

Prepared Remarks – Red Hat Q2FY2019 Earnings Call 09/18/18

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 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.

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 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.

In the second quarter, we continued to see demand from our customers around the globe as they focus on their digital transformation and hybrid cloud initiatives. We enable our customers to succeed on these initiatives with our innovative solutions, award winning support, and global services. Our focus on customers helped us drive strong results in the second quarter, where we delivered double digit growth in a number of our financial metrics. Let me highlight a few from the quarter:

- Our total backlog, driven by strong bookings, grew 20% year-over-year.
- Our major geographic regions each grew bookings at double digit rates year-over-year.
- Our application development-related and other emerging technologies subscription revenues grew more than 30% year-over-year.
- Our services revenue, led by demand for OpenShift and Ansible consulting and training, grew 19% year-over-year in constant currency.

Now let me give you some business metrics and highlights that demonstrate our continued traction with our customers and partners:

- Looking at our deals over \$1 million this quarter, we closed a total of 73 deals over \$1 million, up approximately 11% year-over-year. Within these deals, 11

were greater than \$5 million, which is a record in a Q2 for us, and 1 deal greater than \$10 million.

- Cross selling was strong in this cohort; over 76% of the top deals greater than \$1 million included one or more components from our Application Development-related and emerging technologies offerings.
- One of the deals over \$5 million, was the largest services deal we have ever closed in a quarter. This deal is with a global bank that is digitally transforming their payments business based on our Integration middleware.
- Our top industry verticals within the deals greater than \$1 million were Financial Services and the Government sector.
- Looking at our top deals, 24 out of our 25 largest deals that were up for renewal did so in aggregate value of more than 100% of their previous value. The one deal that did not renew is a rare competitive loss to a legacy on-premise provider based on pricing. We are actively pursuing future business with this customer as they evaluate additional technologies, such as adopting OpenShift as a multi-cloud platform for the digital transformation of their business. Removing the one lost deal and using the next largest deal that did renew, the adjusted top 25 deals in the quarter would have an aggregate value of approximately 115% of their previous value.

Looking more broadly across our customer base at two of our fastest growing technologies, OpenShift and Ansible, let me provide you some recent achievements that demonstrate the momentum we are seeing with our customers and partners.

- Last week, we announced a multi-partner relationship with Hortonworks and IBM Cloud Private to bring their big data and analytics products onto OpenShift. This is designed to enable customers to develop and run data-intensive applications on OpenShift, bringing them the power of hybrid cloud.
- Our Ansible technology reached approximately 2 million managed nodes at the end of Q2, essentially doubling the number of managed nodes since Q4 of last year.
- Overall, both of these technologies added nearly a hundred new customers each since Q1, and we continue to grow the median revenue per customer.

In summary, we continue to drive significant adoption of our hybrid cloud technologies, even as we work through the headwinds in middleware and our renewal base that we view and have previously discussed. We remain confident in our long-term competitive position and our proven ability to become increasingly strategic with our customers, as evidenced by our growth over the past several quarters with larger customer engagements and momentum with our partners.

I want to also thank Red Hat associates for their tireless efforts in serving our customers. From building innovative solutions to delivering and supporting these technologies, we continue to stay focused on the success of our customers and delivering value every day.

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

Speaker: Eric Shander, EVP and CFO

Thank you, Jim.

Let me also recognize and thank our global associates for their continued commitment to helping our customers succeed. Red Hat's ability to deliver business value has been a key driver to building a multi-billion dollar business, and the strength of our strategic customer relationships is one of the reasons we believe we are well positioned for the long-term.

Our performance this quarter was driven by the demand for our hybrid cloud technologies, which enabled us to deliver results that were in-line with our guidance. As a result of our performance to date and the outlook for the remainder of the year, we are re-affirming our full year revenue growth in constant currency at 16%-17%, along with our full year non-GAAP operating margin and cash flow. However, in US dollars, we are lowering the full year revenue range by approximately \$15 million to account solely for the change in FX rates, as the trend of weaker rates against the dollar for many of the major foreign currencies has continued to decline in recent months.

For instance, Q2 total revenue would have been nearly \$3 million higher using the FX rates from my June guidance. As such, for this call, I will discuss our results in both USD and constant currency to provide a full view of the impacts of foreign currency on our results. A more detailed view of our results and reconciliations for our non-GAAP measures to GAAP is included in our earnings press release.

I will now review our Q2 performance and business metrics before finishing with our outlook for Q3 and the rest of FY19.

- In the second quarter, we delivered \$823 million of total revenue, which was in line with guidance and represented growth of 14% in both USD and constant currency. As I mentioned earlier, this result of USD included a foreign exchange headwind of approximately \$3 million from the rates used for guidance in June.
- Subscription revenue, which is mainly renewable, made up 88% of total revenue in Q2 and grew 13% in USD, or 14% in constant currency.
- Subscription revenue for our infrastructure-related offerings was \$527 million, an increase of 8% year-over-year in both USD and constant currency. This result was impacted by the lower available renewal base, which is largely RHEL, and the lower renewal value that Jim discussed in our Top 25 renewals metric. Year-to-date, our infrastructure-related offerings are up 11% in USD and 10% in constant currency.
- Subscription revenue for our Application Development-related and other emerging technology offerings was \$196 million, an increase of 31% year-over-year in both USD and constant currency. Within this portfolio, we continue to drive rapid growth in our Emerging Technologies, particularly in Ansible and OpenShift. As we discussed in the past, this growth has been somewhat offset by the moderation we are experiencing in our middleware offerings. We continue to believe that as customers shift their workloads to container environments, our middleware results and subscription revenue will benefit in the long run.

- Overall, application development-related and emerging technologies revenue represented approximately 24% of total revenue, up 300 basis points from the year ago-quarter.
- Lastly, our services revenue of \$100 million grew 17% year-over-year in USD, or 19% in constant currency. The strong growth of our services business was driven by demand for training and consulting projects for our Ansible and OpenShift offerings. As I have mentioned before, our Services business is both a leading and lagging indicator for the demand around our emerging products. We have seen that customers who buy both services and subscriptions tend to have higher retention, which can lead to future opportunities and additional technology sales.

Before we move to our Non-GAAP operating income results, as a reminder, our non-GAAP operating income adjusts for non-cash share-based compensation expenses, amortization of intangible assets, and transaction costs related to business combinations. Non-GAAP EPS adjusts for all of these items as well as non-cash interest expense related to the debt discount. On a non-GAAP basis, our Q2 operating income of \$197 million grew 3% year-over-year, with a non-GAAP operating margin of 23.9%. This quarterly result was 90 basis points higher than my June guidance and reflects some repositioning of hiring and marketing programs to the second half of the fiscal year. Net other income was \$4 million and in line with guidance.

Shifting to taxes and EPS, our non-GAAP effective tax rate was 22.3% for the quarter, which excludes discrete tax benefits and the impact from certain non-deductible share-

based compensation expense. This resulted in non-GAAP EPS of \$0.85, up 10% year-over-year and above my guidance as a result of the higher non-GAAP operating margin.

Turning to the balance sheet, our total deferred revenue at quarter end was \$2.4 billion, an increase of \$341 million, representing growth of 17% in USD, or 19% in constant currency over the same quarter a year ago. Our cash and investments at the end of the quarter was approximately \$2.2 billion after repurchasing approximately \$250 million or 1.7 million shares, under our new share repurchase authorization, which has a remaining balance of approximately \$750 million. In addition, we had approximately \$245 million of total cash outflows related to repayments of convertible notes.

Moving to operating cash flow, with the adoption of accounting standard ASU 2016-15: Statement of Cash Flows, which requires us to classify the portion of the repayment of convertible notes attributable to debt discount as an operating cash outflow as opposed to a financing cash outflow. In an effort to appropriately reflect the cash generated from the operations of the business and for comparability to prior periods, we will provide both a GAAP and Non-GAAP operating cash flow metric. Our GAAP operating cash flow inclusive of the \$32 million of repayments for the convertible notes attributable to debt discount, was \$133 million, down 7% year-over-year. The Non-GAAP operating cash flow was \$165 million, an increase of 16% year-over-year.

Our FX-adjusted DSO was 61 days, up 5 days from Q2 of last year, driven by business linearity.

The rolling four quarters billings proxy was \$884 million, up 19% 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.

Now I will discuss our total backlog for Q2, which includes billed contracts from the balance sheet, the new ASC 606 performance obligation disclosures, and our backlog for time & material service bookings. Total backlog was up 20% year-over-year in Q2 for an estimated balance of \$3.3 billion in USD.

Our backlog in the quarter was the result of our bookings performance, with all of our regions at double digit growth year-over-year. As for the regional mix in the second quarter, 54% of our bookings came from the Americas, 26% from EMEA, and 20% from Asia-Pacific.

The second quarter route-to-market mix was 77% from the channel and 23% from our direct sales force, compared to the second quarter prior year's split of 79% and 21%.

Our proxy for bookings duration was approximately 22 months, up nearly 1 month from Q2 last year. We attribute this to some customers choosing to extend their commitment to Red Hat with a longer-term strategic partnership.

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

I will begin with our full year guidance which assumes an incremental FX headwind to revenue of \$15 million as compared to our prior guidance. As a result, we are adjusting our total revenue guidance in USD to \$3.360 billion to \$3.395 billion or a year-over-year growth range of 15% to 16% in US dollars. In constant currency, we are re-affirming the year-over-year growth range of 16% to 17%.

From a profitability perspective, we are re-confirming our full year non-GAAP operating margin of 23.9%, which includes the necessary investments to drive future growth.

We are planning an annual non-GAAP effective tax rate of 22.5% for FY19 prior to discrete items and our full-year non-GAAP earnings per share to be approximately \$3.45 to \$3.49 per share. This assumes approximately \$4 million per quarter for net other income and approximately 184 million diluted shares, which is lower due to share repurchases.

Due to the difficulty of predicting the timing and amount of any future convertible note settlements, our guidance will now be on the non-GAAP operating cash flow for FY19. Excluding the repayments of convertible notes that are attributable to the debt discount, our outlook remains unchanged for the full-year. Non-GAAP operating cash

flow is expected to be in a range of approximately \$1.035 billion to \$1.045 billion which includes an incremental \$10 million in tax payments.

For Q3, we offer the following outlook. We expect revenue to be in the range of \$848 million to \$856 million, which is up approximately 13% to 14% in USD and 15% to 16% in constant currency. We expect non-GAAP operating margin of approximately 24.0%.

We expect non-GAAP earnings per share of \$0.87 with a 22.5% tax rate prior to discrete items. This assumes approximately \$4 million in Q3 for net other income and 184 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.

Looking forward, we remain excited that Red Hat is increasingly viewed as a top strategic IT partner to the world's leading companies as they execute on their digital transformation and hybrid cloud initiatives and we remain committed to our customers' success.

Operator, please open-up the call for questions.