--	-0.2%	3.3%	-6%	-4%	-2%	-3%	3%	5%	--	-1%
1992	8%	15%	--	3.4%	5.8%	1%	7%	9%	2%	2%	4%	--	4%
1993	11%	-3%	31%	2.9%	5.1%	4%	5%	4%	9%	2%	7%	--	5%
1994	6%	12%	17%	4.1%	6.3%	7%	8%	12%	11%	3%	9%	--	9%
1995	9%	18%	33%	2.5%	4.7%	6%	8%	7%	8%	4%	11%	--	8%
1996	15%	3%	-1%	3.7%	5.7%	6%	5%	13%	8%	6%	5%	--	8%
1997	26%	16%	22%	4.5%	6.3%	9%	9%	4%	10%	5%	7%	--	7%
1998	17%	-2%	0%	4.4%	5.5%	6%	7%	8%	12%	5%	7%	--	8%
1999	25%	13%	19%	4.8%	6.4%	5%	9%	6%	14%	6%	5%	141%	8%
2000	17%	25%	24%	4.1%	6.4%	5%	8%	15%	12%	5%	8%	75%	11%
2001	1%	-3%	-10%	1.1%	3.4%	-10%	-10%	-9%	-7%	3%	0%	-12%	-7%
2002	-2%	-5%	-8%	1.8%	3.5%	-1%	-1%	7%	6%	1%	3%	-16%	2%
2003	5%	11%	0%	2.5%	4.7%	5%	4%	0%	1%	1%	5%	21%	4%
2004	8%	29%	37%	3.6%	6.5%	5%	7%	12%	3%	1%	8%	32%	7%
2005	6%	18%	8%	3.1%	6.5%	2%	6%	0%	0%	2%	6%	30%	3%
2006 (1)	5%	9%	5%	2.7%	6.0%	0%	3%	6%	0%	1%	6%	35%	4%
2007	7%	23%	32%	2.1%	5.1%	-8%	5%	1%	-5%	1%	3%	26%	-1%
2008	8%	13%	9%	0%	3%	-24%	-10%	-7%	-8%	-5%	-1%	11%	-3%
2009E (2)	12%	-18%	-18%	-2%	-1%	-22%	-13%	-11%	-20%	-6%	-3%	1%	-9%
Correlation (vs Creative Revenue)				0.52	**0.59**	0.42	**0.67**	0.49	0.46	0.31	**0.64**	**0.54**	**0.57**
Correlation (vs Revenue)				0.45	**0.67**	0.34	**0.58**	0.38	0.31	0.35	0.42	0.48	0.45
Correlation (vs Stock Price)				0.02	(0.01)	0.21	**0.17**	0.09	0.21	0.14	0.33	**0.84**	0.22
Software Spending Correlation				0.39	0.33	0.31	0.42	0.23	0.44	**0.50**	0.19	**0.89**	0.41

* All indicators are U.S. only
(1) 2006 Adobe revenue reflects estimate of organic growth excluding Macromedia contribution
(2) IDC forecast in 2009 used for software spending / Historical is BEA data

Source: Robert Coen, Universal McCann, Insider's Report; US Bureau of Economic Analysis; IDC; Factset; Citi Investment Research and Analysis

Adobe has consistently been questioned about the lack of consistent maintenance revenue. While that ratio should change with the Omniture acquisition, it is worth noting that the lack of stable maintenance revenue worked against the company in the downturn. Most software peers were able to buffer results from their balance sheet. Adobe results did not benefit from the smoothing effect of deferred revenue and thus generated more volatile results. That dynamic flips with a recovery. Catering largely to a corporate and government customer base, Adobe's Acrobat (Knowledge Worker segment) and Livecycle products should also benefit from a loosening of enterprise budgets.

Point #4: Steve Jobs has given you an entry point

Adobe has historically been held up by investors as an example of a growth company with exposure to long-term positive secular trends. These include the expected rapid growth of online and dynamic online content, growth in rich Internet applications (RIAs), the movement towards paperless processing, the proliferation of content and application to a multitude of devices (mobile, TV, game consoles, etc.) and workflows in enterprise and government. As we note later, we believe the secular arguments here are complicated and not as straight forward. At times, when the stock is high-flying, these issues have tempered our view of the shares.

Fortunately in the last three weeks, controversy have heated up significantly in these areas. On January 27th, Apple introduced its new "iPad", a mobile computing device that combines features of a netbook, e-book reader and portable media player into a tablet-like form factor. More importantly, the device has an Apple logo and thus instant legitimacy in the market. The device lacks a Flash Player, which is Adobe's run-time for rendering video and other rich Internet content. Despite the Flash Player today having 98% coverage of PCs as well as all smartphones (except Apple's iPhone), lack of Flash on the iPad has created significant controversy.

Moreover, in the week after the iPad release, Apple CEO Steve Jobs was quoted at an Apple employee town hall meeting as say Adobe was "lazy", that Adobe has the "potential to do interesting things but they just refuse to", that "Whenever a Mac crashes, more often than not its because of Flash" and lastly that "no one will be using Flash…the world is going to HTML 5". This has fueled every IT pundit to opine on the virtues of HTML 5 and the generic trend of standards (such as HTML 5) making proprietary technology (such as Flash) obsolete.

We are thoroughly convinced there will be no movement of web standards in the next 5-10 years that will impact Adobe's near ubiquity of Flash in browsers and other environments.

We will tackle this question in more detail in the future, as we believe it is difficult to do justice in this format. However we are thoroughly convinced there will be no movement of web standards in the next 5-10 years that will impact Adobe's near ubiquity of Flash in browsers and other environments. There are two simple reasons we point to.

1. Thus far, the HTML 5 standards efforts have been unable to agree on a consistent means of decoding video. Without addressing video (which is clearly the most important growth media on the Internet), HTML 5 will go nowhere as a standard.

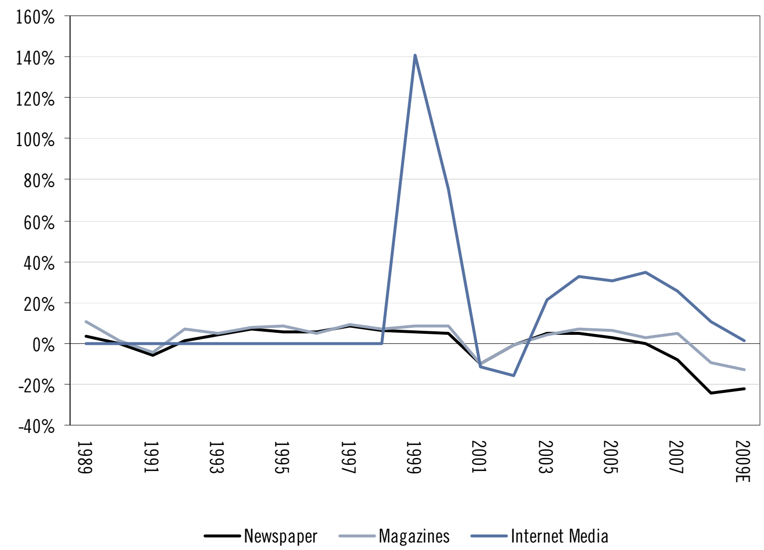
2. Updating of the browser installed base takes an extraordinarily long-time. As an example, despite automatic update mechanisms that have been in place for 5+ years, Internet Explorer 6 is still one of the most broadly used versions of the Internet Explorer browser according to browser research vendor Netapplications.com. Without HTML 5 having the kind of ubiquity that Flash has today (98% penetration), there is no way content producers will rely on the native browser capability for rendering of video or other dynamic content that today is done in the Flash Player.

Thus "Thanks Mr. Jobs!" His comments and the fanfare in the press have contributed to Adobe shares down 10-15% since investors started speculating on the details of Apple's iPad. We believe this has provided an entry point for investors looking to play trend in the business that are likely to drive the stock over the next 12-18 months.

We believe the fundamental changes underway in the publishing, media and advertising markets industries make it more difficult for Adobe to benefit from natural secular growth in the end markets as it did previously.

As has been laid out, the principle driver of near term share appreciation will likely be the success of the CS5 product cycle. However, the bullish short-term view of ADBE shares is not without longer term concerns. Over the next decade the secular changes that are currently underway are likely to present significant business challenges for the company. In a nutshell, we believe the fundamental changes underway in the publishing, media and advertising markets industries make it more difficult for Adobe to benefit from natural secular growth in the end markets as it did previously. As displayed in Figure 9, the secular changes are manifested in newspapers and magazines industry revenue shrinking and ad campaigns being designed for the web and mobile devices first, with a print or television campaign being a secondary consideration. We note that today, the company's CS revenue is correlated to both traditional print advertising as well as online advertising. Some might argue that Adobe's position in online media is just as strong as it is in print, we would disagree. While it may seem subtle, the inherent immaturity of online media should lead investors to question whether there is a role for Adobe that is economically equivalent to the company's position in the traditional media world. If the answer is "yes", then the secular growth story will remain on track over the long-term.

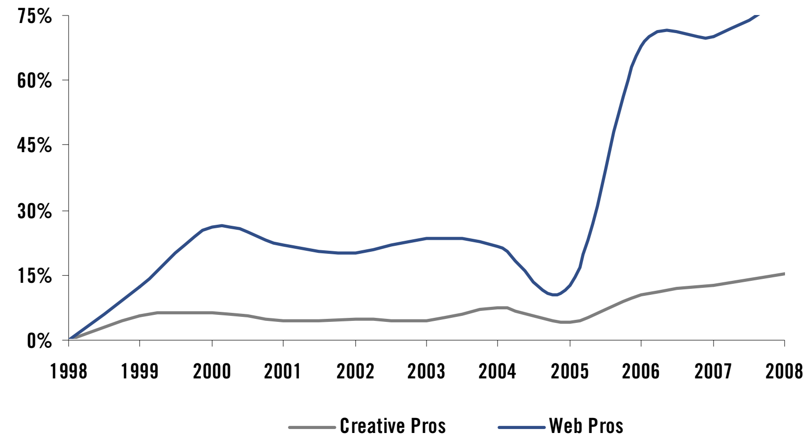
Figure 9. Growth in print and internet advertising



Source: Robert Coen, Universal McCann, Insider's Report; Citi Investment Research and Analysis

The company has also seen a flattening in the growth of its core user demographic. The population of print-based creative professionals has grown at a slower rate than overall U.S. job market over the past five years, however combined with web-focused counterparts; the pace of growth has been significantly higher. There is a shift taking place within the creative professional base from traditional print media creators to individuals with a combination of design and web skill. While still a relatively small base compared to print-based designers, the growth rates of these two employment bases have veered in different directions with print showing little to no growth and web increasing at a significantly higher rate.

Figure 10. Growth Index (Print versus Web)



Source: Bureau of Labor Statistics, Citi Investment Research and Analysis

The traditional content creation process in traditional media is very mature and Adobe's position in these markets is well solidified.

The traditional content creation process in traditional media is very mature and Adobe's position in these markets is well solidified. For example, Photoshop is, and will likely remain, the de-facto standard for image manipulation. Illustrator holds a similar position with graphic design and InDesign has grown to dominate the page layout market. This triumvirate of products benefits from relative price inelasticity and they comprise the core of the design editions of Creative Suite. The primary competition these products face is against older versions that customers already own versus an upgrade to the latest version of the product.

In the Internet and new media arena, Adobe has two important franchises in Flash and Dreamweaver. However, these two products and the Web versions of the Creative Suites do not hold the de facto standard status that the analogous Design products hold. Dreamweaver, which is in many ways analogous to InDesign, is one of many tools that can be used for web site creation. Alternatives range from open source or otherwise free tools such as NVU and Aptana to Microsoft's FrontPage. Similarly, while Flash is analogous to Illustrator, there are other ways to author dynamic content (JavaScript and increasingly native HTML). There is no arguing with Photoshop's status in both traditional and online media, although we'd argue the importance of Photoshop is not increased by the transition from traditional to online media. The company's Premiere video franchise does not hold de-facto leadership of its market like Photoshop, but the product is becoming more important as the cost of video capture decreases.

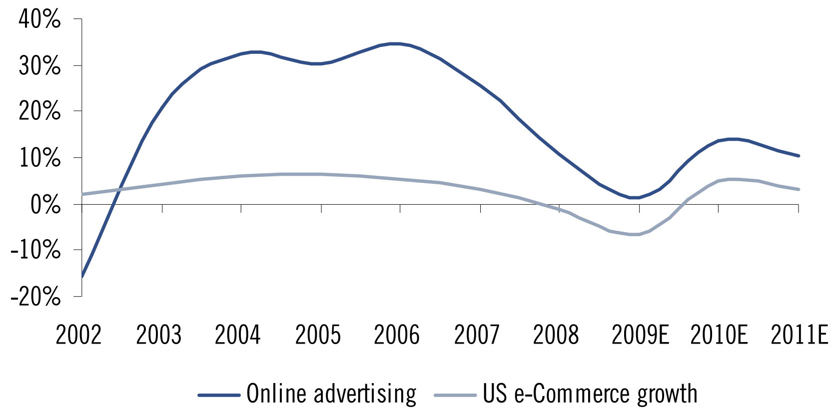
In the last several years, Adobe has attempted to expand from its web designer customer base into the developer market with a new desktop platform (AIR) and with the CS5 launch a version of Flash (Flash Catalyst) that makes it easier to develop true web-based applications (as exposed to dynamic web content, animation and video). Web-based software development, such as where Adobe is focused, is a growth business. Legacy applications are slowly but deliberately being replaced by browser-based applications with superior user interface design being a key reason organizations are moving in this direction. The challenge is in monetization of a developer business. For developers, the content creation tool is the integrated development environment (IDE). Eclipse, the most broadly deployed IDE, is open source, and most companies (including Adobe) either give away a plug-in to Eclipse, or sell their plug-in at a price low enough to entice developers to adopt their platform. As a result, the model most familiar to Adobe for monetizing content creation – one of selling the content creation tools – does not work for developer customers. Going forward, we don't see this dynamic changing. This is due to the fact that the number of software development frameworks has consolidated, leaving a battle among a few technology superpowers (Microsoft, Google, IBM, Oracle). These superpowers are very willing to trade upfront monetization of developers for platform "enrollment" and the ability to monetize them somehow in the future.

The shift from traditional to online media has become obvious, while the challenges making money selling to developers will likely become move obvious over the next 12-18 months as Google releases a desktop operating system (ChromeOS) and Microsoft fully rolls out its suite of cloud-based services targeted at developers (Azure). While growth in online content is certain from a secular basis, there remains uncertainty surrounding Adobe to monetize content creation in online media the way it was able to in traditional media. This backdrop is what we believe has Adobe looking outside of its core content creation market opportunity for long-term growth. As we discuss next, we can not yet conclude the company's fate as it moves aggressively into new market opportunities to drive growth. In fact Adobe has historically been a visionary company that has foreseen changes coming on the horizon far enough in advance to respond offensively. However, we do believe investors should recognize that the company is entering a new phase, one where there is more risk to success and one where success is needed in some part simply to maintain the company's existing growth potential.

Point #5: Omniture Levered to Recovery in Online Trends, Driving Additional Accelerating Growth

The web analytics market like much of the IT landscape stagnated during the economic downturn. The market grew 17% in 2008 (IDC), with Omniture growing significantly above that mark at 27%. The Omniture business saw its topline growth slowly drop to the low teens in 2009. Near term reacceleration of the web analytics market will depend largely on the economic landscape and IT spending. With economics forecast improving and modest improvements in enterprise IT budgets, return to past growth rates appears likely. As the market leader in the space, we believe Omniture will be best positioned to capture growth in the market. Integration into the content creation workflow should only improve its technological advantage.

Figure 11. U.S. Internet Advertising and eCommerce Growth



Source: PricewaterhouseCoopers/Interactive Advertising Bureaualysis

Omniture Acquisition Accretion Not a Meaningful Driver

Looking deeper at Omniture, we believe there are several important factors to consider. The deal is financially accretive, although we believe Adobe shares already price in this accretion. Offsetting this accretion, the share multiples of acquisitive software companies are generally lower than those that are not (Microsoft trades at premium to Oracle, Symantec at discount to less acquisitive security peers McAfee and Check Point). We believe the primary impact of the deal on Adobe's valuation will be whether Adobe can accelerate the growth rate of Omniture or whether Adobe falls victim to execution and integration pitfalls like many other acquisition integration efforts in software.

The table below outlines a simple analysis that concludes the acquisition is $0.05 accretive to 2010 Adobe earnings. Our sensitivity analysis suggests the range is $0.05-0.07, depending on operating expense efficiencies and Omniture's revenue growth rate within the Adobe organization. The potential for accretion upside is more likely to manifest in FY11 as the company is further along in the integration. Much like the Macromedia integration, the true synergies will be realized upon the release of a completely integrated set of tools that seamlessly incorporate SiteCatalyst with Adobe's suite of tools, likely beyond CS5.

Figure 12. Omniture Accretion

	F10E	F11E	F12E
Omniture revenue	$364	$440	$533
Revenue synergy	$0	$0	$0
Total OMTR revenue	$364	$440	$533
Cost of goods	($127)	($154)	($187)
Gross profit	$236	$286	$347
Gross margin %	65%	65%	65%
Operating expenses	($182)	($216)	($256)
Operating income	$55	$70	$91
Operating margin %	15%	16%	17%
Tax rate	24%	24%	24%
Incremntal income	$41	$54	$69
Lost interest income	($13)	($13)	($13)
Accretion	$28	$40	$56
Diluted shares outstanding	527	517	505
EPS accretion	**$0.05**	**$0.08**	**$0.11**

Source: Citi Investment Research and Analysis

Medium-Term Benefit from Product and Selling Synergies

In order to create a true value incentive for customers, Adobe needs to better integrate Omniture into the workflow between the content creators, advertising networks and the delivery networks.

In order to create a true value incentive for customers, Adobe needs to better integrate Omniture into the workflow between the content creators, advertising networks and the delivery networks.

- Omniture tags automatic in Flash. We've heard that extracting data from Flash is much harder (difficult for Google crawlers too)
- Improve the value proposition of Flash for developers and content owners. Native analytics as a feature gives the platform step up vs Silverlight, etc.
- Build analytics native in Flash media server which would compel content publishers to buy. Currently no video server has adequate reporting and analytics built in.

One of the primary benefits that should drive revenue synergies will be the ability to sell Omniture's domestically focused product line into Adobe's global channel. At the time of the acquisition, Omniture's revenue generated outside of the US accounted for a quarter of sales, whereas Adobe gets half of their sales from abroad.

The Adobe Creative Suite's role as the dominant media creation platform should also help drive sales by selling its current customer base. The promise of an embedded product should also drive customer interest much as the company did with its initial Creative Suite. Currently there is little uniformity between developers, designers and agencies when incorporating analytics into web sites and applications.

Adobe's Flash tools will garner most of the revenue synergies to company's existing product line. However, like the potential of its AIR platform, any near term upside would be limited and likely find it way in the broader Creative Solutions segment in form of suite sales.

Is the Omniture Acquisition a Sign of More to Come?

In a nutshell, we believe the answer is yes, but we don't think any moves are imminent and we struggle to find anything large that would make sense.

We believe the motivation here has more to do with Adobe looking to expand its market opportunity forward into areas beyond content creation in the Creative business. Looking at IDC's forecast, Omniture brings a billion dollar market opportunity in web analytics and there are other large markets that are adjacent to Adobe's core content creation market. We expect that this is the first of potentially more moves Adobe will make to establish revenue streams to complement its Creative franchise, given the above-noted dynamics of maturity and slowing growth in Creative.

Adobe's heavy push into the web could result in the need to enter markets adjacent to content creation. As stated by the company, the focus going forward will likely to focus on improvements to the content creation workflow. This could necessitate the need to acquire in areas such as web content management, dynamic advertising placement, mobile advertising or content delivery.

Enterprise Business Holds Long-term Opportunity, But is Not Likely the Biggest Stock Driver in Medium-term

Adobe has a large ($860M) and often overlooked enterprise business, comprised of its Acrobat desktop and LiveCycle server products. While representing 30% of revenue, we don't believe this business has as much potential impact on stock price performance as the Creative and related businesses discussed above.

While for several years we were concerned about a potentially disruptive challenge from Microsoft in this market, we are quite comfortable with the durability of the Acrobat franchise

First, we believe the enterprise market in general is more crowded and the competition is slower to change relative to the more consumer-dependent Creative business. Much like Office in Microsoft's Business Division segment, Acrobat is tied to business PC shipments and information worker employment, which are low-volatility drivers. Signs of product maturity and GDP-like growth have been evident with Acrobat for several years and we don't believe this will change. At the same time, while for several years we were concerned about a potentially disruptive challenge from Microsoft in this market, we are quite comfortable with the durability of the Acrobat franchise. The LiveCycle server products have always amazed us in terms of the potential efficiency benefits they bring in streamlining manual and paper-based processed within vertical markets such as financial services, healthcare and government. However, at the same time, enterprise systems are always slow to modernize and we believe LiveCycle is held back as a result. Growth here comes at a lower margin as it is dependent on a direct sales effort. With revenue that is sub-scale (~$200M as compared to other enterprise software franchises), we believe it will be a while until LiveCycle is a driver of meaningful profits.

We view the most interesting opportunity for Adobe within enterprise as its potential to ride the wave of growth in online collaboration. The combined Acrobat and Flash platform has already emerged as a foundation for collaboration, especially in vertical markets such as legal, government, education and others. The Acrobat Connect online meeting service has seen strong growth since the Macromedia acquisition (where it was previously branded "Breeze"). However, at $654M in revenue (FY09), despite solid double-digit growth potential, this business is not likely to be a significant needle-mover. We do believe Adobe could be a consolidator in this market through acquisition and this remains a possible avenue for inorganic growth, although as we note above, we'd expect that Creative-related services bring a larger market opportunity and therefore are the more likely use of scarce M&A capital.

Company Background

Founded in 1982, Adobe is one of largest software companies in the world. They are the leading provider of digital imaging and print publishing products. With the acquisition of Macromedia in 2005 and Omniture in 2009, Adobe is also a leading provider of web development tools and online analytics software. The company is mostly well known for its Photoshop photo editing tool and the ubiquitous PDF and Flash platforms.

The company's products are sold to a wide variety of customers including individuals (professionals and hobbyist), small creative firms (design studios, ad agencies, etc.) as well as large companies, government agencies and educational institutions.

The company is led by CEO Shantanu Narayen who has been in the role since late 2007, but served in many roles since joining the company in 1998. The management team and employee base has been stable, driving consistent product releases and above market growth. Going into the 2008-9 recession, the company appeared overly optimistic in setting guidance, but responded quickly by cutting costs in order to preserve operating margins. Since this time, the company has set relatively conservative targets and delivered results inline or better than forecasted levels.

Figure 13. Adobe Revenue by Product Area

Revenue segment	Major products	Competition	% of revenue (FY09)	Growth	Profitability profile
Creative Solutions	Creative Suite, Photoshop, InDesign, Illustrator, Flash	Corel, Microsoft	60%	10-15%	Well above corporate average
Business Productivity	Acrobat, LiveCycle	Nuance, NitoPDF	30%	8-12%	Below corporate average
Omniture	NetBackup, Backup Exec, Enterprise Vault, Storage Foundation	Webtrends, Coremetrics, Google	0% (recently acquired)	15-30%	Below corporate average
Other	PDF, Flash Player	Microsoft, Apple, HMTL	10%	2-5%	Well below corporate average

Source: Citi Investment Research and Analysis

Valuation Description

Stocks generally trade on the basis of an expectation of future cash flows and some notion of the certainty or risk to those future cash flows. We believe software companies are no different. This generally translates into a focus on valuation on the basis of forward 12-month earnings or cash flow.

Focus on earnings and cash flow

Earnings may be over-relied on, but it will likely remain the primary valuation metric for some time. While consensus cash flow estimates are just starting to be aggregated, most investors use cash flow mostly as a quality screen for earnings.

We suggest using cash flow multiples for companies where accounting policies drive a significant difference between earnings and cash flow. In general, software companies look cheaper when valued on an Price/FCFE basis as compared to a P/E basis because 1) cash is generally collected from customers before it is recognized as revenue, and 2) cash taxes are generally much less than accrued taxes. In the case of Adobe, other than above discussed dynamic that is broadly applicable to all software companies, there is no reason to focus on cash flow-based valuation.

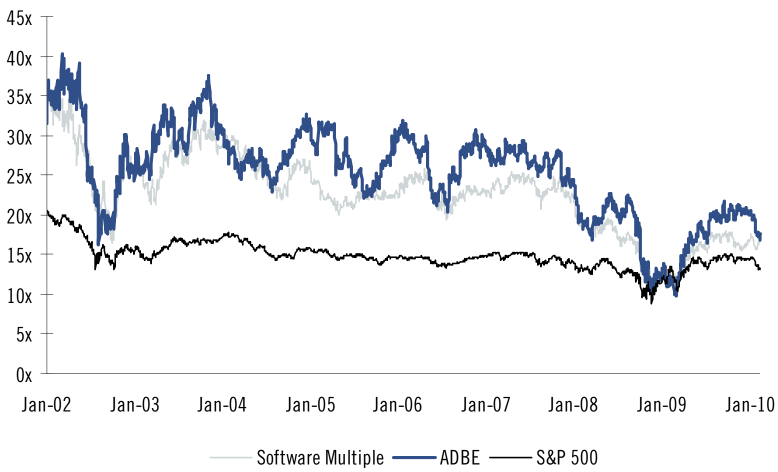
We believe the risk here is falling into the trap of over-paying for high growth companies which are unlikely to be able to sustain above-market growth when it comes time to focus on profit generation.

Many times investors rely upon revenue-based valuations in high growth segments of the market. We believe the risk here is falling into the trap of over-paying for high growth companies which are unlikely to be able to sustain above-market growth when it comes time to focus on profit generation. Many investors also rely on discounted cash flow or the value of maintenance revenue. We believe all of these approaches have their place, generally in identifying stocks that have been oversold. However, given recent strong stock performance in the software sector, most shares are trading at a premium to conservative long-term DCF valuations, including the long-term value of maintenance.

Software Has Generally Traded at Premium Multiple vs. S&P 500

Over the last decade or more, the software sector has generally traded at a premium to the S&P 500. We believe this reflects growth that has been in excess of GDP for several decades, a predictable business model (due to maintenance revenue) and returns on capital (37%) that are well above the average S&P500 company (18%). While we believe the secular growth argument is becoming harder to make, we believe the other two characteristics will remain, keeping industry multiples at a premium to the market.

Figure 14. Adobe Valuation Relative to S&P 500 and Software Peers



Source: FactSet, Citi Investment Research and Analysis

ADBE Trades at a Meaningful Premium to Peers

Figure 15. Adobe Comparable Company Universe

COMPANY	CIRA RATING	Target Price	PRICE 2/12/10	ENTERPRISE VALUE	REVENUE GROWTH '09A - '10E	ENTERPRISE VALUE AS MULTIPLE OF REVENUE CY10E	CY11E	PRICE AS A MULTIPLE OF FCFE CY10E	CY11E	P/E CY10E	CY11E
ADBE	1M	$39.00	$31.45	$15,754	21%	4.3x	4.0x	12.1x	11.8x	16.9x	14.6x
AAPL	1H	$300.00	$200.38	$158,282	25%	2.8x	2.3x	13.3x	12.1x	16.6x	14.3x
ADSK	NC	--	$24.22	$4,644	2%	2.6x	2.3x	16.3x	NA	22.3x	16.7x
AKAM	1H	$31.00	$25.33	$4,412	15%	4.5x	4.0x	13.3x	11.1x	19.3x	16.9x
ANSS	NC	--	$41.59	$3,654	10%	6.5x	5.7x	16.6x	NA	21.8x	19.0x
DASTY	NC	--	$53.60	$5,460	6%	2.9x	2.6x	NM	NA	18.4x	16.4x
INTU	NC	--	$29.39	$9,355	6%	2.7x	2.5x	11.9x	NA	14.6x	12.9x
MSFT	1L	$31.00	$27.93	$225,557	6%	3.5x	3.3x	10.8x	10.0x	13.1x	12.1x
NUAN	NC	--	$14.45	$4,023	21%	3.3x	3.0x	13.2x	NA	12.3x	10.9x
ORCL	NC	--	$23.41	$117,707	18%	4.1x	3.7x	12.0x	NA	13.9x	12.2x
PMTC	NC	--	$16.62	$1,773	8%	1.7x	1.6x	13.4x	NA	16.5x	13.0x
SAP	NC	--	$42.99	$48,684	2%	3.1x	2.9x	15.4x	14.1x	15.1x	13.6x
				Mean		**3.4x**	**3.1x**	**13.6x**	**11.8x**	**16.7x**	**14.4x**
				Median		**3.1x**	**2.9x**	**13.3x**	**11.6x**	**16.5x**	**13.6x**
				Software Group Mean		**3.2x**	**2.9x**	**17.1x**	**14.4x**	**20.6x**	**18.8x**
				Software Group Median		**2.9x**	**2.6x**	**13.5x**	**12.6x**	**16.5x**	**14.2x**

Source: FactSet, Citi Investment Research and Analysis

Within the sector, there appear to be several factors that contribute to the multiple investors are willing to pay for its shares. Below, we noted what we believe consensus is embedding in the shares when assigning a multiple, as well as to whether we agree or disagree with this consensus view.

Figure 16. Factors Impacting Adobe's Share Multiple

Driver of share multiple	Consensus view	Citi Investment Research & Analysis commentary
Earnings growth potential and quality of earnings	Positive	We agree with consensus here. In general, investors view Adobe as a growth story. We believe this will be endorsed with anniversary into easy comps and a new product cycle.
Earnings momentum	Neutral	We are more bullish than the consensus here as we expect the market to begin focusing more squarely on CS5 driven earnings upside.
Impact of industry consolidation	Neutral	We agree with the consensus view here as we believe Adobe is likely too large to be acquired. Likewise, we don't see significant consolidation moves in the industry that will leave Adobe in a worse position.
Impact of secular trends	Negative	We are more bullish than consensus here. The market is overly focused on secular concerns in the web standards are (Flash vs. HTML 5). We expect this controversy to fade as we don't expect there to be significant further evidence to endorse the idea of short or medium-term risk to the position of Flash.

Source: Citi Investment Research and Analysis

Based on our dissection of the contributors to Adobe's multiple, expectations likely embedded in consensus and our view, we expect that Adobe's multiple has an upward bias in the range of 10-20% as the company delivers upside surprises associated with 2010 CS5 product cycle.

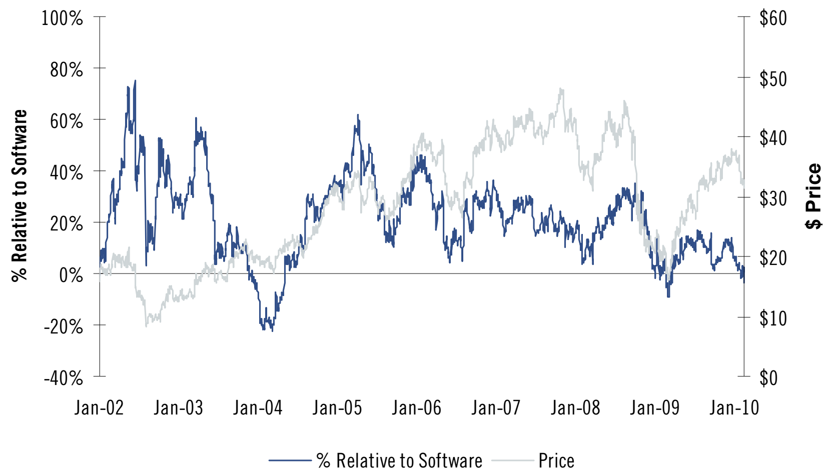
Our $39 price target is based on 21x 2010 EPS, which is still well below peak multiples in prior product cycles.

Recent Price Performance of Shares

We believe the more significant driver of this time period has been the previously noted HTML 5 vs. Flash controversy generated with the announcement of the iPad.

Adobe shares outperformed software peers in early-mid 2009 during the first phase of the market recovery (March-August). During this period, investors gravitated towards highly cyclical companies. Since August, the shares have underperformed the market as investors focused on stocks with high correlation with a potential budget flush in enterprise spending in the fourth calendar quarter of 2009. Trading action thus far in 2010 is consistent with other cyclicals and shares have traded off since mid-January. We believe the more significant driver of this time period has been the previously noted HTML 5 vs. Flash controversy generated with the announcement of the iPad.

Figure 17. Adobe Share Performance Relative to Software Peers



Source: FactSet, Citi Investment Research and Analysis

Figure 18: CIRA Estimates

	FY09	FY10	FY11	Key assumptions for FY10 and FY11
Total revenue	$2.95B	$3.61B	$3.93B	• Strong product cycle coupled with improving economic landscape • ~$300M in acquired revenue from Omniture in FY10 numbers
Y/Y growth	-18%	23%	9%	
Creative Solutions	$1.7B	$1.93B	$2.03B	• Expect strong CS5 product cycle 16% cycle over cycle growth • Driven by pent up demand, better economic landscape and potential price uplift
Y/Y growth	-18%	13%	5%	
Business Productivity	$859M	$953M	$1.07B	• Rebound in enterprise spending should benefit Livecycle and Acrobat product lines.
Y/Y growth	-19%	11%	13%	• Growth in web conferencing
Omniture	$26M	$364M	$440M	• Revenue will improve as impact from deferred write-down lessens over time
Y/Y growth	NA	NM	21%	• Potential revenue synergy from cross-selling
Other	$359M	$365M	$390B	• Print / Publishing tools should also benefit from new product launch • Platforms continue to drive incremental "Toolbar" revenue
Y/Y growth	9%	2%	2%	
Gross margins %	92%	90%	90.6%	• Omniture pro-serv business will cause short term drag on margins
Operating expenses	$1.68B	$1.98B	$2.12B	• OpEX will increase as the company takes on additional cost associated with OMTR
Y/Y growth	-11.8%	17.8%	7.1%	• Expect higher R&D run rate with development of integrated product line • 9% RiF will benefit profitability in 2H
Operating margin %	35.1%	35.3%	36.8%	• Margins will scale with revenue as company is unable to spend upside at same pace
Other income / expense	$28M	$1.8M	$8.5M	• New $1.5B debt financing will result in higher interest expense
Tax rate	23.4%	24%	24%	• Tax rate essentially flat at 24%
Share outstanding (in millions)	530.6	526.9	516.7	• Expecting average buyback of $100M/Q in FY10 and $125M in FY11
EPS	$1.54	$1.84	$2.14	• FY09 had weak product and had macro headwinds • Profits growing inline or better than sales + share buyback
Y/Y growth	-25.8%	19.6%	16.5%	
Operating cash flow	$1.12B	$1.37B	$1.41B	• Strength of earnings will drive cash flow • Strong deferred revenue growth • Weak FY09 bookings provide easy comps
Y/Y growth	-13%	23%	3%	
Unlevered free cash flow	$977M	$1.25B	$1.27B	• $120M in CAPEX in FY10 and $140M in FY11 • Added debt on balance sheet will benefit unlevered cash flow
Y/Y growth	-14.5%	28.2%	1.1%	

Source: Company Reports, Citi Investment Research and Analysis

Figure 18. Adobe Income Statement (in millions)

(FY NOV)	F08A	Feb 09A	May 09A	Aug 09A	Nov 09A	F09A	Feb 10E	May 10E	Aug 10E	Nov 10E	F10E	F11E	F12E
Creative Solutions	**$2,073.0**	**$460.7**	**$411.7**	**$400.4**	**$429.3**	**$1,702.1**	**$434.0**	**$461.0**	**$492.0**	**$541.0**	**$1,928.0**	**$2,028.0**	**$2,013.0**
% Change Y/Y	9%	-15%	-22%	-19%	-16%	-18%	-6%	12%	23%	26%	13%	5%	-1%
Business Productivity Solutions	**1064.0**	**227.0**	**209.7**	**210.0**	**211.8**	**858.5**	**220.4**	**234.4**	**243.1**	**254.6**	**952.5**	**1073.7**	**1140.3**
Knowledge Worker Solutions	810.9	163.1	156.0	154.5	149.3	622.9	152.4	164.4	166.1	169.6	652.5	706.8	718.4
% Change Y/Y	11%	-17%	-21%	-29%	-25%	-23%	-7%	5%	8%	14%	5%	8%	2%
Enterprise and Developer Solutions	253.1	63.9	53.7	55.5	62.5	235.6	68.0	70.0	77.0	85.0	300.0	366.9	421.9
% Change Y/Y	32%	18%	-1%	-15%	-21%	-7%	6%	30%	39%	36%	27%	22%	15%
Omniture					**26.3**	**26.3**	**81.0**	**89.1**	**94.7**	**98.7**	**363.5**	**440.3**	**533.4**
% Change Y/Y					--	--	--	--	--	NM	NM	21%	21%
Other	**442.9**	**98.7**	**83.3**	**87.1**	**89.9**	**359.0**	**90.0**	**89.0**	**92.0**	**94.0**	**365.0**	**390.0**	**406.0**
% Change Y/Y	31%	2%	-22%	-21%	-30%	-19%	-9%	7%	6%	5%	2%	7%	4%
Total revenue	**3579.9**	**786.4**	**704.7**	**697.5**	**757.3**	**2945.9**	**825.4**	**873.5**	**921.8**	**988.3**	**3609.0**	**3932.0**	**4092.7**
% Change Y/Y	13%	-12%	-21%	-21%	-17%	-18%	5%	24%	32%	31%	23%	9%	4%
Product revenue	$3,396.5	$742.2	$660.1	$649.9	$707.3	$2,759.4	$772.4	$818.5	$864.8	$929.3	$3,385.0	$3,676.0	$3,804.7
Services and support	183.3	44.2	44.6	47.6	50.0	186.5	53.0	55.0	57.0	59.0	224.0	256.0	288.0
Cost of revenues													
Product	(149.2)	(44.5)	(41.5)	(35.4)	(46.3)	(167.7)	(61.8)	(65.5)	(69.2)	(69.7)	(266.2)	(266.4)	(266.3)
Service and support	(92.0)	(18.3)	(14.9)	(15.1)	(17.1)	(65.3)	(23.9)	(24.8)	(22.8)	(23.6)	(95.0)	(102.4)	(100.8)
Total cost of revenues	(241.3)	(62.9)	(56.4)	(50.5)	(63.3)	(233.1)	(85.6)	(90.2)	(92.0)	(93.3)	(361.2)	(368.8)	(367.1)
Gross profit	3,338.6	723.5	648.3	647.0	694.0	2,712.8	739.7	783.3	829.8	895.0	3,247.8	3,563.1	3,725.5
Gross margin	93.3%	92.0%	92.0%	92.8%	91.6%	92.1%	89.6%	89.7%	90.0%	90.6%	90.0%	90.6%	91.0%
Research and development	(586.8)	(127.8)	(121.9)	(120.2)	(120.8)	(490.6)	(142.0)	(146.0)	(147.0)	(150.0)	(585.0)	(622.0)	(650.0)
% Total Revenue	16.4%	16.3%	17.3%	17.2%	15.9%	16.7%	17.2%	16.7%	15.9%	15.2%	16.2%	15.8%	15.9%
Sales, marketing and support	(1,030.9)	(235.7)	(228.3)	(217.2)	(241.4)	(922.6)	(265.8)	(267.3)	(264.2)	(285.7)	(1,082.9)	(1,169.9)	(1,224.0)
% of revenue	28.8%	30.0%	32.4%	31.1%	31.9%	31.3%	32.2%	30.6%	28.7%	28.9%	30.0%	29.8%	29.9%
General and administrative	(285.4)	(65.1)	(60.4)	(72.5)	(66.6)	(264.5)	(76.6)	(77.6)	(76.6)	(77.6)	(308.3)	(325.3)	(338.3)
% Total Revenue	8.0%	8.3%	8.6%	10.4%	8.8%	9.0%	9.3%	8.9%	8.3%	7.9%	8.5%	8.3%	8.3%
Total operating expenses	(1,903.1)	(428.6)	(410.6)	(409.9)	(428.7)	(1,677.8)	(484.4)	(490.8)	(487.8)	(513.3)	(1,976.2)	(2,117.2)	(2,212.4)
% of revenue	53.2%	54.5%	58.3%	58.8%	56.6%	57.0%	58.7%	56.2%	52.9%	51.9%	54.8%	53.8%	54.1%
% Change Y/Y	10.1%	-9.2%	-14.4%	-13.7%	-10.1%	-11.8%	13.0%	19.5%	19.0%	19.7%	17.8%	7.1%	4.5%
% Change Q/Q		-10.1%	-4.2%	-0.2%	4.6%		13.0%	1.3%	-0.6%	5.2%			
Operating income	$1,435.5	$295.0	$237.7	$237.1	$265.2	$1,035.0	$255.3	$292.4	$342.1	$381.8	$1,271.6	$1,445.9	$1,513.1
% of revenue	40.1%	37.5%	33.7%	34.0%	35.0%	35.1%	30.9%	33.5%	37.1%	38.6%	35.2%	36.8%	37.0%
% Change Y/Y	18.7%	-17.8%	-32.0%	-32.6%	-29.3%	-27.9%	-13.4%	23.0%	44.3%	43.9%	22.9%	13.7%	4.6%
% Change Q/Q		-21.3%	-19.4%	-0.3%	11.9%		-3.7%	14.5%	17.0%	11.6%			
Other income, net	33.8	12.5	4.2	6.2	5.1	28.0	(0.2)	0.2	0.6	1.2	1.8	8.5	14.8
Income before income taxes	1,469.3	307.5	241.9	243.3	270.3	1,063.0	255.1	292.6	342.7	382.9	1,273.4	1,454.4	1,528.0
Provision for income taxes	(333.5)	(70.7)	(56.9)	(57.2)	(63.5)	(248.2)	(61.2)	(70.2)	(82.2)	(91.9)	(305.6)	(349.1)	(366.7)
Tax rate (%)	22.7%	23.0%	23.5%	23.5%	23.5%	23.4%	24.0%	24.0%	24.0%	24.0%	24.0%	24.0%	24.0%
Net income	$1,135.8	$236.7	$185.0	$186.1	$206.9	$814.7	$193.9	$222.4	$260.4	$291.0	$967.8	$1,105.3	$1,161.3
Net income margin %	31.7%	30.1%	26.3%	26.7%	27.3%	27.7%	23.5%	25.5%	28.3%	29.4%	26.8%	28.1%	28.4%
Diluted shares outstanding	548.6	527.8	528.0	531.8	532.0	530.6	530.0	528.2	526.4	524.6	527.3	517.7	506.8
Pro-forma EPS *	**$2.07**	**$0.45**	**$0.35**	**$0.35**	**$0.39**	**$1.54**	**$0.37**	**$0.42**	**$0.49**	**$0.55**	**$1.84**	**$2.14**	**$2.29**
% Change Y/Y	28.0%	-6.1%	-30.3%	-29.6%	-35.2%	-25.8%	-18.4%	20.1%	41.4%	42.7%	19.5%	16.3%	7.3%
% Change Q/Q		-25.3%	-21.9%	-0.1%	11.1%		-5.9%	15.1%	17.5%	12.1%			

* EPS excludes non-recurring items and stock-based compensation

Source: Citi Investment Research and Analysis

Figure 19. Adobe Balance Sheet (in millions)

(FY NOV)	F08A	Feb 09A	May 09A	Aug 09A	Nov 09A	F09A	Feb 10E	May 10E	Aug 10E	Nov 10E	F10E	F11E	F12E
Assets													
Cash and cash equivalents	$886.5	$1,148.9	$1,226.8	$1,132.1	$999.5	$999.5	$1,180.6	$1,402.0	$1,682.7	$1,852.7	$1,852.7	$2,625.1	$3,437.1
Short-term investments	1,132.8	1,234.8	1,437.4	1,424.3	905.0	905.0	905.0	905.0	905.0	905.0	905.0	905.0	905.0
Trade receivables, net	467.2	300.0	262.6	281.8	410.9	410.9	443.8	411.3	340.0	441.7	441.7	426.6	504.5
Other receivables	45.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deferred income taxes	110.7	81.1	76.9	72.2	77.4	77.4	77.4	77.4	77.4	77.4	77.4	77.4	77.4
Other current assets	92.1	104.1	84.1	80.5	80.9	80.9	80.9	80.9	80.9	80.9	80.9	80.9	80.9
Total current assets	2,735.1	2,869.0	3,087.8	2,990.9	2,473.6	2,473.6	2,687.7	2,876.6	3,085.9	3,357.6	3,357.6	4,114.9	5,004.8
Property and Equipment, net	313.0	300.4	291.7	335.8	388.1	388.1	371.6	357.0	344.1	332.8	332.8	316.4	323.2
Goodwill and other intangibles, net	2,134.7	2,132.4	2,135.0	2,125.9	3,468.2	3,468.2	3,468.2	3,468.2	3,468.2	3,468.2	3,468.2	3,468.2	3,468.2
Purchased and other intangibles	215.0	181.5	148.5	117.4	527.4	527.4	474.6	427.2	384.5	346.0	346.0	227.0	148.9
Investment in Lease Receivable	207.2	207.2	207.2	207.2	207.2	207.2	207.2	207.2	207.2	207.2	207.2	207.2	207.2
Other Assets	216.5	197.1	193.5	184.7	191.3	191.3	191.3	191.3	191.3	191.3	191.3	191.3	191.3
Total Assets	5,821.6	5,887.6	6,063.7	5,962.0	7,255.8	7,255.8	7,400.6	7,527.4	7,681.2	7,903.1	7,903.1	8,525.0	9,343.6
Liabilities and stockholders' equity													
Trade and other payables	55.8	41.4	42.3	48.4	58.9	58.9	55.5	57.5	57.8	67.5	67.5	72.1	74.2
Accrued expenses	400.0	345.7	363.4	349.1	419.6	419.6	486.2	495.6	494.4	517.3	517.3	547.9	572.8
Accrued restructuring	35.7	18.4	11.7	8.2	37.8	37.8	36.8	35.8	34.8	33.8	33.8	29.8	25.8
Income taxes payable	27.1	33.1	11.0	20.3	46.6	46.6	46.6	46.6	46.6	46.6	46.6	46.6	46.6
Deferred revenue	244.0	198.3	185.2	188.3	281.6	281.6	295.7	313.4	329.1	345.5	345.5	372.4	505.9
Current liabilities	762.6	636.9	613.6	614.4	844.6	844.6	920.7	948.9	962.7	1,010.7	1,010.7	1,068.8	1,225.3
Debt	350.0	350.0	350.0	350.0	1,000.0	1,000.0	1,000.0	1,000.0	1,000.0	1,000.0	1,000.0	1,000.0	1,000.0
Deferred revenue	31.4	27.0	28.1	29.9	36.7	36.7	38.6	40.9	42.9	45.1	45.1	48.6	66.0
Deferred income taxes	6.2	114.6	137.2	105.6	252.5	252.5	252.5	252.5	252.5	252.5	252.5	252.5	252.5
Income taxes payable	123.2	120.3	104.5	137.3	223.5	223.5	223.5	223.5	223.5	223.5	223.5	223.5	223.5
Accrued restructuring	117.3	7.0	6.6	5.0	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9	6.9
Other long-term liabilities	20.6	20.7	22.7	25.3	27.5	27.5	29.5	29.5	29.5	29.5	29.5	31.5	33.5
Stockholders' equity	4,410.4	4,611.2	4,801.0	4,694.6	4,864.2	4,864.2	4,928.9	5,025.2	5,163.2	5,335.0	5,335.0	5,893.3	6,535.9
Total liabilities & equity	$5,821.6	$5,887.6	$6,063.7	$5,962.0	$7,255.8	$7,255.8	$7,400.6	$7,527.4	$7,681.2	$7,903.1	$7,903.1	$8,525.0	$9,343.6

Source: Citi Investment Research and Analysis

Figure 20. Adobe Cash Flow (in millions)

(FY NOV)	F08A	Feb 09A	May 09A	Aug 09A	Nov 09A	F09A	Feb 10E	May 10E	Aug 10E	Nov 10E	F10E	F11E	F12E
Operating cash flows													
Net income (loss)	$871.8	$156.4	$126.0	$136.0	($32.0)	$386.5	$119.3	$154.4	$196.4	$230.3	$700.5	$877.5	$972.9
Adjustments													
Depreciation and amortization	270.3	68.7	64.7	63.9	85.0	282.4	99.3	92.1	85.6	79.7	356.7	275.5	231.3
Stock-based compensation expense	172.5	45.6	41.0	39.7	41.4	167.6	45.4	41.9	41.5	41.5	170.3	180.8	169.7
Losses on sale/impairment of investments	(17.4)	15.8	0.7	(3.2)	(1.7)	11.6							
Deferred income taxes	46.6	26.5	(6.5)	2.7	26.9	49.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tax benefit from options	90.4	2.7	0.0	0.0	41.7	44.4							
Provision for losses on receivables	0.0	2.7	0.6	(0.2)	(3.0)	0.0							
Other	4.8	1.6	(0.5)	1.4	2.0	4.4							
Excess tax benefit (stock compensation)	(32.0)	(0.1)	0.0	0.0	(11.9)	(12.0)							
Retirements of property and equipment	0.0	3.2	0.3	0.0	(3.4)	0.0							
Changes in assets and liabilities													
Operating asset and liabilities	(192.1)	92.6	47.2	(8.5)	97.0	228.4	31.0	45.2	71.6	(68.0)	79.8	49.7	(37.4)
Deferred revenue	65.9	(50.0)	(12.0)	4.9	12.0	(45.1)	16.1	17.7	15.7	16.5	65.9	28.9	135.4
Net cash flow from operations	$1,280.7	$365.7	$261.5	$236.7	$253.8	$1,117.7	$311.1	$351.4	$410.7	$300.0	$1,373.2	$1,412.4	$1,472.0
% Change Y/Y	-11.0%	-13.2%	-15.6%	11.8%	-24.9%	-12.7%	-14.9%	34.4%	73.5%	18.2%	22.9%	2.9%	4.2%
Investing cash flows													
Sales and maturities of ST investments	(95.6)	(107.8)	(203.6)	7.6	517.7	213.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Purchases of short-term investments	(2,381.5)	(435.2)	(347.2)	(359.7)	(165.4)	(1,307.4)							
Maturities of short-term investments	1,568.9	137.9	59.8	135.5	130.8	464.0							
Sales of short-term investments	717.1	189.4	83.8	231.7	552.2	1,057.2							
Purchases of property and equipment	(111.8)	(15.9)	(10.3)	(58.4)	(34.9)	(119.6)	(30.0)	(30.0)	(30.0)	(30.0)	(120.0)	(140.0)	(160.0)
Purchases of LT investments	(124.5)	(9.2)	(7.4)	(8.3)	(4.3)	(29.1)							
Cash received for acquisition, net	0.7	0.0	0.0	0.0	0.0	0.0							
Cash paid for acquisition, net	(4.3)	0.0	0.0	0.0	(1,582.7)	(1,582.7)							
Investment in lease receivable	0.0	0.0	0.0	0.0	0.0	0.0							
Additions to other assets	0.0	0.0	3.0	0.3	(0.5)	2.8							
Proceeds from the sale of equity securities	30.7	1.4	0.5	3.0	12.8	17.7							
Issuance costs for credit facility	0.0	0.0	0.0	0.0	0.0	0.0							
Net cash flow from investing	($304.7)	($131.6)	($217.8)	($55.9)	($1,092)	($1,497)	($30.0)	($30.0)	($30.0)	($30.0)	($120.0)	($140.0)	($160.0)
Financing cash flows													
Purchases of treasury stock	(1,722.7)	(0.0)	0.0	(350.0)	(0.0)	(350.0)	(100.0)	(100.0)	(100.0)	(100.0)	(400.0)	(500.0)	(500.0)
Proceeds from issuance of treasury stock	319.2	28.6	20.2	73.4	57.3	179.6							
Repayment of borrowings	(450.0)	0.0	0.0	0.0	(13.9)	(13.9)							
Borrowings under credit facility	800.0	0.0	0.0	0.0	650.0	650.0							
Excess tax benefit (stock compensation)	32.0	0.1	0.0	0.0	11.9	12.0							
Net cash flow from financing	($1,021.6)	$28.7	$20.2	($276.6)	$705.4	$477.7	($100.0)	($100.0)	($100.0)	($100.0)	($400.0)	($500.0)	($500.0)
Effect of F/X	(14.4)	(0.4)	13.9	1.2	0.0	14.7							
Net increase in cash & equivalents	(59.9)	262.5	77.8	(94.6)	(132.7)	113.0	181.1	221.4	280.7	170.0	853.2	772.4	812.0
Billings (Revenue + ? in deferred)	$3,645.8	$736.4	$692.7	$702.4	$769.3	$2,900.7	$841.4	$891.3	$937.5	$1,004.8	$3,674.9	$3,960.9	$4,228.1
% Change Y/Y	13.9%	-17.8%	-22.1%	-22.2%	-19.7%	-20.4%	14.3%	28.7%	33.5%	30.6%	26.7%	7.8%	6.7%
% Change Q/Q		-23.1%	-5.9%	1.4%	9.5%		9.4%	5.9%	5.2%	7.2%			
Free cash flow for equity	1,168.9	349.8	251.2	178.3	218.9	998.1	281.1	321.4	380.7	270.0	1,253.2	1,272.4	1,312.0
Free cash flow for the firm	**$1,142.8**	**$340.2**	**$248.0**	**$173.5**	**$215.0**	**$976.7**	**$281.2**	**$321.2**	**$380.2**	**$269.1**	**$1,251.8**	**$1,266.0**	**$1,300.7**
% Change Y/Y	-8.3%	-12.0%	-11.8%	4.3%	-30.4%	-14.5%	-17.3%	29.5%	119.2%	25.2%	28.2%	1.1%	2.7%

Source: Citi Investment Research and Analysis

Adobe Systems Inc.

Company description

Adobe is one of largest software companies in the world. They are the leading provider of digital imaging and print publishing products. With the acquisition of Macromedia in 2005 and Omniture in 2009, Adobe is also a leading provider of web development tools and online analytics software. The company is best known for their Photoshop photo editing tool and the ubiquitous PDF and Flash platforms.

Investment strategy

We rate the shares of Adobe Systems Buy / Medium (1M) risk. Our rating is based on our belief that the company will realize significant sales growth from its upcoming Creative Suite 5 product cycle. The company is highly leveraged to economic growth and we anticipate that CS5 will benefit from pent up demand generated by delayed IT purchases and typical "every other cycle" upgrade behavior commonly seen in Adobe's customer base.

Valuation

We arrive at our $39 price target for Adobe shares by applying a 21x forward 12-months earnings multiple on our fiscal year 2010 EPS estimate of $1.84. The target multiple is based on the average historical peak multiple of 30x heading into a product cycle. All previous cycles experienced multiple expansion leading up to the launch date. Given the uncertain economic climate, we opted for a conservative approach by taking 70% of the typical peak multiple of 30x.

Risks

We rate shares of Adobe Medium risk. The company's revenues are highly dependant on their Creative Suite product line. Risks to our target price include: 1) Lack of a sustainable subscription software model makes Adobe's software highly discretionary in nature. 2) Poor macro trends could extend the weakness seen during the CS4 product cycle. 3) A secular shift in the company's core customer vertical, print media, leaves to question the potential to drive incremental unit upside in the longer term. The company will look to better monetize their developer base. However, developers have historically avoided paying for premium development tools given the availability of cheap/free alternatives. If the impact of any of these risks is greater than we expect, ADBE shares could have a difficult time achieving our estimates and could fail to reach our target price.

Appendix A-1

Analyst Certification

Each research analyst(s) primarily responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

IMPORTANT DISCLOSURES

Adobe Systems Inc. (ADBE)
Ratings and Target Price History
Fundamental Research

	Date	Rating	Target Price	Closing Price
1	17-Sep-07	1M	*52.00	43.06
2	21-Oct-07	1M	*56.00	46.27
3	4-Mar-08	1M	*46.00	33.07
4	28-May-08	1M	*50.00	42.84
5	8-Oct-08	1M	*37.00	30.00
6	25-Nov-08	1M	*27.00	22.42
7	24-Feb-09	1M	*23.00	18.17
8	4-Mar-09	1M	*20.00	16.32
9	3-May-09	*2M	*28.00	27.46
10	4-Aug-09	Coverage suspended		

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Citigroup Global Markets Inc. or its affiliates beneficially owns 1% or more of any class of common equity securities of Adobe Systems Inc., Akamai Technologies Inc, Yahoo! Inc. This position reflects information available as of the prior business day.

Within the past 12 months, Citigroup Global Markets Inc. or its affiliates has acted as manager or co-manager of an offering of securities of Adobe Systems Inc., Microsoft Corp..

Citigroup Global Markets Inc. or its affiliates has received compensation for investment banking services provided within the past 12 months from Adobe Systems Inc., Apple Inc, Microsoft Corp..

Citigroup Global Markets Inc. or an affiliate received compensation for products and services other than investment banking services from Adobe Systems Inc., Apple Inc, Google Inc, Microsoft Corp., Yahoo! Inc in the past 12 months.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as investment banking client(s): Adobe Systems Inc., Apple Inc, Microsoft Corp..

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as clients, and the services provided were non-investment-banking, securities-related: Adobe Systems Inc., Apple Inc, Google Inc, Microsoft Corp., Yahoo! Inc.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as clients, and the services provided were non-investment-banking, non-securities-related: Adobe Systems Inc., Apple Inc, Google Inc, Microsoft Corp., Yahoo! Inc.

Rohini Malkani has in the past worked with the India government or its divisions in her personal capacity.

Analysts' compensation is determined based upon activities and services intended to benefit the investor clients of Citigroup Global Markets Inc. and its affiliates ("the Firm"). Like all Firm employees, analysts receive compensation that is impacted by overall firm profitability which includes investment banking revenues.

The Firm is a market maker in the publicly traded equity securities of Adobe Systems Inc., Apple Inc, Akamai Technologies Inc, Google Inc, Microsoft Corp., Yahoo! Inc.

For important disclosures (including copies of historical disclosures) regarding the companies that are the subject of this Citi Investment Research & Analysis product ("the Product"), please contact Citi Investment Research & Analysis, 388 Greenwich Street, 29th Floor, New York, NY, 10013, Attention: Legal/Compliance. In addition, the same important disclosures, with the exception of the Valuation and Risk assessments and historical disclosures, are contained on the Firm's disclosure website at www.citigroupgeo.com. Valuation and Risk assessments can be found in the text of the most recent research note/report regarding the subject company. Historical disclosures (for up to the past three years) will be provided upon request.

Citi Investment Research & Analysis Ratings Distribution

Data current as of 31 Dec 2009	**Buy**	**Hold**	**Sell**
Citi Investment Research & Analysis Global Fundamental Coverage	48%	36%	16%
% of companies in each rating category that are investment banking clients	48%	45%	37%

Guide to Citi Investment Research & Analysis (CIRA) Fundamental Research Investment Ratings:
CIRA's stock recommendations include a risk rating and an investment rating.

Risk ratings, which take into account both price volatility and fundamental criteria, are: Low (L), Medium (M), High (H), and Speculative (S).
Investment ratings are a function of CIRA's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.

For securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), investment ratings are:Buy (1) (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold (2) (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell (3) (negative total return).

Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.
Guide to Citi Investment Research & Analysis (CIRA) Corporate Bond Research Credit Opinions and Investment Ratings: CIRA's corporate bond research issuer publications include a fundamental credit opinion of Improving, Stable or Deteriorating and a complementary risk rating of Low (L), Medium (M), High (H) or Speculative (S) regarding the credit risk of the company featured in the report. The fundamental credit opinion reflects the CIRA analyst's opinion of the direction of credit fundamentals of the issuer without respect to securities market vagaries. The fundamental credit opinion is not geared to, but should be viewed in the context of debt ratings issued by major public debt ratings companies such as Moody's Investors Service, Standard and Poor's, and Fitch Ratings. CBR risk ratings are approximately equivalent to the following matrix: Low Risk Triple A to Low Double A; Low to Medium Risk High Single A through High Triple B; Medium to High Risk Mid Triple B through High Double B; High to Speculative Risk Mid Double B and Below. The risk rating element illustrates the analyst's opinion of the relative likelihood of loss of principal when a fixed income security issued by a company is held to maturity, based upon both fundamental and market risk factors. Certain reports published by CIRA will also include investment ratings on specific issues of companies under coverage which have been assigned fundamental credit opinions and risk ratings. Investment ratings are a function of CIRA's expectations for total return, relative return (to publicly available Citigroup bond indices performance), and risk rating. These investment ratings are: Buy/Overweight the bond is expected to outperform the relevant Citigroup bond market sector index (Broad Investment Grade, High Yield Market or Emerging Market), performances of which are updated monthly and can be viewed at https://fidirect.citigroup.com/ using the "Indexes" tab; Hold/Neutral Weight the bond is expected to perform in line with the relevant Citigroup bond market sector index; or Sell/Underweight the bond is expected to underperform the relevant sector of the Citigroup indexes.

Non-US research analysts who have prepared this report are not registered/qualified as research analysts with the NYSE and/or NASD. Such research analysts may not be associated persons of the member organization and therefore may not be subject to the NYSE Rule 472 and NASD Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account. The legal entities employing the authors of this report are listed below:

Citigroup Global Markets Inc	Walter H Pritchard,Kenneth Wong

OTHER DISCLOSURES

The subject company's share price set out on the front page of this Product is quoted as at 12 February 2010 04:00 PM on the issuer's primary market.

Citigroup Global Markets Inc. and/or its affiliates has a significant financial interest in relation to Apple Inc, Google Inc, Microsoft Corp., Yahoo! Inc. (For an explanation of the determination of significant financial interest, please refer to the policy for managing conflicts of interest which can be found at www.citigroupgeo.com.)

Citigroup Global Markets Inc. or its affiliates beneficially owns 5% or more of any class of common equity securities of Yahoo! Inc.

For securities recommended in the Product in which the Firm is not a market maker, the Firm is a liquidity provider in the issuers' financial instruments and may act as principal in connection with such transactions. The Firm is a regular issuer of traded financial instruments linked to securities that may have been recommended in the Product. The Firm regularly trades in the securities of the issuer(s) discussed in the Product. The Firm may engage in securities transactions in a manner inconsistent with the Product and, with respect to securities covered by the Product, will buy or sell from customers on a principal basis.

Securities recommended, offered, or sold by the Firm: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested. Although information has been obtained from and is based upon sources that the Firm believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. Note, however, that the Firm has taken all reasonable steps to determine the accuracy and completeness of the disclosures made in the Important Disclosures section of the Product. The Firm's research department has received assistance from the subject company(ies) referred to in this Product including, but not limited to, discussions with management of the subject company(ies). Firm policy prohibits research analysts from sending draft research to subject companies. However, it should be presumed that the author of the Product has had discussions with the subject company to ensure factual accuracy prior to publication. All opinions, projections and estimates constitute the judgment of the author as of the date of the Product and these, plus any other information contained in the Product, are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Notwithstanding other departments within the Firm advising the companies discussed in this Product, information obtained in such role is not used in the preparation of the Product. Although Citi Investment Research & Analysis (CIRA) does not set a predetermined frequency for publication, if the Product is a fundamental research report, it is the intention of CIRA to provide research coverage of the/those issuer(s) mentioned therein, including in response to news affecting this issuer, subject to applicable quiet periods and capacity constraints. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in the Product must take into account existing public information on such security or any registered prospectus.

Investing in non-U.S. securities, including ADRs, may entail certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations. Investors who have received the Product from the Firm may be prohibited in certain states or other jurisdictions from purchasing securities mentioned in the Product from the Firm. Please ask your Financial Consultant for additional details. Citigroup Global Markets Inc. takes responsibility for the Product in the United States. Any orders by US investors resulting from the information contained in the Product may be placed only through Citigroup Global Markets Inc.

Important Disclosures for Morgan Stanley Smith Barney LLC Customers: Morgan Stanley & Co. Incorporated (Morgan Stanley) research reports may be available about the companies that are the subject of this Citi Investment Research & Analysis (CIRA) research report. Ask your Financial Advisor or use smithbarney.com to view any available

Morgan Stanley research reports in addition to CIRA research reports.
Important disclosure regarding the relationship between the companies that are the subject of this CIRA research report and Morgan Stanley Smith Barney LLC and its affiliates are available at the Morgan Stanley Smith Barney disclosure website at www.morganstanleysmithbarney.com/researchdisclosures.
The required disclosures provided by Morgan Stanley and Citigroup Global Markets, Inc. on Morgan Stanley and CIRA research relate in part to the separate businesses of Citigroup Global Markets, Inc. and Morgan Stanley that now form Morgan Stanley Smith Barney LLC, rather than to Morgan Stanley Smith Barney LLC in its entirety. For Morgan Stanley and Citigroup Global Markets, Inc. specific disclosures, you may refer to www.morganstanley.com/researchdisclosures and https://www.citigroupgeo.com/geopublic/Disclosures/index_a.html.
This CIRA research report has been reviewed and approved on behalf of Morgan Stanley Smith Barney LLC. This review and approval was conducted by the same person who reviewed this research report on behalf of CIRA. This could create a conflict of interest.

The Citigroup legal entity that takes responsibility for the production of the Product is the legal entity which the first named author is employed by. The Product is made available in Australia through Citigroup Global Markets Australia Pty Ltd. (ABN 64 003 114 832 and AFSL No. 240992), participant of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in Australia to Private Banking wholesale clients through Citigroup Pty Limited (ABN 88 004 325 080 and AFSL 238098). Citigroup Pty Limited provides all financial product advice to Australian Private Banking wholesale clients through bankers and relationship managers. If there is any doubt about the suitability of investments held in Citigroup Private Bank accounts, investors should contact the Citigroup Private Bank in Australia. Citigroup companies may compensate affiliates and their representatives for providing products and services to clients. The Product is made available in Brazil by Citigroup Global Markets Brasil - CCTVM SA, which is regulated by CVM - Comissão de Valores Mobiliários, BACEN - Brazilian Central Bank, APIMEC - Associação dos Analistas e Profissionais de Investimento do Mercado de Capitais and ANBID - Associação Nacional dos Bancos de Investimento. Av. Paulista, 1111 - 11º andar - CEP. 01311920 - São Paulo - SP. If the Product is being made available in certain provinces of Canada by Citigroup Global Markets (Canada) Inc. ("CGM Canada"), CGM Canada has approved the Product. Citigroup Place, 123 Front Street West, Suite 1100, Toronto, Ontario M5J 2M3. The Product is made available in France by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. 1-5 Rue Paul Cézanne, 8ème, Paris, France. The Product may not be distributed to private clients in Germany. The Product is distributed in Germany by Citigroup Global Markets Deutschland AG & Co. KGaA, which is regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). Frankfurt am Main, Reuterweg 16, 60323 Frankfurt am Main. If the Product is made available in Hong Kong by, or on behalf of, Citigroup Global Markets Asia Ltd., it is attributable to Citigroup Global Markets Asia Ltd., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. Citigroup Global Markets Asia Ltd. is regulated by Hong Kong Securities and Futures Commission. If the Product is made available in Hong Kong by The Citigroup Private Bank to its clients, it is attributable to Citibank N.A., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. The Citigroup Private Bank and Citibank N.A. is regulated by the Hong Kong Monetary Authority. The Product is made available in India by Citigroup Global Markets India Private Limited, which is regulated by Securities and Exchange Board of India. Bakhtawar, Nariman Point, Mumbai 400-021. The Product is made available in Indonesia through PT Citigroup Securities Indonesia. 5/F, Citibank Tower, Bapindo Plaza, Jl. Jend. Sudirman Kav. 54-55, Jakarta 12190. Neither this Product nor any copy hereof may be distributed in Indonesia or to any Indonesian citizens wherever they are domiciled or to Indonesian residents except in compliance with applicable capital market laws and regulations. This Product is not an offer of securities in Indonesia. The securities referred to in this Product have not been registered with the Capital Market and Financial Institutions Supervisory Agency (BAPEPAM-LK) pursuant to relevant capital market laws and regulations, and may not be offered or sold within the territory of the Republic of Indonesia or to Indonesian citizens through a public offering or in circumstances which constitute an offer within the meaning of the Indonesian capital market laws and regulations. The Product is made available in Italy by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. Foro Buonaparte 16, Milan, 20121, Italy. The Product is made available in Japan by Citigroup Global Markets Japan Inc. ("CGMJ"), which is regulated by Financial Services Agency, Securities and Exchange Surveillance Commission, Japan Securities Dealers Association, Tokyo Stock Exchange and Osaka Securities Exchange. Shin-Marunouchi Building, 1-5-1 Marunouchi, Chiyoda-ku, Tokyo 100-6520 Japan. If the Product was distributed by Nikko Cordial Securities Inc. it is being so distributed under license. In the event that an error is found in an CGMJ research report, a revised version will be posted on the Firm's Global Equities Online (GEO) website. If you have questions regarding GEO, please call (81 3) 6270-3019 for help. The Product is made available in Korea by Citigroup Global Markets Korea Securities Ltd., which is regulated by Financial Supervisory Commission and the Financial Supervisory Service. Hungkuk Life Insurance Building, 226 Shinmunno 1-GA, Jongno-Gu, Seoul, 110-061. The Product is made available in Malaysia by Citigroup Global Markets Malaysia Sdn Bhd, which is regulated by Malaysia Securities Commission. Menara Citibank, 165 Jalan Ampang, Kuala Lumpur, 50450. The Product is made available in Mexico by Acciones y Valores Banamex, S.A. De C. V., Casa de Bolsa, Integrante del Grupo Financiero Banamex ("Accival") which is a wholly owned subsidiary of Citigroup Inc. and is regulated by Comision Nacional Bancaria y de Valores. Reforma 398, Col. Juarez, 06600 Mexico, D.F. In New Zealand the Product is made available through Citigroup Global Markets New Zealand Ltd. (Company Number 604457), a Participant of the New Zealand Exchange Limited and regulated by the New Zealand Securities Commission. Level 19, Mobile on the Park, 157 Lambton Quay, Wellington. The Product is made available in Pakistan by Citibank N.A. Pakistan branch, which is regulated by the State Bank of Pakistan and Securities Exchange Commission, Pakistan. AWT Plaza, 1.1. Chundrigar Road, P.O. Box 4889, Karachi-74200. The Product is made available in Poland by Dom Maklerski Banku Handlowego SA an indirect subsidiary of Citigroup Inc., which is regulated by Komisja Nadzoru Finansowego. Dom Maklerski Banku Handlowego S.A. ul. Chalubinskiego 8, 00-630 Warszawa. The Product is made available in the Russian Federation through ZAO Citibank, which is licensed to carry out banking activities in the Russian Federation in accordance with the general banking license issued by the Central Bank of the Russian Federation and brokerage activities in accordance with the license issued by the Federal Service for Financial Markets. Neither the Product nor any information contained in the Product shall be considered as advertising the securities mentioned in this report within the territory of the Russian Federation or outside the Russian Federation. The Product does not constitute an appraisal within the meaning of the Federal Law of the Russian Federation of 29 July 1998 No. 135-FZ (as amended) On Appraisal Activities in the Russian Federation. 8-10 Gasheka Street, 125047 Moscow. The Product is made available in Singapore through Citigroup Global Markets Singapore Pte. Ltd., a Capital Markets Services Licence holder, and regulated by Monetary Authority of Singapore. 1 Temasek Avenue, #39-02 Millenia Tower, Singapore 039192. The Product is made available by The Citigroup Private Bank in Singapore through Citibank, N.A., Singapore branch, a licensed bank in Singapore that is regulated by Monetary Authority of Singapore. Citigroup Global Markets (Pty) Ltd. is incorporated in the Republic of South Africa (company registration number 2000/025866/07) and its registered office is at 145 West Street, Sandton, 2196, Saxonwold. Citigroup Global Markets (Pty) Ltd. is regulated by JSE Securities Exchange South Africa, South African Reserve Bank and the Financial Services Board. The investments and services contained herein are not available to private customers in South Africa. The Product is made available in Spain by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. 29 Jose Ortega Y Gassef, 4th Floor, Madrid, 28006, Spain. The Product is made available in Taiwan through Citigroup Global Markets Taiwan Securities Company Ltd., which is regulated by Securities & Futures Bureau. No portion of the report may be reproduced or quoted in Taiwan by the press or any other person. No. 1, Songzhi Road, Taipei 110, Taiwan. The Product is made available in Thailand through Citicorp Securities (Thailand) Ltd., which is regulated by the Securities and Exchange Commission of Thailand. 18/F, 22/F and 29/F, 82 North Sathorn Road, Silom, Bangrak, Bangkok 10500, Thailand. The Product is made available in Turkey through Citibank AS which is regulated by Capital Markets Board. Tekfen Tower, Eski Buyukdere Caddesi # 209 Kat 2B, 23294 Levent, Istanbul, Turkey. In the U.A.E, these materials (the "Materials") are communicated by Citigroup Global Markets Limited, DIFC branch ("CGML"), an entity registered in the Dubai International Financial Center ("DIFC") and licensed and regulated by the Dubai Financial Services Authority ("DFSA" to Professional Clients and Market Counterparties only and should not be relied upon or distributed to Retail Clients. A distribution of the different CIRA ratings distribution, in percentage terms for Investments in each sector covered is made available on request. Financial products and/or services to which the Materials relate will only be made available to Professional Clients and Market Counterparties. The Product is made available in