

Speaker – Tom McCallum, VP Investor Relation

Hello everyone and welcome to Red Hat's earnings call for the second quarter of fiscal year 2016.

Speakers for today's call will be Jim Whitehurst, President and CEO; Frank Calderoni, Executive Vice President Operations and CFO.

Our earnings press release was issued after the market closed today and may be downloaded from redhat.com on the investor relations page. Also on this page you will be able to find a copy of today's transcript, a schedule of currency rates and a new metrics presentation that includes a schedule of GAAP to Non-GAAP financial results.

Various remarks that we may make about the company's future expectations, plans and prospects, including statements containing the words “believe”, “anticipate”, “plan”, “project”, “estimate”, “expect”, “intend” or “will” constitute forward-looking statements for purposes of the Safe Harbor Provisions, under the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those indicated by these forward-looking statements as a result of various important factors including those discussed in the company's most recent quarterly report on Form 10-Q filed with the SEC as well as the Safe Harbor statement in today's press release.

In addition, any forward-looking statements represent our estimates or views only as of today, September 21, 2015 and these estimates or views may change. While the company may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so even if our estimates or views do change, and therefore, you should not rely on these forward-looking statements as representing our estimates or views as of any date subsequent to today.

With that I will now turn the call over to Jim.

Speaker – Jim Whitehurst, President and CEO

Thank you Tom, and let me add my welcome to all of you joining us on today's call.

I also want to personally welcome Frank Calderoni to his first earnings call with Red Hat. I am very pleased to have Frank join the Red Hat leadership team where his capabilities and experience will add value and strength as we look to scale our business to the next level in the years ahead.

In Q2, we continued to drive and benefit from the adoption of open, hybrid cloud technology as companies look to modernize the data center and on-ramp to the cloud. We also continued to build momentum for our technologies that enable a new mode of application development where agility, continuous deployment and enhanced customer experience are key deliverables for CIOs. With these trends and strong execution by Red Hat associates, I am pleased to announce that our second quarter results exceeded our guidance, and we are increasing our outlook for the year – as Frank will detail in a moment. In addition, we passed two milestones of note during the quarter:

- First, we exceeded the half billion mark in quarterly revenue, for a run rate of over \$2 billion annually.
- Second, we achieved an annualized run rate of \$100 million from our Certified Cloud and Service Provider or CCSP program. We reached this milestone due in part to the addition of new customers and the expanded utilization of RHEL in production workloads in public clouds.

With that overview, let me discuss a few of our recent technology highlights.

- First, we kicked off Q2 with our premier user event, Red Hat Summit in Boston. With record attendance, energy and excitement were high as our customers led sessions on how they are using Red Hat technologies to improve their businesses' agility, scale and flexibility. Customers, such as Intuit, Volvo, Target, Bloomberg and FICO spoke about their experiences implementing our cloud infrastructure technologies such as OpenStack and CloudForms. For our OpenShift PaaS solution we had customers such as Amadeus, Cisco, Barclays, Dreamworks and Telus speak about the benefits of Red Hat technology and Linux containers for application development and easier production deployment. We believe the strength of our offerings, combined with great endorsements from innovative customers, will help to drive further adoption of Red Hat's cloud solutions across both public and private cloud deployments.
- In conjunction with the Summit, we launched the latest version of our PaaS solution OpenShift Enterprise 3, a container-based application platform. Our enhanced platform, which uses the Docker container format, is powered by RHEL to offer a more secure, efficient and portable way to develop, deploy and run application

services. OpenShift 3 also includes Kubernetes, a container orchestration and management engine developed with Google. Docker, Kubernetes, Linux and OpenShift Origin which are each a part of OpenShift 3 are all open source projects where Red Hat is a leading contributor. Our leadership in the upstream community enables us to bring these technologies together to make it easier for the enterprise to consume open source innovation.

- Also at Summit, we continued to expand Linux container offerings with Red Hat Atomic Enterprise Platform. Utilizing the same core enabling technologies as OpenShift 3 including Docker and Kubernetes, Atomic Enterprise provides a platform for executing multi-container applications. It is designed to help organizations orchestrate across traditional and cloud native applications while scaling to meet changing business demands.
- At Summit, we also announced an exciting new strategic alliance with Samsung Electronics that aims to deliver the next generation of mobile solutions for the enterprise. The alliance draws upon the breadth of Samsung's mobile device portfolio fused with the depth of Red Hat's open source middleware, mobile and cloud technologies – to deliver mobile solutions that facilitate rapid development and integration of enterprise applications for organizations moving toward a mobile-first strategy. We are making great progress in mobile and have been recently named a leader by Forrester Research in “The Forrester Wave Mobile Infrastructure Services” report. In the report Red Hat received the highest cumulative score for vendor strategy based strength of vision, customer satisfaction, speed to market and partner alliances.
- More recently in August, we launched RHEL OpenStack platform 7 based on the Kilo release. Version 7 includes several new features aimed at accelerating the adoption of OpenStack including simplified operational management and resource provisioning, high availability, greater security control and network flexibility. We

have deployed this new version of OpenStack internally and at several large global customers to enthusiastic reviews.

In summary, we executed well in the first half of 2016 and I want to thank all Red Hat associates around the globe for their focus on achieving these results. As we look ahead, I believe we are well positioned for the second half of the year as we continue to execute on behalf of customers to deliver innovation and solutions to solve their challenges.

With that, let me turn the call over to Frank

Speaker – Frank Calderoni EVP Operations and CFO

Thank you, Jim.

It is a great time to be at Red Hat, and I am very excited to be part of the team. One of the top priorities that will remain is our continued focus on creating value for our shareholders, customers, employees and partners. Our company's growth initiatives along with our expanding portfolio of solutions position us very well within the marketplace. I look forward to working with the investors and analysts who follow us.

I am pleased to share that Q2 was another strong quarter with results that exceeded our guidance. Based on the strength of our Q2 and a positive view on the remainder of the year, we are raising our full year outlook as I will detail in a moment. First, I will focus my remarks on the financial highlights of our Q2 performance which is a practice I will

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do my best to follow so that we can maximize the amount of time on our calls dedicated to answering your questions. For a more detailed view of our results and metrics, please refer to our press release, presentation materials and transcript of our prepared remarks that are available in the investor relations section of Redhat.com.

Here are some of the Q2 financial highlights:

- Total revenue for the quarter was \$504 million which grew 21% on a year-over-year basis in constant currency, or 13% in USD. Taking into account the fluctuation in foreign exchange rates, total revenue would have been \$37 million or 820 basis points higher using the rates from Q2 last year. As a result of the FX volatility, I will provide both U.S. dollar and constant currency results for the quarter using the rates from Q2 last year where it is appropriate. In US dollars, we exceeded the high end of our revenue guidance by \$8 million dollars. Our improved revenue performance this quarter resulted from better than expected execution, improved linearity, and upsides in our public cloud business and our customer education and compliance program.
- The main driver of our total revenue growth was subscription revenue of \$442 million, an increase of 21% in constant currency and 13% year-over-year in USD. In USD, this renewable revenue stream now constitutes 88% of total revenue which provides us with a high level of future revenue visibility and predictability.

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- Breaking out the subscription revenue by technology, the subscription revenue for Infrastructure-related offerings was \$363 million, an increase of 17% in constant currency and 9% year-over-year in USD. Subscription revenue for Application development related & emerging technologies offerings was \$79 million an increase of 48% in constant currency and 37% year-over-year in USD. Application development-related and emerging technologies revenue grew to approximately 16% of total revenue in USD, up from 13% in the year-ago-quarter.
- On a non-GAAP basis, operating income grew 13% and non-GAAP operating margin was 24.4%. This non-GAAP operating margin was approximately 140 basis points above our guidance due to the strong revenue growth. We had record hiring of approximately 400 associates this quarter which puts us on track to add approximately 1,200 associates this year, which has been our investment goal. We added approximately 600 year-to-date.
- Using our estimated annual effective tax rate of 29%, non-GAAP diluted earnings per share came to \$0.47, \$0.03 above our guidance.
- We ended the quarter with cash and investments of approximately \$2.0 billion. This balance was after returning \$70 million to shareholders after repurchasing approximately 895 thousand shares of Red Hat stock. We had approximately \$430 million remaining on the current share repurchase authorization at the end of the quarter.

- Total deferred revenue at quarter end was \$1.4 billion, an increase of \$162 million or 13% over the same quarter a year ago. On a constant currency basis, total deferred revenue would have been up 20%.
- The total change in deferred revenue from our cash flow statement that neutralizes most of the impact of currency changes was a decline of \$25 million.
- Operating cash flow of \$120 million for the quarter was up 12% year-over-year. Year-to-date operating cash flow is up 21%.
- Our rolling four quarters billings proxy is calculated by adding revenue plus the change in deferred revenue on the cash flow statement for the last four quarters. On a rolling four quarters basis, the billings proxy was \$539 million, up 16% year-over-year. On a constant currency basis, this metric would have been 22%, a modest increase from the year-ago quarter and continues to demonstrate the momentum in the business. This metric also reflects the higher bookings duration last year and the 20 month average duration we have experienced through the first half of this year. As we look ahead, we would expect the bookings duration for the second half of fiscal 2016 to be closer to the historic 21 month level.

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Now let's look at some of the metrics for the business momentum and the large deals in the quarter.

- On a geographic basis, this quarter 60% of bookings came from the Americas, 22% from EMEA and 18% from Asia-Pacific versus a 59/24/17 split in Q2 last year. We continued to deliver growth globally despite the FX headwind.
- The Q2 sales route to market mix was 75% from the channel and 25% from our direct sales force, versus a 69/31% split in Q2 last year. Consistent with Q2 last year, we closed a number of large channel deals and we are making progress toward our annual goal of a 70/30% split.

Now let me provide you with some additional details on the largest deals and our renewals that closed in the quarter:

- Within our top 30 largest deals metric, all 30 were approximately \$1 million or more. We had 4 deals that were in excess of \$5 million, with one deal well over \$10 million.
- Cross selling was strong, with 65% of the deals including one or more components from our group of application development and emerging technologies offerings. We expect the growing adoption of these technologies,

like Middleware, the RHEL OpenStack platform, OpenShift, cloud management and storage, to continue to drive revenue growth.

- The top vertical for the quarter was Financial, followed closely by mainstream customers in the healthcare, transportation and retail verticals.

On our renewal business, I'm pleased to share that once again we renewed all of the top 25 deals that were up for renewal. The total subscription value of these top 25 renewals was approximately 115% of the prior value.

Now I would like to turn to guidance which will factor in the solid performance we had in the first half of the fiscal year. Our outlook assumes similar business conditions and foreign exchange rates as of September 18, 2015, which included a \$ to Euro of 113 and Yen to \$ of 121.

- With these assumptions, we are raising our full year revenue guidance to \$2.034 billion to \$2.044 billion, up approximately 14% in USD or approximately 20% in constant currency. We are modestly increasing operating margin to a target of 23.6%, and raising cash flow to \$690 million to \$705 million. We are also increasing our target for full year non-GAAP earnings per share in the range of \$1.85-\$1.87 per share, assuming a 29% annual effective tax rate and a \$1 million per quarter forecast for other income. Our guidance also reflects our focused

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investment in our application development and emerging technologies that we believe will further drive future growth.

For Q3 specifically, I offer the following outlook:

- We expect revenue to be in the range of \$519 million to \$523 million which is up 15% in USD or at the high end of the range up approximately 20% in constant currency, non-GAAP operating income of approximately 23% and non-GAAP earnings per share of \$0.47.

Consistent with prior practices at Red Hat, I will not forecast quarterly cash flow. However, I would suggest that while estimating cash flow, you use the AR balance as a starting point.

In summary, we are pleased with the very solid performance in the first half of the fiscal year. With our broad portfolio of solutions and strong execution, we believe we will become the first open source company to exceed \$2 billion in annual revenue.

Operator, I would now like to turn it back over to you for the first question.