13 November 2020

LM CAPITAL RESEARCH

Adobe Inc.

A Quality Balance Sheet & Strong Market Growth

Adobe is a global diversified software firm providing both creative solutions in the form of creative cloud and enterprise solutions through the firms experience cloud. Since moving to a SaaS model in 2012, Adobe has seen CAGR in revenue of 44% and had its valuation increase over 16x. Adobe is in a prime position to take advantage of the continued strong market growth, an increased move to the cloud from COVID-19 and strong cash flow position to leverage both growth and acquisitions into 2021. Adobe has seen a significant markup in valuation so far this year of 43%. I believe this growth is set to continue into 2021 and view Adobe as Overweight with a price target of $600.00, implying a 30% upside.

Company Update

Adobe announced Q3 earnings on September 15th Adjusted revenues jumped 13.8% year over year to $3.23 billion. While non-GAAP EPS was $2.57 beating street estimates of $2.41. Adobe announces Q4 and FY 2020 results on December 12th with Wall Street consensus EPS estimates of $2.66 up 3.5% from the previous quarter and revenue estimates between $3.35 and $3.4 billion up significantly on the previous quarter as business resume spending.

On November 9th the company signed a deal to acquire Workfront, a provider of work management platform, in a bid to enhance the capabilities of its Experience Cloud.

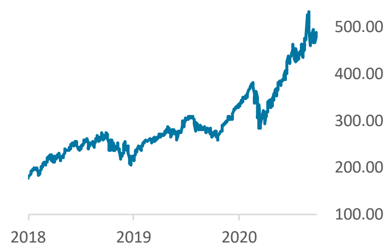
Overview

Adobe has been a dominant force in media creation since it was founded in 1982 and released postscript the first international standard for computer printing and sparking the desktop printing revolution. The majority of Adobe's revenue comes from licencing both digital creation packages and digital experience management software. The firm also offers education and support services.

The company has seen massive success with its Digital Media segment. Revenue for the segment is split into Creative Cloud Adobe's media creation platform, originally Creative Suite, Creative Cloud was launched in 2012 and moved Creative Suite to a SaaS model boosting AAR and Revenue stability. Digital Media also includes Document Cloud containing both Acrobat and E-sign.

Adobe's second revenue segment is Experience Cloud which comprises of products, services, and solutions for creating, managing, executing, measuring, monetising and optimising customer experiences from advertising to commerce. Experience Cloud allows Adobe to capture the full marketing production and execution flow from creation with creative cloud and execution, management and analytics with Experience Cloud.

Adobe Inc.



Source: Yahoo Finance

Valuation	
Opnion	Overweight
Target Price	$ 600.00
Target Price Upside	12 Months
Target Time period	30%
Date	13/11/2020

Company Profile	
Ticker	NASDAQ:ADBE
Price ($)	468.90
52W High ($)	536.88
52W Low ($)	255.13
Shares Outstanding (m)	479.72
Market Cap ($b)	228.30
Beta	0.97
Cash ($m)	5.99
Debt ($m)	4.71
Employees	22,634

Discription

Adobe Inc. develops, markets, and supports computer software products and technologies. The Company's products allow users to express and use information across all print and electronic media. Adobe offers a line of application software products, type products, and content for creating, distributing, and managing information.

Company Management	
CEO	Mr. Shartanu Narayen
CFO	Mr. John F. Murphy
CTO	Mr. Abhay Parasnis
CIO	Ms. Cynthia A. Stoddard
CAO	Mr. Mark S. Garfield
	+1 408 536 6000
	www.adobe.com

Major Holders	
Insiders	0.31%
Institutions	86.20%
# of Institutions	2,785
Other	13.80%

Analyst

Luke McCarthy

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Investment thesis

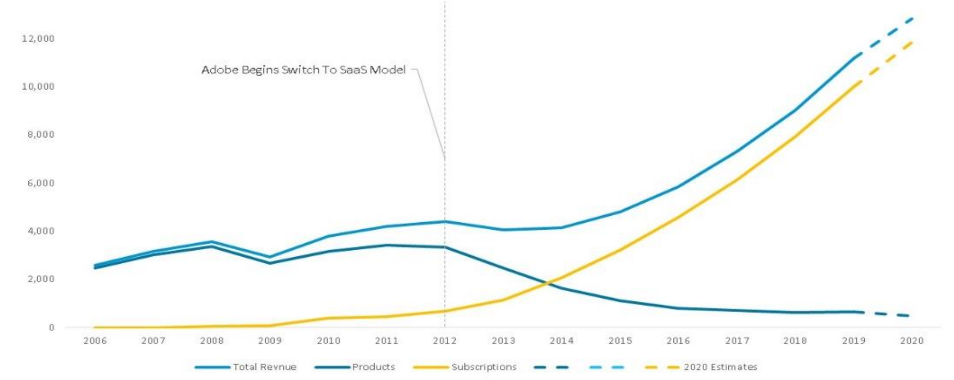
Adobe has seen a significant markup in valuation so far this year of 43%. I believe this growth is set to continue into 2021 and view Adobe as Overweight with a price target of $600.00, implying a 30% upside.

Adobe is in a prime position to take advantage of both low rates and its strong cash generation to leverage Acquisitions going into 2021, further expanding its customer base, especially in Experience Cloud. Adobe’s dominant position in the digital media creation space puts it in a prime position to take advantage of a rapidly expanding market of social media and short-form content with limited competition. Adobe is likely to see some headwinds in investor return over the coming six months from an investor move out of large-cap tech into more cyclical names as economic and virus conditions improve. Adobe may also face currency headwinds from Europe and the middle east (30% of revenue) as the dollar continues to weaken.

Key Drivers

Revenue Growth Will Remain Strong into 2021 for both Digital Media and Digital Experience. Shantanu Narayen’s appointment as CEO in 2007 sparked a move into the then $5.5 billion SaaS industry ($102 billion in 2019) with Adobe’s first subscription product (Photoshop Express) in 2008. Since 2008, Adobe has seen subscription revenue grow from $42 million to $9.99 billion. This growth implies a CAGR from the CC release in 2012 ($673 million in Sub revenue) to 2019 of ~47% and a total revenue CAGR of 14%.

Adobe Subscription vs Product Revenue



Source: Company Filings / LM Capital Research Forecasts

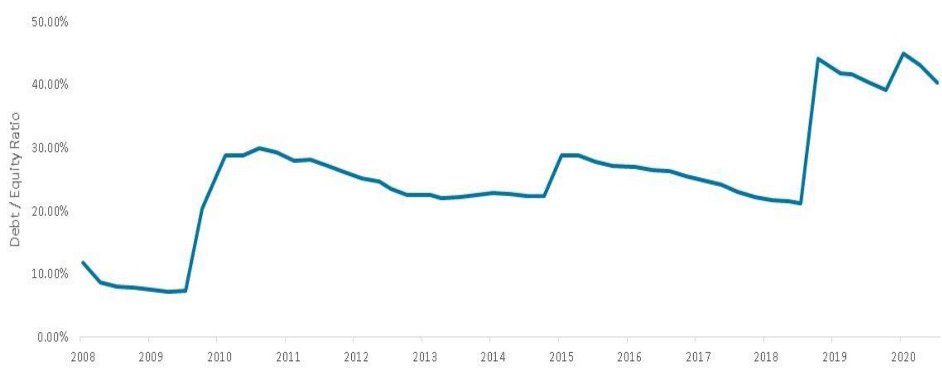
Online video and advertisement creation for YouTube and other platforms have been one of Adobe’s main driving factors. YouTube’s total users growing from 480m in 2010 to over 2.0 billion in 2020 and channels generating over $10,000 in revenue each year growing at 60% YoY, the boom in independently created online video is only picking up steam and creators are requiring more production quality to stand out. Adobe is in a prime position to take advantage of this demand with little competition and no other content creation software provider able to offer a full suite similar to Adobes at an accessible price point.

Experience Cloud accounted for around 27% of total revenue 2019 up from 24% the year prior boosting total revenue growth as Adobe saw its Experience Cloud revenue grow 37% in 2019 to $2.67 billion and 26% in 2018 vs 23.7% total revenue growth for both years. Adobe sees its TAM for Experience Cloud being around $84 billion in 2022 up from $56 billion in 2020, implying revenue growth for the segment of at least 22.5% to 2022. However, this sector has continued to outpace estimates each year as firms becoming ever more reliant on online sales and marketing to succeed.

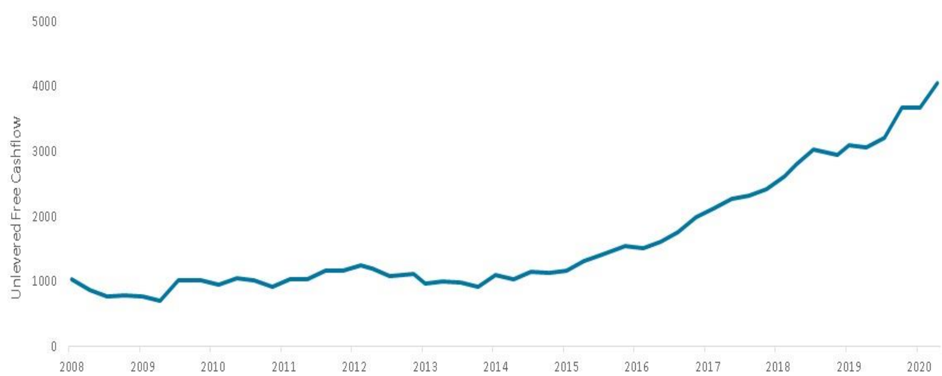
Work From Home Will Continue Boosting Document Cloud as firms move in-person document sharing and signing to the cloud. The E-signature market is expected to grow from $1.5bn in 2019 to $23.9bn in 2030, gaining a significant boost from the current work from home environment. Growth in the sector is likely to be derived from blockchain integration. It puts Adobe in a strong position with E-sign to compete with Docusign for dominance, especially with integration into Acrobat Adobe's PDF editor.

Adobe provides quality for investors in uncertain times, with a current net cash position of over $1 billion and an expected favourable cash position even after the companies $1.5bn purchase of Workfront in Q1 2021, combined with low and improving solvency ratios (Debt/Equity ratio down to 40% from 45% in January) with significant room to leverage and, TTM unlevered free cash flow of $4.06bn up $1bn from the same time last year adobe is in a strong cash and liquidity position to weather poor economic conditions.

Adobe Debt/Equity Ratio (2008 – 2020)



Adobe Unlevered Free Cashflow (2008 – 2020)

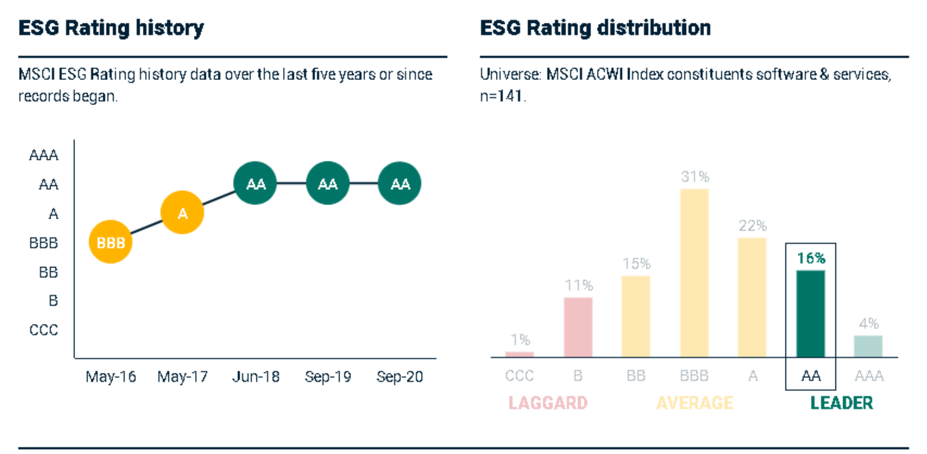


Source: Company Filings

Continued Acquisitions Spending Will Boost Adobe In 2021. On November 9th Adobe announced it would acquire Workfront (work management software) for $1.5bn showing there is still a healthy appetite for M&A. Over the past decade, the firm has acquired 21 businesses with a combined disclosed real purchase price of over $9.0 billion. Current economic conditions stand to create multiple opportunities for Adobe to expand its business, especially in the Digital Experience segment as smaller target firms struggle to stay afloat as businesses pull back on spending. After Adobe's 2018 acquisitions of both e-commerce firm Magento and marketing automation firm Marketo for a combined $6.4bn, the company significantly expanded its coverage on both markets. It expanded its digital experience segment revenue by ~40% in 2019 with revenue from these two acquisitions accounting for 30% of total segment sales and boosting revenue by around $700-800 million in 2019. Continued inorganic expansion taking advantage of the low rates environment will only benefit investors.

Strong Ratings For ESG factors will lift demand for Adobe stock over the coming five years as funds flowing into EGS investments rise. Adobe maintained a AA rating for ESG from MSCI and 6/10 from Refinitiv, excelling in corporate behaviour. ESG investing AUM totalled over $1tn for the first time in 2020, although still a small percentage of the total $41tn total in investment funds worldwide growth is exponential. ESG funds in the UK saw more inflows than between April and June this year than the previous five years combined.

MSCI ESG Rating History for Adobe



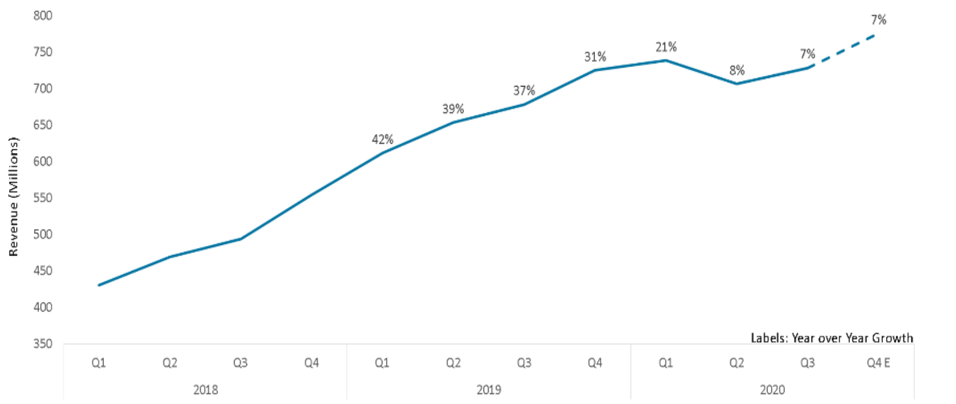
Source: MSCI ESG Company Ratings

Risks

Adobe Faces Significant Competition From social Media Firms in the ever-changing mobile online content market. With apps like Tik Tok and Instagram Reels gaining significant market share in the online content market and providing in-app editing often sufficient to edit short content Adobe may face slowing growth in sales to small and medium-size online content creators. However, this likely represents a small portion of Adobes total customer base.

COVID 19 Significantly Depressed Digital Experience Revenue. Digital Experience revenue growth in Q1 2020 fell to 20.8% YoY down from 30.9% the quarter prior and significantly lower than the 2019 average of 37%. Growth in the segment continued to lag total revenue growth in Q2 at 8.1% vs 14% total and in Q3 7.4% vs 13.8% total. The still positive growth indicated that Adobe isn't losing customers already using their Experience services. Instead, as businesses limit new spending, putting projects on hold and cutting risk on new ventures, firms' willingness to adopt new services has been severely limited. Although ISM Business Activity numbers suggest an improvement (63% up from a low of 26% in May) in spending a new peak in COVID 19 cases in the US and Europe will likely put a dampener on spending again into Q1 2021.

Adobe's Digital Experience Revenue

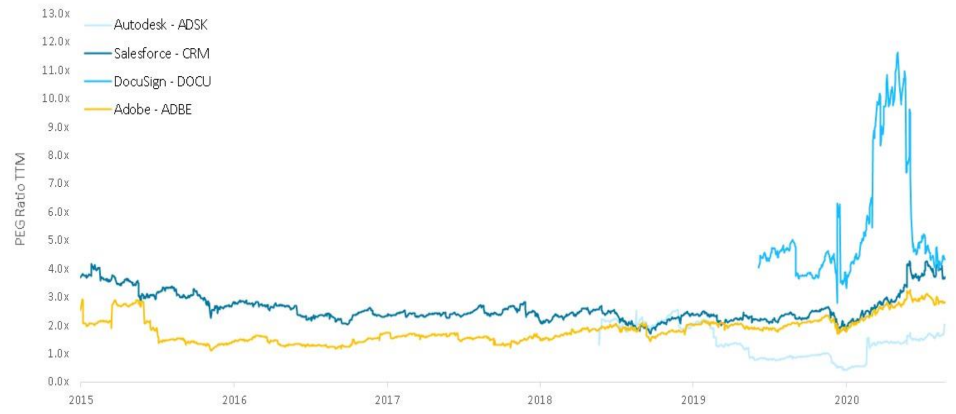


Source: MSCI ESG Company Ratings

Adobe's Digital Experience Cloud Growth Has Suffered Worse Than Competitors From COVID 19. Adobe saw Experience Cloud revenue growth of just 16% in the 12 months up to September 1st, 2020 YoY. In comparison, Salesforce saw revenue growth of 28.7% over the same period. Oracle Enterprise Resource Planning (ERP) and Human Capital Management (HCM) revenues were up 32% up to June 2020 (Oracle's full fiscal year 2020), in comparison, Adobe's Experience Cloud grew 23% over the same period year over year. SAP doesn't disaggregate CRM revenues in its financial reports but grew revenue by 7.4% over this period, although CRM only accounts for around 15% of total revenues.

After A 43% Run Up YTD Adobe's Valuation Is Inflated, with analysts expecting 12 month forward EPS of $11.17 Adobe's forward P/E multiple currently sits at 43x, higher than its historical range of 30x – 38x. However, Adobe's forward P/E is lower than the average of its peers in both Digital Media 50.6x and Digital Experience 53.4x. Adobe's PEG ratio currently sits at 2.8x higher than the average value stock at 1.0x and up from its range of 1.5x – 2.0x of the last three years. Adobe's PEG ratio currently sits as the second-highest of the top 5 ERP providers behind Salesforce (3.7x PEG), above both AutoDesk and Avid in the digital media market, although is below Docusign's PEG of 4.3x.

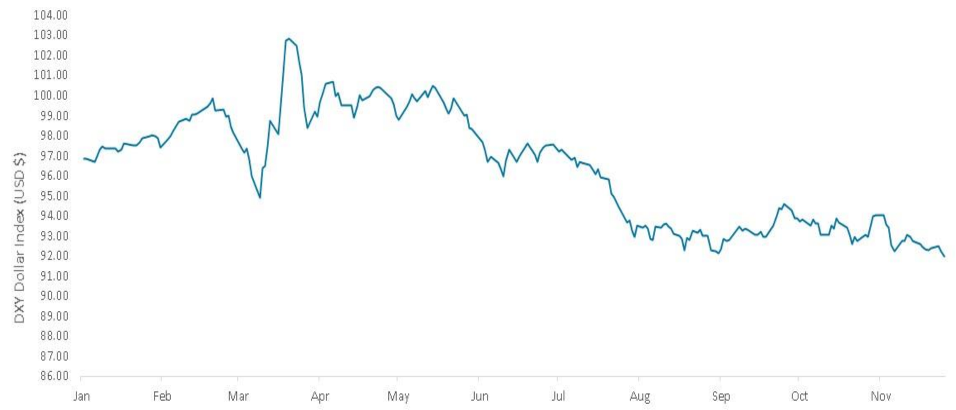
Adobe's PEG Ratio Vs Major Competitors



Source: Company Filings / Yahoo Price Data

Currency Headwinds From A Weaker Dollar are likely to continue into 2021 as the US continues to battle COVID-19, investors move capital from US mega-cap tech to outperforming Asian & Europe equities, US election & political uncertainty continue, stimulus remains weaker than Europe and Asia and lacklustre US growth depresses exports. Adobe has 26% revenue exposure to EMEA, and 16% to APAC combined at least 42% non-dollar revenue.

Dollar Index YTD

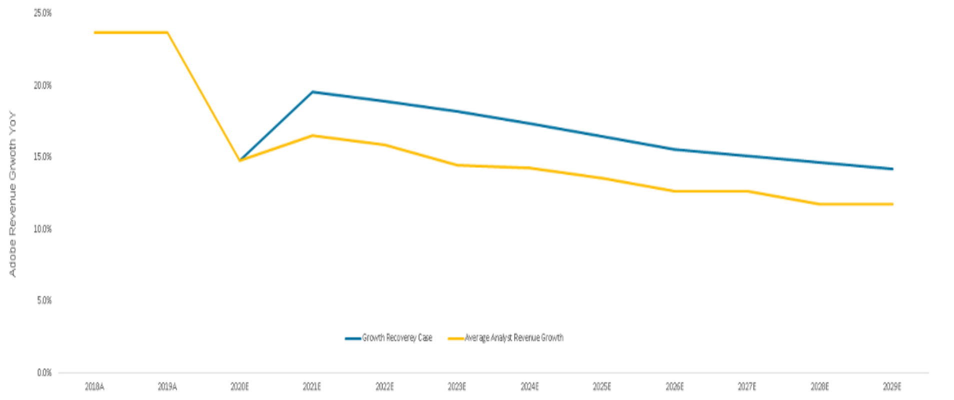


Source: Yahoo Price Data

Valuation

The below chart shows both the consensus analyst revenue forecasts and a more optimistic rebound in growth for 2021 outlook. With research predicting SaaS will grow by between 21% and 14.9% from 2020 to 2030 and 2026, the analyst consensus growth rate below with a CAGR of 14% could be on the conservative side. With revenue by far, the largest variable in the valuation of Adobe when using a present value model finding a likely range of values allowing for some error remains the most accurate approach.

Revenue Forecasts Used in DCF Valuations



Source: refinitiv i/b/e/s / LM Capital Research Forecasts

Using analyst consensus revenue, operating margin, tax rate and assuming both debt remains at current levels and there are no acquisitions, we get a value of between $475 and $557 allowing for some variation in the discount rate and exit multiple. Given a current share price of around $470, this implies an upside of 1-18% within the next twelve months. The more optimistic revenue scenario provides a share price target in the next twelve months of $584 to $687, implying an upside of 24-46%.

DCF Valuation Assumptions

Assumptions:	Model	Exit Multiple	Growth Rate
Terminal Values	Exit Multiple	16x	
Terminal Value in Model (Base)	327,727	327,727	**327,727**
Terminal Value in Model (Bull)	413,610	413,610	**413,610**
Implied Growth Rate			1.3%
Discount Rate (WACC)	7.2%		
Valuation Date	24/10/2020		
Current Fully Dilited Shares O/S	491.57		
Current Share Price	$ 488.50		

Adobe Analyst Consensus DCF Forecast – Base Case

Valuation Timeline	24/10/2020	30/11/2020	30/11/2021	30/11/2022	30/11/2023	30/11/2024	30/11/2025	30/11/2026	30/11/2027	30/11/2028	30/11/2029	30/11/2029
	Year Frac	0.10	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Free Cash Flow to Firm (FCFF)	0	5,244	6,379	7,600	8,738	10,161	11,597	13,214	14,997	16,826	18,913	327,727
Rolling Enterprise Value (NPV)	**252,214**	**253,993**	**266,618**	**278,933**	**290,824**	**302,406**	**313,238**	**323,309**	**332,370**	**340,235**	**346,640**	
Plus: Cash and Marketable Securities	5,264	9,545	16,225	24,136	33,286	43,941	56,138	70,064	85,910	103,730	123,805	
Less: Debt	(4,116)	(4,138)	(4,138)	(4,138)	(4,138)	(4,138)	(4,138)	(4,138)	(4,138)	(4,138)	(4,138)	
Equity Value	253,362	259,400	278,704	298,931	319,971	342,209	365,238	389,234	414,142	439,828	466,307	
Fully Dilited Shares O/S	491.6	485.7	479.8	474.1	468.4	462.8	457.2	451.7	446.3	441.0	435.7	
Adobe Inc Rolling Value Per Share	**$515.41**	**$534.10**	**$580.82**	**$630.54**	**$683.12**	**$739.47**	**$798.82**	**$861.64**	**$927.91**	**$997.43**	**$1,070.32**	
IRR												
Investor Return (Exc. SBC)	**($488.50)**										**$1,070.32**	
Investor IRR (Exc. SBC)	**9.0%**											

Adobe LM Capital Research DCF Forecast – Upside Case

Valuation Timeline	24/10/2020	30/11/2020	30/11/2021	30/11/2022	30/11/2023	30/11/2024	30/11/2025	30/11/2026	30/11/2027	30/11/2028	30/11/2029	30/11/2029
	Year Frac	0.10	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Free Cash Flow to Firm (FCFF)	0	5,244	6,644	8,115	9,664	11,504	13,460	15,745	18,237	21,050	24,143	413,610
Rolling Enterprise Value (NPV)	**310,455**	**312,646**	**329,483**	**346,029**	**362,187**	**377,918**	**392,735**	**406,519**	**418,844**	**429,466**	**437,754**	
Plus: Cash and Marketable Securities	5,264	9,545	16,491	24,924	35,011	47,032	61,131	77,645	96,815	118,975	144,440	
Less: Debt	(4,116)	(4,138)	(4,138)	(4,138)	(4,138)	(4,138)	(4,138)	(4,138)	(4,138)	(4,138)	(4,138)	
Equity Value	311,603	318,052	341,836	366,814	393,060	420,812	449,727	480,026	511,521	544,303	578,055	
Fully Dilited Shares O/S	491.6	485.7	479.8	474.1	468.4	462.8	457.2	451.7	446.3	441.0	435.7	
Adobe Inc Rolling Value Per Share	**$633.89**	**$654.87**	**$712.39**	**$773.73**	**$839.16**	**$909.32**	**$983.60**	**$1,062.62**	**$1,146.10**	**$1,234.36**	**$1,326.82**	
IRR												
Investor Return (Exc. SBC)	**($488.50)**										**$1,326.82**	
Investor IRR (Exc. SBC)	**11.6%**											

Source: refinitiv i/b/e/s / LM Capital Research Forecasts

COVID has significantly depressed analysts' expected market return of the S&P 500 through 2030. The average annual return of the S&P 500 has been 10.1% since 1970. However, given the long-term economic impacts of both the COVID-19 outbreak and potential tax increases and greater regulation on mega-cap tech from a democratic US government, analysts have predicted market average annual market returns as low as 7.1%.

Adobe DCF Senstivity Analysis – Base Case

Terminal Value & Discount Rate Effect on Equity Value					
	Discount Rate				
Exit Multiple	8.2%	7.7%	7.2%	6.7%	6.2%
14x	$438.57	$454.48	$471.10	$488.49	$506.67
15x	$458.93	$475.71	$493.26	$511.61	$530.80
16x	$479.29	$496.95	$515.41	$534.72	$554.93
17x	$499.65	$518.18	$537.56	$557.84	$579.05
18x	$520.00	$539.42	$559.72	$580.96	$603.18

Adobe DCF Senstivity Analysis – Upside Case

Terminal Value & Discount Rate Effect on Equity Value					
	Discount Rate				
Exit Multiple	8.2%	7.7%	7.2%	6.7%	6.2%
14x	$537.33	$557.20	$577.97	$599.70	$622.43
15x	$563.02	$584.00	$605.93	$628.87	$652.88
16x	$588.71	$610.80	$633.89	$658.05	$683.33
17x	$614.40	$637.59	$661.85	$687.23	$713.78
18x	$640.10	$664.39	$689.81	$716.40	$744.23

Source: LM Capital Research DCF

The expected market return has a significant weighting in the cost of equity section for the WACC (weighted average cost of capital) calculation, which is used as the discount rate in this model. Using an expected market return of 10.1% gives a WACC of 7.6% while an expected market return of 7.1% gives a WACC of 5.5%. This significant difference in the discount rate provides substantially different valuations ($500 for a 10.1% expected market return and $583 for a 7.1% expected market return).

Exit Ev/EBITDA (Enterprise value/earnings before interest, tax, depreciation and amortisation) multiple selection becomes difficult when talking about high growth tech names. S&P 500 average EV/EBITDA multiples have been between 11x-14x on average for the last few years. However, the current average multiple on the S&P 500 of 15x reflects valuations continuing to climb after drops in top-line sales in the S&P from COVID. The choice of a 16x exit multiple (1.3% implied perpetual growth rate) lies within a reasonable range for a high growth tech firm in an industry expected to have double-digit revenue growth out to at least 2030.

Disclaimer

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Opinions:

Overweight: 25% + Upisde	Neutral: 25% upside to 10% downside	Underweight: 10% + Downside