

## **Speaker – Tom McCallum VP of Investor Relations**

Thank you operator.

Hello everyone, and welcome to Red Hat's earnings call for the third quarter of FY16. 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 today after the market closed and may be downloaded from [redhat.com](http://redhat.com) on the Investor Relations page. Also on this page you'll be able to find a copy of today's prepared remarks, a schedule of currency rates and a slide deck with financial highlights and supplemental metrics that include a reconciliation of GAAP to non-GAAP financial results.

During this call we will make forward-looking statements about our future financial performance and other future events or trends, including guidance for our fourth fiscal quarter and full fiscal year. These statements are only predictions that are based on what we believe today, and actual results may differ materially. These forward-looking statements are subject to the risks, uncertainties, assumptions and other factors that could affect our financial results and the performance of our business and which we discuss in detail in our filings with the SEC, including today's

press release and the risk factors and other information contained in our most recently filed Form 10-K and Form 10-Q. Red Hat assumes no obligation to update any forward-looking statements we may make on today's call.

And with that, let me 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 am pleased to announce that we delivered another strong quarter, with both revenue and profitability exceeding our guidance for Q3. Even more importantly looking forward, we continued to strengthen our leadership position in the emerging open hybrid cloud sector. Red Hat associates are executing at a high level across the company as we further increase our strategic importance with customers. We believe that Red Hat is highly differentiated in our ability to help organizations transform their IT to become more agile and improve their customer experience. This led to Q3 results that demonstrated:

- Solid growth across our major geographies

- Consistently high revenue growth in both our Infrastructure as well as our Application Development and Emerging technologies.
- And we experienced large deals wins, cross selling and strong renewals within our top deals,

The strength of our results are evidence of the strong demand for technologies that address the modernization of IT and the customer desire to work in a hybrid cloud world. Red Hat continues to grow by better enabling our customers to build, deploy and manage their applications across multiple environments and infrastructures.

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

First, as a premier sponsor of the OpenStack Summit in Tokyo, we took the opportunity to highlight our enterprise customer success stories across a variety of verticals including telecommunications, education and banking. At the conference, we also jointly demonstrated our NFV offerings for OpenStack with a service provider panel that included Verizon, China Mobile and Telus. In addition we announced an

expanded relationship with Lenovo to provide Red Hat Enterprise Linux OpenStack Platform with Lenovo hardware to bring more secure, reliable and flexible platforms to enterprise IT looking to build hybrid cloud deployments.

Second we enhanced our management capabilities with the acquisition of Ansible, an open source IT automation software company, launched in 2013. We chose Ansible because it is aligned with the core principles that shape Red Hat's management strategy in the following ways:

- Ansible is simple to use since it is agentless
- Ansible “playbooks” make it easier to both write and maintain the automation work flows
- The team has built a highly popular open source project with a strong community.
- Ansible technology supports heterogeneous IT environments including Linux, Microsoft, AWS and the Google cloud
- And they expand our capabilities to offer application management across the four footprints – physical, virtual, private cloud and public cloud.

The integration of Ansible is well under way. We are hearing strong interest from customers and there is great internal excitement for the additional value they bring to our technology stack. In fact, the Ansible team has good momentum and closed several new wins including their largest deal to date – a large six-figure deal with a global transportation technology provider. As part of our management portfolio, Ansible's role in DevOps and automation will be an important component of how Red Hat helps customers modernize their IT applications in the world of continuous deployment.

Third, we launched a strategic partnership with Microsoft that was really a milestone event for the industry. Both Microsoft and Red Hat share the same view that it will be a hybrid cloud world and we are working together to enable customers to realize the benefits of this transformation of IT. Let me describe and provide an update on some of the key elements of the partnership:

- RHEL is the preferred choice for enterprise Linux workloads on Azure and is now available for customers, representing the first deliverable of this partnership. We have already enabled customers to take full advantage of their Red Hat subscriptions at Azure through the Red Hat Cloud Access Program where customers are able to bring their own

subscriptions to run in Azure and be fully supported by both Red Hat and Microsoft. Customers are now able to build and deploy applications in Microsoft Azure using subscriptions to RHEL, JBoss EAP, JBoss Web Server, Red Hat Gluster Storage and OpenShift PaaS.

- In the coming months, Red Hat technologies On-Demand will also be available in Azure — these “pay-as-you-go” RHEL images will be available in the Azure Marketplace and supported by Red Hat. Customers will be offered cross-platform, cross-company support spanning the Microsoft and Red Hat offerings in an integrated way, unlike any of our previous partnerships in the public cloud. We have already begun co-locating support teams at Azure premises with the goal of making the customer experience simple and seamless, at cloud speed.
- In addition, being able to manage workloads across a variety of environments and infrastructures will be an important capability for customers in the hybrid cloud world. The management solution to do this will be our CloudForms technology. This month we launched CloudForms 4.0 which gives customers the ability to manage RHEL on both Hyper-V and Azure.

- We are also collaborating on .NET for a new generation of application development capabilities. The plan is to enable developers to access .NET technologies across Red Hat offerings, including OpenShift and RHEL, jointly backed by Microsoft and Red Hat. RHEL will be the primary Microsoft development and reference operating system for .NET Core on Linux. This is an exciting partnership for our joint customers and I look forward to updating you on our progress.

In summary, I am pleased with execution and results so far this year. I am looking forward to a strong finish to the fiscal year where we expect to achieve the \$2 billion in revenue milestone. Beyond this year, we have a compelling opportunity in front of us and exciting work to do to achieve our potential in the open hybrid cloud.

In closing, I want to thank the Red Hat associates around the globe for their hard work. Red Hat's associates have created an exciting, enviable place to make a difference. In fact, Red Hat was recently recognized among the top 50 Best Places to Work in

Glassdoor's 2016 survey. Red Hat has been built by a truly passionate and talented team and I am honored to be a part of it.

With that, let me turn the call over to Frank

**Speaker – Frank Calderoni, EVP Operations and CFO**

Thank you, Jim.

We executed well with another strong quarter, which resulted in our ability to exceed our guidance across a number of metrics. We continue to see our investments in emerging technologies, expanded partnerships and high caliber sales teams contributing to the high growth. This marked our 4<sup>th</sup> consecutive quarter of 20% plus total revenue growth on a constant currency basis.

Let me first start my remarks with the financial highlights of our Q3 performance and then update our outlook for the remainder of FY16. For a more detailed view of our results and metrics, please refer to our press release, supplemental metrics and a copy of our prepared remarks that are available in the investor relations section of Redhat.com.

Here are some of the Q3 financial highlights:



- We were pleased to see total revenue of \$524 million, which grew 21% on a year-over-year basis in constant currency, or 15% in USD. Taking into account the fluctuations in foreign currency exchange rates, total revenue would have been \$28 million or 630 basis points higher using the rates from Q3 last year. Due to the continued high FX volatility, I will provide both U.S. dollar and constant currency results for the quarter using the rates from Q3 last year where it is appropriate.
- Our revenue performance for the quarter exceeded the high end of our guidance by approximately \$1 million on a U.S. dollar basis and approximately \$4 million when using the exchange rates we provided in our guidance in September. Our better than expected revenue performance this quarter resulted from continued strong demand that Jim just referenced as well as execution across our organization.
- The main driver of our total revenue growth was subscription revenue of \$457 million, an increase of 22% in constant currency and 16% year-over-year in USD. This renewable revenue stream now constitutes 87% of total revenue, which

provides us with a high level of revenue visibility in addition to future growth opportunities as we renew and expand our customer relationships.

- Breaking out the subscription revenue by technology, we are very pleased to see the subscription revenue for Infrastructure-related offerings was \$373 million, an increase of 18% in constant currency and 12% year-over-year in USD. In particular to note, our subscription revenue for application development related and emerging technologies offerings was \$84 million, an increase of 45% in constant currency and 37% year-over-year in USD. Application development-related and emerging technologies revenue was approximately 16% of total revenue, up from 14% of total revenue in the year-ago-quarter.
- On a non-GAAP basis, operating income grew 13% and non-GAAP operating margin was 23.5%. This non-GAAP operating margin was approximately 60 basis points above our guidance, which as a reminder included the expenses related to the Ansible acquisition. The 60 basis points of margin upside was due in part to the stronger revenue

growth. With investments in our growth initiatives, we added approximately 400 associates this quarter including approximately 50 associates related to the acquisition of Ansible. As we build our talent base with key skillsets, we have added approximately 950 associates through Q3, and we are on track to add more than 1,250 associates for the full fiscal year.

- Using our estimated annual effective tax rate of 29%, non-GAAP diluted earnings per share came to \$0.48, \$0.02 above the guidance we provided after the Ansible acquisition. Higher revenue and disciplined spending were the main drivers of the EPS upside.
- We ended the quarter with cash and investments of approximately \$1.87 billion. We returned \$78 million to shareholders from repurchasing approximately 987 thousand shares of stock. We had approximately \$352 million remaining on the current share repurchase authorization at the end of the quarter.

- Total deferred revenue at quarter end was \$1.49 billion, an increase of \$187 million or 14% 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 fluctuations was an increase of \$97 million.
- Operating cash flow of \$140 million for the quarter was up 5% year-over-year. The timing of customer collections and cash disbursements can affect the growth rates on a single quarter basis. Year-to-date operating cash flow is up 16%.
- 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 \$559 million, up 15% year-over-year. On a constant currency basis, this metric would have been 21%. This marks the 6<sup>th</sup> consecutive quarter of 20% plus year-over-year growth, demonstrating our consistent growth in the business. This metric also reflects both the higher bookings duration in Q3 of last year of 24 months and the 22 month average duration we have experienced in Q3 of this fiscal year. As we look ahead, we would expect the bookings duration for the 4th

quarter of fiscal 2016 to be closer to the historic 21 month level compared to 22 months in Q4 a year ago.

I will now review the metrics for business momentum and large deals in the quarter.

- Across all geographies, we saw continued growth in our bookings despite FX headwind. This quarter 60% of bookings came from the Americas, 26% from EMEA and 14% from Asia-Pacific versus a 62/25/13 split in Q3 last year.
- The Q3 sales route to market mix was 67% from the channel and 33% from our direct sales force, compared to a 70/30% split in Q3 last year. Consistent with Q3 seasonality, we closed a number of large direct deals and continue to target an annual goal of a 70/30% split.
- Within our top 30 largest deals, all of them were approximately \$1 million or more. We had 11 deals that were in excess of \$5 million and of these deals 3 were over \$10 million.

- Cross selling was strong, with 70% 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 sectors such as healthcare, transportation and retail.

On our renewal business, we once again renewed all of the top 25 deals that we were expecting. The total subscription value of these top 25 renewals was approximately 120% of the prior value.

Jim discussed Red Hat's increasing strategic importance with customers. This quarter we had a great example of this with the 3rd largest deal of the quarter – a global financial services customer that renewed in excess of \$10 million.

First let me give you some background. This global financial services customer was an early adopter of Linux and ran a mixed Linux environment. Around 2007, the customer decided on a

Linux vendor offering free multi-year support of their Linux distribution. The account team did not give up on this customer and by fiscal year 2013 the customer decided to standardize on RHEL, and we closed a multi-year deal for approximately \$2M. Through exemplary account management, we renewed this customer this quarter to a significant 3-year commitment in excess of \$10M. We have not only expanded the footprint of RHEL but we are helping this customer realize the benefits of private cloud computing, software defined storage and containers. This customer is now buying RHEV, Cloudforms, Red Hat Storage, OpenShift, and OpenStack. Congratulations to the account team for an exceptional job of focusing on the needs of the customer.

I would like to turn to guidance. Our outlook assumes similar business conditions and foreign exchange rates as of December 17, 2015, which included a \$ to Euro of 1.09 and Yen to \$ of 123. Foreign exchange rates remain volatile and may change from the rates we are using today. Our guidance also re-affirms our Q4 outlook for the Ansible acquisition which closed in October.

- I am pleased to announce that despite the impact of weaker foreign exchange rates, we are raising our full year revenue guidance to \$2.044 billion to \$2.048 billion, up approximately 15% in USD or approximately 20% in constant currency at the high end of the range. The annual revenue guidance is up approximately \$12 million in constant currency from the high end of the range of our September guidance. We are modestly increasing operating margin to approximately 23.5%, and improving the operating cash flow by tightening the range from \$695 million to \$705 million. We are also increasing our target for full year non-GAAP earnings per share to approximately \$1.86 per share, assuming a 29% annual effective tax rate and a \$1 million per quarter forecast for other income. This EPS is approximately \$0.03 higher than the midpoint of the guidance we provided after the Ansible acquisition.

For Q4 specifically, this implies the following outlook:

- We expect revenue to be in the range of \$535 million to \$539 million, which is up 16% in USD at the high end of the range or up approximately 20% in constant currency. This is an increase of \$10 million from our previous implied fourth



quarter guidance on a constant currency basis. We expect non-GAAP operating margin of approximately 22.5% and non-GAAP earnings per share of \$0.47. Both of these estimates include the previous guidance on the impact of Ansible in Q4, which equates to approximately \$0.02 a share.

Consistent with prior practices, I will not forecast quarterly cash flow even though there is an implied range in the full year outlook.

Overall, we are very pleased with our financial performance in the third quarter. We are excited about our strategic leadership position for both open source and hybrid cloud computing, as we are confident in the long-term to continue to grow our market share. Given our higher outlook for revenue, non-GAAP margin and EPS, we look forward to a strong finish to the fiscal year.

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