

Speaker: Tom McCallum, VP of Investor Relations

Thank you operator,

Hello everyone, and welcome to Red Hat's earnings call for the fourth quarter and full fiscal year of FY17. Speakers for today's call will be Jim Whitehurst, President and CEO and Eric Shander, acting 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 first fiscal quarter and full fiscal year of 2018. 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. I also want to welcome Eric Shander, our acting CFO, to the call to discuss the financial results and our outlook for fiscal year 2018.

Our exceptional fourth quarter capped-off a strong year for Red Hat as we continued to see adoption of our technologies across hybrid cloud environments. As customers embrace digital transformation, they are turning to Red Hat as a strategic partner to deliver solutions that help them realize the benefits of these initiatives. Enterprises and service providers are increasingly adopting hybrid cloud infrastructures and open source technologies, which is fueling our growth and positioning Red Hat for the long-term. The fourth quarter enabled us to set new records and milestones for the fiscal year which reflect our growing strategic position as we continued to focus on the pressing IT challenges facing our customers. Here are just a few of the record highlights:

- First, the fourth quarter marked our 60th consecutive quarter of total revenue growth.
- Second, we exceeded the \$2 billion mark in subscription revenue for the fiscal year.
- Third, strong sales execution and larger, multi-year commitments from our customers drove annual bookings to the \$3 billion milestone level for the first time.
- Fourth, this strong sales execution led to a record total backlog of over \$2.7 billion at fiscal year-end including our first fiscal year of crossing the \$2 billion in total deferred revenue mark.

Evidence of our increasing strategic position with customers is the remarkable growth of our large deals over the course of FY17. In every quarter this year, we saw strength in customer commitments as it related to the volume of large deals, the size of the deals, as well as the breadth of technologies that were purchased.

Growth in large deals contributed to record bookings, billings, backlog and revenue. Let me provide you some of the full year metrics:

- First, we closed more than 280 deals over \$1 million, up approximately 30% year over year. Within this group, we closed a record 35 deals over \$5 million and a record 7 deals over \$20 million. In addition, we closed our first deal of approximately \$100 million in Q4 with a global service provider.

Now looking specifically at the 30 largest deals in Q4, here are some highlights:

- All of the top 30 deals were greater than a \$1 million – in fact all the top 30 were \$3.5 million or greater in size.
- We also had a record 16 deals in Q4 that were in excess of \$5 million. Of these deals, 4 were more than \$20 million.
- Both our middleware and our emerging technologies had strong traction with customers. Cross selling in Q4 was the highest it has ever been in a quarter, with 90% of the deals including one or more components from our group of Application Development-related and other emerging technologies offerings.
- Our emerging technologies accelerated the momentum we saw in Q3 with approximately 1/3 of our largest deals in Q4 containing an OpenStack private cloud component, approximately 1/3 had an OpenShift container platform component and more than 1/3 of the deals contained Ansible, our automation management technology.
- In addition more than half our deals contained 5 or more technologies from across our portfolio.
- Similar to Q4 last year, the top vertical for the quarter was telecom where we closed a number of new, large deals with several global telecom providers. Part of our overall investment strategy was to position our portfolio of technologies and expand our “go to market” capabilities to further address this market. Our

Q4 wins clearly demonstrate the success of our efforts, including the approximately \$100 million agreement that I noted a moment ago.

- The second largest vertical in the largest Q4 deals was financial services followed by a broad segment of mainstream customers.

Let me discuss just a couple highlights related to our OpenStack and OpenShift technologies.

- In the fourth quarter, we continued to expand our broad list of top partners that offer OpenStack to their customers. We announced NFV collaborations with HP and Huawei and we recently announced an expanded cloud computing partnership with IBM to sell Red Hat's distribution of OpenStack as a private cloud offering to their customers.
- In the fall, IDC published a Red Hat commissioned study of customers using OpenShift. They interviewed several organizations that are using OpenShift and quantified a number of benefits that these customers realized including:
 - Average five-year ROI of more than 500%;
 - Average annual benefits of nearly \$1.3 million per 100 developers per year;
 - More than 60% faster application development life cycles and
 - Additional time savings in IT staff and cost savings in infrastructure, as well as millions of dollars of higher revenue per organization.

These types of business benefits reinforce our view that we will be operating in a hybrid cloud world for many years and that Red Hat is well positioned to expand our wallet share as we provide choice, consistency and meaningful value to customers across all four footprints: physical, virtual, private cloud and public cloud.

In summary, the trends shaping the next generation of IT and business capabilities are a positive for Red Hat. As I look at the opportunities in digital transformation, hybrid cloud and open source – I believe Red Hat is important across all these powerful trends.

Before turning the call over, I want to congratulate and thank our 10,000 plus Red Hat associates around the globe for their contributions to an outstanding quarter and fiscal year. Together, I believe we will continue to win in the market place and that we are well positioned to deliver further growth next year and beyond.

On a final note, I hope many of you will be able to join us for the May 2 Analyst Day at Red Hat Summit in Boston. It will be a great opportunity to learn more about our strategic direction and innovative technologies. You will hear directly from our customers and partners including technology visionaries from Dell/EMC, Intel, Azure and Google Cloud Platform.

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

Speaker: Eric Shander, acting CFO

Thank you for the introduction, Jim.

I would also like to take this opportunity to thank our Red Hat associates around the world for their contributions to delivering a strong quarter both operationally and financially.

On last quarter's call we indicated that we expected to close the year on a strong note – I'm pleased to share that we did just that. Our fourth quarter revenue results were well above our guidance, the accelerated growth of our billings in Q4 drove our FX adjusted rolling four quarter average billings proxy metric to the highest level in five quarters and we ended the year with a record backlog. We are seeing our customers increasingly building out hybrid cloud environments and implementing digital transformation

initiatives, which we believe helped to drive these results. Red Hat is benefitting due to our broad portfolio of solutions and proven history of delivering business value and innovation.

Let me begin with the financial highlights of our Q4 performance, followed by a summary of full fiscal year results and our outlook for FY18. For a more detailed view of our results and reconciliations of our non-GAAP measures to GAAP, please refer to our earnings press release.

I am pleased to announce total revenue of \$629 million, approximately \$7 million above the high-end of our guidance and representing growth of 16% in USD and constant currency. Although currency rate volatility continued in Q4, the exchange rates 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 total revenue at \$560 million for the quarter, an increase of 17% year-over-year. This renewable revenue stream was 89% of the total of revenue for the quarter.
- We continued to drive growth across our technology portfolio. Subscription revenue for our Infrastructure-related offerings was \$435 million, an increase of 11% year-over-year. Our Application Development-related and other emerging technologies subscription revenue was \$125 million, an increase of 40% year-over-year. Application Development-related and other emerging technologies revenue was approximately 20% of total revenue, up 340 basis points from the year ago quarter.

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- On a non-GAAP basis, operating income of \$153 million grew 23% year-over-year and non-GAAP operating margin of 24.3%, which was 30 basis points higher than guidance. 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.
- Our non-GAAP effective tax rate of 29.2% was higher than expected due to a higher than expected level of income being generated in higher tax jurisdictions. As such, non-GAAP diluted earnings per share came to \$0.61, in line with our guidance and up 17% year over year.
- We ended the quarter with cash and investments of approximately \$2.1 billion. We returned \$139 million to shareholders in the quarter through the repurchase of approximately 1.9 million shares of stock. Our repurchase program has reduced our fully diluted, weighted average shares by more than 3 million shares year over year.
- Operating cash flow was \$318 million for the quarter and increased 27% from the year-ago-quarter. Strong billings growth, a modest improvement in monthly linearity and solid collections contributed to this result. The FX-adjusted Days Sales Outstanding was at 58 days, improving from 61 days in the year-ago-quarter.
- Total deferred revenue at quarter end was \$2.1 billion, an increase of \$347 million or 20% over the same quarter a year ago.
- The total change in deferred revenue from our cash flow statement which neutralizes most of the impact of currency fluctuations increased by \$357 million compared to the end of Q3.

- The rolling four quarter average billings proxy which is calculated by adding FX adjusted revenue plus the change in deferred revenue on the cash flow statement for the last four quarters was \$690 million, up 19% year over year.

Next, let me discuss our backlog which as a reminder we disclose at the end of each fiscal year. Total backlog was up 28% year-over-year for a record balance in excess of \$2.7 billion in USD. We define total backlog as the value of non-cancellable subscriptions and service agreements, including total deferred revenue, which is billed, plus the value of non-cancellable subscriptions and service agreements to be billed in the future not reflected in our financial statements. Here are the components:

As I mentioned a moment ago, the billed portion of the backlog is total deferred revenue which was \$2.1 billion at the end of fiscal 2017. The other portion of total backlog, which has yet to be billed and as such is not included on our balance sheet, was in excess of \$650 million at the end of fiscal 2017, up nearly 60% compared to in excess of \$410 million last fiscal year. This is the highest growth rate we have reported on this metric since we first disclosed it in FY08.

- It is worth noting that the portion of off-balance sheet backlog to be billed in the next twelve months was in excess of \$330 million, up approximately 20% on a year-over-year basis, which is consistent with the growth in this metric for the prior 2 years.
- The backlog contributes to a significant portion of next year's revenue as well as giving us forward visibility of revenue beyond FY18.

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

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- We had strong bookings growth across our major geographies even with many of our largest deals being attributed to the Americas. This quarter 67% of bookings came from the Americas, 21% from EMEA and 12% from Asia-Pacific versus a 64%/23%/13% split in Q4 last year.
- The Q4 route-to-market mix was 69% from the channel and 31% from our direct sales force, compared to a 71%/29% split in Q4 last year. The increase in the direct channel contribution was driven by the increase in large deals that closed in the quarter.
- Our proxy for bookings duration was approximately 25 months. This is higher than our historic duration of 21 months. Going forward, we would expect duration to move closer to the historic 21 month level. While the short term component will not be impacted by the shorter deal duration, we believe the growth rate of long term component could be impacted by the smaller pool of the out-year deals.

Now to briefly recap and summarize highlights for the full fiscal year:

- Total revenue grew to \$2.4 billion, up 18% in US dollars or up 17% year over year in constant currency and near the high end of guidance from last March.
- Subscription revenue grew to \$2.1 billion, an increase of 18% in both US dollars and constant currency.
- Subscription revenue for Infrastructure related offerings was \$1.7 billion, up 15% in US dollars and 14% in constant currency.
- Subscription revenue for Application Development-related and other emerging technologies was \$439 million, up 36% in both US dollars and constant currency.

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- For FY17, Application Development-related and related emerging technologies subscriptions constituted 18% of total revenue, up from 16% last fiscal year.
- Non-GAAP operating income grew by 15% year-over-year.
- Non-GAAP diluted EPS for the full year was \$2.27, up 19% over the prior year.

Now I would like to turn to guidance. Our outlook assumes current business conditions and current foreign exchange rates. Our outlook is in US dollars but on a constant currency basis, we would expect a 1% headwind to the Q1 revenue growth and a 2% headwind to full year FY18 revenue growth.

- We are forecasting our full year revenue guidance to \$2.72 billion to \$2.76 billion in US dollars, up approximately 14% at the high end of the range.
- In FY18, we will be balancing investment in our growth initiatives and operating leverage. Our plan includes adding approximately 1,000 net new associates or approximately 10% head count growth compared to 19% in the previous fiscal year.

Given this level of investment, we expect operating margin to expand by 50 basis points to approximately 23.6% in FY18 compared to 23.1% in FY17.

- We expect full year non-GAAP earnings per share to be approximately \$2.60 to \$2.64 per share, assuming approximately \$2 million per quarter forecast for net other income, an annual effective tax rate of 28% and approximately 180 million diluted shares.
- On a GAAP basis, we estimate annual stock compensation expenses of approximately \$200 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 \$19 million.

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- We estimate that Capital Expenditures to be in a range of \$75 million to \$85 million.
- Operating cash flow is expected to grow in a range from \$850 million to \$870 million and includes an incremental \$25 million of cash taxes.
- For those of you who try to model billings metrics and quarterly cash flows, we would expect the same business flow in our model as in the past. Along with our assumption of deal duration moving to the historic 21 months level, we also expect bookings and billings to repeat their historical pattern of being lowest in Q1 and growing going forward to end at the highest level in Q4. In addition, we have also seen a continuation of sales toward the fourth quarter. For modeling purposes, we would factor in an approximate 2% increase in the percentage of full year sales that occurs in Q4 when estimating billings. Our operating cash flow guidance for FY18 has factored in this continued shift and the timing lag on collections.

For Q1 specifically, we offer the following outlook:

- We expect revenue to be in the range of \$643 million to \$650 million, which is up 15% in US dollars at the high end of the range. We expect a non-GAAP operating margin of approximately 20% and non-GAAP earnings per share of \$0.52 to \$0.53. Our assumption on Q1 expenses including further investing in our emerging technologies as well as expenses for a number of important events in Q1 including our annual Sales and Partner Kick-off events, the opening of our Executive Briefing Center and Innovation Lab in Boston, the OpenStack Summit and our premier user event, Red Hat Summit which has moved into Q1 which was Q2 last year.

Consistent with prior practices here at Red Hat, I will not be providing a forecast for quarterly cash flow but please note that it can be variable depending upon individual payments or collections.

Overall, we are very pleased with our financial performance in the fourth quarter. We are excited about the company's long-term growth opportunity in the hybrid cloud digital transformation and modernizing data centers with open source solutions.

At Analyst Day in May, we will have the opportunity to have deeper discussions on our plans to realize this large, growing opportunity. I personally look forward to meeting many of you at Analyst Day.

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