Adobe

If you have ever driven past a billboard, read a magazine, scrolled through countless perfectly manicured posts on Instagram, downloaded a document online or watched a blockbuster film, chances are it was made using Adobe's tools, and you didn't even notice. Adobe (ADBE:NYSE, Market Capitalisation US$157.09B) often sits on the periphery when discussing the worlds most successful technology giants, overshadowed by Apple, Google, Microsoft, and Amazon, but they are the company that powers the professional creative community and their software is "mission critical" to almost every industry.

Adobe has an exceptional business model, that is essentially a "monopoly" in the creative tools market, The rise of the "subscription based business model" from Spotify to Netflix was due in part to the overwhelming success of Adobe's recurring revenue model, following a dramatic overhaul in 2011. While Adobe did not pioneer the Software-as-a-Service (SaaS) model, they certainly perfected it, and shareholders have reaped the rewards. Adobe have grown their top-line and bottom-line with incredible consistency over the last decade and their gross margins are amongst the highest in the SaaS industry, in excess of 87%. Despite this strong market positon and business model, Adobe has been one of the worst performing stocks on the NYSE, down ~50% to the market bottom by the end of 2022 as investors have become overly concerned about Adobe's legacy business, with their recent acquisition of competitor Figma.

The storied history of Adobe

1982 John Warnock (to the left) and Charles Geschke leave Xerox and co-found Adobe, following their development of PostScript, a graphic programming language that was later included in Apple's Laserwriter (Steve Jobs tried to buy the company at the time for US$5 million).

1983 Apple becomes the first licensee of Adobe's initial product PostScript, kicking off one of the longest relationships in Silicon Valley.

1987 Adobe introduces Adobe Illustrator which John invented for his wife, Marva Warnock. Her graphic design background had an immeasurable influence on him; he wanted to build a program that would make her job easier; but ended up revolutionising the graphic design profession.

1989 Adobe acquires and introduces Photoshop, forever distorting beauty standards with a push of the liquefy tool. Photoshop became the cornerstone of Adobe, so ubiquitous that the term *Photoshopped* is used to describe any time an image is manipulated.

1991 Adobe introduce, Adobe Premiere Pro, a video editing software that is now the industry standard in Hollywood alongside Final Cut Pro and Avid.

1993 Adobe invent the portable document format (PDF) one of the most significant inventions of the late 20th century and release the Adobe Acrobat Reader.

1999 Adobe release Indesign a landmark layout design software for print designers, (which this report was written with), substituting for PageMaker that Adobe purchased from Aldus in 1994. In the same year Adobe purchase AfterEffects, the premier tool for motion graphics.

2003 With the release of Ceative Suite later Creative Cloud (CC), Adobe aggregates all of its software under one offering. Music editing software is added to the Creative Suite with the purchase of the aptly named Cool Edit Pro, which is renamed Adobe Audition.

2013 After switching to a subscription-only model in 2013 the company's revenue doubled between the years 2013 and 2018.

2021 Adobe is chosen as a Blue Ribbon Company by Fortune and is regarded as one of the most valuable global brands. Charles Geschke passes away at the age of 81 in Los Altos California.

2022/3 In the largest ever acquisition of a private software company, Adobe entered into a definitive merger agreement to acquire Figma, a leading web-first collaborative design platform, for approximately US$20 billion in cash and stock.

Business overview

If content is king; then Adobe is king-maker governing a creative monopoly that spans video, audio, web, photo, content provision, animation, education, advertising and publishing. More so than ever the world craves the digital experiences that Adobe's suite of products can provide, 75% of Fortune 100 companies and millions of individuals use its products spanning from Photoshop, to Adobe Acrobat, used by anyone editing and sending PDFs. However, challengers to Adobe's creative tools monopoly are now growing. Adobe's products were designed for a time before cloud computing, while newer and more agile competition are cloud native, enabling creators to work in sync across multiple devices and locations. To combat this rising threat Adobe has engaged in an aggressive acquisition and transformation strategy over the last decade, migrating their services to the cloud, increasing customer stickiness with their subscription based model, and more recently winning back market share with the acquisition of upstart competitor Figma (see page 7). Adobe's customer base is large and they report revenues under the following segments:

Digital Media

Adobe's flagship product is **Creative Cloud (CC),** a subscription service that allows members to access products such as Photoshop, InDesign, Lightroom etc. CC remains the leading creativity platform, offering a comprehensive portfolio of products for every discipline across imaging, photography, design, video, web, animation and 3D.

Document Cloud (DC) is the undisputed leader in digital documents, whether it's an offer to purchase a new home, a bank deposit form, a school permission slip or a sales contract. DC was once seen as a dying segment, but is now Adobe's fastest growing platform, demonstrating the exceptionally long shelf life of Adobe's software.

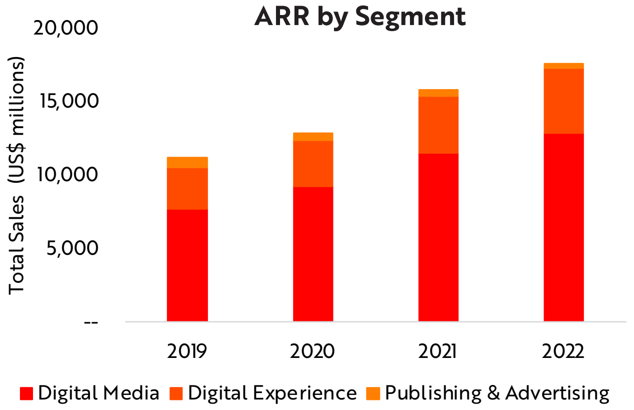
Digital Experience

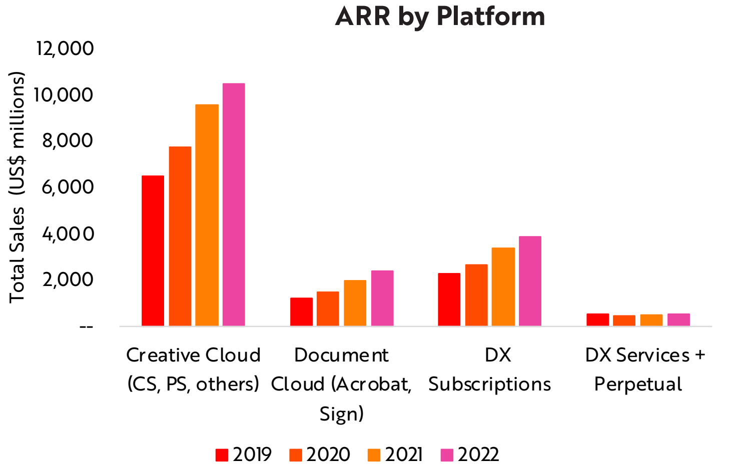
Adobe Experience Cloud (AX/DX) is a collection of integrated online marketing and web analytic products, powering digital businesses in every industry across B2B and B2C often used in conjunction with other enterprise software. Experience Cloud can process ~29 trillion evaluations per day and execute a response time of less than 250 milliseconds.

Adobe offers additional **Publishing & Advertising** such as e-learning solutions, technical document publishing, web conferencing, document and forms platform, web application development, and high-end printing, as well as Advertising Cloud offerings.

23 million business and individuals use Adobes tools

Creative Cloud (CC) is Adobe's proverbial cash cow, ~23 million business, academic institutions and individuals subscribe to CC which can be purchased for US$54.99/month (annual subscription billed monthly). While steep in price, Adobe's growing customer base continues to pay up time and time again, simply because Adobe's products are vastly superior, with far greater capabilities than cheaper alternatives. Since recasting itself as a cloud business over a decade ago, Adobe has become the poster child for a recurring revenue model, not bad for a software company born and bred in the desktop-application era. Annual Recurring Revenue (ARR) as a percentage of total revenues is now close to 100%, while Adobe still receives revenues from its legacy Publishing and Advertising business, this segment continues to dwindle in importance. Adobe's software is ubiquitous, ~58% of ARR is derived from the Americas, compared to ~26.% from EMEA and only ~15% from the APAC region. Much of the Asian market remains under penetrated, and may drive ARR to a greater proportion in the future than Adobe's legacy markets.



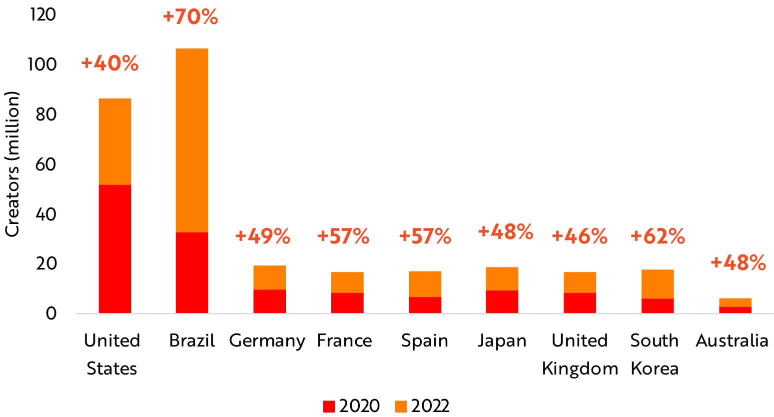


Industry overview

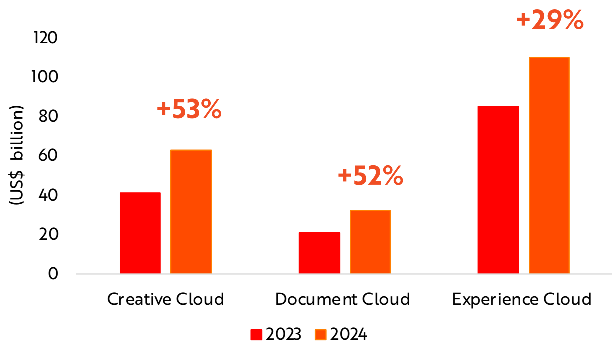
The creator* economy is thriving. Adobe's annual "Future of Creativity" study found more than 165 million creators joined the global creator economy in the last two years which nearly doubled in size to 303 million creators globally. Growth was driven primarily by the U.S, (+34 million new creators), Spain (+10 million), South Korea (+11 million) and Brazil (+73 million). Reflecting increasing demand for advanced methods of producing video and audio content in particular. In an age of continuously expanding content, video has proven to be highly effective in capturing and holding the attention of target audiences. The market for artistic programs such as Adobe Premiere has benefited from this trend. Editing software is also benefiting from the growing demand for high-quality audio products in the media and entertainment industry. Similarly, the entertainment industry's rising emphasis on noise reduction and high-quality audio content drives demand for audio editing software like Adobe Audition.

Although the creative industry has grown rapidly, Adobe does suffer from existing high market penetration which has resulted in slowing growth rates primarily in CC. Adobe's total addressable market (TAM) forecasts are not as reflective off this, forecasting a TAM of US$63 billion by 2024. Given CC's revenue of ~US$10.5 billion in FY22, this would imply market penetration of just 17%, which does not explain CC's slight reduction in revenue growth. A weak economic outlook may explain some of this decline, as enterprises and individuals alike look to reduce IT expenditure to preserve their bottom lines.

Adobe's Future of Creativity Study



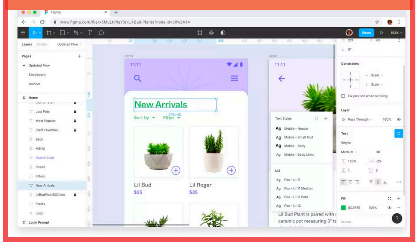
Adobe's TAM Forecasts



**Creators are defined as adults over the age of 18 who participate in creative activities and promote their work from these activities online at least monthly.*

Key trends impacting Adobe

Focus on UI/UX



Demand for user interface/user experience (UI/UX) products has boomed in line with online software development projects. Adobe has missed this key growth vector with the failure of their XD product which was surpassed first by Sketch and then by Figma. Adobe paid a hefty price for this failure, with their acquisition of Figma.

Cloud Migration

Adobe's Creative Suite is not cloud optimised and creators today have an emphasis on collaboration. While several of Adobe's platforms have moved to the cloud, many are too compute-intensive requiring hardware and strong bandwidth to process high workloads. Adobe's access to Figma's architecture could take several years off this migration, if integrated with CC.

Non Professional Creative Market

Adobe's flagship platforms are designed for professional creative users, and Adobe has largely missed the rapidly growing non professional creative market. Companies such as Canva have filled this gap, and seen explosive growth. However, Adobe + Figma's capabilities and ease of use may be able to challenge and win market share from Canva, a previously untapped market for Adobe.

Competitive landscape

The vastness of Adobe's creative empire naturally exposes the firm to competition in several domains, and numerous competitors. While all of these businesses sell excellent creative/enterprise software, on their own, none can challenge the comprehensive suite of creative services Adobe offers.

Platform Competitors

Creative Cloud: Corel, Autodesk, Avid, Sketch, Figma

Document Cloud: Microsoft, Google, nitro, Foxit, DocuSign

Experience Cloud: salesforce, Microsoft, Oracle, SAP, IBM

Corel — Corel is a Canadian software company that offers a wide range of products for graphic design. The company's products are often considered to be a more affordable alternative to Adobe's products, and are particularly popular among small businesses and independent designers.

Avid — Avid Technology specialises in video editing and content creation software. Adobes Premiere Pro is used by enthusiasts and small productions while overwhelmingly, Avid's Media Composer is the software of choice for large productions. (You can read our historical research on Avid here)

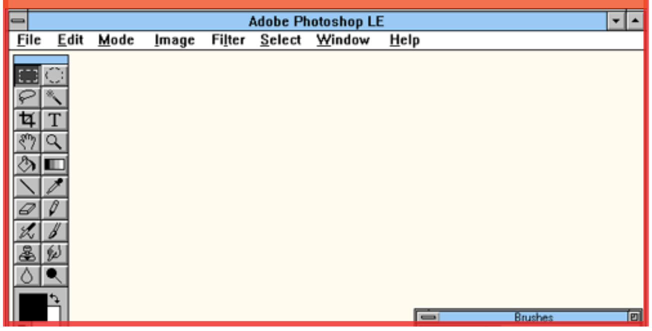
DocuSign — DocuSign is an electronic signature and digital transaction management service that allows users to sign, send, and manage documents electronically; a direct competitor to Adobe Sign.

Oracle — Oracle offers a wide range of enterprise products and services Oracle's products and services are often used as an alternative to Adobe's products and services, particularly in the areas of enterprise resource planning and supply chain management.

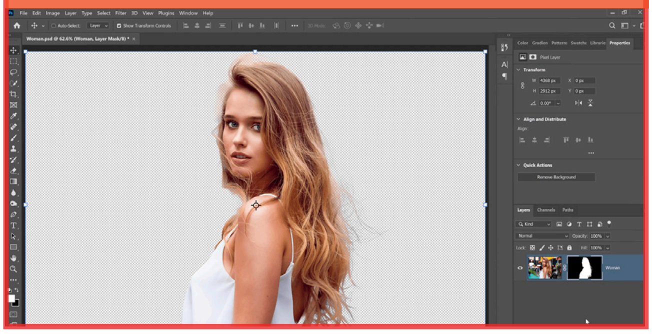
Muscle memory "monopoly"

Adobe's brand has become synonymous with quality and reliability in the software industry, and Adobe regularly drip feeds updates to its subscriber base to ensure its products are consistently improving in response to creator demands. Many subscribers have been using Adobe's products for decades, and are able to call on years of experience to proficiently complete complex tasks. That proficiency is a "monopoly" that application vendors such as Adobe have. Creators have developed a relationship tied to a Adobe's interface and product features that's almost impossible to reproduce even though competitors often try. This is an enormous asset for Adobe. It's also an asset that vendors often squander. Every time a vendor changes an interface, moves menu items to a different location, modifies behaviour so that what you knew last week isn't applicable after an update, the vendor squanders their "monopoly". Yes, developers need to innovate, improve on features and add capabilities. Yet if too much is changed at once, there's the risk that it's just as hard to adjust to a new version as a competitor's offering, then the "monopoly" is gone. Adobe have mastered the art of continually upgrading their offering without alienating their legacy creators. The interface for Photoshop largely looks the same today as it did 20 years ago, but its capabilities are exponentially greater. As a result, Adobe has accumulated a vast trove of subconscious customer loyalty that will continue to pay dividends far into the future.

Photoshop 1 Interface (1987)



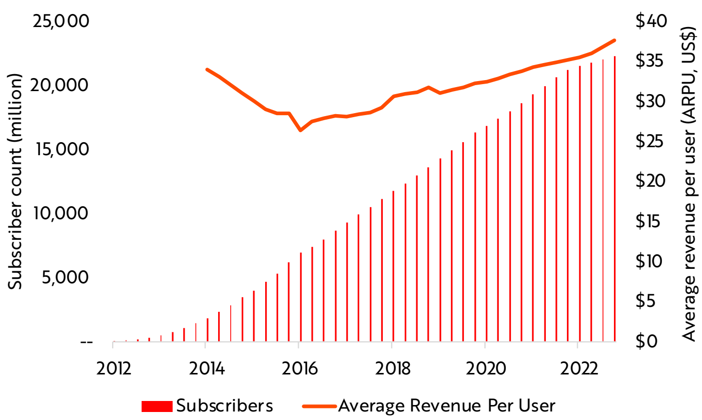
Photoshop 24.1 Interface (2023)



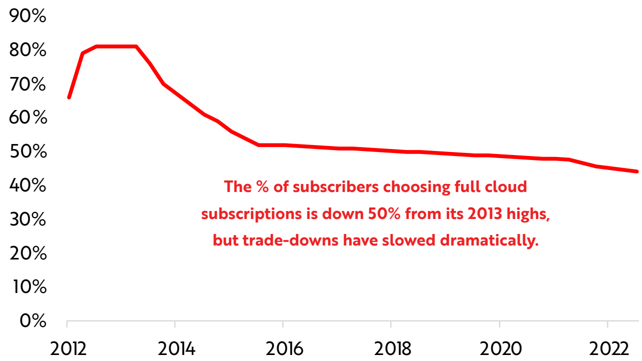
Reborn in the cloud

When Adobe embarked upon their Creative Cloud transition in 2011, revenues took an initial hit as Adobe missed a profitable upgrade cycle, However, the move paid off for Adobe. At its height, Creative Suite (CC's predecessor) had about three million users, but CC has attracted seven times that number. Adobe no longer offers its design tools in the form of physical, shrink-wrapped products to be deployed at customers' sites under a perpetual license. Now Adobe can lay claim to a stream of perpetual revenues, so long as customers use their products. Interestingly, Adobe's average revenue per user, (ARPU) has remained relatively flat, as subscriber growth has taken off. Adobe have increased the price of CC gradually, the most recent price change increased annual subscriptions for individuals from US$52.99 to US$54.99 per month, while a monthly subscription for individuals increased from US$79.49 to US$82.49 per month. Certain legacy customers who joined Adobe prior to the CC subscription plan have openly protested Adobe's business practices, often trading down to the single app use or turning to inferior alternative's in protest. To appease these customers Adobe have responded by bundling apps that are often used in conjunction such as Photoshop and Lightroom—separate from the full Creative Cloud, at a more affordable subscription price.

Subscriber Growth and ARPU/Quarter



% of Subscribers choosing full cloud solutions



A superior business

Adobe offers a superior range of creative tools to the professional creative market than any other business, and have done so for two decades now. Network effects have vastly increased the value of "Adobe Skills" within the creative tools industry, as the next generation of creators are often trained using Adobe's tools. It takes time to learn how to use Adobe's products and while this is a barrier to entry that can deter customers; It means that once an individual is within the Adobe ecosystem they are unlikely to leave as "Adobe Skills" will not be transferable to other creative software. In other words, Adobe's products are extremely sticky, which is reflected in its high attachment and Net Dollar Retention (NDR) rate. Adobe's NDR's (Additional recurring revenues that can be derived from an existing customer base) are some of the best in industry at ~110%. This is possibly due to Adobe's ability to up-sell customers whether through extra cloud services or additional software. A SaaS business with a declining NDR is cause for concern as it means subscribers are "churning out", however the necessity and stickiness of Adobe's platforms ensures exceptionally high retention rates. While any one of their +26m customers can pay a US$84.99/month for access to the entire Creative Cloud ensemble, Photoshop or Premiere Pro alone will set you back US$31.35/month each. Creators often need access to several apps and thus it makes sense to purchase the full Creative Cloud plan, even if 80% of the Apps remain unused. It costs Adobe nothing to service additional subscribers, and with such low COGS Adobe can lay claim to better gross margins (~88%) than almost any other company.

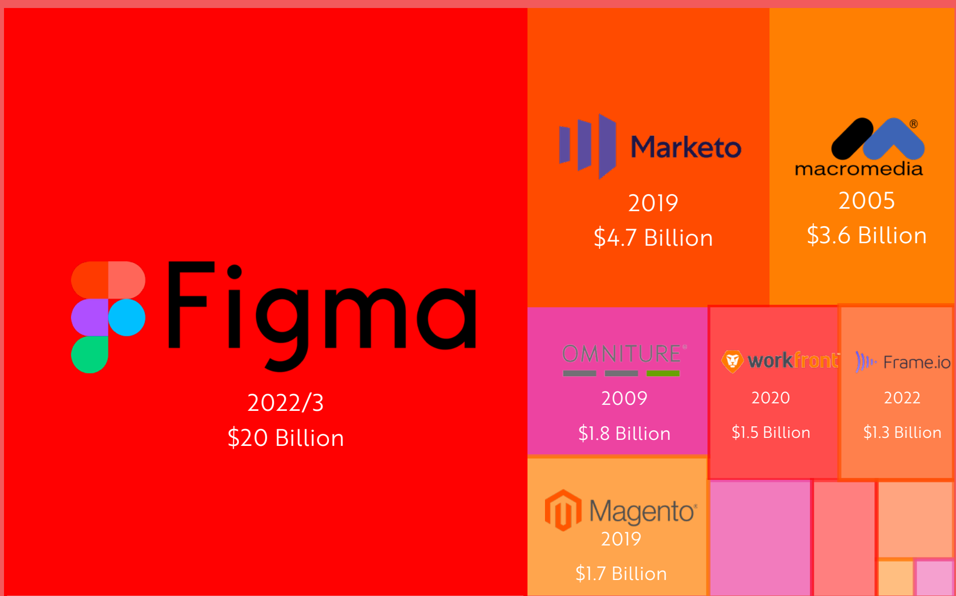
Our thoughts on the Figma acquisition

In September 2009, with the stock market still recovering from the GFC, Adobe announced plans to spend US$1.8 billion for marketing software vendor Omniture, its second-biggest acquisition ever at the time. There's a similar sentiment in the air today. Adobe's stock is down -14% over the last twelve months (LTM) showing signs of recovering from its worst year since 2008. In Septemeber 2022, Adobe agreed to pay US$20 billion for Figma, the largest takeover of a private software company and a sum more than four times greater than what Adobe had ever spent in an acquisition. Figma is highly regarded in Silicon Valley - built with a cloud optimised and collaborative first architecture and a large active community that revere's the product. In essence, Figma is to Adobe what Google Docs is to Microsoft Word.

Adobe is paying about 50x ARR a steep price by any metric, and a price *double* Figma's private valuation last year, even with cloud shares down by more than *half* in the past 12 months. At the time of the announcement, the purchase price amounted to about 12% of Adobe's market cap, compared to almost 10% for Omniture 13 years ago. Adobe shares bottomed out -30% in the days following the announcement, meaning investors could have effectively acquired Figma for free. This is the period that the Elevation Capital Global Shares Fund acquired the bulk of its position in Adobe. Contrary to the behaviour of the market we believe this was not a knee jerk reaction from Adobe, who have been keeping tabs on Figma for over a decade, giving Figma time to demonstrade that it could succeed selling its software inside companies such as Microsoft. Figma's YoY revenue growth is expected to be ~100% for FY22 at US$400m with 90% gross margins (in line with Adobe's ~88%). Their NDR is an impressive 150%, an indicator that churn should not be a worry and that Figma is able to up sell existing customers effectively, a testament to the attractive value of their products.

From a strategic point of view, it's also an excellent acquisition. Adobe has been losing market share to Figma for years. With this move, they regain their grasp on the professional design market, and obtain entry into a new growth vector. That said the Figma deal and its associated price tag have caused investors to wonder whether Adobe is losing their grip on the creative market - Adobe overlooked the explosive growth of the UX/UI design tool market. Regardless the acquisition of Figma is sure to shave years off Adobe's migration to a web based format, using Figma's engineering talent, integrating FigJam with it's creative cloud, or even running CC on top of Figmas cloud.

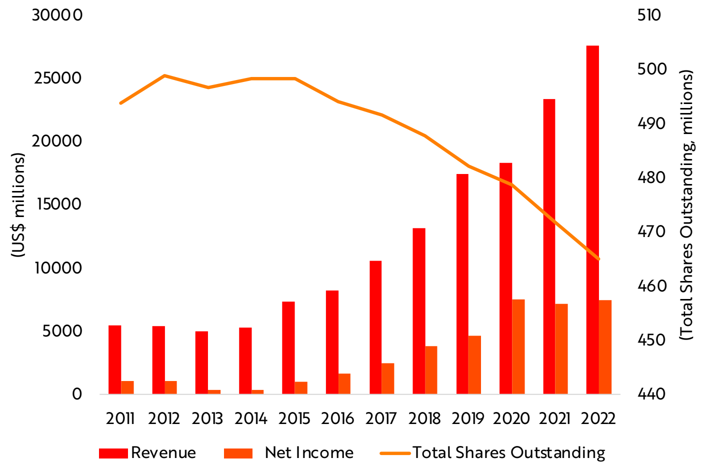
Adobes notable acquisitions over the last two decades
The acquisition of Figma is larger than all others combined since the turn of the century.



Financial analysis

Adobe's management have demonstrated an affinity with shareholders over the past decade. By reducing share count, while growing earnings at an impressive rate, Adobe has the same favourable supply and demand dynamics that all great compounder's share. Adobe's revenue has exploded since pivoting to a subscription based model, growing from US$5.48 Billion in 2011 to US$27.67 Billion in 2022, an impressive +20% CAGR. While the variation of incremental net income is higher than the rhythmic pace of growing revenue, growth has been quicker as Adobe have juiced CC. In the last 10 years, net income has grown from US$1.07 Billion in 2011 to US$7.46 Billion in 2022, representing an astonishing +24% CAGR.

Adobes Favourable Supply & Demand Characteristics



From revolutionising imaging and creative expression with Photoshop to pioneering electronic documents through PDF, to creating the digital marketing category with Adobe Experience Cloud, Adobe continues to invent and transform categories. We are in the golden age of design, and we believe we have a unique opportunity to usher in a new era of collaborative creative computing.

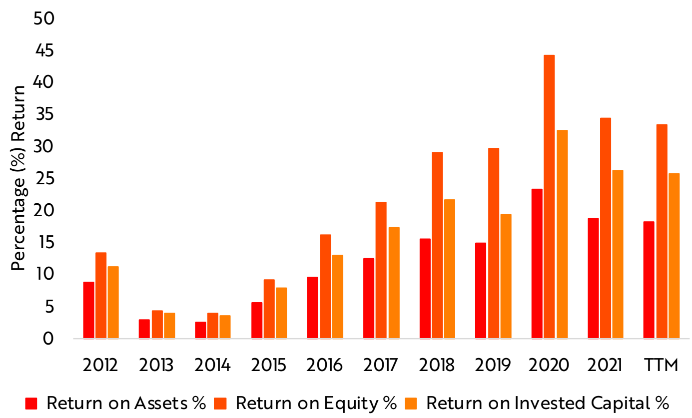
Shantanu Narayen - Adobe Inc. - Chairman & CEO (Q3 2022 Earnings Call)

Share count has declined (-7%) over the decade as management have retired shares from the open market. While the decrease in share count has not been dramatic - decreasing from 500m shares to 463m - Adobe's management have shown that they aren't aggressive diluters of the company's stock.

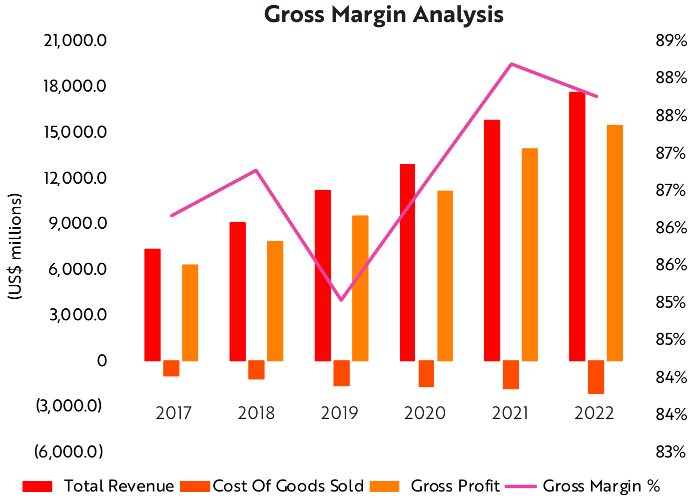
Across a range of metrics operating performance has drastically improved over the last decade, as management have executed their recurring revenue strategy. ROA, ROE and ROIC have all exploded as top line and bottom line growth have outpaced reinvestment back into the business. With an ROIC of ~25% Adobe's management consistently demonstrate exceptional capital allocation, while maintaining conservative debt levels. Following the Figma acquisition there will be a near term decline in ROIC due to the hefty price tag associated with the acquisition.

With better gross margins than most other SaaS businesses, thanks to exceptionally low selling costs, Adobe turns half of its ARR into Free Cash Flow, and boasts a Free Cash Flow Yield, of 4.5% compared to the S&P Information Technology Sector average of 1.1%. Adobe's gross margins have not dropped below 85% over the past decade, this coupled with higher certainty of future cash flows is a key reason behind Adobe's multiple expansion post 2012, and is characteristic of an exceptional business.

Operating Performance



Gross Margin Analysis



Do Adobe shares offer value?

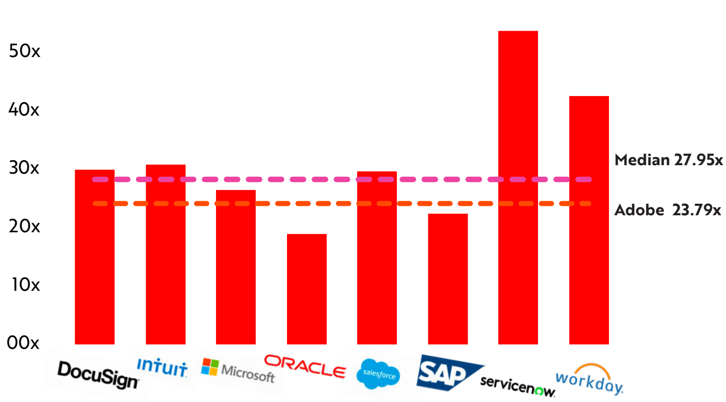
Adobe's shares along with the broader SaaS sector have sold off aggressively over the past 12 months but have staged a recent rally.

Adobe has traditionally traded at a significant premium to the SaaS sector, given the superior capabilities, stickiness and subsequent price point of Adobe's services over its competitors. However, this premium has been greatly reduced or eliminated over the course of the year. While still at a slight premium to peers on a EV/Revenue basis, this premium has narrowed over the past three years. For the first time in nearly a decade Adobe now trades at material discount to SaaS peers on a LTM and NTM PE and on a MktCap/FCF basis.

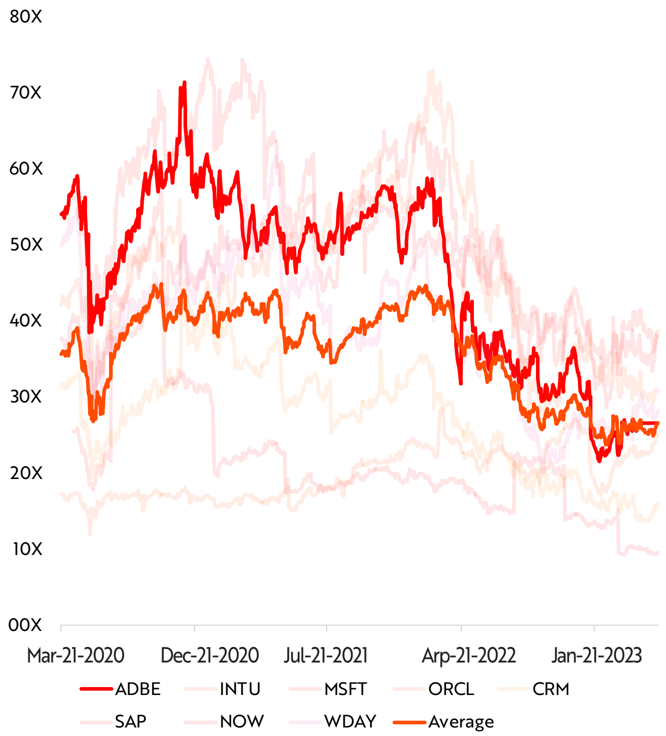
This may signal the markets lack of confidence in the sustainability of Adobe's creative tools monopoly, thus assigning Adobe lower multiples on a go forward basis. However, the SaaS industry has been in a bear market for the better part of two years, and it is natural to assume that any sign of weakness in Adobe's legacy business may lead to a market over reaction. Many analysts saw the acquisition of Figma as Adobe's acknowledgement of the failure of their own internal R&D, a sign that Adobe could no longer keep up with newer competition. The Elevation Capital Global Shares Fund increased markedly what was a small position in Adobe in the aftermath of the Figma acquisition as we believe CC remains architecturally sound, given CC's slow migration to the cloud is symptom of more compute intensive software such as Photoshop vs the less compute intensive nature of UI/UX that is Figma's bread and butter. This is not the same scenario as the disruption of Oracle's on premises application suite by Salesforce's cloud-optimised CRM suite. Adobe remains a compelling, and arguably improved business in the aftermath of the acquisition; over time we believe the market will recognise Adobe's continued superiority, and re-rate the shares accordingly.

Our two stage DCF implies a fair value of ~US$530 per share, assuming a WACC of 7.7% and conservative ARR growth of +10% until FY27.

Forward PE Multiples



Market Cap/LTM Free Cash Flow

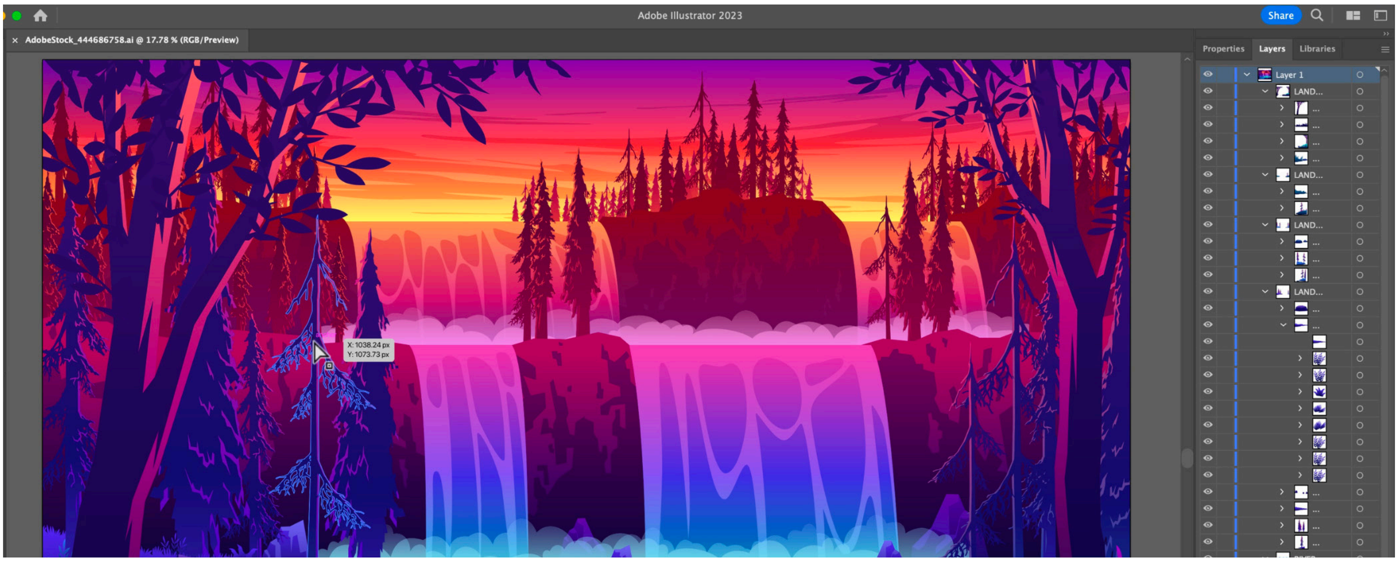


DocuSign excluded as excessively high multiples distort average

Company	Ticker	Price (10/05/23)	12 Month % Change	Market Cap (million)	Operating Statsitics: LTM Gross Margin	Operating Statsitics: LTM Revenue Growth	EV/Revenue: FY21	EV/Revenue: FY22	P/EPS: FY21	P/EPS: FY22
Adobe Inc	ADBE	$342	-12.00%	$157,000	87.7%	13.68%	15.6x	9x	52x	34.1x
DocuSign, Inc	DOCU	$49	-29.00%	$10,000	78.4%	24.52%	13.2x	4.9x	NM	NM
Intuit Inc	INTU	$427	15.00%	$119,190	81.2%	29.07%	15.0x	8.6x	72.7x	59.3x
Microsoft Corporation	MSFT	$307	14.00%	$22,880,000	68.3%	15.22%	12.9x	8.7x	34.7x	25.9x
Oracle Corporation	ORCL	$96	32.55%	$259,560	76.1%	11.29%	7.0x	7.0x	24.8x	27.7x
Salesforce, Inc	CRM	$201	20.36%	$196,000	72.7%	21.26%	9.3x	4.9x	127.2x	NM
SAP SE	SAP	$122	33.76%	$150,760	72.1%	11.01%	5.6x	4.2x	25.4x	39.4x
ServiceNow, Inc	NOW	$441	2..1%	$89,930	77.9%	25.07%	19.0x	11.7x	NM	NM
Workday, Inc	WDAY	$178	-28.50%	$46,210	72.2%	21.48%	12.7x	6.8x	NM	NM
Mean:			**8.31%**		**74.86%**	**19.87%**	**11.8x**	**7.1x**	**57.0x**	**38.1x**
Median:			**15.00%**		**74.40%**	**21.37%**	**12.8x**	**6.9x**	**34.7x**	**33.6x**

An attractively priced long term compounder

We believe Adobe currently trades at a discount to its intrinsic value and its legacy business remains robust, with numerous avenues for future growth. Although challengers to Adobe's creative monopoly continue to arise, Adobe, like Apple, Microsoft and Google, is so entrenched they will be virtually impossible to usurp overnight. The incredible longevity of Adobe's tools is often underestimated, Photoshop has been around for over 30 years; but, if a gradual decline were to occur, Adobe's industry leading margins, high NDR rates and exceptional returns on capital will ensure it remains a financial powerhouse long after the deterioration of its legacy business. Should management continue to retire shares in periods of market weakness that have compressed multiples to more attractive levels, and efficiently execute on their CC, DC and DX strategy we see no reason why this FCF machine will fail to outperform the market over the longer term.



This summary report was written in April/May 2023.

Any data not referenced was sourced from Adobe Annual Reports & Earnings Conference Calls.

1. Capital IQ as at May 10 2023
2. UBS Neo as at 31 April 2023
3. Financial Times as at 26 April 2023

ELEVATION CAPITAL
GLOBAL SHARES FUND

Independent Thinking Disciplined Investing

[In-de-pend-ent Think-ing] ində'pendənt THiNKiNG verb
Is essential to long-term investment success. We are often contrarian and do not pay attention to index compositions when making investment decisions. We believe that when you're several thousand miles away from Wall Street in a different nation, it's easier to be independent and buy the things that other people are selling, and sell the things that other people are buying.

[Dis-ci-plined In-vest-ing] disciplinəd inves'ting verb
The market presents opportunities every day, but disciplined investing is as much about the opportunities you do not take. We also believe that cash is sometimes the most attractive investment.

MORNINGSTAR INTERNATIONAL EQUITIES CATEGORY FUND MANAGER OF THE YEAR 2017, NEW ZEALAND

NOMINEE - FUNDSOURCE INTERNATIONAL EQUITY SECTOR FUND MANAGER OF THE YEAR 2013, NEW ZEALAND

NOMINEE - MORNINGSTAR INTERNATIONAL EQUITIES CATEGORY FUND MANAGER OF THE YEAR 2012, NEW ZEALAND

NOMINEE - FUNDSOURCE INTERNATIONAL EQUITY SECTOR FUND MANAGER OF THE YEAR 2012, NEW ZEALAND

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