Q2 Fiscal Year 2011 Earnings Call Script
FINAL Draft

MIKE SAVIAGE

Good afternoon and thank you for joining us today.

Joining me on the call are Adobe's President and CEO, Shantanu Narayen, as well as Mark Garrett, Executive Vice President and CFO.

In the call today, we will discuss Adobe's second quarter fiscal year 2011 financial results. By now, you should have a copy of our earnings press release – which crossed the wire approximately one hour ago. If you need a copy of the press release, you can go to Adobe.com under the Company and News Room links to find an electronic copy.

Before we get started, I want to emphasize that some of the information discussed in this call, particularly our revenue and operating model targets, and our forward-looking product plans, is based on information as of today, June 21st, 2011, and contains forward-looking statements that involve risk and uncertainty. Actual results may differ materially from those set forth in such statements. For a discussion of these risks and uncertainties, you should review the Forward-Looking Statements Disclosure in the earnings press release we issued today, as well as Adobe's SEC filings.

During this call, we will discuss GAAP and non-GAAP financial measures. A reconciliation between the two is available in today's earnings release and on our investor relations website in the Investor data sheet.

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

I will now turn the call over to Shantanu.

SHANTANU NARAYEN

Thanks Mike and good afternoon.

I am pleased to report we delivered revenue of 1 billion 23 million dollars in Q2, with non-GAAP earnings per share of 55 cents.

Our strong performance reflects our unique value proposition in the industry: we enable our customers to make, manage, mobilize and measure digital experiences across screens in ways no other company can. This end-to-end approach is resonating with our customers and fueling our growth across an increasingly diverse set of markets.

As we have previously shared with you, we are focused on three significant growth opportunities: Content Authoring, Digital Marketing Optimization and Customer Experience Management. We are executing well in each area.

In Content Authoring, we successfully launched Creative Suite 5.5, an update to the CS5 product family. The release features enhancements for mobile content and application creation, new innovations for HTML5 and Flash authoring, and amazing new features and productivity improvements in our video authoring solutions.

CS5.5 is the first release in our transition to an annual release cycle, enabling us to deliver content creation innovations to our customers more frequently in response to the rapidly evolving marketplace. It also allows us to augment our business model to drive incremental revenue. In addition to the perpetual license model we've always offered, we now offer a new Subscription Edition with CS5.5 that provides a lower upfront price point for customers.

Whether it be HTML, Flash or any other output format, the goal of CS5.5 is to be the best authoring suite, regardless of platform, browser or operating system.

Response to our HTML5 tooling capabilities in CS5.5 has been positive, and we recently made new contributions to the HTML standards process by proposing enhancements to build complex, magazine-like layouts in Web browsers using Web standards.

We are working on an implementation of this proposal in the WebKit open source HTML engine with Apple, Google and other members of the community. Looking forward, we will deliver a beta release of Adobe Edge in July, which is a new creative tool for creating expressive animations in HTML for desktops and devices.

While we work to help advance HTML capabilities, we will also continue to innovate with our Flash technology – particularly in areas such as premium video content delivery and measurement, rich Internet applications, and gaming. In premium video content, services such as Amazon Instant Video, HBO Go and Hulu – and media companies such as ABC and CBS; the BBC in the UK, M6 in France, MTV, Turner and many others rely on Adobe's platform for delivering and monetizing their assets.

For mobile apps, the industry is starting to recognize the power of utilizing Flash through the Adobe AIR runtime for devices running Android, iOS, RIM's Blackberry Tablet OS and others. IDC cited Adobe as having a "leading multi-platform mobile development environment." This week we released version 4.5 of FlashBuilder and Flex to extend the capabilities of our developer tools platform.

CS 5.5 integrates with our new Digital Publishing solution, which enables publishers to create, distribute and monetize their digital publications for use on tablets. Our Digital Publishing solution has enabled our customers to launch over 400 titles already – in over 40 countries. We continue to be excited about the opportunity that the tablet market offers us, not only as a consumption device but also as a creation platform for Adobe applications in the future.

Looking forward, expect this type of innovation to continue. We intend to ship the next milestone release of Creative Suite in 2012, and it will include an updated version of Photoshop.

In Digital Marketing Optimization, Q2 was another record revenue quarter. It's clear that the digital marketing category is exploding, as evidenced by our sold-out Digital Marketing Summits in Salt Lake City and London. We announced our next-generation platform for the Adobe Online Marketing Suite that helps our customers more quickly analyze and derive actionable insight from video, social and mobile traffic. We also introduced Adobe Tag Manager, which provides a tag management framework to accelerate digital campaigns within the Suite. These innovations ensure that we continue to have the most comprehensive offering in this space.

As social media becomes an integral part of our customers' marketing, digital marketers find it critical to measure the impact of social media in their campaigns. In March, we announced a beta release of our new Adobe SocialAnalytics product and reaction from customers has been strong. The new product enables users to actively correlate social media sentiment to business impact.

Recent customer wins in our Digital Marketing business include Dell, Lenovo, the European financial group UniCredit and Vodafone.

In Customer Experience Management, we achieved year-over-year growth of 34%. The integration of our Day Software acquisition has gone well, with Q2 customer wins including Delta Airlines, SAP, Barclay's Services, Louis Vuitton and Cathay Pacific.

Yesterday, we announced the new Adobe Digital Enterprise Platform, a unified solution for Customer Experience Management, and a suite of Adobe Customer Experience Solutions to power engaging digital experiences across multiple communication channels. This platform and set of solutions incorporate Day's web content management capabilities along with our LiveCycle capabilities and the measurement and analytics of our Online Marketing Suite.

We will roll out these offerings beginning later this summer, and we're excited about the progress that we are making in delivering integrated solutions which leverage many of our products. This strategy is helping to grow the size of our engagements and sales with large enterprise customers as we are increasingly benefitting from the synergy among our offerings to help customers create differentiated and effective digital experiences.

For example, both Nike and publishing firm Meredith Corporation purchased multi-product solutions across our Omniture and Day product lines in Q2; so did retail and online stores H&M, Marks and Spencer, and Nordstrom. Success in selling multi-million dollar enterprise solutions such as these demonstrate how we've increased the value we provide to customers – and how we are increasingly becoming mission critical to how our customers run their online business.

Later I will have some closing comments, but first I will now turn the call over to Mark for a look at the financial results in the quarter. Mark.

MARK GARRETT

Thanks Shantanu.

In the second quarter of fiscal 2011, Adobe achieved revenue of 1 billion 23 million dollars. This compares to $943 million reported in Q2 fiscal 2010; and $1 billion 28 million reported last quarter. Year-over-year this represents 9% revenue growth.

Q2 GAAP operating expenses were $637.3 million, compared to $607.9 million reported in Q2 fiscal 2010; and $617.7 million last quarter. Non-GAAP operating expenses in Q2 were $556.7 million, compared to $520.2 million reported for Q2 fiscal 2010; and $539.5 million last quarter.

GAAP operating income in Q2 fiscal 2011 was $276.7 million, or 27% of revenue. This compares to GAAP operating income of $227.3 million, or 24.1% of revenue in Q2 fiscal 2010, and $302.3 million, or 29.4% of revenue last quarter. Non-GAAP operating income in Q2 fiscal 2011 was $376.4 million, or 36.8% of revenue. This compares to non-GAAP operating income of $334.5 million, or 35.5% of revenue in Q2 fiscal 2010, and $400.1 million, or 38.9% of revenue last quarter.

Adobe's effective GAAP tax rate in Q2 was 11.5%, and the non-GAAP tax rate was 22%. Our GAAP tax rate was lower in Q2 due to the favorable impact of a state income tax ruling.

GAAP diluted earnings per share for Q2 fiscal 2011 were 45 cents. This compares with GAAP diluted earnings per share of 28 cents reported in Q2 fiscal 2010, and GAAP diluted earnings per share of 46 cents reported last quarter. Non-GAAP diluted earnings per share for Q2 fiscal 2011 were 55 cents. This compares with non-GAAP diluted earnings per share of 44 cents in Q2 fiscal 2010, and 58 cents reported last quarter.

I will now discuss Adobe's results in Q2 by business segment.

Creative and Interactive Solutions segment revenue in Q2 was $433.1 million, compared to $423.3 million in Q2 fiscal 2010 when we launched CS5, and $424.8 million last quarter.

While it's only been a matter of weeks since 5.5 shipped, we can make the following observations:

- The release of CS 5.5 in Q2 has helped maintain the solid run-rate that CS5 established during the prior 4 quarters.

- Interest in Master Collection, as well as Web Premium and the Production Premium video suites has been strong, indicating positive reception to the key innovations and new features that were added to those products.

- Adoption of the new Subscription Edition has met our expectations and is attracting new users. We expect this to build a new recurring revenue stream over time.

Digital Media Solutions Q2 revenue was $136.7 million, compared to $139.3 million in Q2 fiscal 2010, and $151.7 million last quarter. The sequential revenue decline is primarily attributed to product lifecycle timing.

Digital Enterprise Solutions revenue was $283.5 million in Q2, compared to $231.9 million in Q2 fiscal 2010, and $286.6 million last quarter.

Within Digital Enterprise Solutions, Knowledge Worker revenue was $182 million, compared to $156 million in Q2 fiscal 2010, and $181.8 million last quarter. Acrobat grew 17% year-over-year driven by an increase in both ASPs and units.

Enterprise segment revenue was $101.5 million, compared to $75.9 million in Q2 fiscal 2010, and $104.8 million last quarter. Year-over-year revenue growth of 34% was driven by strong adoption of Day content management, and the increased awareness of our broad Customer Experience Management solutions.

Omniture segment revenue in Q2 was a record $115.9 million, compared to $91.9 million reported in Q2 of fiscal 2010, and $110.9 million last quarter.

Omniture server transactions were up 13% on a year-over-year basis. Mobile and tablet device traffic remains the fastest growing part of the Omniture business, with the number of transactions we measured from mobile devices growing 24% quarter-over-quarter in Q2.

Omniture revenue diversification continued, with SiteCatalyst at 51% of Q2 Omniture product revenue. Conversion and multi-channel analytics products are growing in size as the analytics business becomes a smaller percentage of the business. Enterprise renewal rates remained at 95% in the quarter.

Finally, Print and Publishing segment revenue was $54 million, compared to $56.6 million in Q2 fiscal 2010, and $53.7 million last quarter.

Turning to our geographic segments in Q2, results on a percent of revenue basis were as follows:

The Americas 48%
Europe 30%
Asia 22%

At the time of our Q1 earnings call in March, the unfortunate events in Japan caused us to estimate that as much as $50 million in Q2 revenue was at risk in that market. Fortunately, through the strong work of our team in Japan and the resiliency demonstrated in the country, we estimate the impact was only $10 million in the quarter. This helped to drive a sequential increase in our Asia revenue, versus our estimate that revenue would decline sequentially.

Partially offsetting the Q2 upside in Japan, we experienced weaker-than-expected demand in EMEA. In the Americas, the demand environment remained stable.

From a year-over-year currency perspective, FX increased revenue by $35 million. We had a $0.2 million hedge gain in Q2 FY11, versus a $6.2 million hedge gain in Q2 FY10; thus the net year-over-year currency increase to revenue considering hedging gains was $29 million.

From a quarter-over-quarter perspective, FX increased revenue by $15.6 million. We had a $0.2 million hedge gain in Q2 FY11, versus no hedge gain in Q1 FY11; thus the net sequential currency increase to revenue considering hedging gains was $15.8 million.

We entered and exited the second quarter with no shippable backlog.

Employees at the end of Q2 totaled 9,770, versus 9,503 at the end of the last quarter. The increase was primarily due to the addition of summer interns, and hiring in sales and marketing.

Our trade DSO was 51 days, which compares to 42 days in the year-ago quarter, and 47 days last quarter.

Our global channel inventory position at the end of the quarter was within company policy.

During the quarter, cash flow from operations was $389 million. Our ending cash and short-term investment position was $2.6 billion, the same as it was at the end of Q1.

Deferred revenue in the quarter increased by $38.6 million in the quarter to a total of $482 million.

In Q2, we repurchased approximately 13.7 million shares at a total cost of $461.6 million. Entering Q3, $455 million of stock repurchase authority remains against the $1.6 billion stock repurchase authorization announced in July of last year.

This concludes my discussion of our financial results. I would now like to comment on our financial targets for the third quarter of fiscal 2011.

We are targeting a Q3 revenue range of 1 billion to 1 billion 50 million dollars.

At the midpoint of this targeted range, we would expect Omniture and Enterprise segments to grow sequentially; we would expect Creative and Interactive as well as Digital Media Solutions to be flat to slightly up; we would expect Knowledge Worker to decline; and we would expect Print & Publishing to be flat. Geographically, we would expect Americas to grow sequentially, offset by an expected sequential decline in Asia and EMEA due to normal seasonality in those markets.

For margins, we are targeting a Q3 GAAP operating margin range of 24.5% to 27.5%, and a non-GAAP operating margin range of 34% to 36%. We are targeting our Q3 share count to be 501 million to 503 million shares. We are targeting non-operating expense to be between $17 million and $21 million on both a GAAP and non-GAAP basis. For our Q3 effective GAAP and non-GAAP tax rates we are targeting 22%. These targets lead to a GAAP earnings per share range of 35 to 42 cents per share, and a non-GAAP earnings per share range of 50 to 56 cents.

We are also reaffirming today our 10% annual revenue growth target for fiscal year 2011. In addition, we are targeting our full-year operating margin to be approximately 27.5% on a GAAP basis, and approximately 37% on a non-GAAP basis.

This concludes my section. I'd now like to turn the call back over to Shantanu.

SHANTANU NARAYEN

Thanks Mark.

It is an exciting time at Adobe. The company is undergoing a significant transformation and our mission of changing the world through digital experiences has never been more relevant. We continue to focus on our three large growth opportunities – Content Authoring, Digital Marketing Optimization and Customer Experience Management – and most importantly, on the synergies among them. Increasingly, we are finding that the real power is in creating customer solutions—like digital publishing and web experience management—that integrate our product lines. This will be a major thrust for us moving forward.

Regardless of whether our customers are major media companies, enterprises, government agencies, or educational institutions, they all face the same challenge with their digital content and applications: they need to make compelling experiences that will scale across media and devices; manage their assets to streamline touch points with customers; mobilize the experiences to easily reach their audiences across every channel; and measure the effectiveness of experiences to maximize customer conversion and revenue. This need has never been more critical than it is right now, and we see the opportunities for Adobe continuing to grow as the digital landscape becomes richer and more diverse.

Adobe's success has always been due to our incredible team of employees throughout the world. I would like to especially recognize the contributions of our employees in Japan who showed tremendous commitment to serving customers following the earthquakes and tsunami. Their dedication helped limit the impact on our business in Q2.

Thank you for joining us today. Now, I'll turn the call back over to Mike.

MIKE SAVIAGE

Thanks Shantanu. Before we start Q&A I have a number of logistical items to go over. First, we have set a date for our annual financial analyst meeting. This year, the meeting will be held in New York City on Wednesday November 9th. Invitations and additional information will be communicated later this summer.

Registration for Adobe MAX is now open, and once again we are offering a special registration price for Wall Street professionals to attend. MAX will be held once again in Los Angeles during the week of October 3rd. We will send out the special registration offer to attend MAX in the coming weeks.

In regard to today's earnings report, we have posted several documents on our Investor Relations web site today – including a copy of the script containing our prepared remarks for today's call. To access these documents and the other investor-related information, go to www.adobe.com/ADBE. We also encourage you to sign up for easy access to updated documents and communications via RSS feeds that you can subscribe to on the website.

For those who wish to listen to a playback of today's conference call, a Web-based Adobe Connect archive of the call will be available from the IR page on Adobe.com later today. Alternatively, you can listen to a phone replay by calling 888-203-1112; use conference ID #9999062. Again, the number is 888-203-1112 with ID #9999062. International callers should dial 719-457-0820. The phone playback service will be available beginning at 4pm Pacific Time today, and ending at 4pm Pacific Time on Friday June 24th, 2011.

We would now be happy to take your questions. In addition to questions that come in from those participating on the live phone call, we have also enabled the Question pod in the Connect session. So those on the Connect session – feel free to send in your questions and we'll try to take a few. Operator, we'll take the first question from the phones.