

Prepared Remarks – Red Hat Q3FY2018 Earnings Call 12/19/17

Speaker: Tom McCallum, VP of Investor Relations

Thank you operator,

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

I'm pleased to share that Red Hat delivered another strong quarter, with financial results for the quarter exceeding our guidance across each metric. Demand remains strong for hybrid cloud technologies, and Red Hat is one of the key beneficiaries based on the

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breadth and depth of our solutions portfolio as well as our proven track record of delivering significant business value to our customers. Red Hat is increasingly viewed as one of the top strategic technology partners to enterprise organizations, which is evidenced by our growing number of seven figure and multi-seven figure transactions. As we look ahead, we believe we are well positioned to close out the fiscal year on a positive note, and we have again increased our guidance for Fiscal 18, as Eric will detail in a moment.

Some of the financial highlights of the third quarter were subscription revenue growth of 21% year-over-year and our third consecutive quarter of approximately 20% total revenue growth in constant currency. These topline results were driven by:

- First, consistent subscription revenue growth for our Infrastructure-related offerings which includes bare metal RHEL, virtualized RHEL and RHEL on the public cloud.
- Second, consistent subscription revenue growth of more than 40% in our Application Development-related and other emerging technology offerings.
- Third, our service revenue growth continues to outperform our expectations as consulting projects for OpenShift and Ansible are driven by high demand for these technologies.
- And fourth, we achieved strong renewals with our largest customers, including strong growth in the number of deals greater than \$1 million as I noted a moment ago.

Overall, we continued to experience strong demand across our broad portfolio of technologies.

Now let me describe a few business and technology highlights from the quarter:

- First, we announced the availability of OpenShift Container platform as a service broker that enables cloud native services from Amazon Web Services to be

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easily provisioned and managed on the platform including AWS compute, database, analytics, machine learning, networking, and mobile application services. Originally announced at Red Hat Summit in May, this expands our alliance with AWS and provides customers with a unified view of their own applications and public cloud capabilities.

- We also made a number of other announcements related to the integration of additional Red Hat technologies into the OpenShift platform. We have integrated our storage technologies as an enterprise-grade software-defined storage solution built from Red Hat Gluster Storage, which serves container-based storage, both on-premises and in the cloud. In addition, we announced Red Hat OpenShift Application Runtimes or RHOAR. RHOAR is a next-generation set of runtimes for containerized, microservices-based application development. RHOAR stands alongside Red Hat JBoss EAP, leveraging Red Hat's years of runtime expertise in this brand-new offering targeted at cloud-native, DevOps development and microservice optimization.
- Second, we expanded our Certified Cloud Service Provider program to include the Alibaba Cloud which provides a comprehensive suite of cloud computing. Alibaba Cloud is among the world's top IaaS providers and the largest provider of public cloud services in China. Alibaba Cloud intends to offer Red Hat Enterprise Linux in a pay-as-you-go model in the Alibaba Cloud Marketplace and Red Hat Cloud Access which is our innovative "bring-your-own-subscription" for our broad portfolio of technologies. This program gives customers additional choice and consistency when deciding on where to build and run their applications. In the coming months, Red Hat solutions will be available directly to Alibaba Cloud customers, enabling them to take advantage of the full value of Red Hat's broad portfolio of open source cloud solutions.
- Third, at the OpenStack conference held in Sydney in November we continued to showcase our technology innovation and numerous customer references. At the conference we announced Red Hat OpenStack Platform 12, the latest version of our massively scalable and agile cloud Infrastructure-as-a-Service. Based on the

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OpenStack “Pike” release, Red Hat OpenStack Platform 12 introduces containerized services, improving flexibility while decreasing complexity for faster application development.

- Also at the OpenStack conference we announced that Insurance Australia Group Limited (IAG) is using Red Hat OpenStack Platform to help consolidate and simplify its legacy infrastructure. A trusted partner of IAG for seven years, Red Hat is now helping IAG use the power of open source technology to bring together disparate data sources into a single, scalable private cloud solution to improve customer experience. This is a great example of how we are able to build off the trust we have established with customers to then help them enable new innovative technology to address their cloud initiatives.

I am pleased to announce that our long track record of delivering strong growth has enabled Red Hat to be added to the Fortune 1,000 list of the largest American companies. I'd like to thank our Red Hat associates around the globe for the exceptional performance that made this remarkable achievement possible.

As we close out the fiscal year, we are pleased that our fourth quarter revenue outlook will exceed a \$3 billion annual run-rate. In addition, we are confident about our growth prospects based on the substantial markets we are addressing combined with Red Hat's broad product portfolio and strong market position. The execution we are driving today will create additional growth opportunities with our customers and partners for the future.

Speaker: Eric Shander, EVP and CFO

With that, let me turn the call over to Eric

Thank you, Jim.

Let me also add my appreciation for the great execution that our associates around the world delivered during the quarter. This drove another quarter of strong financial results

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that were above our guidance. For the third quarter, we delivered a powerful combination of year-over-year growth of 22% for revenue, 25% for non-GAAP operating income and 18% for operating cash flow. This quarter was also consistent with our strong year-to-date results of 20% total revenue growth, 26% non-GAAP operating income, and 21% operating cash flow growth.

Let me provide you with some additional financial highlights of our third quarter performance. In general, currency rate volatility was fairly stable year-over-year in Q3. The major foreign currencies that we transact business in have modestly weakened from the outlook we provided on the September 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.

Let me start with the income statement. We delivered \$748 million of revenue, which was above the high-end of our guidance and represented growth of 22% in USD or 20% in constant currency. We exceeded the high-end of our guidance by \$11 million which included a foreign exchange headwind of approximately \$2 million due to a weakening of some rates against the dollar. The remaining upside was mainly due to stronger performance and execution by our global sales team, and additional services demand for our emerging technologies. Subscription revenue constituted 88% of total revenue in Q3.

We also experienced continued high growth across our product portfolio.

Subscription revenue for our infrastructure-related offerings was \$495 million, an increase of 15% year-over-year. Subscription revenue for our application development-related and other emerging technology offerings was \$162 million, an increase of 44% year-over-year. This past quarter marked the fourth straight quarter of 40% or higher

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growth in this part of our subscription revenue as demand remains strong for our container, cloud management, middleware and private cloud technologies. Application development-related and emerging technologies revenue represented approximately 22% of total revenue, up 340 basis points from the year ago-quarter.

And lastly, our services revenue of \$91 million grew 27% year-over-year. As we have seen since Q4 last year, the growth of services continued to be faster than we expected due to additional demand for consulting projects around Ansible and OpenShift.

On a non-GAAP basis, operating income of \$179 million grew 25% year-over-year, and non-GAAP operating margin came in at 23.9%. This quarterly result was 20 basis points higher than the operating margin guidance that I provided on our last call and 40 basis points higher than Q3 last year, 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 26.5% after the impact of certain discrete tax items and debt discount expense, non-GAAP diluted earnings per share came to \$0.73, which is \$0.03 higher than our September guidance and up 20% year-over-year due to the stronger performance in the quarter.

Turning to the balance sheet, we ended the quarter with cash and investments of approximately \$2.3 billion, while returning \$100 million to our shareholders in the quarter through the repurchase of approximately 800,000 shares of stock.

Our total deferred revenue at quarter end was \$2.1 billion, an increase of \$398 million or 23% over the same quarter a year ago. Our operating cash flow results were also strong. Operating cash flow of \$160 million for the quarter was up from \$136 million in Q3 last year. This result was driven by higher profitability as well as stronger billings and collections. The FX adjusted days sales outstanding was 60 days, a 2 day improvement from last year.

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On a rolling four quarters basis, the billings proxy was \$776 million, up 22% 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 the million-dollar deals in the quarter. We drove solid bookings growth across our major geographies. This quarter, 57% of bookings came from the Americas, 28% from EMEA and 15% from Asia-Pacific, which is relatively consistent with the third quarter last year. The third quarter route-to-market mix was 67% from the channel, and 33% from our direct sales force, compared to the third quarter prior year's split of 72% and 28%.

Our proxy for booking duration was nearly 24 months, the same that we reported in Q3 last year. This was, however, higher than we anticipated due to strong growth of multi-year deals being booked in the quarter. Looking at the fourth quarter, we continue to expect our bookings duration metric will be lower than last year's record 25 months.

Looking at our top deals, 25 out of 25 of our largest deals that were up for renewal all renewed and did so in aggregate at >120% of their previous value. Our large deal growth in the quarter was strong, with a total of 94 deals over \$1 million, up approximately 30% year-over-year. Within these deals, 17 were greater than \$5 million which is a record for any quarter. Included in the 17 deals were 4 greater than \$10 million with one of those over \$20 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 technologies offerings. Our top industry verticals within the deals greater than \$1 million were financial services, tech & media and other mainstream sectors such as retail, energy and transportation.

Now I'd like to turn to guidance. Our outlook assumes current business conditions and foreign exchange rates, which have generally weakened against the dollar since our

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September guidance. For example, our higher outlook for Q4 revenue also includes a \$4 million headwind from the foreign exchange rates we used for our previous outlook.

For the full-year, we are raising our total revenue guidance to \$2.906 billion to \$2.911 billion, up approximately 21% in USD and 20% in constant currency at the high-end of the range. Given the strong performance so far this year along with our outlook for additional growth and investment, we are modestly raising our non-GAAP operating margin by 10 basis points to 23.9% for the full year.

We're also raising our full-year non-GAAP earnings per share outlook to be approximately \$2.88 per share, assuming approximately \$2 million per quarter forecast for net other income, an annual effective tax rate of 27% and approximately 181 million diluted shares. This guidance also includes a one-time gain on a strategic investment of approximately \$0.05 for both GAAP and non-GAAP earnings per share.

On a GAAP basis, we expect GAAP EPS to be approximately \$2.02 with an estimated annual stock compensation expenses of approximately \$195 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. And finally, we are also raising our full-year operating cash flow outlook to be in a range from \$900 million to \$910 million.

For Q4 specifically, we offer the following outlook. We expect revenue to be in the range of \$758 million to \$763 million, which is up approximately 21% in USD at the high-end of the range and 18% in constant currency. We expect non-GAAP operating margin of approximately 24.6% and non-GAAP earnings per share of approximately \$0.81 with 182 million diluted shares. GAAP EPS is expected to be \$0.54 with 186 million diluted shares. Both GAAP and non-GAAP earnings per share will include the approximately \$0.05 gain I mentioned a moment ago. Although one can derive a quarterly cash flow range based on my annual guidance, we will continue our practice of not providing quarterly cash flow guidance.

In Q3 we delivered strong results that reflect the continued adoption of the technologies that address the opportunities around digital transformation and hybrid cloud computing.

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This momentum will enable us to finish the year with high growth across revenue, non-GAAP operating income and cash flow. We're also optimistic that the execution this year will position us well for future growth.