

RED HAT INC
Form 10-Q
September 29, 2014
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended August 31, 2014

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____.

Commission File Number: 001-33162

RED HAT, INC.

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction of

06-1364380
(I.R.S. Employer

incorporation or organization)

Identification No.)

100 East Davie Street, Raleigh, North Carolina 27601

(Address of principal executive offices, including zip code)

(919) 754-3700

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

As of September 24, 2014, there were 187,822,319 shares of common stock outstanding.

Table of Contents

RED HAT, INC.

| | Page |
|---|-------------|
| <u>CAUTIONARY NOTE ON FORWARD-LOOKING STATEMENTS</u> | 2 |
| PART I FINANCIAL INFORMATION: | |
| ITEM 1: FINANCIAL STATEMENTS | |
| <u>Consolidated Balance Sheets at August 31, 2014 (unaudited) and February 28, 2014 (derived from audited financial statements)</u> | 3 |
| <u>Consolidated Statements of Operations for the three months and six months ended August 31, 2014 (unaudited) and 2013 (unaudited)</u> | 4 |
| <u>Consolidated Statements of Comprehensive Income for the three months and six months ended August 31, 2014 (unaudited) and 2013 (unaudited)</u> | 5 |
| <u>Consolidated Statements of Cash Flows for the three months and six months ended August 31, 2014 (unaudited) and 2013 (unaudited)</u> | 6 |
| <u>Notes to Consolidated Financial Statements (unaudited)</u> | 7 |
| ITEM 2: <u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u> | 27 |
| ITEM 3: <u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u> | 43 |
| ITEM 4: <u>CONTROLS AND PROCEDURES</u> | 46 |
| PART II OTHER INFORMATION: | |
| ITEM 1: <u>LEGAL PROCEEDINGS</u> | 47 |
| ITEM 1A: <u>RISK FACTORS</u> | 47 |
| ITEM 2: <u>UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u> | 65 |
| ITEM 6: <u>EXHIBITS</u> | 66 |
| <u>SIGNATURES</u> | 67 |

Table of Contents

CAUTIONARY NOTE ON FORWARD-LOOKING STATEMENTS

Certain statements contained in this report and the documents incorporated by reference in this report, including in Management's Discussion and Analysis of Financial Condition and Results of Operations, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements provide current expectations of future events based on certain assumptions, and any statement that is not strictly a historical statement could be deemed to be a forward-looking statement (for example, statements regarding current or future financial performance, management's plans and objectives for future operations, product plans and performance, management's expectations regarding market risk and market penetration, management's assessment of market factors or strategies, objectives and plans of Red Hat, Inc. together with its subsidiaries (Red Hat) and its partners). Words such as anticipate, believe, estimate, expect, intend, plan, and similar expressions, may also identify such forward-looking statements. Red Hat may also make forward-looking statements in other filings made with the Securities and Exchange Commission (SEC), press releases, materials delivered to stockholders and oral statements made by management. Investors are cautioned that these forward-looking statements are inherently uncertain, are not guarantees of Red Hat's future performance and are subject to a number of risks and uncertainties that could cause Red Hat's actual results to differ materially from those found in the forward-looking statements and from historical trends. These risks and uncertainties include the risks and cautionary statements detailed in Part II, Item 1A, Risk Factors and elsewhere in this report as well as in Red Hat's other filings with the SEC, copies of which may be accessed through the SEC's web site at <http://www.sec.gov>. Readers are urged to carefully review these risks and cautionary statements. Moreover, Red Hat operates in a rapidly changing and highly competitive environment. It is impossible to predict all risks and uncertainties or assess the impact of any new risk or uncertainty on our business or any forward-looking statement. The forward-looking statements included in this report represent our views as of the date of this report. We specifically disclaim any obligation to update these forward-looking statements in the future. These forward-looking statements should not be relied upon as representing our views as of any date subsequent to the date of this report.

Table of Contents**RED HAT, INC.****CONSOLIDATED BALANCE SHEETS****(In thousands except share and per share amounts)**

| | August 31, 2014 (Unaudited) | February 28, 2014 (1) |
|---|--|--|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 585,381 | \$ 646,742 |
| Investments in debt securities, short-term | 217,659 | 335,387 |
| Accounts receivable, net of allowances for doubtful accounts of \$2,611 and \$1,986, respectively | 283,952 | 360,594 |
| Deferred tax assets, net | 111,522 | 108,264 |
| Prepaid expenses | 125,256 | 118,387 |
| Other current assets | 1,794 | 1,808 |
| Total current assets | \$ 1,325,564 | \$ 1,571,182 |
| Property and equipment, net of accumulated depreciation and amortization of \$221,922 and \$209,295, respectively | 175,844 | 173,917 |
| Goodwill | 870,063 | 687,430 |
| Identifiable intangibles, net | 146,904 | 133,399 |
| Investments in debt securities, long-term | 513,903 | 505,300 |
| Other assets, net | 35,026 | 35,391 |
| Total assets | \$ 3,067,304 | \$ 3,106,619 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | \$ 211,552 | \$ 179,468 |
| Deferred revenue | 920,605 | 966,832 |
| Other current obligations | 1,852 | 1,786 |
| Total current liabilities | \$ 1,134,009 | \$ 1,148,086 |
| Long-term deferred revenue | 331,192 | 322,365 |
| Other long-term obligations | 87,447 | 85,003 |
| Commitments and contingencies (NOTES 12 and 13) | | |
| Stockholders' equity: | | |
| Preferred stock, 5,000,000 shares authorized, none outstanding | | |
| Common stock, \$0.0001 per share par value, 300,000,000 shares authorized, 232,068,444 and 230,915,589 shares issued, and 187,817,247 and 189,712,211 shares outstanding at August 31, 2014 and February 28, 2014, respectively | 23 | 23 |
| Additional paid-in capital | 1,942,659 | 1,891,848 |
| Retained earnings | 804,740 | 720,172 |
| Treasury stock at cost, 44,251,197 and 41,203,378 shares at August 31, 2014 and February 28, 2014, respectively | (1,216,741) | (1,056,419) |
| Accumulated other comprehensive loss | (16,025) | (4,459) |
| Total stockholders' equity | \$ 1,514,656 | \$ 1,551,165 |
| Total liabilities and stockholders' equity | \$ 3,067,304 | \$ 3,106,619 |

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(1) Derived from audited financial statements.

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**RED HAT, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands except per share amounts)****(Unaudited)**

| | Three Months Ended | | Six Months Ended | |
|--|----------------------------|----------------------------|----------------------------|----------------------------|
| | August 31, 2014 | August 31, 2013 | August 31, 2014 | August 31, 2013 |
| Revenue: | | | | |
| Subscriptions | \$ 389,495 | \$ 326,692 | \$ 761,462 | \$ 642,509 |
| Training and services | 56,404 | 47,731 | 108,191 | 95,173 |
| Total subscription and training and services revenue | 445,899 | 374,423 | 869,653 | 737,682 |
| Cost of subscription and training and services revenue: | | | | |
| Cost of subscriptions | 27,791 | 23,518 | 55,551 | 46,893 |
| Cost of training and services | 39,383 | 32,062 | 76,066 | 64,744 |
| Total cost of subscription and training and services revenue | 67,174 | 55,580 | 131,617 | 111,637 |
| Gross profit | 378,725 | 318,843 | 738,036 | 626,045 |
| Operating expense: | | | | |
| Sales and marketing | 174,520 | 144,596 | 351,358 | 287,040 |
| Research and development | 95,265 | 78,299 | 185,204 | 152,100 |
| General and administrative | 44,713 | 38,203 | 86,284 | 72,537 |
| Facility exit costs | | 2,171 | | 2,171 |
| Total operating expense | 314,498 | 263,269 | 622,846 | 513,848 |
| Income from operations | 64,227 | 55,574 | 115,190 | 112,197 |
| Interest income | 2,010 | 1,527 | 3,852 | 3,029 |
| Other income (expense), net | (289) | 1,196 | 68 | 772 |
| Income before provision for income taxes | 65,948 | 58,297 | 119,110 | 115,998 |
| Provision for income taxes | 19,125 | 17,489 | 34,542 | 34,799 |
| Net income | \$ 46,823 | \$ 40,808 | \$ 84,568 | \$ 81,199 |
| Basic net income per common share | \$ 0.25 | \$ 0.22 | \$ 0.45 | \$ 0.43 |
| Diluted net income per common share | \$ 0.25 | \$ 0.21 | \$ 0.44 | \$ 0.42 |
| Weighted average shares outstanding | | | | |
| Basic | 188,162 | 189,437 | 188,767 | 190,276 |
| Diluted | 190,755 | 191,432 | 191,135 | 192,230 |

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**RED HAT, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(In thousands)****(Unaudited)**

| | Three Months Ended | | Six Months Ended | |
|---|---------------------------|-------------------|-------------------------|-------------------|
| | August | August 31, | August | August 31, |
| | 31, | 2013 | 31, | 2013 |
| | 2014 | | 2014 | 2013 |
| Net income | \$ 46,823 | \$ 40,808 | \$ 84,568 | \$ 81,199 |
| Other comprehensive income (loss): | | | | |
| Change in foreign currency translation adjustment | (10,850) | 1,567 | (11,752) | (2,049) |
| Available-for-sale securities: | | | | |
| Unrealized gain (loss) on available-for-sale securities during the period | 79 | (1,985) | 168 | (2,716) |
| Reclassification for (gain) loss realized on available-for-sale securities, reported in Other income (expense), net | 3 | (31) | (150) | (317) |
| Tax benefit | 101 | 755 | 168 | 1,127 |
| Net change in available-for-sale securities (net of tax) | 183 | (1,261) | 186 | (1,906) |
| Total other comprehensive income (loss) | (10,667) | 306 | (11,566) | (3,955) |
| Comprehensive income | \$ 36,156 | \$ 41,114 | \$ 73,002 | \$ 77,244 |

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**RED HAT, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|-------------------|-------------------------|-------------------|
| | August 31, | August 31, | August 31, | August 31, |
| | 2014 | 2013 | 2014 | 2013 |
| Cash flows from operating activities: | | | | |
| Net income | \$ 46,823 | \$ 40,808 | \$ 84,568 | \$ 81,199 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Depreciation and amortization | 19,539 | 18,439 | 38,463 | 36,371 |
| Share-based compensation expense | 36,605 | 29,874 | 65,319 | 53,006 |
| Deferred income taxes | 975 | 1,208 | 3,905 | 11,020 |
| Net amortization of bond premium on debt securities available for sale | 2,525 | 2,285 | 4,558 | 4,336 |
| Other | 595 | (96) | (353) | 47 |
| Changes in operating assets and liabilities, net of effects of acquisitions: | | | | |
| Accounts receivable | (18,349) | (6,341) | 78,231 | 66,081 |
| Prepaid expenses | (2,391) | (5,645) | (7,580) | (2,394) |
| Accounts payable and accrued expenses | 27,266 | 38,902 | 29,921 | 26,293 |
| Deferred revenue | (6,209) | 1,880 | (25,957) | (15,020) |
| Other | 358 | (2,385) | 1,349 | (195) |
| Net cash provided by operating activities | 107,737 | 118,929 | 272,424 | 260,744 |
| Cash flows from investing activities: | | | | |
| Purchase of investment in debt securities available for sale | (50,567) | (217,433) | (319,141) | (347,076) |
| Proceeds from sales and maturities of investment in debt securities available for sale | 140,101 | 153,917 | 409,532 | 479,767 |
| Acquisition of businesses, net of cash acquired | (66,183) | | (217,804) | |
| Purchase of other intangible assets | (1,198) | (10,177) | (1,751) | (12,521) |
| Purchase of property and equipment | (14,290) | (21,829) | (22,884) | (48,506) |
| Other | (1,038) | (2,126) | 2,434 | (1,934) |
| Net cash provided by (used in) investing activities | 6,825 | (97,648) | (149,614) | 69,730 |
| Cash flows from financing activities: | | | | |
| Excess tax benefits from share-based payment arrangements | 423 | 2,610 | 1,409 | 5,643 |
| Proceeds from exercise of common stock options | 644 | 635 | 689 | 1,088 |
| Payments related to net settlement of share-based compensation awards | (3,831) | (3,833) | (17,561) | (14,815) |
| Purchase of treasury stock | (80,028) | (20,009) | (160,061) | (199,345) |
| Payments on other borrowings | (1,635) | (312) | (1,990) | (617) |
| Net cash used in financing activities | (84,427) | (20,909) | (177,514) | (208,046) |
| Effect of foreign currency exchange rates on cash and cash equivalents | (8,902) | (1,576) | (6,657) | (12,718) |
| Net increase (decrease) in cash and cash equivalents | 21,233 | (1,204) | (61,361) | 109,710 |
| Cash and cash equivalents at beginning of the period | 564,148 | 597,998 | 646,742 | 487,084 |

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| | | | | |
|--|------------|------------|------------|------------|
| Cash and cash equivalents at end of the period | \$ 585,381 | \$ 596,794 | \$ 585,381 | \$ 596,794 |
|--|------------|------------|------------|------------|

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 Company

Red Hat, Inc., incorporated in Delaware, together with its subsidiaries (Red Hat or the Company) is a leading global provider of open source software solutions, using a community-powered approach to develop and offer reliable and high-performing operating system, virtualization, middleware, storage and cloud technologies.

Open source software is an alternative to proprietary software and represents a different model for the development and licensing of commercial software code than that typically used for proprietary software. Because open source software code is often freely shared, there are customarily no licensing fees for the use of open source software. Therefore, the Company does not recognize revenue from the licensing of the code itself. The Company provides value to its customers through the development, aggregation, integration, testing, certification, delivery, maintenance, enhancement and support of its Red Hat enterprise technologies, and by providing a level of performance, reliability, scalability, flexibility, stability and security for the enterprise technologies the Company packages and distributes. Moreover, because communities of developers not employed by the Company assist with the creation of the Company's open source offerings, opportunities for further innovation of the Company's offerings are supplemented by these communities.

The Company derives its revenue and generates cash from customers primarily from two sources: (i) subscription revenue and (ii) training and services revenue. These arrangements typically involve subscriptions to Red Hat enterprise technologies. The arrangements with the Company's customers that produce this revenue and cash are explained in further detail in NOTE 2 Summary of Significant Accounting Policies to the Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2014.

NOTE 2 Summary of Significant Accounting Policies

Basis of presentation

The unaudited interim consolidated financial statements as of and for the three months and six months ended August 31, 2014 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the consolidated balance sheets, consolidated operating results, consolidated other comprehensive income and consolidated cash flows for the periods presented in accordance with accounting principles generally accepted in the United States of America. Operating results for the three months and six months ended August 31, 2014 are not necessarily indicative of the results that may be expected for the fiscal year ending February 28, 2015. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted in accordance with the SEC's rules and regulations for interim reporting. For further information, see the Company's Consolidated Financial Statements, including notes thereto, included in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2014.

There have been no changes to the Company's significant accounting policies from those described in NOTE 2 Summary of Significant Accounting Policies to the Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2014. These unaudited financial statements should be read in conjunction with such Annual Report on Form 10-K.

Certain reclassifications have been made to the prior year's financial statements to conform to the current year's presentation.

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Consolidation policy

The accompanying Consolidated Financial Statements include the accounts of the Company and all of its wholly owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. There are no significant foreign exchange restrictions on the Company's foreign subsidiaries.

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet dates and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from such estimates.

Recent accounting pronouncements

In June 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* (ASU 2014-12). The FASB issued ASU 2014-12 to provide explicit guidance for share-based awards which allow for an employee to vest in an award upon achievement of a performance condition met after completion of a requisite service period regardless of whether the employee is rendering service on the date the performance target is achieved. ASU 2014-12 provides that the performance target should not be reflected in estimating the grant-date fair value of the award but rather compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and recognized prospectively over the remaining requisite service period. This guidance is effective for fiscal years and interim periods within those years beginning after December 15, 2015, and is effective for the Company as of the first quarter of fiscal year 2017. The Company has not issued such share-based awards and does not believe that this updated standard will have a material impact on the Company's consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09). The FASB issued ASU 2014-09 to clarify the principles for recognizing revenue and to develop a common revenue standard for generally accepted accounting principles (GAAP) and International Financial Reporting Standards. The standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes the most current revenue recognition guidance. This guidance is effective for fiscal years and interim periods within those years beginning after December 15, 2016, which is effective for the Company as of the first quarter of fiscal year 2018. The Company is currently evaluating the impact that the implementation of this standard will have on the Company's consolidated financial statements.

In July 2013, the FASB issued Accounting Standards Update No. 2013-11, *Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists* (ASU 2013-11), to eliminate diversity in practice of presenting unrecognized tax benefits as a liability or presenting unrecognized tax benefits as a reduction of a deferred tax asset for a net operating loss or tax credit carryforward in certain circumstances by requiring that an unrecognized tax benefit be presented in the financial statements as a reduction to deferred tax assets excluding certain exceptions. ASU 2013-11 became effective for the Company during the three months ended May 31, 2014. The updated standard did not have a material impact on the Company's consolidated financial statements.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

In March 2013, the FASB issued Accounting Standards Update No. 2013-05, *Foreign Currency Matters (Topic 830) Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity* (ASU 2013-05), which requires a parent entity to release a related foreign entity's cumulative translation adjustment into net income only if its sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. ASU 2013-05 became effective for the Company during the three months ended May 31, 2014. The updated standard did not have a material impact on the Company's consolidated financial statements.

NOTE 3 Changes in Equity

The following table summarizes the changes in the Company's stockholders' equity during the three months ended August 31, 2014 (in thousands):

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Total Stockholders Equity |
|--|-----------------|----------------------------------|----------------------|-------------------|--|---------------------------------|
| Balance at May 31, 2014 | \$ 23 | \$ 1,908,934 | \$ 757,917 | \$ (1,136,713) | \$ (5,358) | \$ 1,524,803 |
| Net income | | | 46,823 | | | 46,823 |
| Other comprehensive income (loss), net of tax | | | | | (10,667) | (10,667) |
| Exercise of common stock options | | 644 | | | | 644 |
| Common stock repurchase (see NOTE 10) | | | | (80,028) | | (80,028) |
| Share-based compensation expense | | 36,605 | | | | 36,605 |
| Tax benefits related to share-based awards | | 307 | | | | 307 |
| Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards | | (3,831) | | | | (3,831) |
| Balance at August 31, 2014 | \$ 23 | \$ 1,942,659 | \$ 804,740 | \$ (1,216,741) | \$ (16,025) | \$ 1,514,656 |

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table summarizes the changes in the Company's stockholders' equity during the three months ended August 31, 2013 (in thousands):

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Total Stockholders Equity |
|--|-----------------|----------------------------------|----------------------|-------------------|--|---------------------------------|
| Balance at May 31, 2013 | \$ 23 | \$ 1,819,251 | \$ 582,271 | \$ (996,010) | \$ (12,228) | \$ 1,393,307 |
| Net income | | | 40,808 | | | 40,808 |
| Other comprehensive income (loss), net of tax | | | | | 306 | 306 |
| Exercise of common stock options | | 635 | | | | 635 |
| Common stock repurchase | | | | (20,009) | | (20,009) |
| Share-based compensation expense | | 29,874 | | | | 29,874 |
| Tax benefits related to share-based awards | | 516 | | | | 516 |
| Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards | | (3,833) | | | | (3,833) |
| Other adjustments | | 382 | | (382) | | |
| Balance at August 31, 2013 | \$ 23 | \$ 1,846,825 | \$ 623,079 | \$ (1,016,401) | \$ (11,922) | \$ 1,441,604 |

The following table summarizes the changes in the Company's stockholders' equity during the six months ended August 31, 2014 (in thousands):

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Total Stockholders Equity |
|--|-----------------|----------------------------------|----------------------|-------------------|--|---------------------------------|
| Balance at February 28, 2014 | \$ 23 | \$ 1,891,848 | \$ 720,172 | \$ (1,056,419) | \$ (4,459) | \$ 1,551,165 |
| Net income | | | 84,568 | | | 84,568 |
| Other comprehensive income (loss), net of tax | | | | | (11,566) | (11,566) |
| Exercise of common stock options | | 689 | | | | 689 |
| Common stock repurchase (see NOTE 10) | | | | (160,061) | | (160,061) |
| Share-based compensation expense | | 65,319 | | | | 65,319 |
| Assumed employee share-based awards from acquisitions | | 895 | | | | 895 |
| Tax benefits related to share-based awards | | 1,208 | | | | 1,208 |
| Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards | | (17,561) | | | | (17,561) |
| Other adjustments | | 261 | | (261) | | |
| Balance at August 31, 2014 | \$ 23 | \$ 1,942,659 | \$ 804,740 | \$ (1,216,741) | \$ (16,025) | \$ 1,514,656 |

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table summarizes the changes in the Company's stockholders' equity during the six months ended August 31, 2013 (in thousands):

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Total Stockholders Equity |
|--|-----------------|----------------------------------|----------------------|-------------------|--|---------------------------------|
| Balance at February 28, 2013 | \$ 23 | \$ 1,802,899 | \$ 541,880 | \$ (816,674) | \$ (7,967) | \$ 1,520,161 |
| Net income | | | 81,199 | | | 81,199 |
| Other comprehensive income (loss), net of tax | | | | | (3,955) | (3,955) |
| Exercise of common stock options | | 1,088 | | | | 1,088 |
| Common stock repurchase | | | | (199,345) | | (199,345) |
| Share-based compensation expense | | 53,006 | | | | 53,006 |
| Tax benefits related to share-based awards | | 4,265 | | | | 4,265 |
| Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards | | (14,815) | | | | (14,815) |
| Other adjustments | | 382 | | (382) | | |
| Balance at August 31, 2013 | \$ 23 | \$ 1,846,825 | \$ 623,079 | \$ (1,016,401) | \$ (11,922) | \$ 1,441,604 |

Accumulated other comprehensive loss

The following is a summary of accumulated other comprehensive loss as of August 31, 2014 and February 28, 2014 (in thousands):

| | As of August 31, 2014 | As of February 28, 2014 |
|---|--------------------------|----------------------------|
| Accumulated loss from foreign currency translation adjustment | \$ (16,575) | \$ (4,823) |
| Accumulated unrealized gain, net of tax, on available-for-sale securities | 550 | 364 |
| Accumulated other comprehensive loss | \$ (16,025) | \$ (4,459) |

NOTE 4 Identifiable Intangible Assets

Identifiable intangible assets consist primarily of trademarks, copyrights and patents, purchased technologies, customer and reseller relationships and covenants not to compete which are amortized over the estimated useful life, generally on a straight-line basis with the exception of customer and reseller relationships which are generally amortized over the greater of straight-line or the related asset's pattern of economic benefit. Useful lives range from three to ten years. As of August 31, 2014 and February 28, 2014, trademarks with an indefinite estimated useful life totaled \$12.6 million and \$9.6 million, respectively.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following is a summary of identifiable intangible assets (in thousands):

| | As of August 31, 2014 | | | As of February 28, 2014 | | |
|--------------------------------------|-----------------------|--------------------------|------------|-------------------------|--------------------------|------------|
| | Gross Amount | Accumulated Amortization | Net Amount | Gross Amount | Accumulated Amortization | Net Amount |
| Trademarks, copyrights and patents | \$ 119,930 | \$ (38,769) | \$ 81,161 | \$ 105,269 | \$ (34,784) | \$ 70,485 |
| Purchased technologies | 79,495 | (60,529) | 18,966 | 79,433 | (55,960) | 23,473 |
| Customer and reseller relationships | 102,372 | (67,010) | 35,362 | 89,992 | (63,075) | 26,917 |
| Covenants not to compete | 11,177 | (6,884) | 4,293 | 10,690 | (5,977) | 4,713 |
| Other intangible assets | 8,921 | (1,799) | 7,122 | 8,922 | (1,111) | 7,811 |
| Total identifiable intangible assets | \$ 321,895 | \$ (174,991) | \$ 146,904 | \$ 294,306 | \$ (160,907) | \$ 133,399 |

Amortization expense associated with identifiable intangible assets recognized in the Company's Consolidated Financial Statements for the three months and six months ended August 31, 2014 and August 31, 2013 is summarized as follows (in thousands):

| | Three Months Ended | | Six Months Ended | |
|----------------------------|--------------------|-----------------|------------------|-----------------|
| | August 31, 2014 | August 31, 2013 | August 31, 2014 | August 31, 2013 |
| Cost of revenue | \$ 2,830 | \$ 2,840 | \$ 5,790 | \$ 5,513 |
| Sales and marketing | 1,992 | 2,193 | 3,574 | 4,151 |
| Research and development | 959 | 959 | 1,917 | 1,918 |
| General and administrative | 1,607 | 1,203 | 3,035 | 2,740 |
| Total amortization expense | \$ 7,388 | \$ 7,195 | \$ 14,316 | \$ 14,322 |

NOTE 5 Income Taxes*Income Tax Expense*

The following table summarizes the Company's tax provision for the three months and six months ended August 31, 2014 and August 31, 2013 (in thousands):

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|-----------------|------------------|-----------------|
| | August 31, 2014 | August 31, 2013 | August 31, 2014 | August 31, 2013 |
| Provision for income taxes: | | | | |
| Income before provision for income taxes | \$ 65,948 | \$ 58,297 | \$ 119,110 | \$ 115,998 |
| Estimated annual effective tax rate on current year ordinary income | 29% | 30% | 29% | 30% |
| Provision for income taxes | \$ 19,125 | \$ 17,489 | \$ 34,542 | \$ 34,799 |

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For the three months and six months ended August 31, 2014, the Company's estimated annual effective tax rate of 29% differed from the U.S. federal statutory rate of 35% principally due to foreign income taxed at lower rates. For the three months and six months ended August 31, 2013, the Company's estimated annual effective tax rate of 30% differed from the U.S. federal statutory rate of 35% principally due to foreign income taxed at lower rates and research tax credits.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)***Deferred Taxes*

As of August 31, 2014, deferred tax assets net of deferred tax liabilities (current and non-current) totaled \$96.1 million, of which \$1.5 million was offset by a valuation allowance. The Company continues to maintain a valuation allowance against its deferred tax assets with respect to certain net operating loss (NOL) carryforwards.

As of August 31, 2014, the Company had U.S. federal and state NOL carryforwards of approximately \$56.6 million and \$150.2 million, respectively. As of August 31, 2014, the Company had U.S. federal and state research tax credit carryforwards of approximately \$21.7 million and \$12.0 million, respectively. The tax credit carryforwards are scheduled to expire in varying amounts beginning in the fiscal year ending February 28, 2018.

Unrecognized tax benefits

The Company's unrecognized tax benefits were \$57.5 million as of August 31, 2014 and \$57.1 million as of February 28, 2014. The Company's unrecognized tax benefits at August 31, 2014 and February 28, 2014, which, if recognized, would affect the Company's effective tax rate, were \$52.3 million and \$49.7 million, respectively.

During the six months ended August 31, 2014, the amount of unrecognized tax benefits increased by \$0.4 million, primarily as a result of increases with respect to tax positions taken during prior periods. The results and timing of the resolution of tax audits is highly uncertain and the Company is unable to estimate the range of possible changes to the balance of unrecognized tax benefits. However, the Company does not anticipate that within the next 12 months the total amount of unrecognized tax benefits will significantly change.

It is the Company's policy to recognize interest and penalties related to uncertain tax positions as income tax expense. Accrued interest and penalties related to unrecognized tax benefits totaled \$8.5 million and \$6.0 million as of August 31, 2014 and February 28, 2014, respectively.

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. The following table summarizes the tax years in the Company's major tax jurisdictions that remain subject to income tax examinations by tax authorities as of August 31, 2014. Due to NOL carryforwards, in some cases the tax years continue to remain subject to examination with respect to such NOLs.

| Tax Jurisdiction | Years Subject to | |
|------------------|------------------------|---------|
| | Income Tax Examination | |
| U.S. federal | 1994 | Present |
| North Carolina | 1999 | Present |
| Ireland | 2008 | Present |
| Japan (1) | 2012 | Present |

(1) The Company has been examined for income tax for years through February 28, 2011. A tax examination was concluded in fiscal 2012 with no significant adjustments resulting. However, the statute of limitations remains open for five years.

The U.S. Internal Revenue Service recently completed its examination with respect to the Company's fiscal year ended February 28, 2010 and proposed certain adjustments. The Company believes that it has adequately provided for any reasonably foreseeable outcomes that may result from the proposed adjustments but, depending on the ultimate outcome, the Company could be required to pay additional income taxes. The

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Company does not believe that such outcome would have a material effect on its consolidated financial condition or consolidated results of operations.

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Company is currently undergoing an income tax examination in India.

The Company believes it has adequately provided for any reasonably foreseeable outcomes related to tax audits.

NOTE 6 Assets and Liabilities Measured at Fair Value on a Recurring Basis

Fair value is defined as the exchange price that would be received for the purchase of an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for such asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs. To measure fair value, the Company uses the following fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and are significant to the fair value of the assets or liabilities.

The Company's investments are comprised primarily of debt securities that are classified as available for sale and recorded at their fair market values. Liquid investments purchased with a maturity period of 90 days or less at the date of purchase are classified as cash equivalents. Investments with remaining effective maturities of twelve months or less from the balance sheet date are classified as short-term investments. Investments with remaining effective maturities of more than twelve months from the balance sheet date are classified as long-term investments. The Company's Level 1 financial instruments are valued using quoted prices in active markets for identical instruments. The Company's Level 2 financial instruments, including derivative instruments, are valued using quoted prices for identical instruments in less active markets or using other observable market inputs for comparable instruments.

Unrealized gains and temporary losses on investments classified as available for sale are included within accumulated other comprehensive income, net of any related tax effect. Upon realization, such amounts are reclassified from accumulated other comprehensive income to Other income (expense), net. Realized gains and losses and other than temporary impairments, if any, are reflected in the consolidated statements of operations as Other income (expense), net. The Company does not recognize changes in the fair value of its investments in income unless a decline in value is considered other-than-temporary. The vast majority of the Company's investments are priced with the assistance of pricing vendors. These pricing vendors use the most recent observable market information in pricing these securities or, if specific prices are not available for these securities, use other observable inputs. In the event observable inputs are not available, the Company assesses other factors to determine the security's market value, including broker quotes or model valuations. Independent price verifications of all holdings are performed by pricing vendors which are then reviewed by the Company. In the event a price fails a pre-established tolerance check, it is researched so that the Company can assess the cause of the variance to determine what the Company believes is the appropriate fair market value.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The Company minimizes its credit risk associated with investments by investing primarily in investment grade, liquid securities. The Company's policy is designed to limit exposures to any one issuer depending on credit quality. Periodic evaluations of the relative credit standing of those issuers are considered in the Company's investment strategy.

The following table summarizes the composition and fair value hierarchy of the Company's financial assets and liabilities at August 31, 2014 (in thousands):

| | As of August 31, 2014 | Quoted Prices In Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|------------------------------------|-----------------------------|---|--|---|
| Assets: | | | | |
| Money markets (1) | \$ 179,519 | \$ 179,519 | \$ | \$ |
| Interest-bearing deposits (1) | 29 | | 29 | |
| Available-for-sale securities (1): | | | | |
| U.S. agency securities | 234,038 | | 234,038 | |
| Corporate securities | 414,668 | | 414,668 | |
| Foreign government securities | 82,827 | | 82,827 | |
| Foreign currency derivatives (2) | 16 | | 16 | |
| Liabilities: | | | | |
| Foreign currency derivatives (3) | (143) | | (143) | |
| Total | \$ 910,954 | \$ 179,519 | \$ 731,435 | \$ |

(1) Included in Cash and cash equivalents, Investments in debt securities, short-term or Investments in debt securities, long-term in the Company's Consolidated Balance Sheet at August 31, 2014, in addition to \$405.9 million of cash.

(2) Included in Other current assets in the Company's Consolidated Balance Sheet at August 31, 2014.

(3) Included in Accounts payable and accrued expenses in the Company's Consolidated Balance Sheet at August 31, 2014.

The following table summarizes the composition and fair value hierarchy of the Company's financial assets and liabilities at February 28, 2014 (in thousands):

| | As of February 28, 2014 | Quoted Prices In Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|------------------------------------|-------------------------------|--|--|---|
| Assets: | | | | |
| Money markets (1) | \$ 178,280 | \$ 178,280 | \$ | \$ |
| Interest-bearing deposits (1) | 86,937 | | 86,937 | |
| Available-for-sale securities (1): | | | | |

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| | | | | |
|----------------------------------|--------------|------------|------------|----|
| Commercial paper | 37,643 | | 37,643 | |
| U.S. agency securities | 279,049 | | 279,049 | |
| Corporate securities | 382,516 | | 382,516 | |
| Foreign government securities | 79,841 | | 79,841 | |
| Foreign currency derivatives (2) | 134 | | 134 | |
| Liabilities: | | | | |
| Foreign currency derivatives (3) | (15) | | (15) | |
| Total | \$ 1,044,385 | \$ 178,280 | \$ 866,105 | \$ |

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

- (1) Included in Cash and cash equivalents, Investments in debt securities, short-term or Investments in debt securities, long-term in the Company's Consolidated Balance Sheet at February 28, 2014, in addition to \$443.2 million of cash.
- (2) Included in Other current assets in the Company's Consolidated Balance Sheet at February 28, 2014.
- (3) Included in Accounts payable and accrued expenses in the Company's Consolidated Balance Sheet at February 28, 2014.

The following table represents the Company's investments measured at fair value as of August 31, 2014 (in thousands):

| | Amortized Cost | Gross Unrealized | | Aggregate Fair Value | Balance Sheet Classification | | |
|-------------------------------|-------------------|------------------|------------|-------------------------|---------------------------------|---|--|
| | | Gains | Losses (1) | | Cash and cash equivalents | Investments in debt securities, short-term | Investments in debt securities, long-term |
| Money markets | \$ 179,519 | \$ | \$ | \$ 179,519 | \$ 179,519 | \$ | \$ |
| Interest-bearing deposits | 29 | | | 29 | | 29 | |
| U.S. agency securities | 234,779 | 5 | (746) | 234,038 | | | 234,038 |
| Corporate securities | 413,522 | 1,360 | (214) | 414,668 | | 143,723 | 270,945 |
| Foreign government securities | 82,729 | 102 | (4) | 82,827 | | 73,907 | 8,920 |
| Total | \$ 910,578 | \$ 1,467 | \$ (964) | \$ 911,081 | \$ 179,519 | \$ 217,659 | \$ 513,903 |

- (1) As of August 31, 2014, there were \$0.5 million of accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer.

The following table represents the Company's investments measured at fair value as of February 28, 2014 (in thousands):

| | Amortized Cost | Gross Unrealized | | Aggregate Fair Value | Balance Sheet Classification | | |
|-------------------------------|-------------------|------------------|------------|-------------------------|---------------------------------|---|--|
| | | Gains | Losses (1) | | Cash and cash equivalents | Investments in debt securities, short-term | Investments in debt securities, long-term |
| Money markets | \$ 178,280 | \$ | \$ | \$ 178,280 | \$ 178,280 | \$ | \$ |
| Interest-bearing deposits | 86,937 | | | 86,937 | | 86,937 | |
| Commercial paper | 37,643 | | | 37,643 | 25,299 | 12,344 | |
| U.S. agency securities | 279,657 | 12 | (620) | 279,049 | | 56,314 | 222,735 |
| Corporate securities | 381,446 | 1,279 | (209) | 382,516 | | 131,612 | 250,904 |
| Foreign government securities | 79,818 | 34 | (11) | 79,841 | | 48,180 | 31,661 |
| Total | \$ 1,043,781 | \$ 1,325 | \$ (840) | \$ 1,044,266 | \$ 203,579 | \$ 335,387 | \$ 505,300 |

- (1) As of February 28, 2014, there were \$0.2 million of accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 7 Derivative Instruments**

The Company transacts business in various foreign countries and is, therefore, subject to risk of foreign currency exchange rate fluctuations. The Company from time to time enters into forward contracts to economically hedge transactional exposure associated with commitments arising from trade accounts receivable, trade accounts payable and fixed purchase obligations denominated in a currency other than the functional currency of the respective operating entity. All derivative instruments are recorded on the Consolidated Balance Sheets at their respective fair market values. The Company has elected not to prepare and maintain the documentation required to qualify for hedge accounting treatment and, therefore, changes in fair value are recorded in the Consolidated Statements of Operations.

The effects of derivative instruments on the Company's Consolidated Financial Statements are as follows as of August 31, 2014 and for the three and six months then ended (in thousands):

| | | As of August 31, 2014 | | | Three Months Ended August 31, 2014 | Six Months Ended August 31, 2014 |
|--------------|--|--|---------------|-------------------|--|--|
| | | | Fair Value | Notional Value | Location of Gain (Loss) Recognized in Income on Derivatives | Amount of Gain (Loss) Recognized in Income on Derivatives |
| | | Balance Sheet Location | | | | |
| Assets | foreign currency forward contracts not designated as hedges | | | | Other income | |
| | | Other current assets | \$ 16 | \$ 4,441 | (expense), net | \$ 90 \$ 264 |
| Liabilities | foreign currency forward contracts not designated as hedges | | | | Other income | |
| | | Accounts payable and accrued expenses | (143) | 17,764 | (expense), net | (284) \$ (541) |
| TOTAL | | | \$ (127) | \$ 22,205 | | \$ (194) \$ (277) |

The effects of derivative instruments on the Company's Consolidated Financial Statements are as follows as of August 31, 2013 and for the three and six months then ended (in thousands):

| | | As of August 31, 2013 | | | Three Months Ended August 31, 2013 | Six Months Ended August 31, 2013 |
|--------|--|------------------------|---------------|-------------------|--|--|
| | | | Fair Value | Notional Value | Location of Gain (Loss) Recognized in Income on Derivatives | Amount of Gain (Loss) Recognized in Income on Derivatives |
| | | Balance Sheet Location | | | | |
| Assets | foreign currency forward contracts not designated as hedges | | | | Other income | |
| | | Other current assets | \$ 52 | \$ 13,544 | | \$ 298 \$ 623 |

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| | | | | | | | |
|---|---------------------------------------|---------|-----------|----------------|--------|----|---------|
| Liabilities | | | | (expense), net | | | |
| foreign currency forward contracts not designated as hedges | | | | Other income | | | |
| | Accounts payable and accrued expenses | (114) | 19,691 | (expense), net | (195) | \$ | (2,010) |
| TOTAL | | \$ (62) | \$ 33,235 | | \$ 103 | \$ | (1,387) |

NOTE 8 Share-based Awards

The Company measures share-based compensation cost at the grant date, based on the estimated fair value of the award and recognizes the cost over the employee requisite service period, typically on a straight-line basis, net of estimated forfeitures. The Company estimates the fair value of stock options using the Black-Scholes-Merton valuation model. The fair value of nonvested share awards, nonvested share units and performance share units are measured at their underlying closing share price on the day of grant.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following summarizes share-based compensation expense recognized in the Company's Consolidated Financial Statements for the three months and six months ended August 31, 2014 and August 31, 2013 (in thousands):

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------|--------------------|------------------|------------------|------------------|
| | August 31, 2014 | August 31, 2013 | August 31, 2014 | August 31, 2013 |
| Cost of revenue | \$ 3,425 | \$ 3,100 | \$ 6,543 | \$ 5,939 |
| Sales and marketing | 13,691 | 10,365 | 23,929 | 19,741 |
| Research and development | 11,098 | 9,058 | 19,962 | 15,939 |
| General and administrative | 8,391 | 7,351 | 14,885 | 11,387 |
| Total share-based compensation | \$ 36,605 | \$ 29,874 | \$ 65,319 | \$ 53,006 |

Share-based compensation expense qualifying for capitalization was insignificant for each of the three months and six months ended August 31, 2014 and August 31, 2013. Accordingly, no share-based compensation expense was capitalized during the three months and six months ended August 31, 2014 and August 31, 2013.

Estimated annual forfeitures An estimated forfeiture rate of 10.0% per annum, which approximates the Company's historical rate, was applied to options and nonvested share units. Awards are adjusted to actual forfeiture rates at vesting. The Company reassesses its estimated forfeiture rate annually or when new information, including actual forfeitures, indicate a change is appropriate.

During the three months and six months ended August 31, 2014, the Company granted the following share-based awards:

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|-----------------|------------------|-----------------|
| | August 31, 2014 | | August 31, 2014 | |
| | Shares and | Weighted | Shares and | Weighted |
| | Shares | Average | Shares | Average |
| | Underlying | Per Share | Underlying | Per Share |
| | Awards | Fair Value | Awards | Fair Value |
| Service-based shares and share units | 504,036 | \$ 54.85 | 1,584,742 | \$ 51.97 |
| Performance share units target (1) | 242,352 | \$ 58.28 | 695,218 | \$ 53.24 |
| Performance share awards (2) | | \$ | 184,325 | \$ 50.54 |
| Assumed (3) | | \$ | 219,169 | \$ 48.45 |
| Restricted shares issued as part of a business combination with continued employment service conditions (4) | 529,057 | \$ 54.75 | 529,057 | \$ 54.75 |
| Total awards | 1,275,445 | \$ 55.46 | 3,212,511 | \$ 52.38 |

- (1) Certain executives and senior management were awarded a target number of performance share units (PSUs). PSU grantees may earn up to 200% of the target number of PSUs. Half of the target number of PSUs can be earned by the grantees depending upon the Company's financial performance measured against the financial performance of specified peer companies during a three-year performance period

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beginning on March 1, 2014. The remaining target number of PSUs can be earned by the grantees depending upon the Company's total shareholder return performance measured against the total shareholder return of specified peer companies during a three-year period beginning on March 1, 2014.

During the three months ended August 31, 2014, certain executives were awarded a total of 242,352 PSUs that will pay out only if the price of the Company's common stock plus dividends payable increase by at least 50% within the next three years (TSR Hurdle PSUs). If the TSR Hurdle is achieved during the

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

Performance Period and the executive's business relationship has not ceased, 50% of the TSR Hurdle PSUs shall vest upon achievement of the TSR Hurdle and the remaining 50% of the TSR Hurdle PSUs shall vest on the last day of the four-year period beginning on the Grant Date. If the TSR Hurdle is not achieved on or before the last day of the Performance Period, then all TSR Hurdle PSUs are forfeited. If an executive's continuous service to the Company or its affiliates as an employee, consultant or director ceases for any reason prior to a vesting date for any TSR Hurdle PSUs, subject to certain exceptions, then all unvested TSR Hurdle PSUs will be forfeited.

- (2) Certain executives were granted restricted stock awards. These shares were awarded subject to the achievement of a specified dollar amount of revenue for FY2015 (the RSA Performance Goal). If the Company fails to achieve the RSA Performance Goal for FY2015, then all such shares are forfeited. If the Company achieves the RSA Performance Goal for FY2015, then 25% of the restricted stock vests on July 16, 2015, and the remainder vests ratably on a quarterly basis over the course of the subsequent three year period, provided that the grantee's business relationship with the Company has not ceased.
- (3) Amount represents partially-vested options assumed as part of a business combination.
- (4) As part of the Company's acquisition of eNovance, a total of 529,057 restricted common shares were issued to certain employee-shareholders. The vesting of these restricted shares is conditioned on continued employment with the Company. The shares effectively vest 25% per year and are being amortized on a straight-line basis to share-based compensation expense in the Company's Consolidated Statement of Operations.

NOTE 9 Earnings Per Share

The Company computes basic net income per common share by dividing net income available to common stockholders by the weighted average number of common shares outstanding. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares and dilutive potential common share equivalents then outstanding. Potential common share equivalents consist of shares issuable upon the exercise of stock options or vesting of share-based awards.

The following table reconciles the numerators and denominators of the earnings per share calculation for the three months and six months ended August 31, 2014 and August 31, 2013 (in thousands, except per share amounts):

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|--------------------|--------------------|--------------------|
| | August 31, 2014 | August 31, 2013 | August 31, 2014 | August 31, 2013 |
| Net income, basic and diluted | \$ 46,823 | \$ 40,808 | \$ 84,568 | \$ 81,199 |
| Weighted average common shares outstanding | 188,162 | 189,437 | 188,767 | 190,276 |
| Incremental shares attributable to assumed vesting or exercise of outstanding equity award shares | 2,593 | 1,995 | 2,368 | 1,954 |
| Diluted shares | 190,755 | 191,432 | 191,135 | 192,230 |
| Diluted net income per share | \$ 0.25 | \$ 0.21 | \$ 0.44 | \$ 0.42 |

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following share awards are not included in the computation of diluted earnings per share because the aggregate value of proceeds considered received upon either exercise or vesting was greater than the average market price of the Company's common stock during the related periods and the effect of including such share awards in the computation would be anti-dilutive (in thousands):

| | Three Months Ended | | Six Months Ended | |
|---|---------------------------|-------------------|-------------------------|-------------------|
| | August 31, | August 31, | August 31, | August 31, |
| | 2014 | 2013 | 2014 | 2013 |
| Number of shares considered anti-dilutive for calculating diluted EPS | 151 | 456 | 156 | 443 |

NOTE 10 Share Repurchase Program

On April 15, 2013, the Company announced that its Board of Directors had authorized the repurchase of up to \$300.0 million of Red Hat's common stock from time to time on the open market or in privately negotiated transactions. The program commenced on April 16, 2013, and will expire on the earlier of (i) March 31, 2015, or (ii) a determination by the Board, Chief Executive Officer or Chief Financial Officer to discontinue the program.

As of August 31, 2014, the amount available under the program for the repurchase of the Company's common stock was \$80.0 million.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 11 Segment Reporting**

The following summarizes revenue from unaffiliated customers and income (loss) from operations for the three months and six months ended August 31, 2014 and August 31, 2013 and total cash, cash equivalents and available-for-sale investment securities and total assets as of August 31, 2014 and August 31, 2013, by geographic segment (in thousands):

| | Americas | EMEA | Asia Pacific | Corporate (1) | Consolidated |
|---|--------------|------------|--------------|---------------|--------------|
| Three Months Ended August 31, 2014 | | | | | |
| Revenue from unaffiliated customers | \$ 282,138 | \$ 103,496 | \$ 60,265 | \$ | \$ 445,899 |
| Income (loss) from operations | \$ 60,081 | \$ 26,066 | \$ 14,685 | \$ (36,605) | \$ 64,227 |
| Three Months Ended August 31, 2013 | | | | | |
| Revenue from unaffiliated customers | \$ 237,647 | \$ 86,239 | \$ 50,537 | \$ | \$ 374,423 |
| Income (loss) from operations | \$ 47,021 | \$ 25,023 | \$ 13,404 | \$ (29,874) | \$ 55,574 |
| Six Months Ended August 31, 2014 | | | | | |
| Revenue | \$ 548,232 | \$ 204,270 | \$ 117,151 | \$ | \$ 869,653 |
| Income (loss) from operations | \$ 101,473 | \$ 50,251 | \$ 28,785 | \$ (65,319) | \$ 115,190 |
| Cash, cash equivalents and available-for-sale investment securities | \$ 621,806 | \$ 500,050 | \$ 195,087 | \$ | \$ 1,316,943 |
| Total assets | \$ 2,055,521 | \$ 720,493 | \$ 291,290 | \$ | \$ 3,067,304 |
| Six Months Ended August 31, 2013 | | | | | |
| Revenue | \$ 471,074 | \$ 166,289 | \$ 100,319 | \$ | \$ 737,682 |
| Income (loss) from operations | \$ 94,028 | \$ 45,528 | \$ 25,647 | \$ (53,006) | \$ 112,197 |
| Cash, cash equivalents and available-for-sale investment securities | \$ 679,632 | \$ 426,528 | \$ 184,511 | \$ | \$ 1,290,671 |
| Total assets | \$ 1,955,098 | \$ 562,819 | \$ 221,664 | \$ | \$ 2,739,581 |

(1) Amounts represent share-based compensation expense for each of the three months and six months ended August 31, 2014 and August 31, 2013, which was not allocated to geographic segments.

Supplemental information about geographic areas

The following table lists, for each of the three months and six months ended August 31, 2014 and August 31, 2013, revenue from unaffiliated customers in the United States, the Company's country of domicile, and revenue from unaffiliated customers from foreign countries (in thousands):

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|-------------------|-------------------------|-------------------|
| | August 31, | August 31, | August 31, | August 31, |
| | 2014 | 2013 | 2014 | 2013 |
| United States, the Company's country of domicile | \$ 247,556 | \$ 208,394 | \$ 481,863 | \$ 413,087 |

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| | | | | |
|---|------------|------------|------------|------------|
| Foreign | 198,343 | 166,029 | 387,790 | 324,595 |
| Total revenue from unaffiliated customers | \$ 445,899 | \$ 374,423 | \$ 869,653 | \$ 737,682 |

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

Total tangible long-lived assets located in the United States, the Company's country of domicile, and similar tangible long-lived assets held outside the United States are summarized in the following table as of August 31, 2014 and February 28, 2014 (in thousands):

| | As of August 31, 2014 | As of February 28, 2014 |
|--|-----------------------------|-------------------------------|
| United States, the Company's country of domicile | \$ 134,887 | \$ 137,356 |
| Foreign | 40,957 | 36,561 |
| Total tangible long-lived assets | \$ 175,844 | \$ 173,917 |

Supplemental information about major customers

For each of the three months and six months ended August 31, 2014, the U.S. government and its agencies represented approximately 10% of the Company's total revenue. For each of the three months and six months ended August 31, 2013, the U.S. government and its agencies represented approximately 9% of the Company's total revenue.

Supplemental information about products and services

The following table, for each of the three and six months ended August 31, 2014 and August 31, 2013, provides further detail, by type, of our subscription and services revenues. Infrastructure-related offerings subscription revenue includes subscription revenue generated from Red Hat Enterprise Linux and related technologies such as Red Hat Enterprise Virtualization. Subscription revenue generated from our Application development-related and other emerging technology offerings includes Red Hat JBoss Middleware, Red Hat Storage Server and Red Hat cloud offerings such as OpenStack and OpenShift (in thousands):

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|--------------------|--------------------|--------------------|
| | August 31, 2014 | August 31, 2013 | August 31, 2014 | August 31, 2013 |
| Subscription revenue: | | | | |
| Infrastructure-related offerings | \$ 331,967 | \$ 286,869 | \$ 651,018 | \$ 566,139 |
| Applications development-related and other emerging technology offerings | 57,528 | 39,823 | 110,444 | 76,370 |
| Total subscription revenue | 389,495 | 326,692 | 761,462 | 642,509 |
| Training and services revenue: | | | | |
| Consulting services | 41,917 | 35,144 | 80,991 | 69,548 |
| Training | 14,487 | 12,587 | 27,200 | 25,625 |
| Total training and services revenue | 56,404 | 47,731 | 108,191 | 95,173 |
| Total revenue | \$ 445,899 | \$ 374,423 | \$ 869,653 | \$ 737,682 |

NOTE 12 Commitments and Contingencies

Operating leases

As of August 31, 2014, the Company leased office space and certain equipment under various non-cancelable operating leases. Rent expense under operating leases for the three months ended August 31, 2014 and August 31, 2013 was \$7.5 million and \$7.2 million, respectively. Rent expense under operating leases for the six months ended August 31, 2014 and August 31, 2013 was \$15.0 million and \$14.4 million, respectively.

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Product indemnification

The Company is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party from losses arising in connection with the Company's services or products, or from losses arising in connection with certain events defined within a particular contract, which may include litigation or claims relating to intellectual property infringement, certain losses arising from damage to property or injury to persons or other matters. In each of these circumstances, payment by the Company is conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically allow the Company to challenge the other party's claims. Further, the Company's obligations under these agreements may in certain cases be limited in terms of time and/or amount, and in some instances, the Company may have recourse against third-parties for certain payments made by the Company.

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the Company's obligations and the facts and circumstances involved in each particular agreement. The Company does not record a liability for claims related to indemnification unless the Company concludes that the likelihood of a material claim is probable and estimable. Historically, payments pursuant to these indemnifications have been immaterial.

NOTE 13 Legal Proceedings

The Company experiences routine litigation in the normal course of its business, including patent litigation. The Company presently believes that the outcome of this routine litigation will not have a material adverse effect on its financial position, results of operations or cash flows.

NOTE 14 Business Combinations

Acquisition of eNovance, SAS

On June 24, 2014, the Company completed its acquisition of all of the shares of eNovance, SAS (eNovance), a provider of open source cloud computing services. The acquisition is intended to assist in advancing the Company's market position in OpenStack, and the addition of eNovance's systems integration capabilities and engineering talent is expected to help meet growing demand for enterprise OpenStack consulting, design and deployment.

The cash consideration paid as of the closing date was \$68.3 million. Based on management's provisional assessment of the acquisition date fair value of the assets acquired and liabilities assumed, the total cash consideration transferred of \$68.3 million has been allocated to the Company's assets on a preliminary basis as follows: \$53.0 million to goodwill, \$14.4 million to identifiable intangible assets and the remaining \$0.9 million to working capital.

In addition to the cash consideration transferred, the Company issued a total of 529,057 restricted common shares to certain employee-shareholders. The vesting of these restricted shares is conditioned on continued employment with the Company. As a result of the employment condition, the transfer of these shares has been accounted for separate from the business combination. The shares effectively vest 25% per year, with the closing-date fair value of the shares being amortized, on a straight-line basis, to share-based compensation expense in the Company's Consolidated Statement of Operations.

The Company incurred approximately \$0.9 million in transaction costs including legal and accounting fees relating to the acquisition. These transaction costs have been expensed as incurred and included in general and administrative expense on the Company's Consolidated Statement of Operations for the three and six months ended August 31, 2014.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)***Acquisition of Inktank Storage, Inc.*

On April 30, 2014, the Company completed its acquisition of all of the shares of Inktank Storage, Inc. (Inktank), a provider of scale-out, open source storage systems, whose flagship technology, Inktank Ceph Enterprise, delivers object and block storage software to enterprises deploying public or private clouds. The acquisition is intended to complement the Company's existing GlusterFS-based storage offering. Under the terms of the purchase agreement, the consideration transferred by the Company totaled \$152.5 million. The Company incurred approximately \$2.0 million in transaction costs including legal and accounting fees relating to the acquisition. These transaction costs have been expensed as incurred and included in general and administrative expense on the Company's Consolidated Statement of Operations for the six months ended August 31, 2014.

The total consideration transferred by the Company in connection with the acquisition is summarized in the following table (in thousands):

| | Total Consideration Transferred |
|--|--|
| Cash consideration paid to and/or on behalf of holders of Inktank stock and vested options | \$ 151,648 |
| Fair value of nonvested employee share-based awards assumed and attributed to pre-combination services (1) | 895 |
| Total consideration transferred (2) | \$ 152,543 |

- (1) The total fair value, as of April 30, 2014, of all assumed nonvested share-based awards was \$10.6 million, of which \$0.9 million has been attributed to pre-acquisition employee services and accordingly has been recognized as consideration transferred. The remaining \$9.7 million of fair value will be recognized as compensation expense over the remaining vesting period ranging from 1 month to approximately 4 years.
- (2) In addition to the consideration transferred of \$152.5 million and the assumed nonvested share-based awards with an acquisition-date fair value of \$10.6 million, the Company has committed to pay retention incentives totaling \$8.4 million in cash (payable 25% annually from the date of acquisition assuming continued employment). The Company has also committed to granting key employees share-based awards with a combined value \$15.0 million which will vest 25% annually from the date of grant.

The table below represents the estimated tangible and identifiable intangible assets and liabilities (in thousands) based on management's provisional assessment of the acquisition date fair value of the assets acquired and liabilities assumed. The Company expects to finalize its assessment of the acquisition-date fair value of assets acquired and liabilities assumed by the end of its third quarter in fiscal 2015:

| | Total Consideration Allocated |
|---|--|
| Identifiable intangible assets (see detail below) | \$ 10,770 |
| Cash | 27 |
| Accounts receivable | 657 |
| Deferred tax assets, net | 11,550 |
| Other assets | 161 |

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| | |
|--------------------------------------|-------------------|
| Accrued liabilities | (1,651) |
| Deferred revenue | (1,016) |
| Goodwill | 132,045 |
| Total consideration allocated | \$ 152,543 |

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table summarizes the allocation of consideration transferred to identifiable intangible assets (in thousands). The fair value of the identifiable intangible assets is being amortized over the estimated useful life of each intangible asset on a straight-line basis which approximates the economic pattern of benefits:

| | Amortization Expense Type | Estimated Life (Years) | Total |
|---|----------------------------------|-------------------------------|------------------|
| Customer relationships | Sales and marketing | 5 | \$ 6,800 |
| Tradenames and trademarks | General and administrative | Indefinite | 3,300 |
| Covenants not to compete | Research and development | 3 | 370 |
| Developed technology | Cost of revenue | 5 | 300 |
| Total identifiable intangible assets | | | \$ 10,770 |

Pro forma consolidated financial information

The following unaudited pro forma consolidated financial information reflects the results of operations of the Company for the three and six months ended August 31, 2014 and August 31, 2013 (in thousands, except per share amounts) as if the acquisitions of eNovance and Inktank had closed on March 1, 2013, after giving effect to certain purchase accounting adjustments. These pro forma results are not necessarily indicative of what the Company's operating results would have been had the acquisitions actually taken place at the beginning of the period.

| | Three Months Ended | | Six Months Ended | |
|-------------------------------------|---------------------------|------------------------|-------------------------|------------------------|
| | August 31, 2014 | August 31, 2013 | August 31, 2014 | August 31, 2013 |
| Revenue | \$ 446,558 | \$ 377,341 | \$ 873,255 | \$ 743,236 |
| Net income | 45,634 | 36,868 | 78,181 | 74,382 |
| Basic net income per common share | \$ 0.24 | \$ 0.19 | \$ 0.41 | \$ 0.39 |
| Diluted net income per common share | \$ 0.24 | \$ 0.19 | \$ 0.41 | \$ 0.39 |

Post-acquisition financial information

The following is a summary of eNovance's and Inktank's combined post-acquisition revenue, expenses and losses that are included in the Company's Consolidated Statement of Operations for the three and six months ended August 31, 2014 (in thousands):

| | Three Months Ended August 31, 2014 | Six Months Ended August 31, 2014 |
|--------------------|---|---|
| Revenue | \$ 2,531 | \$ 2,717 |
| Operating expenses | (7,490) | (9,333) |
| Operating loss | (4,959) | (6,616) |
| Other income | 95 | 95 |

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| | | |
|-------------------------|------------|------------|
| Loss before tax benefit | (4,864) | (6,521) |
| Tax benefit | 1,411 | 1,891 |
| Net loss | \$ (3,453) | \$ (4,630) |

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)***Goodwill*

The following is a summary of changes in goodwill for the six months ended August 31, 2014 (in thousands):

| | |
|---|-------------------|
| Balance at February 28, 2014 | \$ 687,430 |
| Acquisition of Inktank | 132,045 |
| Acquisition of eNovance | 52,988 |
| Impact of foreign currency fluctuations | (2,400) |
| Balance at August 31, 2014 | \$ 870,063 |

NOTE 15 Subsequent Event

On September 18, 2014, the Company announced the signing of a definitive agreement to acquire all of the shares of FeedHenry for approximately 63.5 million Euros. FeedHenry is a provider of cloud-based enterprise mobile application platforms. The acquisition is intended to expand the Company's portfolio of application development, integration and platform-as-a-service (PaaS) solutions, enabling it to support mobile application development in public and private environments. The acquisition is expected to close in the third quarter of fiscal 2015.

Table of Contents

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
OVERVIEW**

We are a leading global provider of open source software solutions, using a community-powered approach to develop and offer reliable and high-performing operating system, virtualization, middleware, storage and cloud technologies.

Open source software is an alternative to proprietary software and represents a different model for the development and licensing of commercial software code than that typically used for proprietary software. Because open source software code is often freely shared, there are customarily no licensing fees for the use of open source software. Therefore, we do not recognize revenue from the licensing of the code itself. We provide value to our customers through the development, aggregation, integration, testing, certification, delivery, maintenance, enhancement and support of our Red Hat enterprise technologies, and by providing a level of performance, reliability, scalability, flexibility, stability and security for the enterprise technologies we package and distribute. Moreover, because communities of developers not employed by us assist with the creation of our open source offerings, opportunities for further innovation of our offerings are supplemented by these communities.

We market our offerings primarily to enterprise customers in the form of annual or multi-year subscriptions, and we recognize revenue over the period of the subscription agreements with our customers. Our enterprise technologies are also offered by cloud providers as a service available on demand, and this revenue is reported to and recognized by us following delivery.

We have focused on introducing and gaining acceptance for Red Hat enterprise technologies that comprise our open source architecture. Red Hat Enterprise Linux (RHEL) and Red Hat JBoss Middleware offerings have gained widespread independent software vendor (ISV) and independent hardware vendor (IHV) support. We have continued to build our open source architecture by expanding our enterprise operating system and middleware offerings and introducing virtualization, storage, cloud and other offerings.

We derive our revenue and generate cash from customers primarily from two sources: (i) subscription revenue and (ii) training and services revenue. These arrangements typically involve subscriptions to Red Hat enterprise technologies. Our revenue is affected by, among other factors, corporate, government and consumer spending levels. In evaluating the performance of our business, we consider a number of factors, including total revenue, deferred revenue, operating income, operating margin and cash flows from operations.

The arrangements with our customers that produce this revenue and cash are explained in further detail in Part II, Item 7 under "Critical Accounting Estimates" and in NOTE 2 "Summary of Significant Accounting Policies to the Consolidated Financial Statements of our Annual Report on Form 10-K for the fiscal year ended February 28, 2014.

In our fiscal year ended February 28, 2014, we focused on and expect in our fiscal year ending February 28, 2015 to continue to focus on, among other things, (i) promoting the widespread adoption of Red Hat enterprise offerings by enterprise customers globally, (ii) expanding our virtualization, storage, cloud and other enterprise offerings, (iii) investing in the development of open source technologies, (iv) increasing revenue from our existing customer base, (v) increasing revenue by promoting a range of services to help our customers derive additional value, (vi) expanding routes to market, (vii) growing our presence in international markets, and (viii) pursuing strategic acquisitions and alliances.

Revenue

For the three months ended August 31, 2014, total revenue increased 19.1%, or \$71.5 million, to \$445.9 million from \$374.4 million for the three months ended August 31, 2013. Subscription revenue increased 19.2%,

Table of Contents

or \$62.8 million, driven primarily by additional subscriptions related to our principal Red Hat Enterprise Linux and Red Hat JBoss Middleware offerings, which continue to gain broader market acceptance in mission-critical areas of computing, and our expansion of sales channels and our geographic footprint. The increase is, in part, a result of the continued migration of enterprises in industries such as financial services, government, technology and telecommunications to our open source solutions from proprietary technologies. Training and services revenue increased 18.2%, or \$8.7 million, for the three months ended August 31, 2014 as compared to the three months ended August 31, 2013. The increase is driven primarily by customer interest in new products and increased demand for our open source solutions.

We believe our success is influenced by:

the extent to which we can expand the breadth and depth of our enterprise offerings;

our ability to enhance the value of Red Hat enterprise offerings through frequent and continuing innovation while maintaining stable platforms over multi-year periods;

our ability to generate increasing revenue from channel partner and other strategic relationships, including cloud computing providers, distributors, IHVs, ISVs, hardware original equipment manufacturers, systems integrators and value added resellers;

our ability to generate new and recurring revenue for Red Hat enterprise offerings;

the widespread and increasing deployment of open source technologies by enterprises and similar institutions, such as government agencies and universities; and

our ability to provide customers with consulting and training services that generate additional revenue.

Deferred revenue and billings proxy

Our deferred revenue, current and long-term, balance at August 31, 2014 was \$1.25 billion. Because of our subscription model and revenue recognition policies, deferred revenue improves predictability of future revenue. For example, current deferred revenue provides a baseline for revenue to be recognized over the next twelve months. Similarly, long-term deferred revenue provides a baseline for revenue to be recognized beyond twelve months. Revenue derived from cloud providers for the delivery of our enterprise technologies as a service available on demand is recognized by us following delivery and not billed in advance. As a result, such revenue has no associated deferred revenue. Total deferred revenue at August 31, 2014 decreased \$37.4 million, or 2.9%, as compared to the balance at February 28, 2014 of \$1.29 billion.

The decrease in deferred revenue reported on our Consolidated Balance Sheets of \$37.4 million differs from the decrease we reported on our Consolidated Statements of Cash Flows for the six months ended August 31, 2014 of \$26.0 million as the amount reported on our Consolidated Statements of Cash Flows for the six months ended August 31, 2014 excludes (i) the impact of changes in foreign currency exchange rates used to translate deferred revenue balances from our foreign subsidiaries' functional currency into U.S. dollars and (ii) deferred revenue acquired as parts of business combinations.

Billings proxy

We approximate our quarterly billings by adding revenue recognized on our Consolidated Statements of Operations to the change in total deferred revenue reported on our Consolidated Statements of Cash Flows. We use the change in deferred revenue as reported on our Consolidated Statements of Cash Flows because the amount has been adjusted for the impact of changes in foreign currency exchange rates used to translate deferred revenue balances from our foreign subsidiaries' functional currencies into U.S. dollars.

For the four-fiscal-quarter period ended August 31, 2014 our rolling average billings proxy increased \$76.4 million, or 19.6%, to \$465.3 million from \$388.9 million for the four-fiscal-quarter period ended August 31, 2013. For information regarding seasonality, see Part II, Item 7 under

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Overview of our Annual Report on Form 10-K for the fiscal year ended February 28, 2014.

Table of Contents**Subscription revenue**

Our enterprise technologies are sold primarily under subscription agreements. These agreements typically have a one- or three-year subscription period. A subscription generally entitles a customer to, among other things, a specified level of support, as well as new versions of the software, security updates, fixes, functionality enhancements and upgrades to the technology, if and when available, and compatibility with an ecosystem of certified hardware and software applications. Subscription revenue increased sequentially for the first and second quarters of fiscal 2015 and for each quarter of fiscal 2014 and fiscal 2013 and is being driven primarily by the increased use of our offerings by the enterprise and our expansion of sales channels and geographic footprint during these periods.

Revenue by geography

For the three months ended August 31, 2014, approximately \$198.3 million, or 44.5%, of our revenue was generated outside the United States compared to approximately \$166.0 million, or 44.3%, for the three months ended August 31, 2013. Our international operations are expected to grow as our international sales force and channels become more mature and as we enter new locations or expand our presence in existing locations. As of August 31, 2014, we had offices in more than 80 locations throughout the world.

We operate our business in three geographic regions: the Americas (U.S., Latin America and Canada); EMEA (Europe, Middle East and Africa); and Asia Pacific (principally Australia, China, India, Japan, Singapore and South Korea). Revenue generated by the Americas, EMEA and Asia Pacific for the three months ended August 31, 2014 and the three months ended August 31, 2013 was as follows (in thousands):

| | Americas | EMEA | Asia Pacific | Consolidated |
|------------------------------------|------------|------------|--------------|--------------|
| Three Months Ended August 31, 2014 | \$ 282,138 | \$ 103,496 | \$ 60,265 | \$ 445,899 |
| Three Months Ended August 31, 2013 | \$ 237,647 | \$ 86,239 | \$ 50,537 | \$ 374,423 |

Year-over-year revenue growth rates in U.S. dollars for our three geographical regions were as follows for the three months ended August 31, 2014 and three months ended August 31, 2013:

| | Americas | EMEA | Asia Pacific | Consolidated |
|------------------------------------|----------|-------|--------------|--------------|
| Three Months Ended August 31, 2014 | 18.7% | 20.0% | 19.2% | 19.1% |
| Three Months Ended August 31, 2013 | 13.6% | 29.0% | 8.4% | 16.1% |

Excluding the impact of foreign currency exchange rates, Americas, EMEA and Asia Pacific revenue grew 19.5%, 17.4% and 19.9%, respectively, for the three months ended August 31, 2014 as compared to the three months ended August 31, 2013.

As we expand further within each region, we anticipate revenue growth rates in local currencies to be similar among our geographic regions due to the similarity of products and services offered and the similarity in customer types or classes.

Gross profit

Gross profit margin decreased to 84.9% for the three months ended August 31, 2014 from 85.2% for the three months ended August 31, 2013 primarily due to increased staffing cost to support our emerging cloud offerings, such as OpenStack and OpenShift.

Table of Contents**Gross profit margin by geography**

Gross profit margins by our geographic regions for the three months ended August 31, 2014 and August 31, 2013 were as follows:

| | Americas | EMEA | Asia Pacific | Consolidated (1) |
|------------------------------------|----------|-------|--------------|------------------|
| Three Months Ended August 31, 2014 | 85.1% | 88.1% | 84.3% | 84.9% |
| Three Months Ended August 31, 2013 | 85.1% | 89.7% | 83.7% | 85.2% |

- (1) Consolidated gross margin includes corporate (non-allocated) share-based compensation expense for the three months ended August 31, 2014 and August 31, 2013 of \$3.4 million and \$3.1 million, respectively. For additional information see NOTE 8 Share-based Awards to our Consolidated Financial Statements.

Regional year-over-year variations in gross profit margins are primarily due to slight product mix shifts between subscriptions and services.

As we continue to expand our sales and support services within our geographic regions, we expect gross profit margins across geographic regions to further converge over the long run due to the similarity of products and services offered, similarity in production and distribution methods and the similarity in customer types or classes. These geographic profit margins exclude the impact of share-based compensation expense, which was not allocated to our geographic regions.

Income from operations

Operating income was 14.4% and 14.8% of total revenue for the three months ended August 31, 2014 and August 31, 2013, respectively. The decrease in operating income as a percentage of revenue was primarily due to continued investment in new and emerging cloud management technologies and incremental transaction costs related to business combinations. These investments are described further in our analysis of results of operations below.

Income from operations by geography

Operating income as a percentage of revenue generated by our geographic regions for the three months ended August 31, 2014 and the three months ended August 31, 2013 was as follows:

| | Americas | EMEA | Asia Pacific | Consolidated (1) |
|------------------------------------|----------|-------|--------------|------------------|
| Three Months Ended August 31, 2014 | 21.3% | 25.2% | 24.4% | 14.4% |
| Three Months Ended August 31, 2013 | 19.8% | 29.0% | 26.5% | 14.8% |

- (1) Consolidated operating income as a percentage of revenue includes corporate (non-allocated) share-based compensation expense for the three months ended August 31, 2014 and August 31, 2013 of \$36.6 million and \$29.9 million, respectively. For additional information, see NOTE 11 Segment Reporting to our Consolidated Financial Statements.

Operating margin for EMEA and Asia Pacific decreased for the three months ended August 31, 2014 as compared to the three months ended August 31, 2013 primarily as a result of increased investments in research and development to support new technologies such as cloud management.

These geographic operating margins exclude the impact of share-based compensation expense, which was not allocated to our geographic segments.

Cash, cash equivalents, available-for-sale investments in debt securities and cash flow from operations

Cash, cash equivalents and short-term and long-term available-for-sale investments in debt securities balances at August 31, 2014 totaled \$1.32 billion. Cash generated from operating activities for the three months ended August 31, 2014 totaled \$107.7 million which represents a decrease

of 9.4% in operating cash flow as

Table of Contents

compared to the three months ended August 31, 2013. This decrease is due to the timing of billing and collections and the timing of accounts payable settlements during the same periods.

Our significant cash and investment balances give us a measure of flexibility to take advantage of opportunities such as acquisitions, increasing investment in international areas and repurchasing our common stock.

Foreign currency exchange rates impact on results of operations

Approximately 44.5% of our revenue for the three months ended August 31, 2014 was produced by sales outside the United States. We are exposed to significant risks of foreign currency fluctuation primarily from receivables denominated in foreign currency and are subject to transaction gains and losses, which are recorded as a component of net income. The income statements of our non-U.S. operations are translated into U.S. dollars at the average exchange rates for each applicable month in a period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign-currency-denominated transactions results in increased revenue and operating expenses from operations for our non-U.S. operations. Similarly, our revenue and operating expenses will decrease for our non-U.S. operations if the U.S. dollar strengthens against foreign currencies.

Three Months Ended August 31, 2014

Using the average foreign currency exchange rates from the second quarter of our prior fiscal year ended February 28, 2014, our revenue and operating expenses from non-U.S. operations for the three months ended August 31, 2014 would have been lower than we reported by approximately \$0.1 million and higher than we reported by approximately \$0.5 million, respectively, which would have resulted in income from operations being lower by \$0.6 million.

Six Months Ended August 31, 2014

Using the average foreign currency exchange rates for the six months ended August 31, 2013, our revenue and operating expenses from non-U.S. operations for the six months ended August 31, 2014 would have been lower and higher than we reported by approximately \$0.7 million and \$1.7 million, respectively, which would have resulted in income from operations being lower by \$2.4 million.

Business combinations

eNovance

On June 24, 2014, we completed our acquisition of all of the shares of eNovance, a provider of open source cloud computing services. The acquisition is intended to assist in advancing our market position in OpenStack, and the addition of eNovance's systems integration capabilities and engineering talent is expected to help meet growing demand for enterprise OpenStack consulting, design and deployment. We incurred approximately \$0.9 million in transaction costs including legal and accounting fees relating to the acquisition. These transaction costs have been expensed as incurred and included in general and administrative expense on our Consolidated Statement of Operations for the three and six months ended August 31, 2014.

Inktank

On April 30, 2014, we completed our acquisition of all of the shares of Inktank, a provider of scale-out, open source storage systems, whose flagship technology, Inktank Ceph Enterprise, delivers object and block storage software to enterprises deploying public or private clouds. The acquisition is intended to complement our existing GlusterFS-based storage offering. We incurred approximately \$2.0 million in acquisition-related expenses, including legal and accounting fees. These costs have been expensed as incurred and are included in general and administrative expense on our Consolidated Statement of Operations for the six months ended August 31, 2014.

Table of Contents

As a result of the acquisitions of Inktank and eNovance, operating expenses, other than acquisition-related expenses described above, increased by approximately \$7.5 million and \$9.3 million, respectively, for the three months and six months ended August 31, 2014 as compared to the three months and six months ended August 31, 2013. For further discussion, see NOTE 14 Business Combinations to our Consolidated Financial Statements.

On September 18, 2014, we announced the signing of a definitive agreement to acquire all of the shares of FeedHenry for approximately 63.5 million Euros. FeedHenry is a provider of cloud-based enterprise mobile application platforms. The acquisition is intended to expand our portfolio of application development, integration and platform-as-a-service (PaaS) solutions, enabling us to support mobile application development in public and private environments. The acquisition is expected to close in the third quarter of fiscal 2015.

Table of Contents**RESULTS OF OPERATIONS****Three months ended August 31, 2014 and August 31, 2013**

The following table is a summary of our results of operations for the three months ended August 31, 2014 and August 31, 2013 (in thousands):

| | Three Months Ended (Unaudited) | | \$ Change | % Change |
|--|-----------------------------------|--------------------|--------------|-------------|
| | August 31, 2014 | August 31, 2013 | | |
| Revenue: | | | | |
| Subscriptions | \$ 389,495 | \$ 326,692 | \$ 62,803 | 19.2% |
| Training and services | 56,404 | 47,731 | 8,673 | 18.2 |
| Total subscription and training and services revenue | 445,899 | 374,423 | 71,476 | 19.1 |
| Cost of subscription and training and services revenue: | | | | |
| Cost of subscriptions | 27,791 | 23,518 | 4,273 | 18.2 |
| As a % of subscription revenue | 7.1% | 7.2% | | |
| Cost of training and services | 39,383 | 32,062 | 7,321 | 22.8 |
| As a % of training and services revenue | 69.8% | 67.2% | | |
| Total cost of subscription and training and services revenue | 67,174 | 55,580 | 11,594 | 20.9 |
| As a % of total revenue | 15.1% | 14.8% | | |
| Total gross profit | 378,725 | 318,843 | 59,882 | 18.8 |
| Operating expense: | | | | |
| Sales and marketing | 174,520 | 144,596 | 29,924 | 20.7 |
| Research and development | 95,265 | 78,299 | 16,966 | 21.7 |
| General and administrative | 44,713 | 38,203 | 6,510 | 17.0 |
| Facility exit costs | | 2,171 | (2,171) | (100.0) |