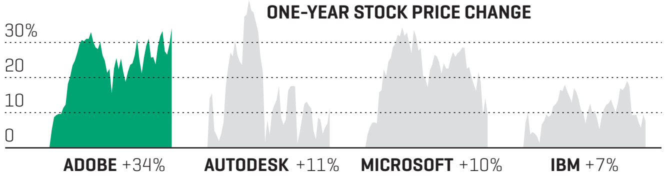
A COMEBACK IN THE MAKING

Adobe's change of strategy appears to be bearing fruit. Investors have been especially encouraged by the 20% annual growth of its marketing division.



CHANGE FROM NOV. 25, 2011, TO NOV. 30, 2012. SOURCE: BLOOMBERG

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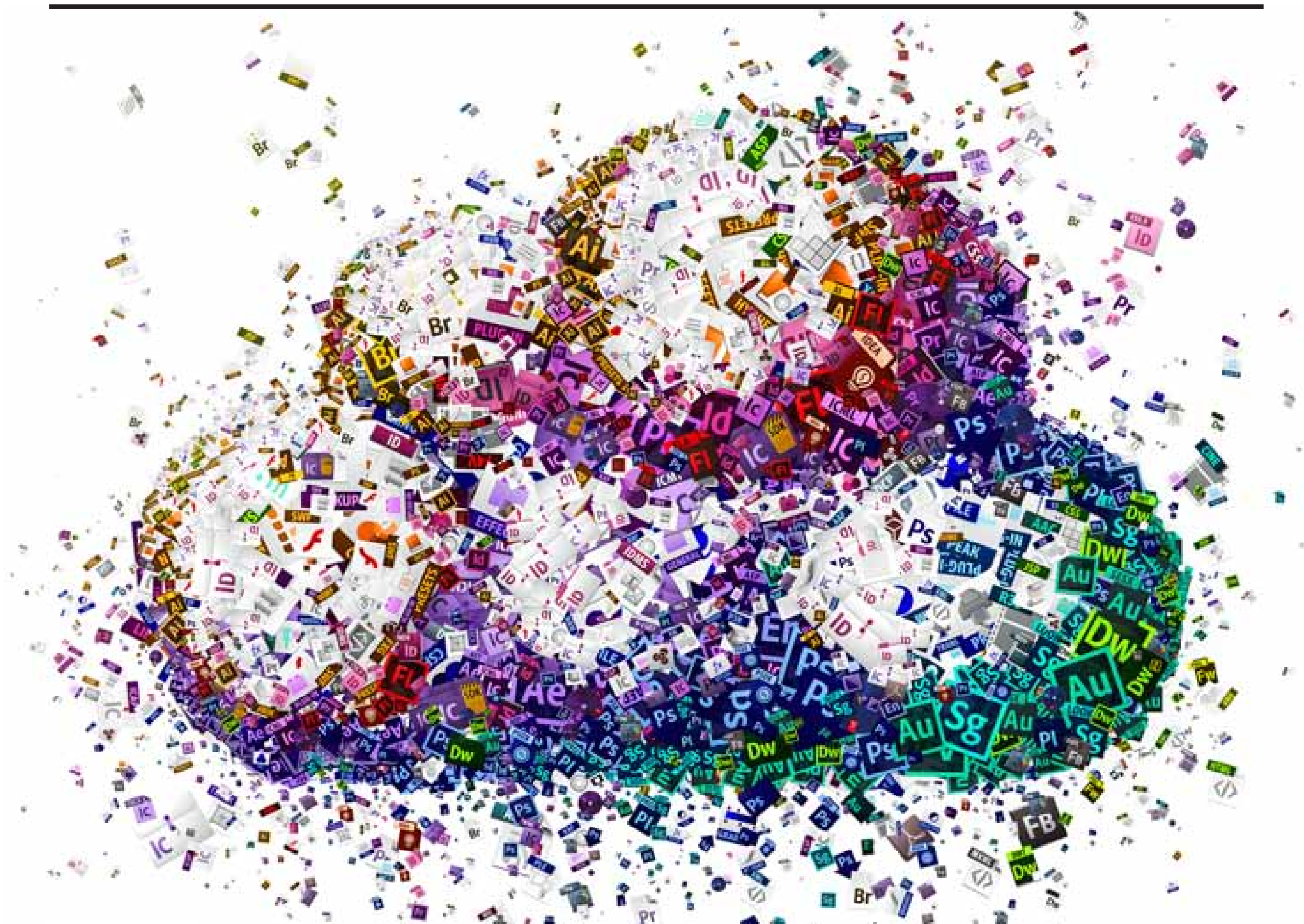

SOFTWARE

WILL ADOBE'S NEW CLOUD STRATEGY PAY OFF?

A risky makeover of the king of shrinkwrapped software is starting to win over skeptics. *by Kevin Kelleher*

ADOBE CHIEF SHANTANU NARAYAN and a dozen of his top executives were sequestered in a tony Carmel Valley spa in California. It was early September of 2011, and the group was running through a corporate bonding exercise. Everyone was to take a penny and recount what they were doing during the year stamped on the coin.

Illustration by CHARIS TSEVIS

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Eyes began to roll, according to those present. Then something strange happened. "It just blew up," recalls Brad Rencher, a senior VP in charge of marketing. The icebreaker quickly turned into an outpouring of emotion about the far more pressing issues facing the company. "Everyone felt we had some hard decisions to make," he says.

After the retreat CEO Narayan unveiled the biggest transformation in Adobe's 30-year history. The firm best known as a purveyor of tools for digital artists, filmmakers, webmasters, and content creators would shed 750 jobs, shutter or limit business units, and combine others. Adobe, executives said, would focus more on growing its digital-marketing business. Its iconic software, meanwhile, would transition further to the cloud, shifting from a pay-beforehand model to monthly subscriptions. "Companies that simply try to preserve the status quo will fail," says Narayan.

But the dramatic shift spooked investors. Not only was the company making a risky transition to a new revenue model, but it was also elbowing its way into the competitive arena of online marketing. All this was happening in the wake of the company's ugly public battle with Apple over Flash—which Adobe had lost. Its stock plunged 15% during the next three weeks as investors bailed out.

One year later Adobe's moves increasingly appear shrewd and likely to produce positive results next year. The stock has risen 34% over the past year as analysts have been won over by Narayan's plans. Switching to a subscription model will weigh on profits through 2013 but could eventually ensure steadier revenue. "The move to subscriptions is a clever and thoughtful way to lower the price

ADOBE'S VISIONARIES

SHANTANU NARAYAN, PRESIDENT AND CEO
Having taken the helm in 2007, Narayan has been the driving force behind the company's acquisitions, including the $1.8 billion Omniture buy in 2009. He's spent $800 million on digital marketing companies since.

KEVIN LYNCH, CTO
Lynch came onboard as part of Adobe's $3.4 billion Macromedia acquisition in 2005. Since becoming CTO in 2008, he has canvassed key partners, like Apple and Microsoft, for ideas—even when that has meant competing with them head-to-head.

point," says Cowen & Co. analyst Peter Goldmacher.

Adobe, which grew powerful during the heyday of shrinkwrapped, boxed software, has become a model for companies coping with tech's changing landscape. Like other giants, Adobe must navigate the rise of the cloud, mobile gadgets, social networking, and highly targeted online advertising. Adobe's transformation also pits it against the world's most powerful tech firms—some of them its most ardent allies: Microsoft and Apple in productivity programs, IBM and Google in digital marketing.

Narayan and Kevin Lynch, the company's chief technology officer, started with their bread and butter: Creative Suite, a business worth some $2 billion annually. The company's flagship product bundles as many as 16 programs, such as Photoshop and Acrobat, as well as InDesign for magazine publishing. Creative Suite licenses ran as high as $2,600, or $1,400 for upgrades, which usually came out every 18 months. Earlier this year Adobe introduced Creative Cloud, the same suite of products accessible online. Much like software from younger companies Google or Dropbox, documents are stored and accessible via the cloud. If a subscriber stops paying, access is cut off. The service costs $20 to $50 a month.

In the same way people who can't afford to buy a Lexus can usually lease one, Adobe is hoping to lure those who balked at Creative Suite's price. The company expects to have signed up 325,000 paid subscribers by the end of 2012. It claims adoption is increasing, with 11,000 new subscribers signing up each week. This month Adobe began rolling out a version for the enterprise market. Overall average revenue per user is 20% higher compared with the old product. That number will rise even further, the company says, because it is much more likely to sell support services, website hosting, or server management to cloud customers.

If that first prong in Adobe's plan vexed some observers as uncertain, the second prong—expanding into digital marketing—seems to be soothing them. The strategy has its roots in the 2008 acquisition of Omniture, a Utah-based web analytics company, for $1.8 billion. At the time analysts scratched their heads over the deal, but Narayan believed his customers would come to demand data-driven marketing. Such marketing now embraces diverse tasks: real-time bidding on Google search ads, targeting display ads using Facebook profiles, analyzing which Tweets or blog posts drive traffic, testing different site designs to see which generate sales.

To make those features possible, Narayan has spent $800 million on acquisitions since Omniture: Day Software for website-content man-

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agement, Demdex for ad targeting, Efficient Frontier for search and social media ad exchanges, and Auditude for inserting ads inside streaming videos. Online marketing will probably be a larger priority for many companies in coming years. According to Gartner, marketing budgets will grow 9% this year, compared with 4.7% for IT. Adobe wants to benefit from that growth by selling marketing services and software simultaneously.

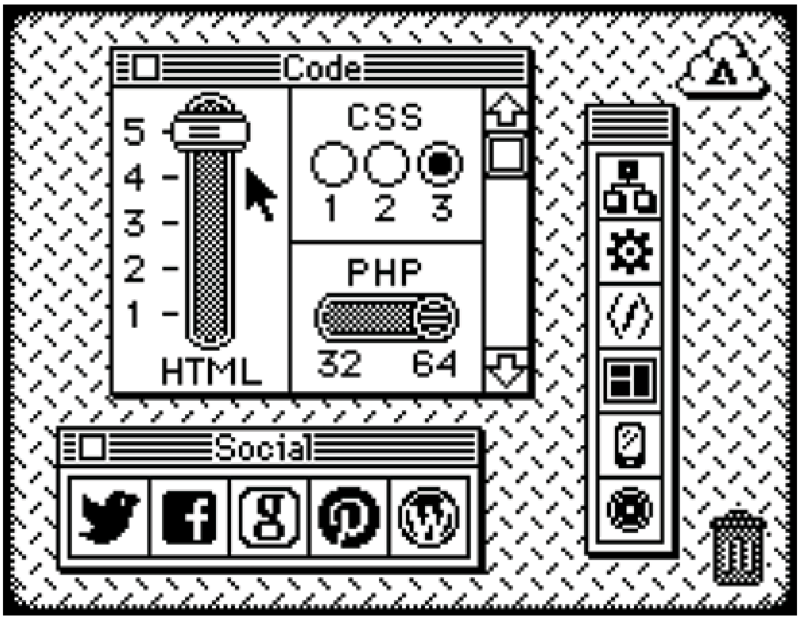
Adobe's marketing products are being used by Expedia, which created and optimized a social media campaign that boosted its Facebook followers by 750%. Movie-rental outfit Redbox used it to design mobile apps directing customers to its video kiosks. Sotheby's tracks which auction items clients are interested in the most when they peruse the company's iPad catalogues. Amy Todd Middleton, Sotheby's senior vice president of global strategic marketing, says that Adobe tools once relied on just for creating a website, for example, have become much more useful.

Both of Adobe's initiatives show early signs of promise. Digital marketing is the fastest-growing segment inside the company, increasing revenue 20% annually, or $768 million in the first nine months of 2012. Revenue from the unit makes up nearly a quarter of the firm's total. According to a Cowen & Co. analysis, Adobe loses $1 billion a year because of Creative Suite piracy, something its new subscription service will help curb.

Still, Adobe's marketing push means going up against deep-pocketed companies like IBM, Microsoft, Oracle, and Google—all of which are more experienced in the enterprise software market. As for the shift from boxed software to subscriptions: It is far from over. In fact, it is the company's greatest source of uncertainty. "We won't know for another year," notes analyst Goldmacher, "whether it will bring more users into their franchise."

Narayan and Lynch shrug off that skepticism, saying they've seen worse. Recall that two years ago Adobe was engaged in a high-profile war of words with Apple CEO Steve Jobs. Jobs refused to support Adobe's ubiquitous Flash standard on iPhones and iPads—and he wasn't shy about publicly berating the technology. Adobe ultimately lost the battle and last year moved to put the controversy behind it by ceasing Flash development for mobile browsers and embracing open-source platforms and the HTML5 web standard championed by Apple and Google. "The reality was that the fight with Apple smacked them hard, and they learned from it," says Forrester analyst Jeffrey Hammond.

Adobe's post-Flash strategy was announced in November 2011, alongside the restructuring that made digital marketing and Creative Cloud the company's top priorities. It was, of course, the Flash news, with its notes of melodrama, that grabbed headlines. As it turns out, the company's future is tied to the other plans announced that day. Narayan says that as software changes, so will Adobe. Now it must show that that will keep its business growing. ■



NEW SOFTWARE, OLD TRICKS

Moving from traditional packaged software hasn't been easy. At first, Adobe created skunkworks projects like Photoshop.com, which allowed people to use popular programs online. They were somewhat successful but not the sea change that executives had hoped for. CTO Kevin Lynch then hit on the idea of moving the entire Creative Suite into the cloud. Employees resisted. So Lynch gathered 40 key managers to convince them. They, in turn, were charged with testifying for the vision to their peers—spreading word through a 10,000-person workforce. "We ended up creating this gravity, where it became cool," says Lynch.

Illustration by JUDE BUFFUM