Adobe

Information Technology
NASDAQ: ADBE
Market Outperform | Hold

December 31, 2022

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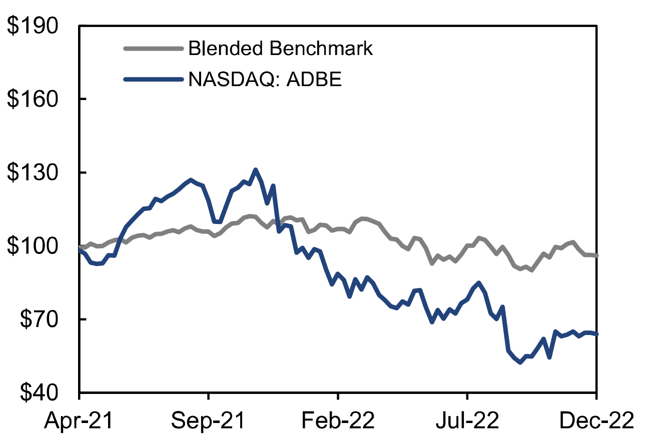
Return on Investment	
Current Share Price	$337.53
Intrinsic Value	$378.00
Dividend Yield	N/A
Implied Discount	12%
Conviction Rating	2

Market Profile	
52-Week Range	$274.73 - $575.00
Market Capitalization (US$mm)	$156,450
Net Debt (US$mm)	($1,463)
Enterprise Value (US$mm)	$154,987
Beta (5-Year Monthly)	1.26

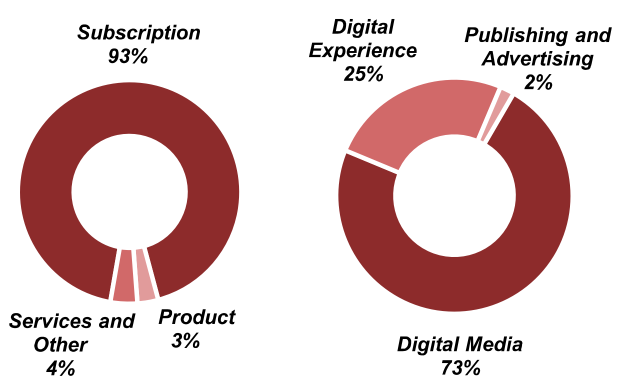
Metrics	2022A	2023E	2024E
Revenue (US$mm)	$17,606	$19,256	$21,460
EBITDA (US$mm)	$6,976	$7,669	$8,765
EPS	$10.10	$10.94	$12.59
EV/EBITDA	22.2x	20.2x	17.7x

Holding Period Trading Performance (Indexed to $100)



Source: S&P Capital IQ

Figure 1: 2022 Revenue Mix



Source: Company Filings

Business Description

Adobe Inc. (NASDAQ: ADBE) is a diversified software company that offers an extensive portfolio of products catering to content creators, creative professionals, students, businesses, and educators around the world. ADBE was founded in 1982 and is headquartered in San Jose, California. The Company has been a global leader in software packaging for more than 40 years, expanding through organic and inorganic channels. ADBE operates through three main business segments: (1) Digital Media, (2) Digital Experience, and (3) Publishing and Advertising. Digital Media offers the Company's Creative Cloud products like Photoshop and Lightroom while Digital Experience includes customer relationship management (CRM) products. Publishing and Advertising contains niche services and products for diverse markets. The product suite is primarily sold through app stores, cloud-based platforms such as Software-as-a-Service (SaaS), system integrators, and value-add resellers.

Industry Overview

The growing digital media industry can be segmented into multiple categories including e-commerce, communication platforms, and CRM. The industry is dominated by a few large players, including ADBE, Microsoft (NASDAQ: MSFT), Salesforce (NYSE: CRM), SAP (NYSE: SAP), and Oracle (NYSE: ORCL), but experiences low barriers to entry and intense competition from disruptive technology development. Customers expect high-quality products and are typically sensitive to price changes. ADBE and its peers have been actively expanding use of the SaaS model to stabilize cash flow and drive customer retention. The digital media industry is expected to grow at an annualized rate of 6% in the next five years, in-line with the adoption of emerging technologies and society's growing dependence on the industry's products.

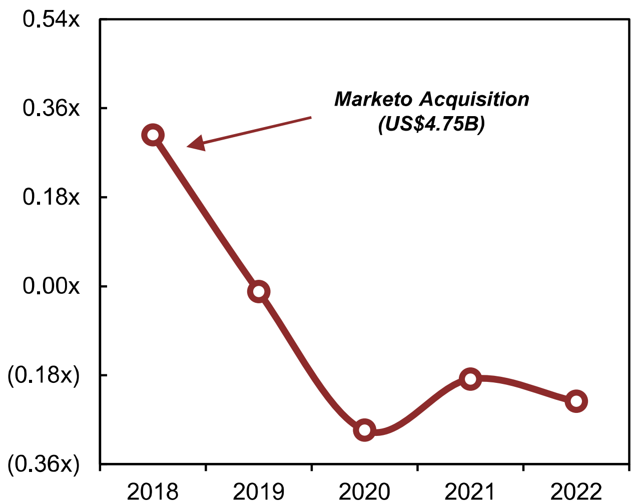
Figma Acquisition

On September 15, 2022, the Company announced the pending acquisition of Figma, a web-first leading design program. The company's primary product offering is its all-in-one multiplayer product design platform that extends across the product design process, from development to marketing. Figma is expected to generate annualized recurring revenue (ARR) of US$200mm in 2022 and surpass US$400mm following YE2023. Additionally, the company boasts positive operating cash flows and gross margins of ~90%. ADBE's management has indicated the acquisition will be accretive three years after the close of the transaction. The deal is planned to close in 2023 following approval from the U.S. Department of Justice which is performing an antitrust investigation on the proposed acquisition.

The acquisition is ADBE's largest to date, valued at US$20B and is expected to be financed with approximately half cash and half stock (~30mm shares). The cash portion of the financing is expected to be funded through cash-on-hand and, if required, a term loan. In addition, ADBE is providing Figma's CEO and employees 6mm restricted share units which ADBE"s management indicated will be offset by future share repurchases.

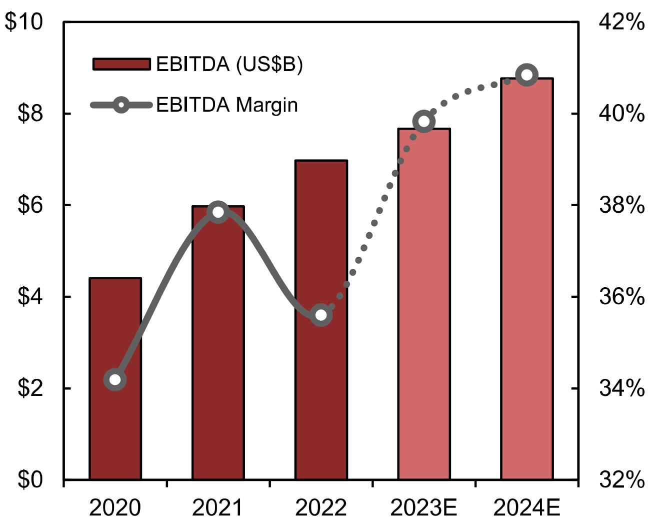
The Fund views the acquisition as strategic and a valuable (cont.)

Figure 2: LTM Net Debt/EBITDA



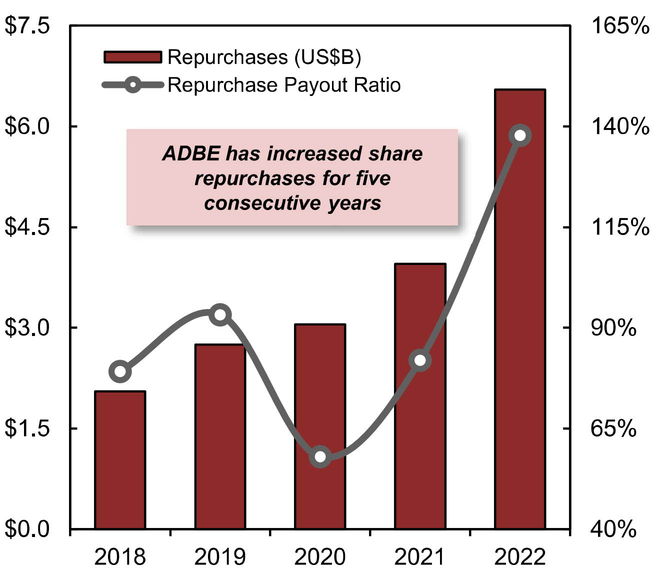
Source: Company Filings

Figure 3: LHS EBITDA vs RHS EBITDA Margin



Source: Company Filings, CPMT Estimates

Figure 4: LHS Repurchases vs RHS Repurchase Payout



Source: Company Filings

addition to ADBE's product portfolio with significant bundling and cross-selling opportunities. The acquisition is not of a competitor but of a business that complements ADBE's existing product portfolio, enabling it to sustain consistent FCF growth. ADBE's management has indicated that there are many existing joint customers between the companies and that Figma will help ADBE appeal to smaller businesses. However, the CPMT questions the high valuation of the transaction, which is ~50x ARR. Additionally, the timing of the acquisition is of questionable, considering the current period of growing economic uncertainty. Following the announcement of the acquisition, ADBE's share price fell 17%, ADBE's worst trading day in over 10 years. Nonetheless, ADBE's acquisition of Figma follows the Company's strategy of purchasing leading SaaS companies to continuously improve its product portfolio.

Mandate Fit

Quality Management: ADBE is led by CEO and Chairman Shantanyu Narayen, who has been with the Company since 1998 and has served as CEO for over 15 years. During his tenure, Shantanyu has demonstrated his ability to identify and execute on strategic SaaS acquisitions like Omniture and Marketo, which have strengthened ADBE's position in the industry. The Fund remains confident in management's ability to execute its business strategy.

Competitive Advantage: The Company's extensive product portfolio of high quality and easy-to-use services has become pervasive in the creative world and as a result has created significant barriers for replacement. ADBE also has an extensive 40-year track record demonstrating its ability to provide multi-functional and reliable products that simplify complex tasks for end users.

ADBE's Creative Cloud bundle has developed itself to be the standard software service for creative and educational professionals, which has resulted in customer stickiness. Additionally, the creative industry incentivizes individuals and firms to become well-versed with Creative Cloud Products, which has led to decreased competition. Lastly, ADBE's growing extensive product portfolio and consistent software updates provides users with a one-stop-shop experience that is difficult to replicate.

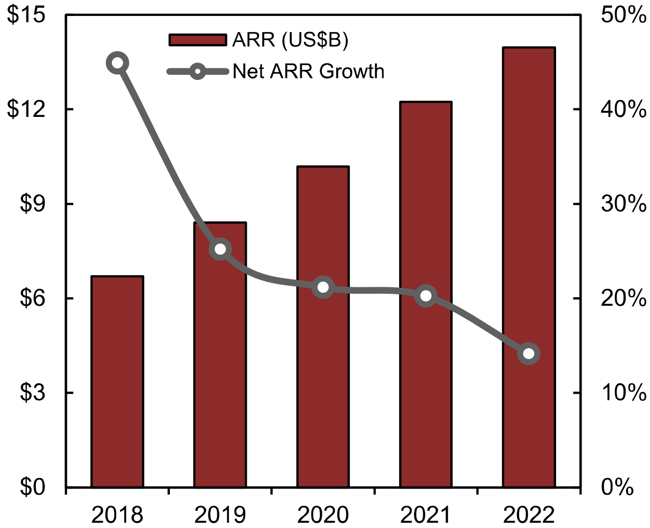
Strong Balance Sheet: The Company's balance sheet remains healthy, driven by robust FCF generation and low leverage, with net debt of (US$1.5B). Furthermore, the Company has available liquidity of US$1.5B under its undrawn revolver and a US$4.2B cash position. ADBE has previously used leverage to fund acquisitions such as Marketo in 2018. One year following the Marketo acquisition, ADBE returned to a net cash position demonstrating management's commitment to maintain balance sheet strength. ADBE's management has indicated they may use leverage to fund the Figma acquisition. The Fund expects any use of leverage will be followed by a focus on deleveraging to a net cash position. ADBE maintains an investment-grade credit rating of A+ and A2 from S&P Global and Moody's, respectively.

Growing Free Cash Flow: ADBE has continuously demonstrated strong FCF generation, achieving a five-year CAGR of 22.5% and US$7.1B during FY2022. Additionally, the Company has consistently grown its Digital Media ARR (i.e., recurring subscription service revenue) from US$6.7B in 2018 to US$14.0B in 2022. ADBE's use of capital has been focused on returning capital to shareholders and inorganically growing its product portfolio through acquisitions.

Risks

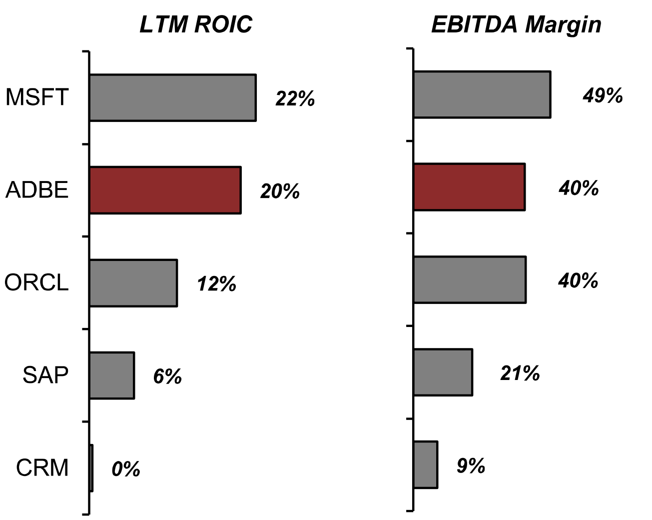
The Company's primary idiosyncratic risk is its niche product (cont.)

Figure 5: LHS Digital Media ARR vs RHS Net ARR Growth



Source: Company Filings

Figure 6: Comparable Company Analysis



Source: S&P Capital IQ

focus, decelerating growth, and consequently, management's pressure to maintain high growth through acquisition. Additionally, ADBE is subject to the risk of management's capital allocation strategy and, more specifically, the integration of Figma. The Company also operates in an industry prone to disruptive technology development which could lead to increased unforeseen competition.

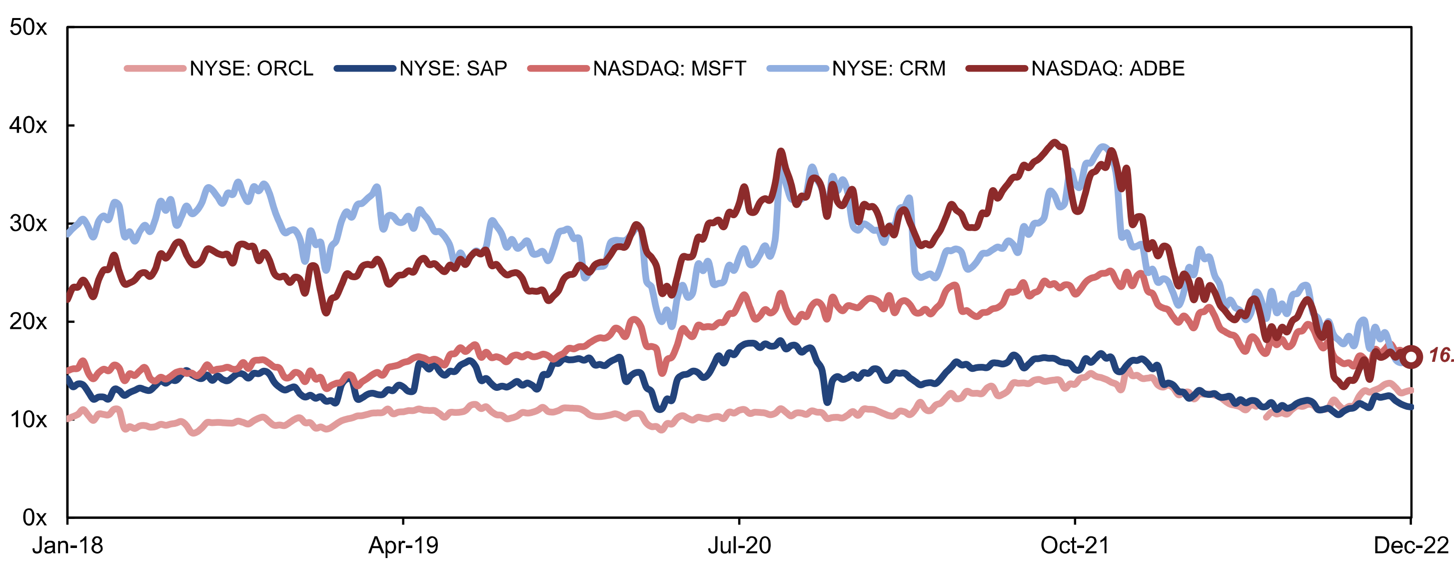
Investment Thesis and Valuation

The CPMT entered a position in ADBE in April 2021. The original investment thesis was based on the Company's integrated-software packaging platform, which generated growing cash flows by serving millions of individuals and professionals globally. Furthermore, management possessed a strong track record of integrating major acquisitions to enhance the product mix available to its customers.

ADBE has largely delivered on the original investment thesis as the Company has continued to deliver growing ARR, disciplined use of the Company's balance sheet, and returning value to shareholders through share repurchases. However, the Fund questions management's consideration of growing economic uncertainty and shareholder appetite for high valuation acquisitions in its capital allocation strategy, especially given the limited disclosure on the Figma transaction. The Fund is unable to perform thorough due diligence on Figma until the transaction is closed, at which point the CPMT will develop a more conclusive conviction in the transaction and ADBE's overall acquisition strategy. However, ADBE is trading at a 41.0% discount to its all-time high despite continuing to demonstrate its strong business fundamentals. Additionally, ADBE has historically traded at a premium relative to its peers but has recently traded more in-line. The CPMT believes that ADBE possesses significant upside potential which justifies a premium due to its strong acquisition track record, consistent FCF and ARR growth, and continuous product portfolio enhancement. The Fund plans to increase ADBE's AUM from 2.7% back to 4.0% pending internal discussion and upon acquisition close, as well as further analysis on Figma and ADBE's rationale behind the investment.

The intrinsic value of US$378 was derived using a 50/50 blend of (1) Gordon Growth method using a WACC of 10% and 1% terminal growth rate, and (2) applying an EV/FCF exit multiple of 23x, resulting in an implied discount of 12%.

Figure 7: NTM EV/EBITDA vs Peers



Source: S&P Capital IQ