

Speaker: Tom McCallum, VP of Investor Relations

Thank you operator,

Hello everyone, and welcome to Red Hat's earnings call for the first 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 second 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 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.

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.

The first quarter was a strong start to fiscal year 18 and a continuation of last year's momentum. Our growth is being driven by high levels of customer interest in our broad portfolio of technologies, as well as our growing position as a trusted partner to enterprise customers. Specifically, IT organizations are looking to modernize their IT infrastructure for the hybrid cloud – and they are increasingly turning to Red Hat as a key partner to help them make this transformation.

Let me describe a few highlights that illustrate the growing adoption of Red Hat technologies from the quarter:

- First, we delivered our highest Q1 total revenue growth rate in USD in 4 years at 19%.
- Second, subscription revenue for our Infrastructure-related offerings, which is mainly comprised of our flagship RHEL technologies, is approaching a \$2 billion annual run rate and grew 14% year over year in the first quarter.
- Third, we drove over 40% growth in our Application Development-related and other emerging technology subscription revenue, which now has an annual run rate of over \$500 million.
- Fourth, we delivered more than 20% growth in our consulting and training services as our customers prioritized their move toward our emerging technologies into production.

- And fifth, our largest customers continue to expand their commitments with Red Hat – All of our Top 25 largest deals renewed during the first quarter and in aggregate renewed for more than 120% of their previous annual purchase.

This type of momentum around our technologies and services has enabled us to raise our full year guidance, which Eric will detail in a few moments.

With that overview of our first quarter results, let me discuss some of our recent business and technology highlights from the quarter:

- Starting with our marquee user event, the Red Hat Summit that was held in Boston in May. We had record attendance with over 6,000 users, IT decision makers and partners, many of whom came to hear how Red Hat could help them with their hybrid cloud, container and Dev Ops initiatives. One key theme coming out of the Red Hat Summit this year was the high level of customer participation. We had 13 customer keynotes, followed by 65 customer-led breakout sessions, nearly a dozen press releases with customer references and a doubling of the number of CIO and IT executives attending our Executive Exchange at Summit. These global customers came to Summit so they could discuss how implementing Red Hat solutions helped to achieve significant success from a business as well as social perspective – ranging from the build out of the largest private cloud based on OpenStack at Sprint, to saving lives through technology and community participation in Singapore.

- We also had over 100 partner sponsors, of which 37% were new to the Red Hat Summit. A key theme among our partners was our joint commitment and expanding relationships with our public cloud partners. We had a high level of participation from many of the largest public cloud providers in the world including Amazon Web Services, Google Cloud, IBM/Softlayer, Microsoft Azure and Rackspace.
- In addition to promoting the customer benefits of Red Hat solutions running on a public cloud, we also announced an extended strategic alliance with Amazon Web Services (AWS) to further integrate OpenShift, our container platform, as a service broker to hybrid cloud users. This unique offering will make AWS services accessible directly within OpenShift, allowing customers to take advantage of a broad portfolio of AWS services whether using them on AWS or in an on-premises environment.
- In addition to the expanded partnership announcements with a number of partners, we were also able to showcase a number of diverse use cases of our container platform with customers such as the Schiphol airport in Amsterdam, Barclays Bank, BMW and Disney.
- Following our Summit event, we were a top sponsor at the OpenStack Summit in Boston. We were pleased to see some of our OpenStack customers, Paddy Power BetFair and UKCloud were recognized with Super-user Awards at the event. We also launched our latest version of Red Hat OpenStack Platform 11 which is based on the upstream OpenStack release,

Ocata, the 15th release of OpenStack. One of the key enhancements in this version was to our deployment tool, Red Hat OpenStack director, which makes deploying and upgrading enterprise, production-ready private clouds even easier.

- Recently we announced the acquisition of Codenvy which is a provider of leading cloud-native development tools. The technology is built on top of the open-source Eclipse Che project and provides a cloud-based, integrated development environment and a workspace management system that enables developers to get up and running more quickly to create modern container-based and cloud-native applications.

Codenvy started Eclipse Che in 2014 and it has grown in popularity with more than 100 contributors, more than 4,000 GitHub stars, and 1 million usage hours / month. With this acquisition, Eclipse Che and the Codenvy enhancements will become central to Red Hat's developer tooling strategy and reinforces our commitment to the developer community.

In summary, as we experienced at the Red Hat Summit, customers are looking more and more at their IT platforms to enable them to compete in digital transformation. We believe Red Hat has the solutions and the talent to help them realize the benefits of modern technologies and cloud computing. Our focus on delivering real business value for our customers will help to drive Red Hat's growth into the future.

Before turning the call over, I want to welcome the team from Codenvy and thank our 10,000 plus Red Hat associates around the globe for a strong start to the year.

Together with the open source community and our business partners, we will continue to push the pace of innovation and deliver solutions that help our customers capitalize on the power of hybrid cloud strategies.

With that, let me turn the call over to Eric

Speaker: Eric Shander, EVP and CFO

Thank you, Jim.

Let me first thank our customers who continued to allow us to serve them as well as our Red Hat associates around the world who have maintained the momentum from Q4 to deliver a very solid operational and financial start to the new fiscal year. Strong execution from our sales and services teams, combined with solid global demand, enabled us to deliver results that exceeded our guidance across a number of metrics. Total revenue was \$677 million, above the high-end of our guidance and representing growth of 19% in USD or 20% in constant currency. We exceeded the high end of our guidance by \$27 million with approximately \$4 million due to an improvement in foreign exchange rates. The remaining \$23 million of upside was split, with approximately half driven by stronger performance and execution from our global sales team and approximately half driven by additional services mainly supporting our emerging technologies.

Let me provide you with some additional financial highlights of our first quarter performance. In general, currency rate volatility was fairly stable year-over-year in Q1 and the major foreign currencies that we transact business in have improved from our initial guidance in March. So, for this quarter I will keep my prepared remarks focused on the reported USD results and where appropriate add constant currency details. In addition, you will find a table of the constant currency results in our press release. Also for a more detailed view of our results and reconciliations of our non-GAAP measures to GAAP, please refer to our press release.

- Now let me turn to subscription revenue, which constituted 88% of total revenue in Q1. This was the largest driver of our growth at \$597 million for the quarter, representing an increase of 19% year-over-year.
- We also continued to drive growth across our technology portfolio. Subscription revenue for our Infrastructure-related offerings was \$458 million, an increase of 14% year-over-year. Subscription revenue for our Application Development-related and other emerging technologies was \$139 million, an increase of 41% year-over-year. Application development related and emerging technologies revenue represented approximately 20% of total revenue, up 320 basis points from the year ago quarter.
- Our Services revenue exceeded our expectations, coming in at more than 20% year over year growth. This is the result of several customers prioritizing

consulting projects around Ansible, Openstack and OpenShift faster than we expected.

- On a non-GAAP basis, operating income of \$139 million grew 12% year-over-year and non-GAAP operating margin was 20.5%. This quarterly result was slightly higher than the operating margin guidance I provided on our last call due primarily to the higher revenue results. 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.
- Using our non-GAAP effective tax rate of 27.8% after the impact of certain discrete tax items, non-GAAP diluted earnings per share came to \$0.56, which is \$0.03 higher than our March guidance and up 12% year-over-year.
- We ended the quarter with cash and investments of approximately \$2.3 billion while returning \$62 million to our shareholders in the quarter through the repurchase of approximately 700,000 shares of stock.
- Total deferred revenue at quarter end was \$2.1 billion, an increase of \$362 million or 21% over the same quarter a year ago.
- 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. On a rolling four quarters basis, the billings proxy was \$717 million, up 20% year-over-year.

- Operating cash flow of \$258 million for the quarter increased 11% from the prior year quarter operating cash flow of \$232 million. The FX-adjusted Days Sales Outstanding was 62 days.

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

- Our geographies saw continued growth in bookings. This quarter 55% of our bookings came from the Americas, 24% from EMEA and 21% from Asia-Pacific versus a 60%/21%/19% split in the first quarter last year. The Asia Pacific and EMEA regions had the strongest growth; North America performance was also solid in the quarter offset by the continued external challenges in the LATAM region.
- The first quarter route-to-market mix was 72% coming from the channel and 28% from our direct sales force, compared to a 78%/22% split in the first quarter last year. The year over year change in mix was driven by a number of large deals that were closed by our direct sales team.
- Our proxy for booking duration was nearly 22 months; we continue to believe this metric will approach our 21 month historic level as the fiscal year progresses.
- Starting this fiscal year, we are updating our top deals metric to expand beyond the top 30 deals in a quarter. Going forward, we will report all deals over \$1 million, providing visibility to a larger pool of business in the quarter. To provide some historical perspective, last fiscal year the number of million dollar deals was

much higher than the 30 deals we talked about each quarter. The total number of deals over \$1 million in a quarter in FY17 ranged from 45 to 110 over the course of the fiscal year. In our Q1 FY18 quarter, there were a total of 44 deals over \$1M. Within these deals, 7 were greater than \$5 million and 4 of those were greater than \$10 million including 1 deal greater than \$20 million.

- Of note in the \$5 million deal category was our largest deal ever for Ansible. This deal was with a large government agency which will deploy Ansible across several data centers to drive cost savings by leveraging Ansible's automation management capabilities.
- Cross selling was strong, with over 68% of the top \$1 million deals including one or more components from our group of Application Development and emerging technologies offerings.
- Our top verticals within the deals >\$1M were financial services, government and other mainstream customers in sectors such as healthcare and retail.

Now I would like to turn to guidance. Our outlook assumes current business conditions and foreign exchange rates which have generally improved against the dollar since our March guidance.

- We are raising our full year revenue guidance to \$2.785 billion to \$2.825 billion, up approximately 17% in USD at the high end of the range. Approximately half of the \$65 million increase in our outlook is being driven by our stronger

performance with the remaining balance coming from an improvement in foreign exchange rates.

- Due to the increase in forecasted revenue, we expect non-GAAP operating income to grow more than our previous guidance while still maintaining a 50 basis point increase year over year for a 23.6% non-GAAP operating margin. This forecast assumes additional focused investment in our emerging technologies as well as the effects of our Codenvy acquisition.
- We expect full year non-GAAP earnings per share to be approximately \$2.66 to \$2.70 per share, assuming approximately \$2 million per quarter forecast for net other income, an annual effective tax rate of approximately 28% and approximately 180 million diluted shares. At the top end of the guidance, this would be 19% growth in earnings per share.
- On a GAAP basis, we estimate annual stock compensation expenses of approximately \$200 million and annual amortization expense of approximately \$30 million. GAAP fully-diluted EPS guidance includes non-cash interest expense related to the convertible debt discount of approximately \$20 million.
- Operating cash flow is still expected to grow in the range of \$850 million to \$870 million.

For Q2 specifically, we offer the following outlook:

- We expect revenue to be in the range of \$695 million to \$702 million, which is up 17% in USD at the high end of the range. We expect non-GAAP operating margin of approximately 24% and non-GAAP earnings per share of \$0.67.
- 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. Similar to the last two fiscal years, we would expect Q2 to be the lowest level for the fiscal year.

Overall, our strategy to seize the opportunities around digital transformation and hybrid cloud computing continued to drive strong results for Red Hat. We are also pleased with our progress to increase our strategic importance with customers. We continued to deliver high value solutions that help our customers to realize the benefits of a modern, cloud enabled architecture. We believe that our continued success with customers and partners will drive additional value for our shareholders.

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