

**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 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](http://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 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, CEO**

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

In Q3, our execution allowed us to continue to deliver double digit growth in a number of our financial metrics including revenue, non-GAAP operating income and non-GAAP EPS. Some key highlights of the quarter include:

- Strong demand for our cloud-enabling technologies, which is reflected in the 32% constant currency growth in our application development-related and other emerging technologies revenue.
- Our continuing customer traction is evident in our top 25 renewal deals where all 25 deals renewed during the quarter, and they did so at more than 120% of their prior annual commitment. As Frank will describe, we closed many large deals, including some of the largest deals in Red Hat's history, with strong cross selling and longer term commitments from our customers.
- Our customers are increasingly adopting the cloud as part of their overall IT strategy and are using Red Hat as a partner. We see customers deploying our cloud-enabling technologies both on-premise or in the public cloud. This group of hybrid cloud customers is growing revenue in the aggregate faster than the customers that have not yet embraced these technologies. In fact, in Q3 we added hundreds of customer wins with products from our hybrid cloud portfolio including several OpenStack deals over a million dollars. Also of note, we closed

### **Q3 FY17 prepared remarks 12/21/16**

our second OpenShift deal over \$10 million and one OpenShift deal over \$5 million.

In spite of the many positives in the quarter, we faced a few challenges that tempered the growth of some items in our reported results.

- First, some sizeable November deals in the US Federal space have taken longer than initially expected to close, though we expect them to ultimately move forward in the fourth quarter.
- In addition, similar to the first half of the fiscal year, we were able to secure large multi-year commitments from customers. However, as these deals continue to get larger, sales activity was again more concentrated in the last month of the quarter, and this quarter there was a lower level of customers paying upfront for their multi-year deals.

We are adjusting our revenue and cash flow outlook for the year based on these factors, but it's important to note that we continue to expect full year total revenue growth of approximately 17%, with subscription revenue, which is renewable, growing even faster. We are re-affirming our operating margin for the full year of 23%, and we are forecasting cash flow in Q4 up 22% to approximately 28% from Q4 last year based on confidence in our outlook.

### **Q3 FY17 prepared remarks 12/21/16**

Importantly for the long-term, we remain confident in our competitive position and our ability to drive future growth. In fact, given our visibility into our pipeline and what has already closed to date, we are confident that we will see re-acceleration of billings in Q4 to the mid-teens growth rate range and we will end the year with a strong total backlog.

Before turning the call over to Frank to discuss the details of the quarter and our outlook, let me provide some additional business highlights for the quarter.

We continue to see momentum with our customers and community around our cloud-enabling technologies including OpenStack, OpenShift, CloudForms and related offerings that our customers are using to build hybrid clouds. Within our Top 30 deals, 7 included Red Hat OpenStack Platform, 5 included OpenShift and 5 included storage.

- Starting with an OpenStack customer. Swisscom has deployed Red Hat OpenStack Platform and Red Hat Virtualization to build their newest technology platform, providing the flexibility needed to support ongoing innovation and development across its own organization and customer base.
- We continue to improve scalability and usability of OpenStack with our recent release of Red Hat OSP 10. Based on the upstream OpenStack 'Newton' release, Red Hat OSP 10 drives new features that increase system-wide scalability, ease infrastructure management and improve orchestration, while also enhancing network performance and platform security. A new 5-year

lifecycle support offering for Red Hat OSP 10 can help customers achieve the long-term stability required for mission-critical operations.

- We also announced a broad alliance with Ericsson to deliver fully open source and production-ready cloud infrastructure, spanning OpenStack, containers, NFV, SDN and SDI. Through the collaboration, we plan to work together to certify Ericsson's platform and portfolio of solutions.
- Red Hat 3scale API Management Platform was positioned in the "Leaders" quadrant of Gartner's October 2016 Full Life Cycle API Management Magic Quadrant. Red Hat 3scale API Management Platform complements our existing application development-related and other emerging technologies and strengthens our ability to help simplify and accelerate customers' digital transformation initiatives.
- In our storage portfolio, Red Hat Ceph and Gluster storage were both positioned in the "Visionaries" quadrant of Gartner's October 2016 Distributed File Systems and Object Storage Magic Quadrant. Red Hat Ceph Storage and Red Hat Gluster Storage are both highly agile solutions that are built to handle different types of demanding workloads.

Before my final remarks, I would like to talk about the leadership transition at the CFO level. Effective in late January, Frank will be resigning to join another company as its CEO. Frank was able to accomplish a great deal to help advance and scale of our enterprise, as we continue to experience significant growth.

I'm grateful that Frank has agreed to stay on until late January and assist with the transition, as needed. Upon his resignation, Eric Shander, Vice President Finance and Accounting and our Principal Accounting Officer, will assume the role of acting CFO. Eric will bring a rich and solid experience base to this role from his work at Red Hat and his almost 25 years of experience at IBM and Lenovo.

Frank, I have really enjoyed getting to know you and working side by side with you. You will be missed and we wish you nothing but success in your new role. You are a talented business leader and executive. You have left us stronger and well positioned to address the opportunity before us. Thank you, Frank.

In summary, we continue to be pleased with our progress in delivering on our mission to work with communities, customers and partners to create better technology the open source way. I want to thank Red Hat associates for their continued focus on the success of our customers. I am confident that this team will continue to deliver against our hybrid cloud growth strategy.

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

**Speaker: Frank Calderoni, EVP Operations & CFO**

Thank you, Jim.

### **Q3 FY17 prepared remarks 12/21/16**

Let me begin with a summary of Q3 performance. Q3 was driven by strong renewals in our large deals, cross-selling of our cloud-enabling technologies and lengthening of customer commitments to Red Hat. This sales traction is reflected in our deals greater than a million, which are up 20% year-over-year. This is also a reflection of our strategic position with customers as they look to deploy in hybrid cloud environments using our technologies for years to come.

As Jim noted, the quarter did come with a couple of challenges that affected other metrics.

- First, we saw a few large deals in the Federal space that didn't close on the timeframe we expected. We believe that the proximity of our quarter to the Continuing Resolution legislation relating to the Federal budget was a factor. The Continuing Resolution legislation has been signed, and we expect them to move forward in the fourth quarter.
- Second, we closed several large multi-year deals, including two deals over \$20 million, which did not bill beyond the first year. As we have stated in the past, customers' desire to pay beyond one year can fluctuate and it has an impact on the long term portion of our billings proxy when this occurs. In Q2 we saw strong growth in our billings proxy due in part to more customers paying upfront for their multi-year contracts, whereas strength in multi-year contracts during Q3 contributed more to growth in our backlog.

### **Q3 FY17 prepared remarks 12/21/16**

- Third, as Jim noted, we saw our sales activity more concentrated in the last month of the quarter vs. our historical norm, similar to the second quarter. We are focusing on improvements in linearity, and we believe similar linearity could occur for Q4 from a forecasting perspective. As we build our FY18 plan, we plan to drive better quarterly linearity.
- Finally, foreign exchange volatility negatively impacted our Q3 revenue by more than \$3 million, and our previously implied guidance for Q4 by \$16 million, due to the fact that the dollar has strengthened against some of our major currencies since we provided our guidance in September.

With this information as a back drop, let me provide you with additional information on our quarterly metrics and results.

As I just noted, currency rate volatility returned in Q3. Although there has been some stabilization on rates year-over-year, rates used for Q3 guidance and full year guidance have weakened against the U.S. dollar. So, for this quarter I provide both USD and constant currency as well as describe the impact of the currency rate volatility from our previous guidance assumptions. We have also provided a table of constant currency results in our earnings press release. In addition for a more detailed view of our results and the reconciliations of our non-GAAP measures to GAAP, please refer to our earnings press release.



### Q3 FY17 prepared remarks 12/21/16

- We delivered total revenue of \$615 million, up 18% or 17% in constant currency. Compared to our September guidance, our result was in the middle of our guidance range excluding the \$3 million impact of FX volatility.
- Subscription revenue continued to be the largest driver of our growth at \$543 million for the quarter, an increase of 19% year-over-year and 18% in constant currency. 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 \$431 million, an increase of 16% year-over-year or 14% in constant currency. Our application development-related and other emerging technologies subscription revenue was \$112 million, an increase of 33% year-over-year or 32% in constant currency. Application development-related and other emerging technologies revenue was approximately 18% of total revenue, up 210 basis points from the year ago quarter.
- On a non-GAAP basis, operating income of \$143 million grew 16% year-over-year and non-GAAP operating margin was 23.3% which is consistent with the operating margin direction we provided on our last call. 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 \$0.58. This is in -line with our guidance after excluding a \$0.03 discrete tax benefit which brought the EPS reported to \$0.61 and up 27% year-over-year.
- We ended the quarter with cash and investments of approximately \$2.0 billion. We returned \$125 million to shareholders in the quarter through the repurchase of approximately 1.6 million shares of stock. Year-to-date we have repurchased approximately 23% more shares this year than for the full year last year.
- Total deferred revenue at quarter end was \$1.7 billion, an increase of \$221 million or 15% over the same quarter a year ago. On a constant currency basis, total deferred revenue was up 14%.
- The total change in deferred revenue from our cash flow statement which neutralizes most of the impact of currency fluctuations increased by \$64 million since the end of Q2.

- The rolling four quarters billings proxy, which is calculated by adding revenue plus the change in deferred revenue on the cash flow statement for the last four quarters, was \$635 million, up 14% on a constant currency basis and 13% USD year-over-year.
- Operating cash flow of \$136 million for the quarter decreased from the year-ago Q3's operating cash flow of \$148 million. Year-to-date operating cash flow is \$465 million. Although we continued to deliver strong collections resulting in FX-adjusted Days Sales Outstanding at 58 days, down from 59 days in the year-ago quarter, overall collections and cash flow were mainly impacted by the similar sales linearity we saw in Q2.

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

- Our geographies saw continued growth in bookings. This quarter 57% of bookings came from the Americas, from 27% EMEA and from 16% Asia-Pacific versus a 60%/26%/14% split in Q3 last year.
- The Q3 route-to-market mix was 72% from the channel and 28% from our direct sales force, compared to a 67%/33% split in Q3 last year. This mix shift year-

over-year is driven in part by our desire to leverage channel partners that influence customers' buying decision.

- Our proxy for booking duration was 24 months, higher than duration last year and the historic duration of 21 months. Customers' demand to extend the length of their commitment with Red Hat, combined with the strength in our cloud-enabling technologies is an additional proof point of customers choosing to implement hybrid cloud strategies.
- Within our top 30 largest deals, this marks the first time for this metric that all 30 of them were \$2 million or more, 8 of those deals were in excess of \$5 million and 3 of those deals were in excess of \$10 million. We also had 2 deals of \$20 million in the same quarter.
- Cross selling was strong, with over 60% of the top 30 deals including one or more components from our group of Application development-related and other emerging technologies offerings.
- Financial Services and Technology and Media were our top verticals in Q3 followed by Government and other mainstream customers in sectors such as Healthcare & Industrial Products.

- Looking beyond the Top 30 deals to all deals over \$1 million, this was a record third quarter for large deals with 73 deals over \$1M which was up 20% year-over-year. For fiscal year 2017 year-to-date, we have seen a 40% increase in the number of deals over \$1 million compared to the same period in fiscal year 2016. This traction highlights Red Hat's growing strategic importance in our customers' data centers.
- And finally, all 25 of our top 25 deals that renewed in the quarter did renew. The average value of the top 25 deals up for renewal exceeded 120%.

Now I would like to turn to guidance. Our outlook assumes current business conditions and the foreign exchange rates that have weakened significantly since we last gave guidance in September.

- We are adjusting our full year revenue guidance to reflect the change in foreign currency rates, our Q3 performance and linearity impact. We are now forecasting to \$2.397 billion to \$2.405 billion, up approximately 17% in USD. We are reaffirming our non-GAAP operating margin to approximately 23%. We are adjusting the operating cash flow in the range from \$770 million to \$785 million to reflect the linearity impact and our forecast of collections and disbursements. We are forecasting full year non-GAAP earnings per share to approximately \$2.27 per share, assuming approximately \$1 million to \$2 million per quarter forecast

**Q3 FY17 prepared remarks 12/21/16**

for other income, a 27% non-GAAP annual effective tax rate and fully-diluted share count of 183 million shares.

For Q4 specifically, this implies the following outlook:

- We expect revenue to be in the range of \$614 million to \$622 million, which is up 14% in USD or approximately 16% in constant currency at the high end of the range. We expect non-GAAP operating margin of approximately 24% and non-GAAP earnings per share of \$0.61 and 181 million fully diluted shares.
- Based on my annual guidance, the implied cash flow for Q4 is \$305 million to \$320 million or up 22% to approximately 28%.

Overall, we remain optimistic about the company's long-term growth opportunity with our position to serve our customers demand for hybrid cloud solutions. We continue to see strong adoption of hybrid cloud solutions that span both private and public clouds.

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