BEHIND THE NUMBERS
Quality of Earnings Analysis
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Adobe (ADBE)
Earnings Quality Update- 3/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We maintain our earnings quality rating of ADBE of 4+ (Acceptable)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

ADBE's 3/21 quarter non-GAAP EPS of $3.14 was 35 cps ahead of consensus estimates. The effective tax rate of 16% was below the forecasted 17.5% driven by a favorable tax ruling but this only added about 6 cps to EPS.

- Deferred revenue growth has been lagging revenue growth despite a shift to Cloud-based services which should result in a larger percentage of revenue being deferred. This has been influenced in the pandemic quarters as sales through its Adobe.com online channel accelerated. These sales are billed monthly rather than annually resulting in less revenue deferred. However, deferred revenue days of subscription and support revenues rose to 112 which was even with the year-ago quarter and up from 104 in the 11/20 period. We view this as a positive sign for earnings quality and future revenue trends. Continued improvement in deferred revenue could drive an upgrade in rating in future quarters.

- Capitalized costs to obtain contracts were 14.3 days of sales in the 3/21 quarter which is in the typical 14-15 days range. We continue to see no signs of aggressive capitalization and consider the company's 5-year amortization period to be reasonable.

- The company adds stock-based compensation back to non-GAAP earnings. We maintain that stock compensation should be viewed as a cash expense and believe ignoring it overstates reported results. In the case of ADBE, stock compensation amounts to 15-17% of non-GAAP operating income. While material, it is less than that the 30-40% ranges seen at peers such as Salesforce.com (CRM) and Autodesk (ADSK).

- The $1.5 billion acquisition of Workfront resulted in a $1.1 billion increase to goodwill and a $460 million increase to intangibles. The amortization periods are reasonable with 10 years for customer relationships and 3 years for technology. However, the company adds back amortization to non-GAAP results. While we believe this practice distorts adjusted earnings by ignoring the cost of deals, the impact on ADBE's results is less than some software peers. We do note that prior to the Workfront deal, amortization was declining which was actually penalizing non-GAAP growth.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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