

Red Hat Q1 FY17 Earnings Call – Prepared Remarks

June 22, 2016

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 FY17. Speakers for today's call will be Jim Whitehurst, President and CEO, and Frank Calderoni, Executive Vice President Operations 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 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 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.

Digital transformation and cloud computing are changing the way companies compete in virtually every industry today. Organizations that rapidly embrace agile IT technology are succeeding as industry innovation accelerates around them. With our open source-based technologies, we are helping customers to capture the business benefits associated with this rapid rate of change. Strong adoption of our technologies is evidenced in our financial results where we:

- delivered our highest Q1 total revenue growth rate in USD in 3 years;
- grew both Q1 total revenue and subscription revenue at 18% year-over-year, and

- Had strong sales execution that led to a record number of deals over \$1 million dollars in a Q1.

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

- Starting with OpenShift, our PaaS solution, where we made a number of recent announcements: First our OpenShift Commons membership crossed 200 organizations from over 40 countries and includes Global 2000 enterprises, ISVs/SaaS providers, Systems Integrator partners and public sector institutions. OpenShift Commons is an open community that encourages collaboration, contribution and best practices for open source technologies in PaaS and containers.
- Second, we announced the next generation of OpenShift Online that was made available for developer preview this week. OpenShift Online has had over 3M applications deployed to it and has now been updated to become the industry's first multi-tenant, Docker container and Kubernetes powered public cloud platform.
- And lastly, our OpenShift technology won a CODiE award for best platform-as-a service for the second year in a row. This is a prestigious peer reviewed award presented by the SIIA. OpenShift also received InfoWorld's 2016 Technology of the Year earlier in the year for the second time.

- As a headline sponsor of the OpenStack Summit in Austin, we announced the general availability of two new technologies that help bridge the gap between development and operations teams at the scale of cloud computing. First, we launched Cloud Suite that is designed to offer an integrated hybrid cloud stack with a container application platform, a scalable infrastructure based on OpenStack and unified management tools.
- Second, and in conjunction with the event, we released the general availability of the latest version of our OpenStack distribution, Red Hat OSP 8.0, which is based on the OpenStack community “Liberty” release. A co-engineered solution, Red Hat OSP 8.0 integrates the foundation of RHEL with Red Hat’s OpenStack technology to form a production-ready cloud platform. Red Hat’s core OpenStack offering now natively includes additional automation for upgrades and updates, infrastructure and workload management and software-defined storage.

Our new offerings further solidify Red Hat’s early leadership position in OpenStack. This is exciting given the considerable growth in OpenStack interest levels among enterprises, growing levels of customer adoption, and further signs of market maturation as more enterprises are moving into live production each quarter. Importantly, we believe that Red Hat OSP is increasingly being recognized as the gold standard for large-scale production OpenStack deployments. We have:

- Hundreds of production deployments across the globe and even more proof-of-concepts are underway including recent wins with Cambridge

University, Paddy Power Betfair, FastWeb, NASA JPL, and Produbon, the IT services division of Santander Bank .

- A broadening group of enterprise and service provider customers that have deployed Red Hat OSP including Verizon and CA Mobile.
- A strong ecosystem of industry leaders that have rallied around Red Hat OSP for transformative network functions virtualization (NFV) and software-defined networking (SDN) deployments.

Of course Red Hat OSP and Cloud Suite are just part of the portfolio of technologies that customers are deploying to address their digital transformation needs. To this point, we had an important new win in Q1 with a global financial services provider, BBVA, that speaks to the power of the breadth and depth of Red Hat's offerings. This global strategic collaboration with BBVA, establishes Red Hat as one of their priority partners. The partnership is designed to focus on business and technical alignment, enabling BBVA to accelerate innovation, manage the growth of financial transactions on digital devices and deliver digital banking services to its global customers.

Moreover, new IaaS and PaaS-based platforms utilizing Red Hat technology will enable BBVA to focus on developing applications that can support the heavy demands of those global digital bank services and provide customers with the service and information they want, when it is needed.

BBVA is a fantastic example of a global enterprise that has turned to an open source-based cloud solution, and Red Hat in particular, to drive business innovation through technology. We are thrilled to collaborate with them on this

journey to transform their business and to help them reach their goal of becoming the world's first truly digital global bank.

More broadly, we believe that Red Hat is seeing and winning a growing number of large deal opportunities due to the breadth and depth of our stack. As customers move workloads to the cloud and develop innovative new applications, they are turning to open-source based solutions that provide them with speed, agility, security, reliability and enterprise features. They are turning to Red Hat, and we believe we are well positioned to benefit as organizations invest in private, hybrid and public clouds.

Today we announced the acquisition of JBoss middleware partner, 3scale. 3scale was founded in 2007 with a goal of enabling organizations of all sizes to successfully create, manage, and use APIs in a web-enabled world where APIs are paramount. It offers a hybrid cloud-based API management platform that separates the cloud management layer from the API gateway, offering customers more flexibility, performance, and scale. The company powers more than 700 APIs for more than 500 organizations across many industries, including Coldwell Banker; Johnson Controls; SITA; Crunchbase; and the University of California, Berkeley. 3scale has offices in Barcelona and San Francisco. I want to formally welcome the 3scale associates to Red Hat.

Next week, we will be showcasing more of our portfolio of technologies, customer success stories and partner traction at Red Hat Summit in San Francisco. Once again we are expecting strong attendance at our premier user event which is also one of the largest annual open source events. I hope many of you will be able to join us.

In summary, we are excited about our strong start to the fiscal year. We remain optimistic about our outlook for the remainder of the year as Frank will detail in a moment.

As a final note, I want to thank all Red Hat associates around the globe for the innovative ideas and technologies that led to Red Hat being recognized by sdtimes as a top 10 Influencers in 2016 along with companies like Apple, Facebook, Google and Microsoft. sdtimes published that these are the companies that are making a mark on the entire industry and whose work has had a significant impact on what others build, how they build it, and ultimately, who uses it.

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

Speaker Frank Calderoni, EVP Operations and CFO

Thank you, Jim.

We are seeing very good momentum in our business and solid execution. This enabled us to deliver results that exceeded our guidance across a number of metrics. At the same time, we continued to invest in our high growth application development platform and emerging technologies, which are responding to our customer's needs to enable cloud computing and digital transformation.

Let me begin with the financial highlights of our Q1 performance. For a more detailed view of our results and reconciliations of our non-GAAP measures to GAAP, please refer to our press release.

I am pleased to announce total revenue of \$568 million, above the high-end of our guidance and representing growth of 18% in USD and in constant currency on a year-over-year basis. In general, currency rate volatility has stabilized to a point where many of our USD and constant currency growth rates are essentially equivalent. So, for this quarter I will keep my prepared remarks focused on our reported USD results where appropriate and you will find a table of constant currency results in our press release.

- Subscription revenue continued to be the largest driver of our growth at \$502 million for the quarter, an increase of 18% year-over-year. This renewable revenue stream now constitutes 88% of total revenue providing a large base for future renewals and upselling opportunities for new technologies.
- We continued to drive high growth across our technology portfolio. Subscription revenue for our Infrastructure-related offerings was \$403 million, an increase of 14% year-over-year. Our application development related and emerging technologies subscription revenue was \$98 million, an increase of 39% year-over-year. Application development related and emerging technologies revenue was approximately 17% of total revenue, up 260 basis points from the year ago quarter. We are pleased to see that we have reached an annualized run rate of nearly \$400 million a year as customers continue to adopt our portfolio of technologies, like Middleware, the Red Hat OpenStack platform, OpenShift, cloud management and storage.
- On a non-GAAP basis, operating income of \$124 million grew 9% year-over-year and non-GAAP operating margin was 21.8%; which is consistent with the 22% operating margin direction we provided on our last

call which included the investment in the Ansible acquisition. 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 estimated annual effective tax rate of 27%, non-GAAP diluted earnings per share came to \$0.50; consistent with our guidance and up 14% year-over-year.
- We ended the quarter with cash and investments of approximately \$2.1 billion. We returned \$66 million to shareholders in the quarter through the repurchase of approximately 900 thousand shares of stock. Given our strong cash position, ability to generate meaningful cash flow and firm belief in our long term prospects for the business, I am pleased to announce a new \$1 billion stock repurchase program that will replace our previous \$500 million plan. We believe this new plan will contribute further value for our shareholders.
- Total deferred revenue at quarter end was \$1.7 billion, an increase of \$256 million or 18% over the same quarter a year ago. On a constant currency basis, total deferred revenue was up 17%.
- The total change in deferred revenue from our cash flow statement which neutralizes most of the impact of currency fluctuations decreased \$46 million compared to the end of 2016. This follows the pattern we've seen historically in Q1's.

- Operating cash flow of \$232 million for the quarter was up 8% year-over-year and was at a record for a Q1. Strong collections contributed to this result with FX-adjusted Days Sales Outstanding at 56 days, down from 59 days in the year-ago-quarter. In addition, during the first quarter, we made the decision to adopt Accounting Standards Update 2016-09 earlier than required related to accounting for stock compensation. The impact to operating cash flow in Q1 FY17 was a benefit of \$8 million and it was a benefit of \$6 million when adjusting Q1 FY16. In Q2, we currently expect this benefit to be only \$1 million. Also, a schedule with historical adjustments for ASU 2016-9 to FY16 operating cash flows can be found in the supplemental data presentation that we provided with this call.
- On a rolling four quarters basis, the billings proxy was \$596 million, up 16% on a constant currency basis and 13% USD year-over-year. 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 metrics for business momentum and large deals in the quarter.

- Our geographies saw continued growth in bookings. This quarter 60% of bookings came from the Americas, 21% from EMEA and 19% from Asia-Pacific versus a 55/25/20 split in Q1 last year. Although some companies have pointed to geographic weakness, we continue to see strong growth across all of our major geographies. In fact, while EMEA's relative contribution to our total bookings was lower than the prior year, its underlying momentum was strong. In Q1, the EMEA sales team was

faced with a smaller number of multi-year deals in its renewal base when compared to Q1 last year. There was a focus on driving significant new business and a higher growth rate in single year bookings.

Congratulations to the EMEA team on great execution in Q1 in renewing existing deals and growing their new business.

- The Q1 route-to-market mix was 78% from the channel and 22% from our direct sales force, compared to a 75/25% split in Q1 last year.
- Our proxy for booking duration was 21 months, in-line with historic duration.
- Within our top 30 largest deals, all of them were \$1 million or more. We had record 6 deals in Q1 that were in excess of \$5 million and of these deals 2 were over \$10 million.
- This was a record first quarter for large deals with 45 deals over \$1M which was up 50% year-over-year. This traction highlights Red Hat's growing strategic importance in our customers' data centers and our talented sales teams' ability to land and expand our wallet share of IT dollars.
- Cross selling was strong, with a record high of 80% of the top 30 deals including one or more components from our group of Application Development and emerging technologies offerings.
- Mainstream customers in sectors such as healthcare, industrial & agricultural products and retail were the top verticals followed by Government and Financial Services customers.
- With our renewal business, we once again renewed all of the top 25 deals that we were expecting. The total subscription value of these top 25 renewals was approximately 105% of the prior value. Similar to what we experienced a couple of years ago, we had several large US Government

deals that renewed at approximately 100% of their original values weighing on this metric for Q1. Excluding these Government renewals, the subscription value of our other top renewals was approximately 110%. It is important to note that overall, our Government sales team delivered double digit growth across the Federal segment in Q1.

Now I would like to turn to guidance. Our outlook assumes current business conditions, the impact of the acquisition of 3scale and foreign exchange.

- We are reaffirming our full year revenue guidance to \$2.380 billion to \$2.420 billion, up approximately 18% in USD at the high end of the range. We are modestly decreasing operating margin to approximately 23% due to a \$5 million impact from the 3scale acquisition. We are reaffirming the operating cash flow in the range from \$800 million to \$820 million. We are also adjusting our target for full year non-GAAP earnings per share to approximately \$2.19 to \$2.23 per share, assuming a 27% non-GAAP annual effective tax rate, approximately \$1 million to \$2 million per quarter forecast for other income and the investment related to 3scale which is approximately (\$0.03).

For Q2 specifically, this implies the following outlook:

- We expect revenue to be in the range of \$587 million to \$593 million, which is up 18% in USD at the high end of the range. We expect non-GAAP operating margin of approximately 22.8% and non-GAAP earnings per share of \$0.54 which includes a (\$0.01) impact for 3scale in Q2.
- Consistent with prior practices, I will not forecast quarterly cash flow but please note that it is important to consider the AR balances to reflect the quarter over quarter change to cash flows. Also although payments can

fluctuate in a quarter, I would also anticipate AP balances to be approximately flat to slightly up with Q1 balances.

Overall, we are very pleased with our financial performance in the first quarter, and we believe we are off to a very good start for FY17. We are excited about the company's long-term growth opportunity as we are uniquely positioned to further drive the adoption of open source technologies as IT organizations transition their application development and infrastructure to hybrid cloud environments. Finally, we look forward to seeing many of you next week in San Francisco for the Red Hat Summit and for our Analyst Day on Thursday, June 30.

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