

Red Hat Q2 FY17 Earnings Call Prepared Remarks

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 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, 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 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 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, Red Hat CEO

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

Our continued business momentum combined with solid execution drove strong growth in Q2. We therefore delivered revenues above our guidance, driven mainly by subscription revenue which grew 20% in U. S. dollars:

- This growth was highlighted by 18% growth for our infrastructure offerings combined with 33% growth for our application development and emerging technologies.
- Our growth was driven in part by expanding our footprint with customers as we closed a record number of deals over \$1 million dollars – up approximately 60% year-over-year.

Digital transformation and hybrid cloud computing are changing how applications are built, deployed, and managed. As organizations adopt agile application development technologies such as Linux containers, they are increasingly relying on Red Hat as their strategic partner to modernize their infrastructure and application development platforms. These trends are reflected in our results.

With that overview, let me discuss some of our recent business and technology highlights from the quarter. At the beginning of Q2, we held our largest Red Hat Summit event in the history of the company, with record attendance up 10% compared to last year. We showcased our portfolio of technologies, customer success stories and partner traction. Let me summarize some of the exciting announcements from Summit:

- Starting with Linux containers. This year's Summit was all about containers. We expanded our offerings around OpenShift, which is our container platform, so it is now available across a number of environments. We have

OpenShift for developers that they can run on laptops. We have OpenShift for the lab that enables developers to move more easily from dev to test. And as the application moves into production, we have OpenShift Enterprise. We cover the lifecycle of an application with our end-to-end platform, and because these three offerings are the same platforms and customers should not have to retool on their platform to build their container applications. The developer experience is designed to be similar from the day they first start writing code for a new application until they provision and manage a mission critical application for live deployment.

- In middleware, we released JBoss EAP 7. It has been optimized for hybrid cloud environments and, when deployed with Red Hat OpenShift, EAP 7 offers the benefits of containers, load balancing, elastic scaling, health monitoring, and the ability to deploy to a containers directly - which can improve the developer experience and productivity. In addition, JBoss EAP with OpenShift contributes to a more architecturally efficient DevOps environment since overlapping features are no longer needed.

We also announced the general availability of Red Hat JBoss Data Grid 7. The latest version of Red Hat's in-memory data management technology introduces enhancements to help organizations generate insights for continuous business optimization through real-time data analytics, contributing to greater agility and competitiveness.

- In our storage portfolio, we announced Red Hat Ceph Storage 2 with several new capabilities that enhance support for object storage workloads and promote greater ease of use. This latest version of the product is the most significant update to Red Hat Ceph Storage to date. We believe our customers will find Red Hat Ceph Storage 2 to be a full-featured, technically-advanced storage platform that's easier to use and helps them manage vast quantities of data.

- On the management side, we continued to evolve our offerings with new versions of Ansible Tower 3 and Red Hat Insights launched at Summit.

Following-up on these announcements, we recently launched Red Hat Virtualization 4 which includes new and enhanced capabilities around: performance, management and automation. RHEV 4 introduces support for OpenStack and Linux containers to run with enhanced security and reliability. This type of leadership in innovation enabled us to be recognized as the only company included in the Visionaries quadrant in Gartner's Magic Quadrant for x86 Server Virtualization Infrastructure. We believe that this position reinforces our continued innovation, momentum and strong vision for an open, high-performance virtualization alternative.

Rounding out our portfolio of hybrid, cloud solutions, we recently introduced OpenStack Platform 9. OSP 9 builds on the proven, trusted foundation of Red Hat Enterprise Linux to provide critical dependencies needed in production OpenStack environments. It is a production-ready OpenStack distribution that offers automated upgrade and update paths for mission-critical operations. Red Hat OSP 9 brings significant updates from the upstream Mitaka version to a number OpenStack services. Overall, Red Hat OSP, backed by a robust ecosystem of partners, including Cisco, Dell, Intel and Lenovo, has emerged as a proven solution to power private clouds across hundreds of customers worldwide, such as BBVA; Cambridge University; FICO; NASA's Jet Propulsion Laboratory; Paddy Power Betfair; Santander Bank; and Verizon.

In summary, we are pleased to close out the first half of our fiscal year on a strong note, and we are even more excited about Red Hat's future. We believe that Red Hat is uniquely positioned to benefit from long-term, secular changes in the IT infrastructure that companies are deploying to support their business. We are delivering innovation and enterprise capabilities to the open source market place at a rapid pace. In doing so, we continue to build out a portfolio of technologies and capabilities to enable our

customers to enjoy benefits associated with the digital transformation and hybrid cloud computing as they develop their applications. We remain optimistic about our outlook for the remainder of the year as Frank will detail in a moment.

As a final note, this past quarter Linux celebrated the 25th year since its creation. I want to recognize and thank the creative energy of the open source community including Red Hat associates that have continued to drive innovation and helped to build Red Hat. Collaboration with the open source community and the focused efforts of associates around the globe has enabled Red Hat to be recognized once again as one of Forbes *Most Innovative Companies*. This is a key reason that Red Hat is trusted as one of the strategic technology providers to enterprises around the world.

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

Speaker Frank Calderoni, CFO and EVP Operations

Thank you, Jim.

Our business continued to demonstrate good momentum and strong execution by our global teams. We exceeded our guidance across a number of metrics in Q2. The strength in our subscription revenue continued to drive our results, highlighted by accelerated revenue growth in our core infrastructure offerings and high revenue growth in our portfolio of new technologies that enable hybrid cloud computing and digital transformation.

Let me begin with the financial highlights of our Q2 performance. For a more detailed view of our results and for reconciliations of our non-GAAP measures to GAAP, please refer to our earnings press release and the slide deck with financial highlights and

supplemental metrics. These non-GAAP disclosures should not be used as a substitute for our GAAP results, but rather read in conjunction with our GAAP results.

Similar to Q1, currency rate volatility has stabilized year-over-year for example on a constant currency basis using rates from Q2 last year, total revenue growth would have 18% or approximately 70 basis points lower. 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.

- I am pleased to announce total revenue of \$600 million, above the high-end of our guidance and representing growth of 19% in USD. This result was driven mainly by modestly better than expected sales performance and additional revenue related to our education and compliance program.
- As I discussed, subscription revenue continued to be the largest driver of our growth at \$531 million for the quarter, an increase of 20% year-over-year. This mainly renewable revenue stream now constitutes 89% of total revenue, providing us with a large base to expand our relationships with our customers.
- We continued to drive high growth across our technology portfolio. Subscription revenue for our Infrastructure-related offerings was \$427 million, an increase of 18% year-over-year. Our application development related and emerging technologies subscription revenue was \$104 million, an increase of 33% year-over-year. Application development related and emerging technologies revenue

was approximately 17% of total revenue, up 180 basis points from the year ago quarter.

- On a non-GAAP basis, operating income of \$137 million grew 11% year-over-year and non-GAAP operating margin was 22.8%; which is consistent with the operating margin direction we provided on our last call and up 100 basis points from Q1. 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 estimated annual effective tax rate of 27%, non-GAAP diluted earnings per share came to \$0.55 which was \$0.01 above our guidance and up 17% year-over-year.
- We ended the quarter with cash and investments of approximately \$2.0 billion. We returned \$127 million to shareholders in the quarter through the repurchase of approximately 1.8 million shares of stock. This is one of our largest direct repurchases in a quarter and reflects our commitment to return value to shareholders with our recent \$1 billion repurchase authorization.
- Total deferred revenue at quarter end was \$1.7 billion, an increase of \$267 million or 19% over the same quarter a year ago. On a constant currency basis, total deferred revenue was up 17%.
- Operating cash flow was \$97 million for the quarter, compared to \$123 million in the year ago quarter. Comparing the two quarters, our Days-Sales-Outstanding was one day better than Q2 last year at 57 days on an FX-adjusted basis; however, the majority of our strong second quarter billings performance occurred

in the last month of the quarter and contributed to a sequential increase of \$31 million in our accounts receivable balance. In addition, our first-half investments in our hybrid cloud technologies and sales capabilities led to an increase in expenses of \$20 million year-over-year. Some of this expense led to a higher use of operating cash flow. Although predicting the timing of cash inflows and outflows can be difficult on a quarterly basis, we remain comfortable with our full year cash flow guidance which includes our assumption of higher revenue, seasonally higher billings, increased non-GAAP operating margin for the remainder of the fiscal year and the slightly different linearity of cash flows.

- 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. On a rolling four quarters basis, the billings proxy was \$620 million, up 17% on a constant currency basis and 15% USD year-over-year.

I will now review the metrics for business momentum and large deals in the quarter.

- All of our geographies saw double digit growth in bookings with particular strength in EMEA and APAC. This quarter 57% of bookings came from the Americas, 24% from EMEA and 19% from Asia-Pacific versus a 60/22/18 split in Q2 last year.
- The Q2 route-to-market mix was 81% from the channel and 19% from our direct sales force, compared to a 75/25% split in Q2 last year. This is the largest portion of channel business in a quarter and reflects channel strength across our major geographies.

- Our proxy for booking duration was 22 months, up approximately 1.5 months from Q2 last year and driven in part by growth in our deals over \$1 million. In fact, this was a record second quarter for large deals with 55 deals over \$1M which was up 60% 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.
- Looking specifically at our top 30 largest deals metric, all of the deals were \$1 million or more and 5 of those deals were in excess of \$5 million.
- Cross selling was strong, with over 70% of the top 30 deals including one or more components from our group of Application Development and emerging technologies offerings.
- Financial services and Government were our top verticals in Q2.

Within our top 25 renewal business, we renewed 23 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. One of the two deals that did not renew was related to a government agency project that was cancelled. This agency continues to rely on Red Hat technologies including a six figure deal that closed in the quarter. The second deal that did not renew was lost to an on premise legacy Linux distribution. We are still engaged with this customer in other areas of their business. As with the few times this has happened over the past decade, we are optimistic that we can win back the lost portion over time as a result of our award winning service and innovation. Substituting

these 2 deals with the next two deals up for renewal, the revised top 25 deals that did renew were approximately 115% higher than the prior year value. Given the growth in million dollar deals this quarter, we are clearly driving larger wallet-share by taking a number of six figure deals and expanding them to million dollar plus renewals.

Now I would like to turn to guidance. Our outlook assumes current business conditions and foreign exchange.

- We are raising our full year revenue guidance to \$2.415 billion to \$2.435 billion, up approximately \$15 million in USD at the high end of the previous range.
- We are reaffirming our non-GAAP operating margin at approximately 23%.
- We are reaffirming the operating cash flow in the range from \$800 million to \$820 million.
- Given our revenue guidance, our target for full year non-GAAP earnings per share is estimated to be approximately \$2.23 to \$2.25 per share, assuming a 27% annual effective tax rate, approximately \$1 million to \$2 million per quarter forecast for other income.

For Q3 specifically, this implies the following outlook:

- We expect revenue to be in the range of \$613 million to \$623 million, which is up 19% in USD at the high end of the range or 18% in constant currency. We expect non-GAAP operating margin of approximately 23.3% and non-GAAP earnings per share of \$0.58.

- Consistent with prior practices, I will not forecast quarterly cash flow given the variability of cash inflows and outflows.

Overall, we are very pleased with our financial performance in the first half of FY17. We continue to see strong global demand for our hybrid cloud technologies as organizations continue to modernize their infrastructure platform and their application development platform.

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