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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 FY19. 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.

Please note, this quarter we adopted ASC606 using the full retrospective method. The impacts of adoption are reflected in the financial information provided in the Supplemental Information section of the Press Release. The adoption of ASC 606 did not, as previously reported, materially impact our total revenues and had no impact on net cash. The primary impact of adopting ASC 606 related to the deferral of incremental commission and other costs of obtaining contracts with customers. Previously, we deferred only direct and incremental commission costs and amortized those costs over the contract term. Under the new standard, we are also amortizing related fringe benefit costs over the contract term. These changes are reflected in the current and prior year results for both GAAP and non-GAAP.

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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 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.

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.

As customers continue to view the move to hybrid cloud architectures as a top strategic IT priority, Red Hat is positioned as one of the foundational components to this strategy. We were able to demonstrate this at Red Hat Summit, where more than 100 customers from around the globe spoke about how they deployed our broad portfolio of technologies to successfully achieve their initiatives and transform their business. Before I expand on some of key events from Red Hat Summit, let me provide you with some highlights in the quarter:

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We delivered total revenue growth of approximately 20% for the fourth straight quarter in USD.

We delivered double digit core Infrastructure growth while also driving growth in Application Development and other emerging technologies above 30%. This resulted in an annualized revenue run rate approaching \$800 million, and was particularly strong when considering the ongoing transition of middleware from standalone deployments to containerized, cloud-based services.

Our overall growth is being driven by our ability to deliver next generation platforms to help our customers address some of the most pressing challenges they are facing when creating, deploying and managing applications that run their businesses. Let me give you a few examples.

- First, we delivered a 48% year-over-year increase in deals over \$1 million, due in part to the fact that 70% of these deals included one or more components from our group of Application Development-related and emerging technologies offerings.
- Second, we drove strong growth in our Linux container platform, OpenShift, where we added over 100 new customers in the quarter and continued to grow the median revenue per customer.
- Third, we continued to experience high demand for our services business, which grew 27%. This result was mainly driven by additional consulting demand for Ansible and OpenShift.
- A fourth example, we eclipsed the 1,000 customer mark for our Ansible subscribers in Q1, up approximately 70% year-over-year.

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We believe this type of momentum around our end-to-end suite of next generation technologies and related services will enable us to deliver choice and innovation for our customers as they develop, deploy and manage their applications.

Now, let's turn to discuss some of our recent business and technology highlights:

Our marquee user event, the Red Hat Summit, was held in San Francisco in May. We had record attendance, with approximately 7,500 attendees including developers, IT decision makers and partners. This was a 20% increase from last year's event.

In addition to the high level of customer participation and several technology announcements, we also had some key partner announcements with OpenShift, our container platform. As published in their October 2017, Smarter with Gartner blog, 6 Best Practices for Creating a Container Platform Strategy, "Gartner predicts that, by 2020, more than 50% of global organizations will be running containerized applications in production, up from less than 20% today". Clearly containers are becoming a major driver for application development. This is further evident in announcements I will describe between Red Hat and two of the major public cloud providers that are in addition to last year's announcement at Summit in Boston where we extended our strategic alliance with Amazon Web Services to further integrate OpenShift, enabling AWS services within OpenShift Container Platform for hybrid users.

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First, we expanded our alliance with Microsoft to empower enterprise developers to run container-based applications across both Microsoft Azure and on premise environments. With this collaboration, we will introduce the first jointly managed OpenShift offering in the public cloud, combining the power of Red Hat OpenShift, the industry's most comprehensive enterprise Kubernetes platform, and Azure, Microsoft's public cloud. OpenShift on Azure will be configured and designed to reduce the complexity of container management for customers. As the companies' preferred offering for hybrid container workflows for our joint customers, Red Hat and Microsoft will manage the solution for customers, with support from both companies.

In addition to being a fully managed service, Red Hat OpenShift on Azure is expected to bring enterprise developers:

- Flexibility to freely move applications between both on premise environments and Azure using OpenShift, which offers a consistent container platform across the hybrid cloud.
- It will also bring increased productivity by providing a development platform that integrates natively with Azure infrastructure.
- We are excited about this new offering, which will be available in preview in the coming months.

The second key partner announcement from Summit for OpenShift was with IBM, where we extended our long-standing collaboration to bring together OpenShift and IBM Cloud Private with a number of IBM's software and cloud solutions.

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This agreement builds on the recent move by IBM to modernize its software portfolio with containers, including WebSphere, MQ Series and Db2. Container technologies are increasingly being used as a reliable way to move applications across multiple IT footprints, from existing data centers or private clouds to the public cloud and vice versa. This collaboration between IBM and Red Hat provides an additional pathway for enterprises to adopt hybrid cloud computing.

Through the new agreement, IBM and Red Hat customers can now:

- Maximize their existing technology investments and move them more easily to the hybrid cloud with IBM Cloud Private and Red Hat OpenShift serving as the common foundation;
- Build and deploy Red Hat certified containerized applications on one single, integrated container platform: IBM Cloud Private, which provides a single view of all enterprise data;
- Enable developers to design, modernize, and deploy new applications more quickly while taking advantage of IBM's cloud-based services such as artificial intelligence, Internet of Things and blockchain with IBM Cloud Private on the Red Hat OpenShift Container Platform.

As part of the agreement, IBM will extend its private cloud platforms and middleware offerings to OpenShift as Red Hat Certified Containers. This exemplifies the broader transition we are seeing in middleware to deployments as a service on top of containers. Our dual strength in containers and middleware positions us well to compete in the middleware addressable market that is estimated to reach \$18 billion by 2021. We have

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recently announced a series of product updates and enhancements to integrate our offerings more closely with OpenShift. This allows us to offer our middleware as containerized cloud-based services. We have created a new team focused on this area and will update you on our progress to drive additional growth in middleware over the next few quarters.

In summary, as was on display at the Red Hat Summit, customers are deploying hybrid cloud technologies to enable them to compete in this world of digital transformation. We believe Red Hat has the portfolio of solutions and partners to be one of the leaders of digital innovation. We have worked hard to build a reputation as a trusted brand in modern IT technology, and believe we are well positioned to drive growth as we look ahead.

Before turning the call over, I want to thank all of our global associates, from the team that runs great events like Red Hat Summit to everyone at Red Hat that supports our customers and partners every day. With over 12,000 customer-focused associates and a broad portfolio of hybrid cloud technologies and an ecosystem that spans across open source communities to commercial partners, we are well positioned to drive future growth and returns for our shareholders.

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

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Speaker: Eric Shander, Executive Vice President and CFO

Thank you, Jim.

Let me also thank our global associates for their continued commitment to our customers, partners and the open source communities.

As Jim discussed, our financial performance continues to be driven by the strong demand for our hybrid cloud technologies. Highlighting the Q1 financial results, we delivered a combination of the following:

- Year over year revenue growth of 20% in USD or 17% in constant currency
- Non-GAAP operating income growth of 19%
- And operating cash flow growth of 34%

Before I discuss our results in further detail, please note that many of the major foreign currencies that we conduct business in have weakened against the dollar since we provided guidance back in March. For instance, total revenue for the quarter would have been \$3 million higher using the FX rates from March. As for the impact to our full year revenue outlook, we are re-affirming the growth on a constant currency basis of 16%-17%, while we adjust the dollar range down by \$50 million for the changes in FX rates as of today, which I will discuss in more detail at the end of the call.

Given this FX volatility in the quarter, I will provide results in both USD and constant currency growth, and you will find a more detailed table of our constant currency results and reconciliations for our Non-GAAP measures to GAAP in our earnings press release.

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Now I will begin with a review of our Q1 performance and business metrics and then I will move to our outlook for Q2 and FY19.

- We delivered \$814 million of total revenue for the first quarter, which was above the high-end of our guidance and represented growth of 20% in USD or 17% in constant currency. Adjusting for the \$3 million FX headwind I noted earlier, we exceeded the high end of our guidance by \$7 million. The upside was driven primarily by a higher demand for services supporting our emerging technologies.
- Subscription revenue, which is mainly renewable, constituted 87% of total revenue in Q1 and grew 19% in USD or 16% in constant currency. Double digit growth across our subscription portfolio drove this result.
- Subscription revenue for our Infrastructure-related offerings was \$522 million, an increase of 14% in USD year-over-year or 11% in constant currency.
- Subscription revenue for our Application Development-related and emerging technology offerings was \$189 million, a year-over-year increase of 37% in USD or 32% in constant currency. Within this portfolio of solutions, our emerging technologies which include Ansible, OpenStack, OpenShift, Storage and cloud management offerings continue to make strong traction. As we discussed last quarter, the emerging technology performance is somewhat offset by a moderated growth rate for our Middleware offerings, as some customers begin to consider shifting their workloads from traditional physical deployments to container environments. We believe this transition will impact the revenue growth of the middleware business

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this year and as such, had previously factored this into our full year guidance provided back in March. We believe that in the long run as customers shift more applications to container environments, it will benefit our middleware results and Red Hat overall.

- Overall application development-related and emerging technologies revenue represented approximately 23% of total revenue, up 270 basis points from the year ago-quarter.
- Lastly, our services revenue of \$102 million grew 27% year-over-year in USD or 24% in constant currency. The impressive growth of our services business has been fueled by the demand for consulting projects around Ansible and OpenShift offerings.

Before I move to the income statement, 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.

On a non-GAAP basis, operating income of \$168 million grew 19% in USD year-over-year and the non-GAAP operating margin was 20.7%. This quarterly result was 20 basis points higher than our guidance. As for net other income it was \$4 million for the quarter, in line with guidance.

Shifting to taxes and EPS, our non-GAAP effective tax rate, inclusive of discrete tax benefits was 22.8% for the quarter, and lower than our original guidance of 25% due to the US tax reform. Our Non-GAAP EPS for the quarter was \$0.72, up 24% year over year in USD, and above our guidance of \$0.68, with the lower tax rate contributing \$0.02 to the \$0.04 beat.

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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 incremental repatriation in Q1, our US versus non-US cash balances is a 55% / 45% split.

Our total deferred revenue at quarter end was \$2.4 billion, an increase of \$390 million up 19% in USD or 18% in constant currency from the same quarter a year ago.

Moving to operating cash flow, we delivered \$346 million for the quarter, up 34% year-over-year. Our Q1 cash flow performance was the result of strong collections on our Q4 billings, which as we discussed last quarter was more heavily weighted to February shifting the collections to this quarter. Our FX-adjusted DSO was 66 days, up from 62 in the prior year quarter.

The rolling four quarters billings proxy was \$858 million, up 20% in USD or 17% in constant currency. 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 total backlog, which we will now be disclosing on a quarterly basis in our Form 10-Q filing pursuant to the changes of adopting ASC 606. Estimated total backlog was up 21% year-over-year in USD from the prior year quarter, for a balance of \$3.3 billion in USD.

I will now review some highlights related to our bookings performance. Looking at our top deals, 25 out of 25 of our largest deals that were up for renewal, renewed and did so in aggregate at >120% of

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their previous value. This continues to demonstrate the strong partnership our customers have with Red Hat as they modernize their IT environments.

In addition to our top deals, cross selling was strong, with over 70% of the top deals greater than \$1 million including one or more components from our group of Application Development-related and emerging technologies offerings. Our top industry vertical within the deals greater than \$1 million was our “other mainstream” vertical which includes sectors such as healthcare, hospitality and transportation. Our second largest industry vertical was the Government.

As Jim also noted, the growth of deals over \$1 million was strong in the quarter with a total of 65 deals, up approximately 48% year-over-year. Within these deals, 6 were greater than \$5 million and 1 deal was greater than \$10 million, which was 3 less than Q1 last year. As we discussed at Analyst Day, we are focused on building our strategic partnerships within our mid-market customers. In Q1, our mid-market deals greater than \$250k increased 138% year-over-year from 21 deals to 50 deals, with notable growth in Ansible and OpenShift. Our partnership with Global Systems Integrators is helping to drive growth in the mid-market with these emerging technologies. As for the route-to-market, 75% was from the channel and 25% from our direct sales force, compared to the prior Q1 split of 72% and 28%.

Our proxy for bookings duration was just over 21 months, half a month shorter than Q1 last year. Consistent with our discussion at Analyst Day, we continue to believe duration will be approximately one month shorter for the full fiscal year. The shorter duration is driven in part by an increased

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focus on our mid-market customers, which typically start out with shorter subscription duration. As we also highlighted at Analyst Day, there is a smaller base of large customer renewals this year, as we increased our strategic partnerships with many of our largest customers back in FY17. The longer deal duration in FY17, has enabled us to increase our focus on driving adoption of emerging technologies, which as I noted earlier continues to grow at a rapid rate. The shorter deal duration will have an impact on both bookings and billings growth rates in FY19.

Lastly, our geographical bookings mix was 50% from the Americas, 28% from EMEA and 22% from Asia-Pacific. The percent mix in the Americas was impacted by the smaller base of large customer renewals we just mentioned.

Now I'd like to turn to guidance. Our outlook assumes current business conditions and foreign exchange rates. As I discussed at the beginning of my prepared remarks, many of the foreign exchange rates we conduct business in, have weakened against the dollar since we gave guidance in March.

As a result, for the full year, we are adjusting our total revenue guidance in USD to \$3.375 billion to \$3.410 billion to reflect the \$50 million impact from foreign exchange rates as of today. In constant currency growth, we are re-affirming the year over year growth range of approximately 16% to 17% at the high end. As a result of the foreign currencies weakening since March, the resulting year over year growth in USD would be approximately 16% to 17%.

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As for other changes to our full year guidance, as I mentioned earlier our annual effective tax rate was lower than expected and we are now planning for a 22.5% tax rate. Our full year non-GAAP EPS will increase to approximately \$3.44 to \$3.48 per share. This also assumes approximately \$4 million per quarter for net other income and approximately 185 million diluted shares, which does not include any impact from the new \$1 billion share repurchase program announced today. While we are reducing our effective tax rate to 22.5% for FY19, we believe it would be prudent to continue to use a 25% tax rate in FY20 and beyond as we continue to evaluate the impact from US tax reform.

All other previous non-GAAP guidance remains unchanged including our full-year Non-GAAP operating margin of 23.9%, and operating cash flow outlook of approximately \$1.035 billion to \$1.045 billion.

For Q2, we offer the following outlook. After adjusting for the foreign exchange rate impact of approximately \$15 million, we expect revenue to be in the range of \$822 to \$830 million, which is up approximately 14% to 15% in both USD and constant currency. We expect non-GAAP operating margin of approximately 23%.

We expect non-GAAP earnings per share of \$0.81 with 185 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 the quarter, we delivered financial results that were in line with our expectations. We remain confident and focused on partnering with our

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customers on their journey to adopting our technologies that address the opportunities around digital transformation and hybrid cloud computing.