

Prepared Remarks – Red Hat Q2FY2018 Earnings Call September 25, 2017

Speaker: Tom McCallum, VP of Investor Relations

Thank you operator,

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

Jim Whitehurst, President and CEO

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

In the second quarter, we continued to experience high levels of demand across our portfolio of technologies. Our strong second quarter results are further evidence that IT organizations are increasingly turning to Red Hat as a strategic technology partner as they modernize their IT infrastructure for the hybrid cloud and digital transformation.

Looking specifically at the second quarter, we delivered total revenue growth of 21% year-over-year which was fueled by demand across our subscription and service offerings. The drivers were:

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- Subscription revenue growth of 14% for our Infrastructure-related offerings, led by our flagship RHEL technologies. Another driver to our strong growth in this area is our on-demand RHEL revenue from our public cloud provider partners, which now exceeds a \$200 million annualized run rate and is growing twice as fast as the overall company.
- Our total subscription revenue growth was also fueled by more than 40% growth in our Application Development-related and other emerging technology offerings, which include cloud enabling technologies like OpenShift and OpenStack. There are few technology companies generating a similar combination of strong growth at substantial scale when compared to this area of our business.
- In addition, service revenue growth of 25% also had a strong performance and was driven primarily by consulting projects for OpenShift and Ansible.

Increased demand for hybrid cloud technologies contributed to accelerated revenue, operating income and cash flow growth during the first half of the fiscal year. Due to our first half execution and expectations for continued strong momentum, we have increased our guidance for Fiscal '18 when compared to our view entering the year.

Before Eric provides you additional financial highlights from the quarter and our increased outlook, let me describe a few business and technology highlights that illustrate the growing adoption of Red Hat technologies from the quarter:

- First, our recent announcement with Microsoft that expands our alliance, with plans for new initiatives aimed at enabling enterprises to more easily adopt containers. These initiatives include native support for Windows Server containers on OpenShift, OpenShift Dedicated on Microsoft Azure, and SQL Server on RHEL and OpenShift. These additions to the companies' joint roadmap will focus on simplifying container technologies to help enterprise customers increase their agility, flexibility and choice while simplifying complexity across hybrid cloud footprints.
- Second, we made several announcements around our Fall automation event, Red Hat's Ansiblefest which was held in San Francisco in September. We had record attendance with approximately 900 Ansible users, IT decision makers and partners, up nearly 60% from the previous year. They heard about how Ansible could help them with their hybrid cloud, networking and Dev Ops initiatives. Some of the new technology announcements are:

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- In addition to announcing the availability of Ansible Tower 3.2 which includes several new and enhanced features, we introduced a new offering that provides support for the open source Ansible Engine. Ansible Engine enables easier and quicker deployment of IT services, applications and environments, by automating routine activities. While the upstream Ansible community is known for fast-moving innovations, many enterprises require a more secure, stable and supported approach. With Ansible Engine, organizations can access the tools and innovations available from the underlying Ansible technology in a hardened, enterprise-grade manner.
- Ansible Engine is also available with a new Networking Add-on, helping to address a critical component of today's modern infrastructure. With networking automation, IT organizations can now use fully supported Ansible modules, developed and maintained in-house for many popular networking devices. This offering includes full engineering support for Arista, Cisco, Juniper and VyOS technologies.
- Third, we acquired the assets and technology of Permabit Technology Corporation. Permabit is an open source provider of software for data deduplication, compression and thin provisioning. With the addition of Permabit's technology to the RHEL platform, Red Hat will enable more efficient storage options. This technology will help our customers to derive a more efficient storage footprint to power further business innovation.

I'd like to welcome the team from Permabit to Red Hat. In addition, I'd like to thank our 11,000 strong Red Hat associates for an exceptional performance in the first half of the fiscal year. It was a great start to the year, and we are excited about the growth opportunity in front of us as Red Hat is well positioned to capitalize on a generational shift in the infrastructure technologies that underpin IT strategies. We remain focused on delivering compelling business value to our customers, and enable them to further drive innovation and flexibility into their organizations.

The strategy that we have outlined over the years is working, and it is delivering a compelling combination of strong growth, profitability and cash flow. We have remained committed to investing in the business to position Red Hat well in multiple large, growing markets - and we believe our strategy will continue to create value for our shareholders.

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With that, let me turn the call over to Eric

Eric Shander, EVP and CFO

Thank you, Jim.

Let me first thank the global team of Red Hat associates who delivered another strong performance in the second quarter, maintaining the momentum that began during Q4 of last year. Strong execution from our sales and services teams, combined with global demand for Red Hat technologies, drove financial results that were well above our guidance. For the second quarter we delivered year-over-year growth of 21% for revenue, 40% for non-GAAP operating income and 48% for operating cash flow. It was a great performance overall. For the first half of fiscal 2018, we delivered a powerful combination of 20% total revenue growth, 26% non-GAAP operating income growth, and 22% operating cash flow growth.

Let me provide you with some additional financial highlights of our second quarter performance. In general, currency rate volatility was fairly stable year-over-year in Q2. The major foreign currencies that we transact business in have improved modestly from the outlook we provided on the June earnings call, but the overall impact was minimal to our results. So for this quarter, I will keep my prepared remarks focused on reported USD results, and where appropriate, add constant currency details. In addition, you will find a table of 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.

Starting with total revenue, we delivered \$723 million of revenue which was above the high-end of our guidance and represented growth of 21% in USD or 20% in constant currency. We exceeded the high-end of our guidance by \$21 million, with approximately \$5 million due to an improvement in foreign exchange rates. The remaining \$16 million of upside was comprised of approximately \$12 million driven by stronger performance and execution from our global sales team, and approximately \$4 million driven by additional services mainly supporting our emerging technologies.

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Turning to subscription revenue, it constituted 88% of total revenue in Q2, and it was the largest driver of our growth at \$638 million for the quarter, representing an increase of 20% year-over-year. We also continued to drive strong growth across our product portfolio.

Subscription revenue for our infrastructure-related offerings was \$487 million, an increase of 14% year-over-year. Subscription revenue for our application development-related and other emerging technology offerings was \$150 million, an increase of 44% year-over-year. This part of our subscription business has achieved a \$600 million annualized revenue run rate while growing in excess of 40% year-over-year – which further reinforces our focused investment strategy that drives our differentiation and the value being realized by our customers. Application development-related and emerging technologies revenue represented approximately 21% of total revenue, up 340 basis points from the year ago-quarter.

And lastly our services revenue of \$86 million which also exceeded our expectations came in at 25% year-over-year growth. Although we forecasted strong growth for Q2 services, the actual growth was even faster than we expected due to additional demand for consulting projects around Ansible and OpenShift.

On a non-GAAP basis, operating income of \$191 million grew 40% year-over-year, and non-GAAP operating margin came in at 26.4%. This quarterly result was higher than the operating margin guidance that I provided on our last call, due primarily to the higher revenue results as well as some additional sales productivity and delayed investment on our emerging technologies which we plan to utilize in the second half of the fiscal year.

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 28.4% after the impact of certain discrete tax items and debt discount expense, non-GAAP diluted earnings per share came to \$0.77, which is \$0.10 higher than our June guidance and up 40% year-over-year.

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Turning to the balance sheet, we ended the quarter with cash and investments of approximately \$2.3 billion, while returning \$75 million to our shareholders in the quarter through the repurchase of nearly 800,000 shares of stock.

Our total deferred revenue at quarter end was \$2.1 billion, an increase of \$372 million or up 22% over the same quarter a year ago.

Our operating cash flow results were also strong. Operating cash flow of \$143 million for the quarter increased from the operating cash flow of \$97 million in Q2 last year. This result was due to a mix of higher profitability and stronger billings and collections. The FX adjusted day sales outstanding was 56 days, a one day improvement from last year.

On a rolling four quarters basis, the billings proxy was \$745 million, up 20% 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.

I will now review the bookings metrics related to our business momentum, top renewals, and million dollar deals in the quarter.

- We drove balanced bookings growth across our major geographies. This quarter, 57% of bookings came from the Americas, 24% from EMEA, and 19% from Asia-Pacific – which is consistent with the second quarter last year.
- The second quarter route-to-market mix was 79% from the channel and 21% from our direct sales force, this result was relatively in-line with the second quarter prior year's split of 81% and 19%.
- Our proxy for bookings duration was nearly 21 months and as expected is lower than the 22 months that we reported in Q2 last year. Looking at the second half

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of this year, we continue to believe the bookings duration metric will be closer to the 21-month historic level rather than the elevated duration levels we experienced in Q3 and Q4 of last year.

- 25 out of 25 of our largest deals that were up for renewal all renewed and did so in aggregate at approximately 115% of their previous value.
- Our large deal growth in the quarter was strong, with a total of 66 deals over \$1 million, up 20% year-over-year. Within these deals, 4 were greater than \$5 million.
- Cross selling was strong, with over 60% of the top deals greater than \$1 million including one or more components from our group of application development-related and emerging technology offerings. Our top industry verticals within the deals greater than \$1 million were government, financial services and other mainstream sectors such as retail, energy and transportation.

Now I would like to turn to guidance. Our outlook assumes the current business conditions and foreign exchange rates, which have generally improved against the dollar since our June guidance. We are raising our full-year revenue guidance to \$2.880 billion to \$2.895 billion, up approximately 20% in USD and 19% in constant currency at the high-end of the range. Compared with our original March guidance for FY18 and the high end of our current outlook, approximately 60% of the \$135 million increase in our outlook is being driven by our stronger performance, with the remaining amount coming from an improvement in foreign exchange rates. Given the strong performance so far this year along with our outlook for additional growth and investment, we are modestly raising non-GAAP operating margin outlook by 20 basis points to 23.8% for the full year.

We are also raising our full-year non-GAAP earnings per share outlook to be approximately \$2.77 to \$2.79 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 a 23% year-over-year growth in earnings per share.

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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.

We are increasing our full year operating cash flow to grow in a range from \$880 million to \$900 million.

For Q3 specifically, we offer the following outlook. We expect revenue to be in the range of \$730 million to \$737 million, which is up 20% in USD at the high-end of the range and 18% in constant currency. We expect non-GAAP operating margin of approximately 23.7% and non-GAAP earnings per share of \$0.70.

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.

In Q2 we continued to seize the opportunities around digital transformation and hybrid cloud computing. This momentum drove strong results for the quarter and year-to-date. We're also pleased with the rate at which customers are embracing our multiple cloud enabling technologies. We believe this trust from customers and partners for Red Hat as a strategic advisor will help drive additional value for our shareholders.

With that, we will now open the call for questions.

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