

Red Hat Q4 FY16 Earnings Call – Prepared Remarks

March 22, 2016

Speaker Tom McCallum. VP of Investor Relations

Thank you, operator.

Hello everyone, and welcome to Red Hat's earnings call for the fourth quarter and full year for 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 today after the market closed and may be downloaded from 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 first quarter and full year for fiscal year 2017. 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 James Whitehurst, President and CEO

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

The fourth quarter was a strong finish to another great year for Red Hat and our momentum and outlook are strong as we begin the new fiscal year. Our results reflect the fact that enterprises are increasingly adopting hybrid cloud infrastructures and open source technologies, and they are turning to Red Hat as their strategic partner as they do so. We exceeded guidance across all our financial metrics in the fourth quarter in addition to setting new records and milestones for the fiscal year. Here are a few highlights:

- First, the fourth quarter marked our 56th consecutive quarter of revenue growth which contributed to Red Hat's first year of crossing the \$2 billion in total revenue milestone
- Second, we drove accelerated full year revenue growth in both the Infrastructure-related technologies at 18% constant currency growth compared to 13% in the prior year and the Application Development & emerging technologies at 46% constant currency growth, up from 43% last year.
- Third, strong sales execution led to record total backlog of over \$2.1 billion at year end.
- Fourth, we delivered full year revenue growth of 21% in constant currency, non-GAAP operating income growth of 16% and operating cash flow growth of 15%

Looking our large deal wins in the quarter, we saw strength as it related to the volume of large deals, the size of the deals, as well as the breadth of technologies that were purchased. Here are some highlights of our top 30 largest deals:

- All of them were greater than a \$1 million – in fact, we closed 3 times that many, delivering more than 90 deals in excess of a million dollars in Q4. We also had a record

14 deals in Q4 that were in excess of \$5 million. Of these deals, we closed 5 deals in excess of \$10 million which is a record number of deals over \$10 million for any quarter.

- Cross selling was strong, with 80% of the deals including one or more components from our group of application development and emerging technologies offerings. Middleware in particular had strong traction in our largest deals with 75% including a middleware component. This type of traction demonstrates our continued share gain in the middleware space.
- Our emerging cloud technologies are also gaining traction in our top deals including a multi-million dollar win for OpenStack that we expect will be one of the largest installations of Openstack once it is fully implemented.
- The top vertical for the quarter was telecom where we closed a number of deals with several global telecom providers. The next highest vertical in the top deals was financial services.

In addition to our success on premise, we have continued to be very active with our partners in the Certified Cloud and Service Provider program or CCSP program. We have added more partners in FY16 and now have approximately 150 certified partners around the globe.

In Q4, we further expanded our technology offerings that can be consumed in the cloud, for instance:

- RHEL on-demand was activated on Azure in February
- OpenShift, our PaaS solution, and our storage technologies will be added to the Google cloud
- And RHEL OpenStack platform is now available at RackSpace as a managed service. We already have our first reference customer using the service – TD Bank.

The CCSP program has generated over \$100 million this fiscal year and grew approximately 90% year-over-year!

During meetings Frank and I have hosted over the quarter, investors have asked whether the public cloud is a positive driver for Red Hat. We firmly believe that it will be a hybrid cloud world where applications will run across all four footprints – physical, virtual, private cloud and public cloud. Furthermore, we are providing technologies that enable choice and consistency across all four environments and we enhance this value with application development technologies, storage and management. The public cloud specifically acts as a channel for us and it is part of the value we bring to customers. Beyond the expansion of our relationships with cloud providers and high growth revenue results, let me share with you some customer data from our largest public cloud partner.

First, as a channel partner, this public cloud has been a great resource for us to reach new customers including small and medium-sized businesses. We see approximately half the revenue from this public cloud comes from usage totaling less than \$5,000 per customer in a quarter. This group most likely includes small and medium-sized businesses, test and development environments, business divisions and start-up companies.

Second, the public cloud enables our existing customers' additional choice on where to run their workloads. The other approximately half of the revenue with this public cloud vendor comes from existing customers. We matched this data with the on premise purchasing patterns of subscriptions for these existing customers. What we found was that this group of customers has continued to expand their on premise subscriptions purchases while they are also rapidly utilizing the public cloud environment for additional RHEL workloads. This reinforces our view that it will be a hybrid cloud world and that Red Hat can continue to expand our wallet share as we provide choice and consistency to customers across all four footprints.

As I noted previously, we achieved higher rates of revenue growth across our Infrastructure, Application development and emerging technologies during fiscal 2016 which represents strong growth across all four footprints. Within the Application development and emerging

technologies are our fast growing OpenStack private cloud, OpenShift PaaS, and CloudForms cloud management. We made significant progress this past year expanding our position in this part of the hybrid cloud environment and driving faster adoption. Here are some highlights:

- We closed a number of large production deployments and hundreds of initial deployments along with hundreds of proof of concepts.
- Our sales traction has led to lighthouse customer wins with Cox Enterprises, Union Bank and FICO just to name a few from FY16.
- We doubled the number of Red Hat OpenStack certified professionals worldwide over the past year, and we trained over 10,000 customers on OpenStack in calendar 2015 alone. Companies wanting to bring Red Hat OpenStack into their IT environments can look to this growing pool of qualified professionals to make it happen. Our combination of training, certification and professional services is speeding adoption of this technology.
- We are excited about our accomplishments to date. Our revenue from the private IaaS, PaaS and cloud management technologies is growing nearly twice as fast as our public cloud revenue did when it was at the same level. We believe FY17 will be another year of significant revenue growth with new customer adoption and further expansion with existing ones.

In summary, customers are demanding technologies that modernize the development, deployment and life-cycle management of applications across hybrid cloud environments. Many are relying on Red Hat to provide both the infrastructure and the application development platforms to run their enterprise applications consistently and reliably across physical, virtual, private cloud and public cloud environments. This has positioned Red Hat for solid growth in Fiscal 17 that Frank will detail in a moment. We continue to focus on capturing market share in each of the new, high growth market areas in which we compete. To achieve this goal our plan is to continue to invest for long-term growth of our open, hybrid cloud technologies with enterprise and service provider customers.

Before turning the call over, I want to congratulate and thank our 8,800 Red Hat associates around the globe for their efforts to achieve the \$2 billion milestone and position us for further growth next year and beyond.

On a final note, I hope many of you will be able to join us for the June 30 Analyst Day at Red Hat Summit in San Francisco. It will be a great opportunity to learn more about our strategic direction and innovative technologies.

With that, let me turn the call over to Frank

Speaker Frank Calderoni, Executive Vice President Operations and CFO

Thank you, Jim.

We executed well in the fourth quarter and throughout FY16. We effectively managed our investments in expanding our open, hybrid cloud opportunities with strong execution while delivering profitable growth. We exceeded our guidance, which led to double-digit growth in revenue, non-GAAP operating income, operating cash flow and total backlog for the fiscal year. The fourth quarter also marked our 5th consecutive quarter of 20% plus total revenue growth on a constant currency basis. We are proud to be one of very few software companies who can deliver this type of growth at over \$2 billion in scale – and it is a testament to our leadership position, business model and market opportunity.

Here are some of the Q4 financial highlights:

- We were pleased to generate total revenue of \$544 million, which grew 21% on a year-over-year basis in constant currency, or 17% in USD. Taking into account the fluctuations in foreign currency exchange rates, total revenue would have been \$17 million or 360 basis points higher using the rates from Q4 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 Q4 last year where it is appropriate.

- Our revenue performance for the quarter exceeded the high end of our guidance by approximately \$5 million on a U.S. dollar basis. Both subscription and service revenue were stronger than forecasted.
- All of major geographies recorded strong growth with the Americas up 19%, EMEA up 24% and APAC up 26% on a constant currency basis.
- The main driver of our total revenue growth was subscription revenue of \$480 million, an increase of 22% in constant currency and 18% year-over-year in USD. This renewable revenue stream now constitutes 88% of total revenue.
- We continued to drive high growth across our technology portfolio. The subscription revenue for Infrastructure-related offerings was \$391 million, an increase of 18% in constant currency and 15% year-over-year in USD. Our subscription revenue for application development related and emerging technologies offerings was \$89 million, an increase of 43% in constant currency and 38% year-over-year in USD. Application development-related and emerging technologies revenue was approximately 16% of total revenue, up 250 basis points from the year ago quarter.
- On a non-GAAP basis, operating income was \$124 million and grew 13%. Non-GAAP operating margin was 22.9%. As a reminder, non-GAAP operating income adjusts for non-cash share-based compensation expense, amortization of intangible assets and transaction costs related to business combinations. This non-GAAP operating margin was modestly above our guidance while it included a full quarter of expenses and investment related to the Ansible acquisition.

- As our results have demonstrated and combined with the growth drivers that Jim just discussed, we believe we can further extend our market share gains with additional investments in our hybrid cloud capabilities. In Q4, we were proactive on our fiscal 2017 investments due to the strong momentum of our business. We added approximately 480 associates this quarter, mainly in sales, customer support, consulting and R&D. For the full fiscal year we have added approximately 1,500 associates for a total of approximately 8,800 associates globally.
- After adjusting for non-cash share-based compensation expense, amortization of intangible assets, transaction costs related to business combinations, and non-cash interest expense related to the convertible debt discount, non-GAAP diluted earnings per share came to \$0.52, \$0.05 above the guidance we provided in December. In addition to higher revenue and disciplined spending which drove \$0.01 per share of upside, we benefitted from a discrete tax benefit of approximately \$0.04 per share related to the re-authorization of the R&D tax credit.
- Next, let me discuss our annual backlog that we disclose with the fourth quarter results. First, total backlog was up 15% year-over-year on February 29 for a record balance in excess of \$2.13 billion in USD. On a constant currency basis, total backlog growth would have exceeded 16%. We define total backlog as the value of non-cancellable subscriptions and service agreements including total deferred revenue, which is billed plus the value of non-cancellable subscriptions and service agreements to be billed in the future not reflected in our financial statements. Here are the component pieces:
- The portion of total backlog that has been billed is total deferred revenue which was \$1.72 billion at the end of fiscal 2016, up 16% year-over-year. On a constant currency basis, total deferred revenue would have been up 18%.

- The portion of total backlog to be billed in the future, or our off-balance sheet backlog, was in excess of \$410 million compared to in excess of \$380 million last fiscal year, up over 8% year-over-year in USD. On a constant currency basis, the off-balance sheet backlog would have been up more than 10%.
- It is worth noting that the portion of off-balance sheet backlog to be billed in the next twelve months was in excess \$275 million, up approximately \$45 million or 20% from fiscal 2015.
- The combination of deferred revenue and off balance sheet backlog provides us with forward visibility into a significant portion of FY17 revenue as well as contributing to revenue beyond FY17.
- The average contract length in the quarter was 22 months. For the full year, the average deal length returned to the historic 21 months duration after being elevated at 22 months in FY15.
- Deferred revenue is also a component of our billing proxy. Our preferred view of billings is the rolling four quarters billings proxy which 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 fourth quarter billings proxy was \$578 million, up 12% year-over-year. On a constant currency basis, this metric would have been up 17% year-over-year.
- We ended the quarter with cash and investments of approximately \$2.0 billion. During the quarter, we returned \$114 million to shareholders from repurchasing approximately 1.6 million shares of stock. We had approximately \$237 million remaining on the current share repurchase authorization at the end of the quarter. For the full year, we returned

\$263 million to shareholders from repurchasing approximately 3.5 million shares of stock. Over the past 5 years, our repurchase programs have reduced our fully diluted share count by over 10 million shares or approximately 6% lower.

- Operating cash flow of \$247 million for the quarter was up 14% year-over-year and a record for any quarter. Strong collections contributed to this result with FX-adjusted Days Sales Outstanding at 61 days, down from 63 days in the year-ago-quarter.

Now to briefly recap and summarize highlights for the full fiscal year:

- Total revenue grew to \$2.05 billion, up 21% year over year in constant currency, or up 15% in US dollars.
- Subscription revenue grew to \$1.8 billion, an increase of 22% in constant currency or 16% in US dollars.
- Subscription revenue for Infrastructure related offerings was \$1.48 billion, up 18% in constant currency and 12% in USD.
- Subscription revenue for Application Development & Emerging Technologies was \$323 million, up 46% in constant currency and 37% in USD. For FY16, Application Development & Emerging Technologies subscriptions constitute 16% of total revenue, up from 13% last fiscal year.
- Non-GAAP operating income grew by 16%. Full year FY16 Non-GAAP operating margin was 30 basis points higher than FY15 and included the dilutive impact from the Ansible acquisition.
- Non-GAAP EPS for the full year was \$1.91, up 19% over the prior year.

Overall, our priorities to continue to make smart investments, focus on long-term objectives, and remain the open source market leader are proving to be effective. We remain highly focused on strong execution across all areas of the business.

I will now review the metrics for business momentum and top renewals in the quarter.

- Across all geographies, we saw continued growth in our bookings. This quarter 64% of bookings came from the Americas, 23% from EMEA and 13% from Asia-Pacific versus a 63/25/12 split in Q4 last year.
- The Q4 sales route to market mix was 71% from the channel and 29% from our direct sales force, compared to a 68/32% split in Q4 last year. For the full fiscal year, we surpassed our multi-year, annual goal with a 72/28% split.

This quarter, we once again renewed all of the deals in our top 25 deals metric. The total subscription value of these top 25 renewals was approximately 120% of the prior value.

Our ability to renew and increase our wallet share with large customers demonstrates Red Hat's increasing strategic importance with customers. This fiscal year, we renewed all of the deals in the top 25 deals metric per quarter, renewing all of our deals in each quarter with upsell growth between 115% to 120% for this metric. Over the past 5 years we have had similar success, renewing 498 out of 500 top deals. This is a phenomenal track record.

While we never want to lose a deal, if we do, we never give up trying to win-back the business. This quarter, I am pleased to report that we closed a multi-million dollar "win-back" of one of these two former top deals from the 500 deals we reported. We won back this deal on RHEL because of our award winning support and expanded portfolio of technologies. In addition to now running RHEL, this customer is relying on Red Hat to help them modernize their application development with Red Hat JBoss Middleware and to realize the benefits from hybrid cloud computing with our OpenStack technology. Congratulations to the account team for an exceptional job of positioning Red Hat to win and expanding our footprint with this customer.

Now I would like to turn to guidance. Our outlook assumes current business conditions and foreign exchange.

- We are forecasting our full year revenue guidance to \$2.380 billion to \$2.420 billion, up approximately 18% at the high end of the range.
- Our non-GAAP operating margin forecast reflects our increased hiring in sales, R&D, services and support at the end of FY16 and our plan to continue to invest in business and emerging technologies as well as the full year impact of on-going operational expenses from the Ansible acquisition. We expect operating income to grow by 14% to 16% with an operating margin of approximately 23.2%. Our plan includes adding 1,400 net new associates or 16% head count growth, down from 20% head count growth in FY16.
- We expect full year non-GAAP earnings per share to be approximately \$2.22 to \$2.26 per share, assuming a \$1 million to \$2 million per quarter forecast for net other income, a lower annual effective tax rate of 27% and approximately 184 million diluted shares. At the top end of the guidance, this would be an 18% growth in earnings per share.
- On a GAAP basis, we estimate annual stock compensation expenses of approximately \$180 million and annual amortization expense of approximately \$29 million. GAAP fully-diluted EPS guidance includes non-cash interest expense related to the convertible debt discount of approximately \$19 million.
- Operating cash flow is expected to grow in a range from \$800 million to \$820 million. This range includes a head wind of approximately \$10 million for increased cash taxes as the company continues to drive greater profitability.
- For those of you who try to model billings metrics, we would expect the same business flow in our renewal subscription model as in the past. We expect bookings and billings to repeat their historical pattern of being lowest in Q1 and growing going forward to end at the highest level in Q4.

For Q1 specifically, we offer the following outlook:

- We expect revenue to be in the range of \$558 million to \$566 million, which is up 18% in USD at the high end of the range. One should note that FY16 Q1 revenue had a one-time catch-up benefit from the CCSP program that will not repeat in Q1 this year. We expect non-GAAP operating margin of approximately 22% and non-GAAP earnings per share of \$0.50.
- Consistent with prior practices, I will not forecast quarterly cash flow but please note that it can be variable depending upon individual payments or receipts.

Overall, we delivered a strong performance in Q4 and throughout FY16. We continue to believe there is significant opportunity for Red Hat as IT organizations transition their application development and infrastructure to the hybrid cloud environments. We are well positioned to deliver an attractive combination of revenue growth, profitability and cash flow for FY17. We remain optimistic about the company's long-term opportunity as we are uniquely positioned to further drive the adoption of open source technologies and to enable customers to reap the benefits of hybrid cloud computing.

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