

Prepared Remarks 03/26/18

Speaker: Tom McCallum, VP of Investor Relations

Thank you operator,

Hello everyone, and welcome to Red Hat's earnings call for the fourth quarter of FY18. Speakers for today's call will be Jim Whitehurst, President and CEO and Eric Shander, Executive Vice President 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, along with our earnings release, 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 fiscal year FY19. 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 earnings 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.

Prepared Remarks 03/26/18

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.

Our fourth quarter capped-off an excellent year for Red Hat. Our global team executed well and we continued to experience strong demand for our technologies that enable digital transformation and hybrid cloud environments. We also continued to extend our strategic position as a trusted vendor for our customers as they look to modernize their data centers and adopt Red Hat technologies to build, deploy and manage cloud native applications.

Our results for the quarter were strong and contributed to several new records and milestones for the fiscal year. Here are just a few of the highlights:

- First, the fourth quarter marked our 64th consecutive quarter of total revenue growth.
- Second, our annual billings proxy exceeded the \$3 billion milestone, while the fourth quarter marked the first time our billings proxy exceeded \$1 billion in a quarter.
- Third, strong sales execution led to our third straight quarter of 20% or better revenue growth with 21% total revenue growth for the year. We exited Q4 with an annualized revenue run-rate that exceeded the \$3 billion mark.
- Fourth, sales execution also contributed to a record total backlog of approximately \$3.4 billion, up approximately 24% year-over-year.

Prepared Remarks 03/26/18

- Fifth, we continued to win larger, multi-year commitments from our customers. We had a record number of deals over \$1 million for the fourth quarter and the fiscal year. On a year-over-year basis, we had a 50% increase in deals over \$1 million for Q4 and a greater than 30% increase in deals over \$1 million for the year.

Let me discuss some more highlights regarding Q4 deals:

- Overall our large deal growth in the quarter was strong due to cross selling and solid demand. For the quarter, we closed a total of 169 deals over \$1 million and as I discussed a moment ago, this was up approximately 50% year-over-year. Within these deals, 26 were greater than \$5 million which is a record for any quarter. Included in the 26 deals were 14 greater than \$10 million with two of those over \$20 million.
- Cross selling was strong, with 81% of the top deals greater than \$1 million including one or more components from our group of Application Development-related and emerging technologies offerings. One-third of the deals contained 5 or more technologies across our portfolio of offerings – providing evidence of the value Red Hat is delivering to our customers based on the expansion of our product portfolio in recent years.
- Our top industry verticals within the deals greater than \$1 million were financial services, tech & media and our other category which includes mainstream sectors such as retail, healthcare and manufacturing.

Prepared Remarks 03/26/18

On the technology front, our biggest announcement during the quarter was our acquisition of CoreOS, an innovator and leader in Kubernetes and container-native solutions. The acquisition of CoreOS further enhances our ability to help customers build applications and deploy them across hybrid environments. By combining CoreOS's complementary capabilities with Red Hat's already broad Kubernetes and container-based portfolio, including OpenShift, we aim to further accelerate adoption and development of the industry's leading hybrid cloud platform for modern application workloads.

CoreOS is the creator of CoreOS Tectonic, an enterprise-ready Kubernetes platform that provides automated operations, enables portability across private and public cloud providers, and is based on open source software. It also offers CoreOS Quay, an enterprise-ready container registry. In addition CoreOS's talented technical team is well-known for helping to drive many of the open source innovations that are at the heart of containerized applications, including Kubernetes, where it is a leading contributor. These innovations include a lightweight Linux distribution created and maintained by CoreOS, called Container Linux, which automates software updates and is streamlined for running containers.

We continue to believe that the next era of technology will be driven by container-based applications that span multi- and hybrid cloud environments and that Kubernetes, containers and Linux will be the foundation of this transformation. Both Red Hat and CoreOS have been leaders in open source communities and in bringing Kubernetes to enterprise customers. This acquisition further advances Red Hat as a

Prepared Remarks 03/26/18

leader of hybrid cloud and modern application deployments and will help us to expand our strategic position with customers.

In closing, we celebrated 25 years of Open Source software this past quarter, and Red Hat has been a major catalyst. As we welcome the team from CoreOS as part of the nearly 12,000 team of global Red Hat associates; we are excited to have them join our efforts to drive innovation and growth in the future. Let me also extend my thanks to all of our Red Hat associates who are keenly focused on helping out our customers to succeed. And as a company, we are confident in our ability to capitalize on the market opportunity in front of us.

On a final note, I hope many of you will be able to join us for the May 8 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. You will hear directly from our customers and partners, including technology visionaries, leading industry players and cloud providers.

With that, let me turn the call over to Eric.

Speaker: Eric Shander, EVP and CFO

Thank you, Jim.

Let me also add my appreciation for the strong execution and efforts that our global associates delivered during the quarter and the fiscal year which resulted in strong financial performance that was above our guidance. Our execution this year resulted in higher growth than FY2017 across total revenue, non-GAAP operating income and operating cash flow and

Prepared Remarks 03/26/18

continues to be attributable to the demand for our hybrid cloud technologies.

Highlighting the fourth quarter, we delivered a powerful combination of year-over-year growth of 23% for total revenue, 24% for non-GAAP operating income and 14% for operating cash flow.

With that introduction, I will begin my remarks with a review of our Q4 performance, followed by a summary of the fiscal year results and then our outlook for FY19. As I discuss our results, please note that many of the major foreign currencies that we transact business in have strengthened against the dollar since we provided guidance in December and as compared to prior year. So for this quarter, I will keep my prepared remarks focused on reported USD results with occasional references to constant currency details. You will find a more detailed table of constant currency results as well as a more detailed view of our results and reconciliations for our non-GAAP measures to GAAP in our earnings press release.

- We delivered \$772 million of total revenue for the fourth quarter, which was above the high-end of our guidance and represented growth of 23% in USD or 18% in constant currency. We exceeded the high-end of our guidance by \$9 million, which included a foreign exchange tailwind of approximately \$6 million. The remaining upside was driven mainly by stronger performance in our subscriptions business, coupled with continued healthy demand for services supporting our emerging technologies.

Prepared Remarks 03/26/18

- Subscription revenue, which is mainly renewable, constituted 88% of total revenue in Q4 and grew 22% year-over-year in USD or 18% in constant currency. Higher growth across our subscription portfolio drove this result. Subscription revenue for our infrastructure-related offerings was \$510 million, an increase of 17% year-over-year in USD or 13% in constant currency. Subscription revenue for our application development-related and other emerging technology offerings was \$173 million, an increase of 39% year-over-year in USD or 34% in constant currency. The primary driver to the performance in this area of our business was the growth we continued to experience with our Ansible, OpenShift, and OpenStack technologies. The higher growth rates in these emerging technologies were partially offset by a slight moderation in the growth in our middleware offerings as some customers begin to shift their workloads from traditional physical deployments to container environments, where they would run “middleware as a service” within the OpenShift environment. We believe these initial efforts to use “middleware as a service” will increase over time as customers shift more applications to container environments, benefiting our middleware results over the long run. We view OpenShift and our middleware products as highly complementary to our overall cloud-native application development strategy. Application development-related and emerging technologies revenue represented approximately 22% of total revenue, up 260 basis points from the year ago-quarter. Lastly, our services revenue of \$89 million grew 29% year-over-year in USD or 23% in constant currency. The impressive growth of our services business has been

Prepared Remarks 03/26/18

fueled by the demand for consulting projects around our Ansible and OpenShift offerings.

On a non-GAAP basis, operating income of \$190 million grew 24% year-over-year and non-GAAP operating margin came in at 24.6%. This quarterly result was 30 basis points higher than Q4 last year, and in-line with the operating margin guidance that I provided on our last call. This also includes the partial impact from the CoreOS acquisition of approximately \$3 million.

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.

Other income was \$11 million which included a one-time gain from the sale of a strategic investment which we noted in our December guidance.

Shifting to taxes and EPS, our Non-GAAP effective tax rate was 18.6% for the quarter, which is inclusive of discrete tax benefits. This resulted in Non-GAAP EPS of \$0.91, up 46% year-over-year and \$0.10 higher than our December guidance. The lower tax rate is a result of the US tax reform and is the main reason for our higher non-GAAP EPS result vs our original guidance. Also related to the reform, we repatriated \$486 million of foreign earnings and recorded a one-time tax expense of \$123 million. The one-time tax expense was due to the transition tax on the repatriation and the re-measurement of our deferred tax assets. The one-time tax expense, along with our debt discount expense of approximately \$5 million are excluded from non-GAAP net income.

Prepared Remarks 03/26/18

Turning to the balance sheet, we ended the quarter with cash and investments of approximately \$2.5 billion. After factoring in the additional cash from the repatriation and the cash used for the acquisition of CoreOS, our US versus non-US cash based balances represent a 58%/42% split.

Our total deferred revenue at quarter end was \$2.6 billion, an increase of \$525 million or 25% over the same quarter a year ago.

Moving to operating cash flow, we delivered \$362 million for the quarter, up 14% year-over-year. Our FX adjusted DSO was 58 days, in-line with Q4 last year. Our cash flow performance was the result of higher profitability and strong billings, which was slightly moderated by our business linearity, as it was weighted to the back-end of the quarter. As Jim noted, we experienced significant growth in deals over \$1 million which was up 50% year-over-year, however many of these deals closed late in the quarter. As a result, the cash will be collected in the following quarter. This monthly linearity is something that we have discussed on prior calls and continue to actively manage.

The rolling four quarters average billings proxy was \$838 million, up 21% year-over-year. As a reminder, the 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.

Next, let me discuss our annual backlog, which we disclose at the end of each fiscal year. Total backlog was up 24% year-over-year for a record balance in excess of \$3.4 billion in USD. We define total backlog as the value of non-cancellable subscriptions and service agreements, which have billed, plus the value to be billed in the future but not yet reflected in our

Prepared Remarks 03/26/18

financial statements. The billed portion of the backlog is total deferred revenue, which was \$2.6 billion. The other portion of total backlog, which has not yet billed, was in excess of \$775 million up 19% from the prior year. Of the \$775 million, the portion to be billed over the next twelve months was in excess of \$450 million, up approximately 36% year over year.

I will now review some highlights related to our bookings. We continued to drive balanced bookings growth across our major geographies. This quarter, 58% of bookings came from the Americas, 27% from EMEA and 15% from Asia-Pacific. The percent of business in the Americas was affected by a tough comparison due to the \$100 million deal we closed in Q4 last year. After adjusting for this deal, the Americas would have had double digit growth. The fourth quarter route-to-market mix was 71% from the channel and 29% from our direct sales force, compared to the fourth quarter prior year's split of 69% and 31%.

Looking at our top deals, 24 out of 25 of our largest deals that were up for renewal, renewed and did so in aggregate at greater than 120% of their previous value. The one deal that did not renew is with a customer that is experiencing many challenges within their industry. We continue to partner with this customer to help understand the business transformation they need to implement and where our products may help accelerate this process. On an annual basis for this metric, we renewed 99 out of 100 of the top deals at greater than 120% in aggregate.

Our proxy for bookings duration was nearly 23 months, two months shorter than the 25 months duration reported in Q4 last year. This was, however, longer than we anticipated due to the strong growth of multi-year deals that

Prepared Remarks 03/26/18

were closed in the quarter. Looking at FY19, we expect our bookings duration metric will be one month lower than this past year's average of 22 months.

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

- Total revenue grew to \$2.9 billion, up 21% in US dollars or up 20% in constant currency.
- Subscription revenue grew to \$2.6 billion, an increase of 21% in US dollars or 19% in constant currency.
- Subscription revenue for Infrastructure related offerings was nearly \$2 billion, up 15% in US dollars or 14% in constant currency.
- Subscription revenue for Application Development-related and other emerging technologies was \$624 million, up 42% in US dollars or 40% in constant currency.
- For FY18, Application Development-related and other emerging technologies subscriptions constituted 21% of total revenue, up from 18% last fiscal year.
- Non-GAAP operating income grew by 26% year-over-year.
- Full year operating cash flow was \$923 million, up 18% for a cash flow margin of approximately 32%.
- We repurchased \$237 million or 2.3 million shares of Red Hat stock in the fiscal year, leaving a balance of \$399 million in our repurchase program.

Prepared Remarks 03/26/18

Now I'd like to turn to guidance. Our outlook assumes current business conditions and foreign exchange rates, which have generally, strengthened against the dollar year-over-year.

For the full-year, we are estimating total revenue guidance of \$3.425 billion to \$3.460 billion, up approximately 19% in USD and 17% in constant currency at the high-end of the range. Given the upfront financial impact related to the recent acquisition of CoreOS, coupled with our desire to target the strong demand for container technology, we plan on maintaining a non-GAAP operating margin of 23.9% in FY19. This plan includes more than 100 basis points of expense related to the acquisition of CoreOS. In FY20, we anticipate increasing operating margins by 25 to 50 basis points per year while continuing to invest in the strategic growth areas.

We're estimating our full-year non-GAAP earnings per share to be approximately \$3.38 to \$3.41 per share, assuming approximately \$4 million per quarter for net other income, an annual effective tax rate of 25% and approximately 185 million diluted shares.

On a GAAP basis, we expect GAAP EPS to be approximately \$2.25 to \$2.28 with estimated annual stock compensation expense of approximately \$215 million and annual amortization expense of approximately \$38 million. GAAP fully-diluted EPS guidance includes non-cash interest expense related to the convertible debt discount of approximately \$20 million. We estimate capital expenditures to be in a range of \$55 million to \$65 million. Finally, we expect our full-year operating cash flow to be in a range of \$1.035 billion to \$1.045 billion.

Prepared Remarks 03/26/18

We do not provide guidance on billings, but as we have experienced in past years, we expect Q1 to typically be our lowest quarter and we continue to see a modest shift to the second half of the year. Also as I mentioned previously, we are expecting 1 less month of bookings duration in FY19. Typically Q1 has the lowest duration of the year but in Q1 FY18 we closed a deal for \$30 million for 3 years that both booked and billed upfront.

For Q1, we offer the following outlook. We expect revenue to be in the range of \$800 million to \$810 million, which is up approximately 20% in USD at the high-end of the range and 16% in constant currency. We expect non-GAAP operating margin of approximately 20.5% which includes expenses for Red Hat Summit and our regional sales kick-off events. We expect non-GAAP earnings per share of \$0.68 with 185 million diluted shares. GAAP EPS is expected to be \$0.42 with 187 million diluted shares. We will continue our practice of not providing quarterly cash flow guidance, but please note that it can be variable depending upon individual payments or collections.

Recapping FY18, we delivered strong results that reflect the continued adoption of the technologies that address the opportunities around digital transformation and hybrid cloud computing. Finally, I would like to thank all of our customers whom have trusted us as their business partner, and our associates around the world whose dedication and hard work helped to deliver these strong results both financially and operationally for our customers. We're optimistic that the execution this year will position us well for continued future growth.