RED HAT INC
Form 10-Q
July 09, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended May 31, 2018
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)

Delaware	06-1364380
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer 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 x 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 x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	¨
		Emerging growth company	¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:
As of July 3, 2018, there were 177,373,891 shares of common stock outstanding.

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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," "outlook," "plan," "project," "will," and similar expressions, ma 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.

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PART I

ITEM 1. FINANCIAL STATEMENTS

RED HAT, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands—except share and per share amounts)

	May 31, 2018 (Unaudited)	February 28, 2018 (1)
ASSETS		
Current assets:		
Cash, cash equivalents and restricted cash	$1,768,480	$1,724,132
Investments in debt and equity securities, short-term	329,872	318,358
Accounts receivable, net of allowances for doubtful accounts of $2,566 and $2,167, respectively	498,964	806,744
Prepaid expenses	247,175	267,197
Other current assets	61,123	25,666
Total current assets	2,905,614	3,142,097
Property and equipment, net of accumulated depreciation and amortization of $281,523 and $269,429, respectively	196,653	206,105
Goodwill	1,278,708	1,288,830
Identifiable intangibles, net	220,176	224,953
Investments in debt securities, long-term	428,777	430,442
Deferred tax assets, net	82,826	92,606
Other assets, net	78,807	89,460
Total assets	$5,191,561	$5,474,493
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$359,706	$427,139
Deferred revenue, short-term	1,721,300	1,853,719
Other current obligations	685	843
Convertible notes	194,544	23,806
Total current liabilities	2,276,235	2,305,507
Deferred revenue, long-term	723,207	741,453
Convertible notes	554,503	744,194
Other long-term obligations	205,672	205,215
Commitments and contingencies (NOTES 9 and 10)		
Stockholders' equity:		
Preferred stock, $0.0001 per share par value, 5,000,000 shares authorized, none outstanding	—	—
Common stock, $0.0001 per share par value, 300,000,000 shares authorized, 239,779,276 and 238,688,708 shares issued, and 177,472,140 and 177,073,904 shares outstanding, respectively	24	24
Additional paid-in capital	2,399,925	2,416,080
Retained earnings	1,733,270	1,619,688
Treasury stock, at cost, 62,307,136 and 61,614,804 shares, respectively	(2,657,774)	(2,525,072)
Accumulated other comprehensive loss	(43,501)	(32,596)
Total stockholders' equity	1,431,944	1,478,124
Total liabilities and stockholders' equity	$5,191,561	$5,474,493

(1) Derived from audited financial statements except for line items adjusted by the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

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

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RED HAT, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands—except per share amounts)
(Unaudited)

	Three Months Ended	
	May 31, 2018	May 31, 2017 (1)
Revenue:		
Subscriptions	$711,521	$596,508
Training and services	102,009	80,288
Total revenue	813,530	676,796
Cost of revenue:		
Subscriptions	52,173	43,633
Training and services	70,526	57,063
Total cost of revenue	122,699	100,696
Gross profit	690,831	576,100
Operating expense:		
Sales and marketing	348,815	294,323
Research and development	166,506	137,163
General and administrative	63,354	54,870
Total operating expense	578,675	486,356
Income from operations	112,156	89,744
Interest income	7,834	3,993
Interest expense	6,319	6,085
Other expense, net	(2,194)	(586)
Income before provision for income taxes	111,477	87,066
(Benefit) provision for income taxes	(1,713)	11,752
Net income	$113,190	$75,314
Net income per share:		
Basic	$0.64	$0.42
Diluted	$0.59	$0.41
Weighted average shares outstanding:		
Basic	177,302	177,243
Diluted	190,739	181,810

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

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

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RED HAT, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(Unaudited)

	Three Months Ended	
	May 31, 2018	May 31, 2017 (1)
Net income	$113,190	$75,314
Other comprehensive income (loss):		
Change in foreign currency translation adjustment	(10,831)	22,670
Available-for-sale securities:		
Unrealized gain on available-for-sale securities during the period	38	164
Reclassification for gain realized on available-for-sale securities, reported in Other expense, net	(128)	—
Tax benefit (expense)	16	(222)
Net change in available-for-sale securities (net of tax)	(74)	(58)
Total other comprehensive (loss) income	(10,905)	22,612
Comprehensive income	$102,285	$97,926

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

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

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RED HAT, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

	Three Months Ended	
	May 31, 2018	May 31, 2017 (1)
Cash flows from operating activities:		
Net income	$113,190	$75,314
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	27,054	21,817
Amortization of debt discount and transaction costs	5,838	5,540
Deferred income taxes	(3,395)	7,917
Share-based compensation expense	46,005	43,718
Net amortization of bond premium on debt securities available for sale	743	2,436
Other	1,097	961
Changes in operating assets and liabilities:		
Accounts receivable	299,439	208,761
Other receivables	(35,160)	(19,397)
Prepaid expenses	25,382	12,024
Accounts payable and accrued expenses	(28,642)	(55,326)
Deferred revenue	(104,592)	(45,717)
Other	(800)	(176)
Net cash provided by operating activities	346,159	257,872
Cash flows from investing activities:		
Purchase of investment in debt securities available for sale	(108,336)	(149,524)
Proceeds from maturities of investment in debt securities available for sale	87,004	112,041
Proceeds from sales of investment in debt securities available for sale	525	14,324
Proceeds from sales of strategic equity investments	1,300	—
Purchase of developed software and other intangible assets	(2,866)	(1,774)
Purchase of property and equipment	(12,963)	(25,900)
Other	(986)	—
Net cash used in investing activities	(36,322)	(50,833)
Cash flows from financing activities:		
Proceeds from exercise of common stock options	875	2,968
Proceeds from employee stock purchase program	15,262	11,761
Payments related to net settlement of share-based compensation awards	(77,094)	(41,010)
Purchase of treasury stock	(150,019)	(61,987)
Payments on other borrowings	(299)	(443)
Repayments of convertible notes	(25,953)	—
Net cash used in financing activities	(237,228)	(88,711)
Effect of foreign currency exchange rates on cash, cash equivalents and restricted cash	(28,261)	21,321
Net increase in cash, cash equivalents and restricted cash	44,348	139,649
Cash, cash equivalents and restricted cash at beginning of the period	1,724,132	1,090,808
Cash, cash equivalents and restricted cash at end of the period	$1,768,480	$1,230,457
Restricted cash included in cash, cash equivalents and restricted cash	$1,137	$3,112

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

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

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, management, middleware, cloud, mobile and storage 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, generally, is 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 technologies, and by providing a level of performance, scalability, flexibility, reliability and security for the 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 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.

NOTE 2—Summary of Significant Accounting Policies

Basis of presentation

The unaudited interim consolidated financial statements as of and for the three months ended May 31, 2018 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 for a fair statement of 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 U.S. ("U.S. GAAP"). Operating results for the three months ended May 31, 2018 are not necessarily indicative of the results that may be expected for the fiscal year ending February 28, 2019. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. GAAP have been omitted in accordance with the SEC's rules and regulations for interim reporting. These unaudited financial statements should be read in conjunction with 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, 2018. Other than the accounting pronouncement adopted during the three months ended May 31, 2018 related to accounting for revenue from contracts with customers as described below, 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, 2018.

The Company adopted Accounting Standards Update 2014-09, Revenue from Contracts with Customers, now commonly referred to as Accounting Standards Codification Topic 606 ("ASC 606"), effective March 1, 2018, using the full retrospective transition method. All amounts and disclosures set forth in this Form 10-Q have been updated to comply with the new standard and such information is designated "as adjusted."

Certain amounts for the three months ended May 31, 2017 have been reclassified to conform to the current period presentation.

The Company's fiscal year ends on the last day of February, and the Company identifies fiscal years by the calendar years in which they end. For example, the fiscal year ending February 28, 2019 is referred to as "fiscal 2019."

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 are eliminated in consolidation. There are no significant foreign exchange restrictions on the Company’s foreign subsidiaries.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Use of estimates

The preparation of financial statements in conformity with U.S. GAAP 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. Estimates are used for, but not limited to, revenue recognition, goodwill and other long-lived assets, share-based compensation, income taxes and loss contingencies.

Revenue recognition

The Company derives its revenues from subscription contracts and training and service contracts. Revenue is recognized when performance obligations, as stipulated in the contracts, are transferred to a customer for an amount that reflects the consideration the Company expects to receive in exchange for those subscription contracts and training and service contracts.

The Company applies the following five steps to recognize revenue:

1) Identify the contract with a customer. The Company determines that it has a contract with a customer when the contract is approved, the party's rights regarding the products and services to be transferred can be identified, the payment terms for the products and services are identified, the customer's ability and intent to pay can be determined, and the contract has commercial substance. Judgment is used to assess the customer's ability and intent to pay, which is based upon factors including the customer's historical payment experience or credit and financial information pertaining to the customer.

2) Identify the performance obligations in the contract. The Company's performance obligations are identified based on the products and services that will be transferred to the customer that are both capable of being distinct and are distinct in the context of the contract and consist of (i) subscription offerings, including non-proprietary open-source software code delivered to the customer, software support subscriptions delivered to the customer, software support subscriptions embedded in partner products and learning subscriptions and (ii) training and services, including professional services sold at a fixed fee, professional services sold on a time-and-material-basis, training courses or units, and consulting units. In limited cases, the option to purchase additional subscription offerings or training and services may be offered at a price representing a material right. In such cases, the option to purchase is considered a distinct performance obligation.

3) Determine the transaction price. The Company determines transaction price based on the consideration expected to be received in exchange for transferring certain performance obligations to the customer. In determining the transaction price, variable consideration, if any, would be considered if, in management's judgment, it is probable that a significant future reversal of cumulative revenue under the contract will not occur.

The Company's contracts do not contain significant financing components. Specifically, the Company does not typically extend customer payment terms beyond a standard 30- to 60-day term and as a result the Company has elected the one-year-or-less safe harbor expedient and does not impute any interest.

The Company has elected to exclude all taxes from the transaction price (e.g. sales, use, value-added, etc). Revenue is recognized net of such taxes.

4) Allocate the transaction price to performance obligations in the contract. When a contract contains a single performance obligation, the entire transaction price is allocated to that one performance obligation. Contracts that contain multiple performance obligations require an allocation of the transaction price to each performance obligation based on a relative standalone selling price ("SSP"). The Company typically determines SSP based on the observable price when the Company sells the subscriptions or training and services separately, taking into consideration the geographical region of the customer, type of offering and sales channel. In instances where SSP is not directly observable, the Company determines SSP either from the renewal rate paid for the performance obligation to the extent it is the same rate as stipulated in the initial customer contract or by using the expected-cost-plus-margin approach.

5) Recognize revenue when or as the performance obligation is satisfied. Revenue is recognized at the time the related performance obligation is satisfied by transferring the promised subscription offerings and training and services to a customer. For each performance obligation, a determination is made as to whether the control is transferred over time or at a point in time. For performance obligations satisfied over time, a method to measure progress toward complete satisfaction is selected, based upon the most faithful depiction of performance. The selected method for each performance obligation type is applied consistently to similar contracts.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Subscription revenue

Subscription revenue is comprised of direct and indirect sales of subscriptions relating to Red Hat technologies. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding and non-cancellable subscription agreement for the purchase of a subscription, subscription services are made available to the customer and the customer is billed. The deferred revenue amount is recognized as revenue ratably over the subscription period. Red Hat technologies are generally offered with either one- or three-year base subscription periods; the majority of the Company's subscriptions have one-year terms. Under these subscription agreements, renewal rates are generally specified for one or three-year renewal terms. Subscriptions generally entitle the end user to the technology itself and post-contract customer support, generally consisting of varying levels of support services as well as access to security updates, fixes, functionality enhancements, upgrades to the technologies, each on an if and when available basis, and compatibility with an ecosystem of certified hardware and software, during the term of the subscription. The Company sells its offerings through two principal channels: (1) direct, which includes sales by the Company's sales force as well as web store sales, and (2) indirect, which includes certified cloud and service providers ("CCSPs"), distributors, original equipment manufacturers ("OEMs"), systems integrators and value added resellers.

The Company recognizes revenue from the sale of Red Hat technologies ratably over the period of the subscription beginning on the commencement date of the subscription agreement. The Company has determined that the delivery of software code underlying the subscription is a distinct performance obligation as it is both capable of being distinct and is distinct within the context of a customer contract. The Company uses a non-proprietary open-source development and licensing model to provide its software technologies to customers and therefore the amount of transaction price allocated to the underlying software code is negligible. The Company derives a portion of its revenue from CCSPs that provide public clouds with, and allow users to consume, computing resources as a service. The Company earns revenue based on subscription units consumed by the CCSP or its end users. The Company uses its historical cloud-usage data to estimate the amount of revenue earned and recognized each month and adjusts to actual amounts earned upon receipt of usage reports from the CCSPs in the following month. The differences between actual amounts earned and estimates made have generally been insignificant.

Training and services revenue

Training and services revenue is comprised of revenue for consulting, engineering and customer training courses or units and education services. Consulting services consist of time-based units or fixed-fee arrangements. For time-based arrangements, revenue is recognized over time as these services are performed and for fixed-fee arrangements, revenue is recognized based on the proportion of services performed. Engineering services represent revenue earned under fixed-fee arrangements with the Company's OEM partners and other customers to provide for significant modification and customization of Red Hat technologies. The Company recognizes revenue for these fixed-fee engineering services based on a proportional performance basis using actual costs incurred to date over the estimated total projected costs along with a representative profit margin. A representative profit margin is determined based on analysis of a population of similar contracts by region. Revenue for customer training and education services is recognized on the dates the services are performed.

See NOTE 16—Segment Reporting for further information, including revenue by geographic area and significant product and service offerings.

Contract Balances

Timing of revenue recognition may differ from the timing of invoicing to customers. The Company records a receivable when revenue is recognized prior to invoicing, or deferred revenue when revenue is recognized subsequent to invoicing. For multi-year arrangements, the Company will generally invoice customers upfront or annually at the beginning of each annual coverage period. See below for the accounting policy related to receivables and see NOTE 12—Deferred Revenue and Performance Obligations for further information on deferred revenue balances.

Accounts receivable and allowance for doubtful accounts

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is the Company's estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company determines the allowance based on historical write-off experience and other qualitative factors. The Company reviews its allowance for doubtful accounts monthly. Past due balances over 90 days and over a specified amount are reviewed individually for collectability. All other balances are reviewed on a pooled basis by type of receivable. Account balances are charged off against the allowance when the Company determines it is probable the receivable will not be recovered. The Company does not have off-balance sheet credit exposure related to its customers. Unbilled receivables related to subscription and training and services contracts are included in accounts receivable.

See NOTE 3—Accounts Receivable for further information on accounts receivable balances.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Deferred selling costs

Deferred commissions are the incremental costs that are directly associated with non-cancellable subscription contracts with customers and consist of sales commissions and certain related fringe benefits earned by the Company's sales force. The commissions are deferred and amortized on a straight-line basis over a period that approximates the subscription period. In determining the period that approximates the subscription period, the Company utilizes a portfolio approach that allows for the analysis of customer contracts with similar characteristics. The Company has determined that the effects on the financial statements of the portfolio approach would not differ materially from an individual customer contract analysis approach. The commission payments are paid in full subsequent to the month in which the customer's service commences. The deferred commission amounts are recoverable through the future revenue streams under the non-cancellable customer contracts. In addition, the Company has the ability and intent under the commission plans with its sales force to recover commissions previously paid to its sales force in the event that customers breach the terms of their subscription agreements and do not fully pay for their subscription agreements.

See NOTE 5—Deferred Selling Costs for further information on deferred commissions and the related amortization of deferred commissions.

Recent accounting pronouncements

Accounting pronouncements adopted

In January 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update 2016-01, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2016-01"). The FASB issued ASU 2016-01 to require equity investments with readily determinable fair values to be measured at fair value with changes in fair value recognized in net income. Equity investments that do not have readily determinable fair values are allowed to be remeasured upon the occurrence of an observable price change or upon identification of an impairment. Along with ASU 2016-01, the Company evaluated the Accounting Standards Update 2018-03, Technical Corrections and Improvements to Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2018-03"), which was issued in February 2018, and Accounting Standards Update 2018-04, Investments—Debt Securities (Topic 320) and Regulated Operations (Topic 980): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 117 and SEC Release No. 33-9273 ("ASU 2018-04"), which was issued in March 2018. The Company adopted ASU 2016-01, ASU 2018-03 and ASU 2018-04 as of March 1, 2018. The adoption of these standards did not significantly impact the Company's Consolidated Financial Statements.

In May 2014, the FASB issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers, now commonly referred to as Accounting Standards Codification Topic 606 ("ASC 606"). The FASB issued ASC 606 to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP. 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. ASC 606 requires the recognition of revenue when control of performance obligations as stipulated in the contracts, is transferred to a customer for an amount that reflects the consideration the entity expects to receive in exchange promised goods and services. The standard also includes Subtopic 340-40, Other Assets and Deferred Costs—Contracts with Customers, which requires the deferral of incremental costs of obtaining a contract with a customer. Collectively, ASC 606 and Subtopic 340-40 are referred to as "ASC 606."

The Company adopted ASC 606 as of March 1, 2018, utilizing the full retrospective method of transition, which requires a restatement of each prior reporting period presented. In adopting ASC 606, the Company used the practical expedient where the transaction price allocated to the remaining performance obligations before the date of the initial application is not disclosed. The Company implemented new policies, processes and systems to enable both the preparation of financial information and internal controls over financial reporting in connection with its adoption of

ASC 606. The impact of adopting ASC 606 on the Company's fiscal 2018 and fiscal 2017 revenue was not material. The primary impact of adopting the standard related to the deferral of incremental commission and other costs of obtaining contracts with customers. Previously, the Company deferred direct and incremental commission costs to obtain a contract and amortized those costs on a straight-line basis over a period that approximated the subscription period, and under ASC 606, the Company now also defers related fringe benefit costs.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Select adjusted unaudited financial statement information, which reflects the Company's adoption of ASC 606, is set forth below.

Consolidated balance sheets (in thousands):

	February 28, 2018		
	As Reported	Adjustments	As Adjusted
Prepaid expenses	$260,092	$ 7,105	$267,197
Deferred tax assets, net	$93,300	$ (694)	$92,606
Other assets, net	$87,924	$ 1,536	$89,460
Accounts payable and accrued expenses	$427,086	$ 53	$427,139
Retained earnings	$1,611,794	$ 7,894	$1,619,688

Consolidated statements of operations (in thousands, except per share amounts):

	Three Months Ended May 31, 2017		
	As Reported	Adjustments	As Adjusted
Operating expense:			
Sales and marketing	$296,459	$ (2,136)	$294,323
Net income	$73,190	$ 2,124	$75,314
Net income per share:			
Basic	$0.41	$ 0.01	$0.42
Diluted	$0.40	$ 0.01	$0.41

The Company's adoption of ASC 606 had no impact on net cash provided by or used in operating, investing or financing activities for any of the periods reported.

Accounting pronouncements being evaluated

In February 2018, the FASB issued Accounting Standards Update 2018-02, Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income ("ASU 2018-02"). The FASB issued ASU 2018-02 to give entities the option to reclassify tax effects stranded in accumulated other comprehensive income as a result of the enactment of the Tax Cuts and Jobs Act (the "Tax Act") to retained earnings. The guidance is effective for the Company as of the first quarter of its fiscal year ending February 28, 2020, with early adoption permitted. The Company is currently evaluating the impact that this updated standard will have on its consolidated financial statements.

In February 2016, the FASB issued Accounting Standards Update 2016-02, Leases (Topic 842) ("ASU 2016-02"). The FASB issued ASU 2016-02 to increase transparency and comparability among organizations with respect to accounting for leases. Under ASU 2016-02, lessees will recognize a right-of-use asset and a lease liability for virtually all of their leases (other than leases that meet the definition of a short-term lease). The liability will be equal to the present value of lease payments. The asset will be based on the liability, subject to adjustment, such as for initial direct costs. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. This guidance is effective for the Company as of the first quarter of its fiscal year ending February 28, 2020.

The Company continues to assess the impact of ASU 2016-02, including for example, any potential changes to and investments in the Company's policies, processes, systems and internal controls over financial reporting that may be required to comply with the new guidance related to identifying and measuring right-of-use assets and lease liabilities.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

NOTE 3—Accounts Receivable

Accounts receivable are presented net of an allowance for doubtful accounts. Activity in the Company's allowance for doubtful accounts is presented in the following table (in thousands):

As of	Balance at beginning of period	Charged to (recovery of) expense	Adjustments [1]	Balance at end of period
February 28, 2018	$ 2,791	172	(796)	$ 2,167
May 31, 2018	$ 2,167	562	(163)	$ 2,566

[1] Represents foreign currency translation adjustments and amounts written-off as uncollectible accounts receivable.

Included in accounts receivable, net of allowance for doubtful accounts, are unbilled receivables of $28.6 million and $25.8 million as of May 31, 2018 and February 28, 2018, respectively.

As of May 31, 2018 and February 28, 2018, no individual customer accounted for 10% or more of the Company's accounts receivable.

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, all of 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 over the estimated useful life or the related asset's pattern of economic benefit. Useful lives range from two to 10 years. As of May 31, 2018 and February 28, 2018, trademarks with an indefinite estimated useful life totaled $11.6 million and $12.0 million, respectively. The following is a summary of identifiable intangible assets (in thousands):

	May 31, 2018			February 28, 2018		
	Gross Amount	Accumulated Amortization	Net Amount	Gross Amount	Accumulated Amortization	Net Amount
Trademarks, copyrights and patents	$169,385	$ (73,732)	$95,653	$167,005	$ (70,749)	$96,256
Purchased technologies	210,714	(98,336)	112,378	208,096	(93,748)	114,348
Customer and reseller relationships	105,665	(96,735)	8,930	106,076	(95,558)	10,518
Covenants not to compete	15,565	(14,300)	1,265	15,861	(14,324)	1,537
Other intangible assets	8,833	(6,883)	1,950	8,833	(6,539)	2,294
Total identifiable intangible assets	$510,162	$ (289,986)	$220,176	$505,871	$ (280,918)	$224,953

Amortization expense associated with identifiable intangible assets recognized in the Company's Consolidated Financial Statements is summarized as follows (in thousands):

	Three Months Ended	
	May 31, 2018	May 31, 2017
Cost of revenue	$6,485	$4,180
Sales and marketing	1,362	1,459
Research and development	34	34
General and administrative	2,373	1,826
Total amortization expense	$10,254	$7,499

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RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

NOTE 5—Deferred Selling Costs

Deferred selling costs include commissions paid to the Company's sales associates that are the incremental costs incurred to obtain contracts with customers. The commissions are deferred and amortized over a period to approximate the period of the subscription term. For further discussion on deferred commissions, see NOTE 2—Summary of Significant Accounting Policies. Current and non-current deferred commissions are included in Prepaid expenses and Other assets, respectively, on the Company's Consolidated Balance Sheets and are as follows (in thousands):

	May 31, 2018	February 28, 2018 (1)
Deferred commissions, current	$181,901	$ 188,944
Deferred commissions, non-current	39,295	48,653
Total deferred commissions	$221,196	$ 237,597

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

Amortization of deferred commissions is included in Sales and marketing expense on the Company's Consolidated Statements of Operations. Amortization expense related to deferred commissions totaled $56.2 million and $44.1 million for the three months ended May 31, 2018 and May 31, 2017, respectively. There was no impairment loss in relation to the costs capitalized for the periods presented.

NOTE 6—Derivative Instruments

The Company transacts business in various foreign countries and is, therefore, subject to risk of foreign currency exchange rate fluctuations. From time to time, the Company 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 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. See NOTE 15—Assets and Liabilities Measured at Fair Value on a Recurring Basis for information regarding the fair value hierarchy of derivative instruments.

The effects of derivative instruments on the Company's Consolidated Financial Statements are as follows (in thousands):

	May 31, 2018			Classification of Gain (Loss)	Three Months
	Balance Sheet Classification	Fair Value	Notional Value	Recognized in Income on Derivatives	Ended May 31, 2018
Assets—foreign currency forward contracts not designated as hedges	Other current assets	$111	$21,554	Other expense, net	$ 289
Liabilities—foreign currency forward contracts not designated as hedges	Accounts payable and accrued expenses	(790)	28,112	Other expense, net	(1,136)
Total		$(679)	$49,666		$ (847)

	May 31, 2017			Classification of Gain (Loss)	Three Months
	Balance Sheet Classification	Fair Value	Notional Value	Recognized in Income on	Ended May 31,

				Derivatives	2017
Assets—foreign currency forward contracts not designated as hedges	Other current assets	$278	$18,901	Other expense, net	$ 605
Liabilities—foreign currency forward contracts not designated as hedges	Accounts payable and accrued expenses	(137)	27,053	Other expense, net	(320)
Total		$141	$45,954		$ 285

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

NOTE 7—Income Taxes

On December 22, 2017, the Tax Cuts and Jobs Act ("Tax Act") was enacted into law. This new law includes significant changes to the U.S. corporate income tax system, including a permanent reduction in the corporate income tax rate from 35% to 21%, limitations on the deductibility of interest expense and executive compensation, elimination of the domestic production activities deduction and the transition of U.S. international taxation from a worldwide tax system to a territorial tax system.

In December 2017, the SEC staff issued Staff Accounting Bulletin 118 ("SAB 118"), which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC Topic 740—Income Taxes ("ASC 740"). The Company has calculated as final its re-measurement of deferred taxes and uncertain tax positions. While the Company has substantially completed its provisional analysis of the income tax effects of the Tax Act and recorded a reasonable estimate of such effects, the Company regards as provisional the transition tax, withholding and other taxes on future repatriation of cash, and the accounting for compensation accruals. These provisional tax effects may differ during the measurement period, possibly materially, due to further refinement of the calculations, changes in interpretations and assumptions made, and additional guidance that may be issued by the Department of the U.S. Treasury, the Internal Revenue Service, and other regulatory and standard setting bodies. The Company will complete its analysis within fiscal 2019 consistent with the guidance provided in SAB 118, and any adjustments during this measurement period will be included in net earnings from continuing operations as an adjustment to income tax expense in the reporting period when such adjustments are determined. No such adjustments were included in income tax expense for the three months ended May 31, 2018.

The effective tax rate for the three months ended May 31, 2018 of (1.5)%, differed from the U.S. federal statutory rate of 21% primarily due to excess tax benefits from share-based compensation, research tax credits and the impact from the Tax Act. Tax expense for the three months ended May 31, 2018 included net discrete tax benefits of $26.8 million, primarily related to net excess tax benefits from share-based compensation.

For the three months ended May 31, 2017, the Company's then-effective tax rate of 13.5%[1], differed from the U.S. federal statutory rate of 35% primarily due to excess tax benefits from share-based compensation, foreign income taxes at lower rates and research tax credits. Tax expense for the three months ended May 31, 2017 included net discrete tax benefits of $11.6 million, primarily related to net excess tax benefits from share-based compensation.

The Company files a consolidated U.S. federal income tax return, as well as separate and combined income tax returns in numerous state and international jurisdictions. The Company is currently subject to examination by various taxing jurisdictions. The Company regularly assesses the potential outcomes of both ongoing and future examinations for the current and prior years, and believes that its provision for income taxes is adequate. The outcome of any one examination is not expected to have a material impact on the Company's consolidated financial statements. The Company believes that some of these audits and negotiations may conclude during the next 12 months.

As of May 31, 2018, it is reasonably possible that total unrecognized tax benefits may be reduced by up to $0.1 million within the next 12 months primarily as a result of statutes of limitations expirations in various tax jurisdictions, all of which would affect the Company's effective tax rate.

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(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

NOTE 8—Convertible Notes

Convertible note offering

On October 7, 2014, the Company completed its offering of $805.0 million aggregate principal amount of the convertible notes. The convertible notes were sold in a private placement under a purchase agreement, dated as of

October 1, 2014, entered into by and among the Company and the initial purchasers, for resale to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, as amended. For additional information, see NOTE 11—Convertible Notes to the Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2018.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
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Indenture

On October 7, 2014, the Company entered into an indenture (the "Indenture") with respect to the convertible notes with U.S. Bank National Association, as trustee (the "Trustee"). Under the Indenture, the convertible notes are senior unsecured obligations of the Company and bear interest at a rate of 0.25% per year, payable semiannually in arrears on April 1 and October 1 of each year, beginning on April 1, 2015. The convertible notes will mature on October 1, 2019, unless previously purchased or converted.

The convertible notes are convertible into shares of the Company's common stock at an initial conversion rate of 13.6219 shares per $1,000 principal amount of the convertible notes (which is equivalent to an initial conversion price of approximately $73.41 per share), subject to adjustment upon the occurrence of certain events. Upon conversion of the convertible notes, holders will receive cash or shares of the Company's common stock or a combination thereof, at the Company's election.

At their option, holders may convert their convertible notes prior to the close of business on the business day immediately preceding April 1, 2019, only upon the occurrence of certain circumstances. For example, during any fiscal quarter commencing after the fiscal quarter ended on November 30, 2014 (and only during such fiscal quarter), if the last reported sale price of the Company's common stock for at least 20 trading days (whether or not consecutive) during the period of 30 consecutive trading days ending on the last trading day of the immediately preceding fiscal quarter is greater than or equal to 130% of the conversion price, the convertible notes become convertible at the holders' option. The price of the Company's common stock was greater than or equal to 130% of the conversion price, which is $95.43, for at least 20 trading days during the 30 consecutive trading days ending on the last trading day of each of the fiscal quarters ended August 31, 2017 through May 31, 2018. Therefore, as of May 31, 2018, the convertible notes remain convertible at the holders' option until August 31, 2018.

On and after April 1, 2019, holders may convert their convertible notes at any time until the close of business on the second scheduled trading day immediately preceding the maturity date of the convertible notes.

During the first quarter of the fiscal year ending February 28, 2019, the Company settled notices of conversion with respect to $26.0 million aggregate principal amount of the convertible notes and elected to settle such conversions by paying cash for the principal amount and issuing 185,252 shares of common stock for the excess conversion value. During the three months ended May 31, 2018, the Company recognized a loss on settled conversions of $0.3 million. Total settled conversions as of May 31, 2018 amounted to $26.0 million aggregate principal amount of the convertible notes. The Company expects to settle conversions of $202.3 million in principal amount of the convertible notes in the second quarter of the fiscal year ending February 28, 2019 by paying cash for the principal amount and issuing shares of common stock for the excess conversion value. The Company continues to receive conversion requests and as of July 6, 2018, such incremental requests totaled $45.3 million in principal amount of the convertible notes. The aggregate principal amount of the convertible notes remaining is expected to be $531.4 million after the expected conversion settlements as discussed above and the incremental conversion requests received as of July 6, 2018.

Based on the closing price of the Company's common stock of $162.42 on the last trading day of the first quarter of the fiscal year ending February 28, 2019, the if-converted value of the convertible notes as of May 31, 2018 exceeded their principal amount by approximately $944.5 million.

The Company continues to classify the net carrying amount of the convertible notes as a long-term liability, except for $194.5 million, classified as current and expected to be cash-settled within the next fiscal quarter. The equity component of the convertible notes will continue to be classified as additional paid-in capital because the Company has the option to settle the principal amount in shares and the convertible notes' maturity date is more than 12 months away. However, it is the Company's intent to settle the principal amount of the convertible notes in cash.

The conversion rate is subject to customary anti-dilution adjustments. If certain corporate events described in the Indenture occur prior to the maturity date, the conversion rate will be increased for a holder who elects to convert its convertible notes in connection with such corporate event in certain circumstances.

The convertible notes are not redeemable prior to maturity, and no sinking fund is provided for the notes. If the Company undergoes a “fundamental change,” as defined in the Indenture, subject to certain conditions, holders may require the Company to purchase for cash all or any portion of their convertible notes. The fundamental change purchase price will be 100% of the principal amount of the convertible notes to be purchased plus any accrued and unpaid special interest up to but excluding the fundamental change purchase date.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
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The Indenture contains customary terms and covenants, including that upon certain events of default occurring and continuing, either the Trustee or the holders of at least 25% in principal amount of the outstanding convertible notes may declare 100% of the principal of, and accrued and unpaid interest, if any, on, all the convertible notes to be due and payable.

In accounting for the issuance of the convertible notes, the Company separated the convertible notes into liability and equity components. The Company allocated the total transaction costs incurred to the liability and equity components based on their relative fair values. Issuance costs attributable to the liability component are being amortized to interest expense over the term of the convertible notes. The excess of the face value of the convertible notes as a whole over the carrying amount of the liability component (the "debt discount") is being amortized to interest expense over the term of the convertible notes. The convertible notes consisted of the following (in thousands):

	May 31, 2018	February 28, 2018
Liability component:		
Principal	$779,013	$804,966
Less: debt issuance costs	(3,864)	(4,695)
Less: debt discount	(26,102)	(32,271)
Net carrying amount	$749,047	$768,000
Equity component [1]	$96,051	$96,890

[1] Recognized in the Consolidated Balance Sheets in Additional paid-in capital.

The following table includes total interest expense recognized related to the convertible notes (in thousands):

	Three Months Ended	
	May 31, 2018	May 31, 2017
Coupon rate 0.25% per year, payable semiannually	$471	$503
Amortization of convertible note issuance costs — liability component	831	673
Accretion of debt discount	5,007	4,867
Total interest expense related to convertible notes	$6,309	$6,043

The fair value of the convertible notes, which was determined based on inputs that are observable in the market (Level 2), and the carrying value of convertible notes (the carrying value excludes the equity component of the convertible notes classified in equity) is as follows (in thousands):

	May 31, 2018	
	Fair Value	Carrying Value
Convertible notes	$753,518	$749,047

Convertible note hedge transactions and warrant transactions

On October 1, 2014, the Company entered into convertible note hedge transactions and warrant transactions with certain of the initial purchasers of the convertible notes or their respective affiliates. In connection with the conversions of the convertible notes that settled in the first quarter of the fiscal year ending February 28, 2019, the Company exercised a portion of the options that are part of the convertible note hedge transactions for 185,239 shares of the Company's common stock.

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RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
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The convertible note hedge transactions are expected to offset, to the extent the Company's common stock per share price does not exceed $101.65, the potential dilution with respect to shares of the Company's common stock upon any conversion of the convertible notes and/or offset any cash payments the Company is required to make in excess of the principal amount of the converted notes, as the case may be. To partially offset the $148.0 million cost of the convertible note hedge transactions, the Company issued warrants and received proceeds of $79.8 million. The number of shares of the Company's common stock underlying the warrants total 10,965,630, the number of shares originally underlying the convertible notes and the convertible note hedge transactions. The combination of the convertible note hedge transactions and the warrant transactions effectively increases the initial conversion price of the convertible notes from $73.41 per share to $101.65 per share. As a result, the warrant transactions will have a dilutive effect with respect to the Company's common stock to the extent that the market price per share of the Company's common stock, as measured under the terms of the warrant transactions, exceeds the $101.65 strike price of the warrants. For the three months ended May 31, 2018, the warrants were included in the computation of diluted shares outstanding because the warrants' exercise price was less than the average market price of the Company's common stock during the related period. However, subject to certain conditions, the Company may elect to settle all of the warrants in cash.

NOTE 9—Commitments and Contingencies

Operating leases

As of May 31, 2018, the Company leased office space and certain equipment under various non-cancellable operating leases. Rent expense under operating leases for the three months ended May 31, 2018 and May 31, 2017 was $13.4 million and $12.5 million, respectively.

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. Payments pursuant to these indemnification claims during the three months ended May 31, 2018 and May 31, 2017 were, in the aggregate, immaterial.

NOTE 10—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.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

NOTE 11—Stockholders' Equity

The following table summarizes the changes in the Company's stockholders' equity during the three months ended May 31, 2018 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings [1]	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
Balance at February 28, 2018	$ 24	$2,416,080	$1,619,688	$(2,525,072)	$ (32,596)	$1,478,124
Net income	—	—	113,190	—	—	113,190
Other comprehensive loss, net of tax	—	—	—	—	(10,905)	(10,905)
Vest and exercise of share-based awards	—	875	—	—	—	875
Common stock repurchase	—	(17,175)	—	(132,844)	—	(150,019)
Share-based compensation expense	—	46,005	—	—	—	46,005
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards	—	(77,094)	—	—	—	(77,094)
Re-issuance of treasury stock under employee stock purchase plan	—	18,471	—	13,740	—	32,211
Convertible note conversions	—	(835)	—	—	—	(835)
Exercises of convertible note hedges	—	13,598	—	(13,598)	—	—
Cumulative-effect adjustment from adoption of ASU 2016-01		—	392	—	—	392
Balance at May 31, 2018	$ 24	$2,399,925	$1,733,270	$(2,657,774)	$ (43,501)	$1,431,944

[1] As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

The following table summarizes the changes in the Company's stockholders' equity during the three months ended May 31, 2017 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings [1]	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
Balance at February 28, 2017	$ 24	$2,294,462	$1,357,837	$(2,311,805)	$ (88,352)	$1,252,166
Net income	—	—	75,314	—	—	75,314
Other comprehensive income, net of tax	—	—	—	—	22,612	22,612
Vest and exercise of share-based awards	—	2,968	—	—	—	2,968
Common stock repurchase	—	—	—	(61,987)	—	(61,987)
Share-based compensation expense	—	43,718	—	—	—	43,718
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards	—	(41,010)	—	—	—	(41,010)
Re-issuance of treasury stock under employee stock purchase plan	—	—	—	23,748	—	23,748
Other adjustments	—	(5,015)	—	—	—	(5,015)
Balance at May 31, 2017	$ 24	$2,295,123	$1,433,151	$(2,350,044)	$ (65,740)	$1,312,514

[1] As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

Share Repurchase Programs

On June 22, 2016, the Company announced that its Board of Directors authorized the repurchase of up to $1.0 billion of Red Hat's common stock from time to time on the open market or in privately negotiated transactions. The program commenced on July 1, 2016, and expired on June 30, 2018.

During the three months ended May 31, 2018, the Company repurchased 948,638 shares of its common stock at an aggregate cost of $150.0 million under this repurchase program. These amounts are recognized in Treasury stock on the Company's Consolidated Balance Sheets except for $17.2 million, representing 103,744 shares, recognized in Additional paid-in capital. The $17.2 million, representing 103,744 shares, will be reclassified to Treasury stock in the quarter ending August 31, 2018.

From its commencement on July 1, 2016 through May 31, 2018, the Company repurchased 8,167,871 shares of its common stock for $751.3 million under this program. As of May 31, 2018, the amount available under this program for the repurchase of the Company's common stock was $248.7 million.

On June 21, 2018, the Company announced that its Board authorized a new repurchase program effective July 1, 2018, replacing the repurchase program described above that expired on June 30, 2018. See NOTE 18—Subsequent Events for additional information regarding the Company's new share repurchase program.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
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Accumulated other comprehensive loss
Accumulated other comprehensive loss was comprised of the following (in thousands):

	May 31, 2018	February 28, 2018
Accumulated loss from foreign currency translation adjustment	$(40,510)	$(29,679)
Accumulated unrealized loss, net of tax, on available-for-sale securities	(2,991)	(2,917)
Accumulated other comprehensive loss	$(43,501)	$(32,596)

NOTE 12—Deferred Revenue and Performance Obligations
Activity in the Company's deferred revenue accounts is presented in the following table (in thousands):

	February 28, 2018	Revenue recognized from opening balance	Deferred revenue, net [1]	May 31, 2018
Deferred revenue, short-term	$1,853,719	$(611,353)	$478,934	$1,721,300
Deferred revenue, long-term	741,453	—	(18,246)	723,207
Total deferred revenue	$2,595,172	$(611,353)	$460,688	$2,444,507

(1) Includes revenue recognized from current period customer contracts and the impact from foreign currency exchange rate fluctuations.

As of May 31, 2018, the value of customer contracts allocated to performance obligations not yet satisfied, including $2.44 billion of total deferred revenue, was approximately $3.20 billion, of which approximately 60% is expected to be recognized as revenue within the next 12 months and the remainder thereafter.
In addition to the approximately $3.20 billion of customer contract value allocated to performance obligations not yet satisfied, as of May 31, 2018, the Company has offered customers options to purchase additional services at an agreed-upon price per hour that total approximately $122.8 million.
The summation of the customer contract value allocated to performance obligations not yet satisfied and the options to purchase additional services equals approximately $3.33 billion, which the Company considers as its total backlog.
NOTE 13—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, vesting of share-based awards, settlement of convertible notes, or exercise of warrants.
The following table reconciles the numerators and denominators of the earnings per share ("EPS") calculation (in thousands, except per share amounts):

	Three Months Ended	
	May 31, 2018	May 31, 2017 (1)
Net income, basic and diluted	$113,190	$75,314
Weighted average common shares outstanding	177,302	177,243
Incremental shares attributable to assumed vesting or exercise of outstanding equity award shares	3,833	2,974
Dilutive effect of convertible notes	5,686	1,593
Dilutive effect of warrants	3,918	—

Diluted shares	190,739	181,810
Diluted net income per share	$0.59	$0.41

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

With respect to the Company's convertible notes, the Company has the option to pay cash or deliver, as the case may be, either cash, shares of its common stock or a combination of cash and shares of its common stock for the aggregate amount due upon conversion of the convertible notes. The Company's intent is to settle the principal amount of the convertible notes in cash upon conversion. As a result, upon conversion of the convertible notes, only the amounts payable in excess of the principal amounts of the convertible notes are considered in diluted EPS under the treasury stock method. See NOTE 8—Convertible Notes for detailed information on the convertible notes.

Warrants to purchase 10,965,630 shares of the Company's common stock at $101.65 per share were outstanding during the three months ended May 31, 2018 and May 31, 2017. For the three months ended May 31, 2018, the warrants were included in the computation of diluted EPS because the warrants' exercise price was less than the average market price of the Company's common stock during the related period.

The following share awards are not included in the computation of diluted EPS 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	
	May 31, 2018	May 31, 2017
Number of shares considered anti-dilutive for calculating diluted EPS	—	14

NOTE 14—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. 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.

The following summarizes share-based compensation expense recognized in the Company's Consolidated Financial Statements (in thousands):

	Three Months Ended	
	May 31, 2018	May 31, 2017
Cost of revenue	$5,128	$3,948
Sales and marketing	19,520	20,612
Research and development	14,782	13,447
General and administrative	6,575	5,711
Total share-based compensation expense [1]	$46,005	$43,718

[1] Total share-based compensation expense included $4.0 million and $2.9 million, respectively, of expense related to the Company's employee stock purchase plan ("ESPP") for the three months ended May 31, 2018 and May 31, 2017.

Share-based compensation expense qualifying for capitalization was insignificant for each of the three months ended May 31, 2018 and May 31, 2017. Accordingly, no share-based compensation expense was capitalized during these periods.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

The following table summarizes the Company's share-based awards granted, by type:

	Three Months Ended			
	May 31, 2018		May 31, 2017	
	Shares and Shares Underlying Awards	Weighted Average Per Share Award Fair Value	Shares and Shares Underlying Awards	Weighted Average Per Share Award Fair Value
Service-based shares and share units	669,450	$ 160.53	838,395	$ 86.17
Performance share units—target	173,014 (1)	$ 163.56	261,760	$ 87.99
Performance share awards	64,219 (2)	$ 163.56	104,362	$ 87.99
Total share-based awards	906,683	$ 161.32	1,204,517	$ 86.72

(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 beginning on March 1, 2018. 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 performance of specified peer companies during a three-year period beginning on March 1, 2018.

(2) Certain executives were granted restricted stock awards. These shares were awarded subject to the achievement of a specified dollar amount of revenue for the fiscal year ending February 28, 2019 (the "RSA Performance Goal"). If the Company fails to achieve the RSA Performance Goal then all such shares are forfeited. If the Company achieves the RSA Performance Goal then 25% of the restricted stock vests on or about July 16, 2019, 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.

NOTE 15—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 values. Liquid investments with effective maturities of three months 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.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

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. Realized gains and losses are recorded using the specific identification method and upon realization, such amounts are reclassified from accumulated other comprehensive income to Other expense, net. Realized gains and losses and other than temporary impairments, if any, are reflected in the Company's Consolidated Statements of Operations as Other 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 by 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 fair value, including broker quotes or model valuations. Independent price verifications of all holdings are performed by pricing vendors that 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 value.

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 May 31, 2018 (in thousands):

	May 31, 2018	Level 1	Level 2	Level 3
Assets:				
Money markets [1]	$349,062	$349,062	$—	$ —
Interest-bearing deposits [1]	87,494	—	87,494	—
Available-for-sale securities [1]:				
Commercial paper	609,776	—	609,776	—
U.S. agency securities	303,837	—	303,837	—
Corporate securities	357,380	—	357,380	—
Foreign currency derivatives [2]	111	—	111	—
Liabilities:				
Foreign currency derivatives [3]	(790)	—	(790)	—
Total	$1,706,870	$349,062	$1,357,808	$ —

(1) Included in Cash, cash equivalents and restricted cash, Investments in debt and equity securities, short-term or Investments in debt securities, long-term in the Company's Consolidated Balance Sheet at May 31, 2018, in addition to $819.6 million of cash.

(2) Included in Other current assets in the Company's Consolidated Balance Sheet at May 31, 2018.

(3) Included in Accounts payable and accrued expenses in the Company's Consolidated Balance Sheet at May 31, 2018.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

The following table summarizes the composition and fair value hierarchy of the Company's financial assets and liabilities at February 28, 2018 (in thousands):

	February 28, 2018	Level 1	Level 2	Level 3
Assets:				
Money markets [1]	$334,665	$334,665	$—	$ —
Interest-bearing deposits [1]	61,125	—	61,125	—
Available-for-sale securities [1]:				
Commercial paper	615,043	—	615,043	—
U.S. agency securities	308,267	—	308,267	—
Corporate securities	381,514	—	381,514	—
Equity securities	1,166	1,166	—	—
Foreign currency derivatives [2]	298	—	298	—
Liabilities:				
Foreign currency derivatives [3]	(312)	—	(312)	—
Total	$1,701,766	$335,831	$1,365,935	$ —

(1) Included in Cash, cash equivalents and restricted cash, Investments in debt and equity securities, short-term or Investments in debt securities, long-term in the Company's Consolidated Balance Sheet at February 28, 2018, in addition to $771.2 million of cash.
(2) Included in Other current assets in the Company's Consolidated Balance Sheet at February 28, 2018.
(3) Included in Accounts payable and accrued expenses in the Company's Consolidated Balance Sheet at February 28, 2018.

The following table represents the Company's investments measured at fair value as of May 31, 2018 (in thousands):

					Balance Sheet Classification		
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses [1]	Aggregate Fair Value	Cash Equivalent Marketable Securities	Investments in debt and equity securities, short-term	Investments in debt securities, long-term
Money markets	$349,062	$—	$—	$349,062	$349,062	$ —	$ —
Interest-bearing deposits	87,494	—	—	87,494	—	87,494	—
Commercial paper	609,776	—	—	609,776	599,838	9,938	—
U.S. agency securities	307,704	6	(3,873)	303,837	—	99,685	204,152
Corporate securities	358,340	540	(1,500)	357,380	—	132,755	224,625
Total	$1,712,376	$546	$(5,373)	$1,707,549	$948,900	$ 329,872	$ 428,777

(1) As of May 31, 2018, there were $4.1 million of accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer. The aggregate related fair value of investments with unrealized losses was $528.4 million.

The following table summarizes the stated maturities of the Company's investment in available-for-sale securities (in thousands):

	As of May 31, 2018	Less than 1 Year	1-5 Years	More than 5 Years

Maturity of available-for-sale debt securities	$671,155	$242,378	$428,777	$ —

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RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

The following table represents the Company's investments measured at fair value as of February 28, 2018 (in thousands):

					Balance Sheet Classification		
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses [1]	Aggregate Fair Value	Cash Equivalent Marketable Securities	Investments in debt and equity securities, short-term	Investments in debt securities, long-term
Money markets	$334,665	$—	$—	$334,665	$334,665	$ —	$ —
Interest-bearing deposits	61,125	—	—	61,125	—	61,125	—
Commercial paper	615,043	—	—	615,043	615,043	—	—
U.S. agency securities	312,537	—	(4,270)	308,267	—	93,175	215,092
Corporate securities	382,497	696	(1,679)	381,514	3,272	162,892	215,350
Equity securities	650	516	—	1,166	—	1,166	—
Total	$1,706,517	$1,212	$(5,949)	$1,701,780	$952,980	$ 318,358	$ 430,442

(1) As of February 28, 2018, there were $4.4 million of accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer. The aggregate related fair value of investments with unrealized losses was $515.4 million.

NOTE 16—Segment Reporting

The Company is organized primarily on the basis of three geographic business units: the Americas (U.S., Canada and Latin America), Europe, Middle East and Africa ("EMEA") and Asia Pacific. These business units are aggregated into one reportable segment due to the similarity in nature of products and services provided, financial performance economic characteristics (e.g. revenue growth and gross margin), methods of production and distribution and customer classes (e.g., cloud service providers, distributors, reseller and enterprise).

The following summarizes revenue from unaffiliated customers; income (loss) from operations; total cash, cash equivalents and available-for-sale investment securities and total assets by geographic segment (in thousands):

	Americas	EMEA	Asia Pacific	Corporate [1]	Consolidated
	Three Months Ended May 31, 2018				
Revenue from unaffiliated customers	$500,306	$195,148	$ 118,076	$ —	$ 813,530
Income (loss) from operations	$71,864	$48,860	$ 37,437	$ (46,005)	$ 112,156
Total cash, cash equivalents, restricted cash and available-for-sale investment securities	$1,524,311	$576,171	$ 426,647	$ —	$ 2,527,129
Total assets	$3,559,900	$1,015,187	$ 616,474	$ —	$ 5,191,561
	Three Months Ended May 31, 2017				
Revenue from unaffiliated customers	$438,380	$143,671	$ 94,745	$ —	$ 676,796
Income (loss) from operations [2]	$74,591	$30,923	$ 27,948	$ (43,718)	$ 89,744
Total cash, cash equivalents, restricted cash and available-for-sale investment securities	$1,186,481	$779,346	$ 343,754	$ —	$ 2,309,581
Total assets [2]	$2,864,857	$1,135,329	$ 519,263	$ —	$ 4,519,449

(1) Amounts represent share-based compensation expense that was not allocated to geographic segments.

(2) As adjusted from retrospective adoption of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

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RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Supplemental information about geographic areas

The Company approximates its geographic sources of revenue based on the country of origin of its non-cancellable subscription and service agreements initiated during the year (commonly referred to as bookings). The following table lists revenue from unaffiliated customers in the U.S., the Company's country of domicile, and revenue from foreign countries (in thousands):

	Three Months Ended	
	May 31, 2018	May 31, 2017
U.S., the Company's country of domicile	$442,421	$394,542
Foreign	371,109	282,254
Total revenue from unaffiliated customers	$813,530	$676,796

Total tangible long-lived assets located in the U.S., the Company's country of domicile, and similar tangible long-lived assets held outside the U.S. are summarized in the following table (in thousands):

	May 31, 2018	February 28, 2018
U.S., the Company's country of domicile	$132,328	$137,112
Foreign	64,325	68,993
Total tangible long-lived assets	$196,653	$206,105

Supplemental information about major customers

For each of the three months ended May 31, 2018 and May 31, 2017, the U.S. government and its agencies represented in the aggregate approximately 10% and 11% of the Company's total revenue, respectively.

Supplemental information about products and services

The following table provides further detail, by type, of the Company's subscription and services revenues. Subscription revenue for infrastructure-related offerings includes subscription revenue generated from Red Hat Enterprise Linux and related technologies such as Red Hat Satellite and Red Hat Virtualization. Subscription revenue generated from the Company's Application Development-related and other emerging technology offerings includes Red Hat JBoss Middleware, Red Hat OpenShift, Red Hat Cloud Infrastructure, Red Hat OpenStack Platform, Red Hat Ansible Automation, Red Hat CloudForms, Red Hat Storage technologies and Red Hat Mobile Application Platform (in thousands):

	Three Months Ended	
	May 31, 2018	May 31, 2017
Subscription revenue:		
Infrastructure-related offerings	$522,402	$457,961
Application Development-related and other emerging technology offerings	189,119	138,547
Total subscription revenue	711,521	596,508
Training and services revenue:		
Consulting services	79,147	61,488
Training	22,862	18,800
Total training and services revenue	102,009	80,288
Total revenue	$813,530	$676,796

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RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
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NOTE 17—Business Combinations

Acquisition of CoreOS, Inc.

On January 30, 2018, the Company completed the acquisition of all of the shares of CoreOS, Inc. ("CoreOS"). The addition of CoreOS, a provider of Kubernetes and container-native solutions, is expected to further enable the Company's customers to build any application and deploy them in any environment with the flexibility afforded by open source. By combining CoreOS's complementary capabilities with the Company's Kubernetes and container-based portfolio, including Red Hat OpenShift, the Company aims to further accelerate adoption and development of its hybrid cloud platform for modern application workloads.

The consideration paid was $238.7 million in cash. Based on management's provisional assessment of the acquisition-date fair value of the assets acquired and liabilities assumed, the total consideration transferred of $238.7 million was allocated to the Company's assets and liabilities on a preliminary basis as follows: $160.7 million to goodwill, $81.7 million to identifiable intangible assets and $3.7 million to working capital as a net current liability.

Acquisition of Permabit Technology Corporation

On July 31, 2017, the Company acquired the assets and technology of Permabit Technology Corporation ("Permabit"), a provider of software for data deduplication, compression and thin provisioning technology. Adding Permabit's data deduplication and compression capabilities to the Company's Red Hat Enterprise Linux platform will better enable enterprise digital transformation through more efficient storage options.

During the three months ended February 28, 2018, the Company completed its assessment of the acquisition-date fair value of the assets acquired and liabilities assumed. The total consideration transferred of $49.8 million was allocated to the Company's assets and liabilities as follows: $39.4 million to goodwill, $10.4 million to identifiable intangible assets and a nominal amount to working capital. The goodwill acquired is expected to be deductible for tax purposes.

Acquisition of Codenvy S. A.

On June 1, 2017, the Company completed its acquisition of all of the shares of Codenvy S.A. ("Codenvy"), a provider of cloud-native development tools that enable developers to more easily create modern container-based and cloud-native applications. By adding Codenvy to its existing portfolio of developer tools and application platforms, including Red Hat JBoss Middleware and Red Hat OpenShift, the Company continues its efforts to provide solutions that enable developers to create applications for hybrid cloud environments. The Company plans to make Codenvy an integral part of OpenShift.io, the Company's hosted development environment for building hybrid cloud services on OpenShift.

During the three months ended November 30, 2017, the Company completed its assessment of the acquisition-date fair value of the assets acquired and liabilities assumed. The total consideration transferred of $34.2 million was allocated to the Company's assets and liabilities as follows: $25.4 million to goodwill, $11.3 million to identifiable intangible assets and $2.5 million to working capital as a net current liability.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Pro forma consolidated financial information

The following unaudited pro forma consolidated financial information reflects the results of operations of the Company (in thousands, except per share amounts) as if the acquisitions of CoreOS, Permabit and Codenvy had occurred as of the beginning of the fiscal year prior to the fiscal year of acquisition, 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 fiscal year prior to the fiscal year of acquisition.

	Three Months Ended May 31, 2017
Revenue	$679,373
Net income	$66,852
Basic net income per common share	$0.38
Diluted net income per common share	$0.37

Goodwill and other business combinations

The following is a summary of goodwill (in thousands):

Balance at February 28, 2018	$1,288,830
Impact of foreign currency fluctuations	(7,589)
Other adjustments	(2,533)
Balance at May 31, 2018	$1,278,708

The excess of purchase price paid for CoreOS, Permabit, Codenvy and other acquisitions over the fair value of the net assets acquired was recognized as goodwill. Goodwill comprises the majority of the purchase price paid for each of the acquired businesses because these businesses were focused on emerging technologies such as development and operations automation, mobile technologies, cloud-enabling technologies and software-defined storage technologies, which consequently—at the time of acquisition—generated relatively little revenue. However, these acquired businesses, with their assembled, highly-specialized workforces and community of contributors, are expected to both expand the Company's existing technology portfolio and advance the Company's market position overall in open source solutions.

NOTE 18—Subsequent Events

On June 21, 2018, the Company announced that its Board authorized the repurchase of up to $1.0 billion of Red Hat's common stock from time to time on the open market or in privately negotiated transactions. The new program commenced on July 1, 2018, and will expire on the earlier of (i) June 30, 2020 or (ii) a determination by the Board, Chief Executive Officer or Chief Financial Officer to discontinue the program.

The new program replaced the previous $1.0 billion repurchase program, which expired on June 30, 2018.

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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, management, middleware, cloud, mobile and storage 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 ,generally, is 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 technologies, and by providing a level of performance, scalability, flexibility, reliability and security for the 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 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 technologies are also offered by certified cloud and service providers ("CCSPs") as a service available on demand, and this revenue is recognized by us upon delivery.

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 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 Note 2—Summary of Significant Accounting Policies to our Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q. We adopted ASC 606, effective March 1, 2018, using the full retrospective transition method. All amounts and disclosures set forth in this Form 10-Q have been updated to comply with the new standard and such information is designated "as adjusted."

We believe our success is influenced by: (i) our ability to utilize the innovation derived from software developed by an open source community and make it consumable for enterprise customers, (ii) the extent to which we can expand the breadth and depth of our offerings, (iii) strategic business combinations and acquisitions of technical talent and technologies, (iv) our ability to enhance the value of our offerings through frequent and continuing innovation while maintaining platforms designed to be stable and secure over multi-year periods, (v) the extent to which adoption of our emerging technology offerings and software development processes such as CI/CD (continuous integration and continuous deployment) and DevOps increases, (vi) our involvement and leadership in key open source communities and projects, which enable us to develop, enhance and maintain our offerings, (vii) our corporate culture, which we believe fosters innovation, creativity and collaboration, (viii) our ability to generate increasing revenue directly and through partners and other strategic relationships, including CCSPs, distributors, embedded technology partners, independent hardware vendors ("IHVs"), independent software vendors ("ISVs"), OEMs, systems integrators and value added resellers, (ix) our ability to generate new and recurring revenue for our offerings, (x) the widespread and increasing deployment of open source technologies by enterprises and similar institutions, (xi) our software, hardware, application and cloud service certification programs, which are intended to create an ecosystem of technologies that are compatible with our offerings and supported by us, (xii) our ability to provide customers with consulting and training services that generate additional subscription revenue, and (xiii) our ability to provide greater subscription value, enhance the experience of our customers and promote customer loyalty by focusing on ways in which we can help our customers succeed.

In fiscal 2019, we expect to focus on, among other things: (i) driving the widespread adoption of our offerings, (ii) investing in the development of open source technologies and promoting the use of our technologies by software developers globally, (iii) pursuing strategic acquisitions and alliances, and (iv) promoting a range of services to help

our customers derive additional value.

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Non-GAAP disclosures

In accordance with U.S. GAAP, the income statements of our non-U.S. operations are translated into U.S. dollars using the average exchange rates for each month in an applicable period. To the extent the U.S. dollar weakens against foreign currencies, the translation of transactions denominated in foreign currencies results in increased revenue, as stated in U.S. dollars, for our non-U.S. operations. Similarly, revenue, as stated in U.S. dollars, for our non-U.S. operations decreases if the U.S. dollar strengthens against foreign currencies. In this Part I, Item 2, we disclose non-GAAP amounts and growth rates that exclude the impact of foreign currency exchange rate fluctuations for the three months ended May 31, 2018 in an effort to provide a comparable framework for assessing how our business performed when compared to the three months ended May 31, 2017. To compute the non-GAAP impact of foreign currency exchange rate fluctuations, we translate amounts from our non-U.S. operations for the three months ended May 31, 2018 using the average foreign currency exchange rate for the three months ended May 31, 2017.

Revenue

For the three months ended May 31, 2018, total revenue increased 20.2%, or $136.7 million, to $813.5 million from $676.8 million for the three months ended May 31, 2017. Excluding the impact of foreign currency exchange rate fluctuations, total revenue increased by 16.9% for the three months ended May 31, 2018, as detailed in the following table.

The growth rates of subscription revenue by offering type, training and services revenue and total revenue, as reported and excluding the impact of foreign currency exchange rate fluctuations, for the three months ended May 31, 2018 versus the three months ended May 31, 2017 are as follows (in thousands):

	Three Months Ended		
	May 31, 2018	May 31, 2017	Year-Over-Year Growth Rate
Infrastructure-related subscription revenue, as reported	$522,402	$457,961	14.1%
Adjustment for foreign currency exchange rates	(13,938)	—	
Infrastructure-related subscription revenue, excluding foreign currency impact	508,464	457,961	11.0%
Application Development-related and other emerging technology subscription revenue, as reported	189,119	138,547	36.5%
Adjustment for foreign currency exchange rates	(6,130)	—	
Application Development-related and other emerging technology subscription revenue, excluding foreign currency impact	182,989	138,547	32.1%
Total subscription revenue, as reported	711,521	596,508	19.3%
Adjustment for foreign currency exchange rates	(20,068)	—	
Total subscription revenue, excluding foreign currency impact	691,453	596,508	15.9%
Total training and services revenue, as reported	102,009	80,288	27.1%
Adjustment for foreign currency exchange rates	(2,450)	—	
Total training and services revenue, excluding foreign currency impact	99,559	80,288	24.0%
Total revenue, as reported	813,530	676,796	20.2%
Adjustment for foreign currency exchange rates	(22,518)	—	
Total revenue, excluding foreign currency impact	$791,012	$676,796	16.9%

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Subscription revenue

Our enterprise technologies are delivered 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 security updates, fixes, functionality enhancements, upgrades to the technologies, each if and when available, and compatibility with an ecosystem of certified hardware and software. Subscription revenue increased sequentially for the first quarter of fiscal 2019 and for each quarter of fiscal 2018 and fiscal 2017 and was driven primarily by the increased use of our offerings by customers and our expansion of sales channels and geographic footprint during these periods.

Subscription revenue increased 19.3%, or $115.0 million, for the three months ended May 31, 2018 as compared to the three months ended May 31, 2017. Excluding the impact of foreign currency exchange rate fluctuations, subscription revenue increased by 15.9% for the three months ended May 31, 2018. The increase in subscription revenue is driven primarily by additional subscriptions related to our Red Hat Enterprise Linux, Red Hat JBoss Middleware and certain emerging technology offerings: Ansible, OpenShift and OpenStack. The increase is, in part, a result of the continued migration of enterprises in industries such as financial services, government and telecommunications to our open source solutions from proprietary technologies. Revenue growth in our Middleware portfolio has moderated as customers shift their workloads from traditional Java deployments to containerized environments with middleware-as-a-service on OpenShift. We believe this transition will impact the revenue growth of the Middleware portfolio throughout fiscal 2019.

Training and services revenue

Training and services revenue increased 27.1%, or $21.7 million, for the three months ended May 31, 2018 as compared to the three months ended May 31, 2017. Excluding the impact of foreign currency exchange rate fluctuations, training and services revenue increased by 24.0%. The increase is driven primarily by customer interest in new products and increased demand for consulting projects supporting Ansible, OpenShift and OpenStack solutions.

Deferred revenue and billings proxy

Year-to-date deferred revenue

Our deferred revenue, current and long-term, balance at May 31, 2018 was $2.44 billion. Total deferred revenue at May 31, 2018 decreased 5.8%, or $150.7 million, as compared to the balance of $2.60 billion at February 28, 2018. Excluding the impact of foreign currency exchange rate fluctuations, total deferred revenue decreased by 4.0%, or $104.6 million, from February 28, 2018 to May 31, 2018, which is the change in deferred revenue reported on our Consolidated Statements of Cash Flows. The decrease in deferred revenue is primarily attributable to our typically lower seasonal first quarter billings.

Below is a summary of our deferred revenue, as reported and excluding the impact of foreign currency exchange rate fluctuations for May 31, 2018 and February 28, 2018 (in thousands):

	May 31, 2018	February 28, 2018	Year-to-Date Growth Rate
Current deferred revenue, as reported	$1,721,300	$1,853,719	(7.1)%
Adjustment for foreign currency exchange rates	28,639	—	
Current deferred revenue, excluding foreign currency impact	$1,749,939	$1,853,719	(5.6)%
Long-term deferred revenue, as reported	$723,207	$741,453	(2.5)%
Adjustment for foreign currency exchange rates	17,434	—	
Long-term deferred revenue, excluding foreign currency impact	$740,641	$741,453	(0.1)%
Total deferred revenue, as reported	$2,444,507	$2,595,172	(5.8)%
Adjustment for foreign currency exchange rates	46,073	—	
Total deferred revenue, excluding foreign currency impact	$2,490,580	$2,595,172	(4.0)%

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Year-over-year deferred revenue

Total deferred revenue increased by 19.0%, or $390.3 million, to $2.44 billion at May 31, 2018 from $2.05 billion at May 31, 2017. Excluding the impact of foreign currency exchange rate fluctuations, total deferred revenue increased by 18.2%, or $374.2 million, from May 31, 2017 to May 31, 2018. This increase in deferred revenue of $374.2 million is the summation of the changes in deferred revenue reported on our Consolidated Statements of Cash Flows for each quarter of the four-fiscal-quarter period ended May 31, 2018, which includes an insignificant amount of deferred revenue acquired from business combinations.

Below is a summary of our deferred revenue (in thousands):

	May 31, 2018	May 31, 2017	Year-Over-Year Growth Rate
Current deferred revenue, as reported	$1,721,300	$1,486,409	15.8%
Adjustment for foreign currency exchange rates	(13,619)	—	
Current deferred revenue, excluding foreign currency impact	$1,707,681	$1,486,409	14.9%
Long-term deferred revenue, as reported	$723,207	$567,755	27.4%
Adjustment for foreign currency exchange rates	(2,559)	—	
Long-term deferred revenue, excluding foreign currency impact	$720,648	$567,755	26.9%
Total deferred revenue, as reported	$2,444,507	$2,054,164	19.0%
Adjustment for foreign currency exchange rates	(16,178)	—	
Total deferred revenue, excluding foreign currency impact	$2,428,329	$2,054,164	18.2%

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.

Below is a summary of our billings proxy (in thousands):

	Three Months Ended		
	May 31, 2018	May 31, 2017	Year-Over-Year Growth Rate
Revenue, as reported	$813,530	$676,796	20.2%
Change in deferred revenue, as reported on Statements of Cash Flows	(104,592)	(45,717)	
Billings proxy	708,938	631,079	12.3%
Adjustment to revenue for foreign currency exchange rates	(22,518)		
Billings proxy, excluding foreign currency impact	$686,420	$631,079	8.8%

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We provide a calculation for a four-fiscal-quarter rolling average billings proxy, which is intended to neutralize quarterly fluctuations, as discussed below, to the growth rate of our billings proxy. Below is a summary of our four-fiscal-quarter period rolling average billings proxy (approximated as described above by adding revenue for the period with the change in deferred revenue as reported on our Consolidated Statements of Cash Flows for the same period) for the four-fiscal-quarter periods ended May 31, 2018 and May 31, 2017 (in thousands):

	Four-Fiscal-Quarter Period Ended		
	May 31, 2018	May 31, 2017	Year-Over-Year Growth Rate
Four-fiscal-quarter period rolling average billings proxy	$857,626	$717,403	19.5%
Adjustment to revenue for foreign currency exchange rates	(15,524)	—	
Four-fiscal-quarter period rolling average billings proxy, excluding foreign currency impact	$842,102	$717,403	17.4%

Our deferred revenue and billings proxy can be subject to quarterly fluctuations due to a number of factors. For example, our deferred revenue and billings can be adversely impacted when larger deals anticipated to close in a particular quarter close in a subsequent quarter or customers renew their agreements with us prior to the expiration of such agreements. Additionally, when customers enter into multi-year agreements and choose to be billed annually rather than up-front, billings for the quarter in which those agreements close can be adversely impacted.

For information regarding seasonality , see Part II, Item 7 under “Overview” of our Annual Report on Form 10-K for the fiscal year ended February 28, 2018. For information regarding total backlog, see NOTE 12—Deferred Revenue and Performance Obligations to our Consolidated Financial Statements.

Revenue by geography

For the three months ended May 31, 2018, approximately $371.1 million, or 45.6%, of our revenue was generated outside the U.S. compared to approximately $282.3 million, or 41.7%, for the three months ended May 31, 2017. Excluding the impact of foreign currency exchange rate fluctuations, our revenue generated outside the U.S. would have been 44.1%, or $348.6 million, of our total revenue for the three months ended May 31, 2018. Our international operations are expected to grow as our international sales force and channels become more mature and as we enter new locations outside the U.S. or expand our presence in existing international locations. As of May 31, 2018, we had offices in more than 95 locations throughout the world.

We operate our business in three geographic regions: the Americas (U.S., Canada and Latin America); EMEA (Europe, Middle East and Africa); and Asia Pacific (principally Australia, China, India, Japan, Singapore and South Korea). Revenue, as reported and excluding the impact of foreign currency exchange rate fluctuations, and related year-over-year (“YoY”) revenue growth rates generated by the Americas, EMEA and Asia Pacific were as follows (in thousands):

	Americas		EMEA		Asia Pacific		Consolidated	
Three Months Ended	Revenue	YoY Growth %	Revenue	YoY Growth %	Revenue	YoY Growth %	Revenue	YoY Growth %
May 31, 2018, as reported	$500,306	14.1%	$195,148	35.8%	$118,076	24.6%	$813,530	20.2%
Adjustment for foreign currency exchange rates	1,970		(21,041)		(3,447)		(22,518)	
May 31, 2018, excluding foreign currency impact	$502,276	14.6%	$174,107	21.2%	$114,629	21.0%	$791,012	16.9%
May 31, 2017, as reported	$438,380	19.9%	$143,671	15.6%	$94,745	21.7%	$676,796	19.2%

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

Gross profit margin

Gross profit margin decreased to 84.9% for the three months ended May 31, 2018 from 85.1% for the three months ended May 31, 2017. This decrease was driven by a higher mix of training and services revenue relative to subscription revenue. Training and services revenue as a percentage of total revenue was 12.5% for the three months ended May 31, 2018 as compared to 11.9% the three months ended May 31, 2017.

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Gross profit margin by geography

Gross profit margins by our geographic regions were as follows:

	Americas	EMEA	Asia Pacific	Consolidated [1]
Three Months Ended May 31, 2018	85.3%	87.9%	83.0%	84.9%
Three Months Ended May 31, 2017	85.6%	87.1%	83.9%	85.1%

(1) Consolidated gross profit includes corporate (non-allocated) share-based compensation expense for the three months ended May 31, 2018 and May 31, 2017 of $5.1 million and $3.9 million, respectively. Share-based compensation expense was not allocated to geographic segments. For additional information, see NOTE 14—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 13.8% and 13.3% of total revenue for the three months ended May 31, 2018 and May 31, 2017, respectively. Operating expenses as a percent of total revenue decreased to 71.1% for the three months ended May 31, 2018 from 71.9% for the three months ended May 31, 2017 due to improved sales productivity as well as efficiencies in our marketing and general administrative support areas of the business.

Income from operations by geography

Operating income as a percentage of revenue generated by our geographic regions was as follows:

	Americas	EMEA	Asia Pacific	Consolidated [1]
Three Months Ended May 31, 2018	14.4%	25.0%	31.7%	13.8%
Three Months Ended May 31, 2017 [2]	17.0%	21.5%	29.5%	13.3%

(1) Consolidated operating income includes corporate (non-allocated) share-based compensation expense for the three months ended May 31, 2018 and May 31, 2017 of $46.0 million and $43.7 million, respectively. Share-based compensation expense was not allocated to geographic segments. For additional information, see NOTE 14—Share-based Awards to our Consolidated Financial Statements.

(2) As adjusted to reflect the impact of the retrospective application of ASC 606. See Note 2—Summary of Significant Accounting Policies to our Consolidated Financial Statements for detailed information on adoption of ASC606.

Cash, cash equivalents, restricted cash, investments in debt and equity securities and cash flow from operations

Cash, cash equivalents, restricted cash and short-term and long-term available-for-sale investments in debt and equity securities balances at May 31, 2018 totaled $2.53 billion. Cash generated from operating activities for the three months ended May 31, 2018 totaled $346.2 million, which represents an increase of 34.2% in operating cash flow as compared to the three months ended May 31, 2017. This increase is primarily due to collections on billings.

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

Foreign currency exchange rate impact on results of operations

Approximately 45.6% of our revenue for the three months ended May 31, 2018 came from sales outside the U.S. 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.

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Using the average foreign currency exchange rates for the three months ended May 31, 2017, our revenue from non-U.S. operations for the three months ended May 31, 2018 would have been lower than we reported by approximately $22.5 million and operating expenses from non-U.S. operations for the three months ended May 31, 2018 would have been lower than we reported by approximately $15.8 million, which would have resulted in income from operations being lower by $6.7 million.

Business combinations

CoreOS

On January 30, 2018, we acquired all of the shares of CoreOS, Inc. (“CoreOS”), a Linux and container-focused company, for approximately $238.7 million. The addition of CoreOS, a provider of Kubernetes and container-native solutions, is expected to further enable our customers to build any application and deploy them in any environment with the flexibility afforded by open source. By combining CoreOS’s complementary capabilities with our Kubernetes and container-based portfolio, including Red Hat OpenShift, we aim to further accelerate adoption and development of our hybrid cloud platform for modern application workloads.

Permabit

On July 31, 2017, we acquired the assets and technology of Permabit Technology Corporation (“Permabit”) for approximately $49.8 million. Permabit is a provider of software for data deduplication, compression and thin provisioning technology. Adding Permabit’s data deduplication and compression capabilities to our Red Hat Enterprise Linux platform will better enable enterprise digital transformation through more efficient storage options.

Codenvy

On June 1, 2017, we completed our acquisition of all of the shares of Codenvy S.A. (“Codenvy”) for approximately $34.2 million. Codenvy is a provider of cloud-native development tools that enable developers to more easily create modern container-based and cloud-native applications. By adding Codenvy to our existing portfolio of developer tools and application platforms, including Red Hat JBoss Middleware and Red Hat OpenShift, we continue our efforts to provide solutions that enable developers to create applications for hybrid cloud environments. We plan to make Codenvy an integral part of OpenShift.io, our hosted development environment for building hybrid cloud services on OpenShift.

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CRITICAL ACCOUNTING ESTIMATES

We prepare our consolidated financial statements in accordance with U.S. GAAP. Our significant accounting policies are disclosed in NOTE 2—Summary of Significant Accounting Policies to our Consolidated Financial Statements contained in our Annual Report on Form 10-K for the fiscal year ended February 28, 2018 and describe our methods for applying U.S. GAAP in areas such as revenue recognition, deferred selling costs, fair value measurements, and foreign currency translation among other areas deemed significant. Other than the accounting pronouncement adopted during the three months ended May 31, 2018 related to accounting for revenue from contracts with customers as described in NOTE 2—Summary of Significant Accounting Policies to our Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q, there have been no changes to our significant accounting policies.

In applying certain significant accounting policies, we have to make estimates and assumptions that affect our reported amounts of assets, liabilities, revenue and expenses, as well as related disclosure of contingent assets and liabilities. In some cases, changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ materially from our estimates. To the extent that there are material differences between these estimates and actual results, our financial condition, results of operations or cash flows could be adversely affected. We base our estimates on past experience and other assumptions that we believe are reasonable under the circumstances, and we evaluate these estimates on an ongoing basis. We refer to accounting estimates of this type as critical accounting estimates, which were applied in the following areas:

- Revenue recognition;
- Goodwill and other long-lived assets;
- Share-based compensation;
- Income taxes; and
- Loss contingencies.

Other than the changes to critical accounting estimates for revenue recognition described below, there have been no changes to “Critical Accounting Estimates” contained in Part II, Item 7 of our Annual Report on Form 10-K for the fiscal year ended February 28, 2018.

Revenue recognition

Application of accounting principles related to the measurement and recognition of revenue requires judgment. For example, in transactions that include multiple performance obligations, we must exercise judgment in determining the stand-alone selling price (“SSP”) for each distinct performance obligation. We typically determine SSP based on the observable price when we sell the subscriptions or training and services separately, taking into consideration the geographical region of the customer, type of offering and sales channel. In instances where SSP is not directly observable, we determine SSP either from the renewal rate paid for the performance obligation to the extent it is the same rate as stipulated in the initial customer contract, or by using the expected-cost-plus-margin approach. Changes to the SSP for each distinct performance obligation could materially affect the amount of earned and unearned revenue.

In addition, determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together may require significant judgment.

We also derive a portion of our revenue from CCSPs that provide public clouds with computing resources that allow users to consume such resources as a service. We use our historical cloud-usage data to estimate the amount of revenue earned and recognized each period and adjust to actual amounts earned upon receipt of usage reports from the CCSPs in the following period.

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RESULTS OF OPERATIONS

Three months ended May 31, 2018 and May 31, 2017

The following table is a summary of our results of operations (in thousands):

	Three Months Ended (Unaudited)			
	May 31, 2018	May 31, 2017 (1)	$ Change	% Change
Revenue:				
Subscriptions	$711,521	$596,508	$115,013	19.3 %
Training and services	102,009	80,288	21,721	27.1
Total revenue	813,530	676,796	136,734	20.2
Cost of revenue:				
Subscriptions	52,173	43,633	8,540	19.6
As a % of subscription revenue	7.3 %	7.3 %		
Training and services	70,526	57,063	13,463	23.6
As a % of training and services revenue	69.1 %	71.1 %		
Total cost of revenue	122,699	100,696	22,003	21.9
As a % of total revenue	15.1 %	14.9 %		
Gross profit	690,831	576,100	114,731	19.9
Operating expense:				
Sales and marketing	348,815	294,323	54,492	18.5
Research and development	166,506	137,163	29,343	21.4
General and administrative	63,354	54,870	8,484	15.5
Total operating expense	578,675	486,356	92,319	19.0
Income from operations	112,156	89,744	22,412	25.0
Interest income	7,834	3,993	3,841	96.2
Interest expense	6,319	6,085	234	3.8
Other expense, net	(2,194)	(586)	(1,608)	N/A
Income before provision for income taxes	111,477	87,066	24,411	28.0
(Benefit) provision for income taxes	(1,713)	11,752	(13,465)	(114.6)
Net income	$113,190	$75,314	$37,876	50.3 %
Gross profit margin—subscriptions	92.7 %	92.7 %		
Gross profit margin—training and services	30.9 %	28.9 %		
Gross profit margin	84.9 %	85.1 %		
As a % of total revenue:				
Subscription revenue	87.5 %	88.1 %		
Training and services revenue	12.5 %	11.9 %		
Sales and marketing expense	42.9 %	43.5 %		
Research and development expense	20.5 %	20.3 %		
General and administrative expense	7.8 %	8.1 %		
Total operating expenses	71.1 %	71.9 %		
Income from operations	13.8 %	13.3 %		
Income before provision for income taxes	13.7 %	12.9 %		
Net income	13.9 %	11.1 %		
Effective income tax rate (2)	(1.5)%	13.5 %		

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See Note 2—Summary of Significant Accounting Policies to our Consolidated Financial Statements for detailed information on adoption of ASC 606.

(2) See NOTE 7—Income Taxes to our Consolidated Financial Statements for further discussion.

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Revenue

Subscription revenue

Subscription revenue, which is primarily comprised of direct and indirect sales of Red Hat offerings, increased by 19.3%, or $115.0 million, to $711.5 million for the three months ended May 31, 2018 from $596.5 million for the three months ended May 31, 2017.

Revenue derived from the sale of subscriptions supporting our Infrastructure-related offerings increased by 14.1%, or $64.4 million, to $522.4 million for the three months ended May 31, 2018 from $458.0 million for the three months ended May 31, 2017. The increase in subscription revenue is primarily due to increases in volumes sold, including additional subscriptions attributable to geographic expansion, and the continued migration of customers to our open source Linux platform from proprietary operating systems.

Revenue derived from the sale of subscriptions supporting our Application Development-related and other emerging technology offerings increased by 36.5%, or $50.6 million, to $189.1 million for the three months ended May 31, 2018 from $138.5 million for the three months ended May 31, 2017. The increase is primarily driven by additional subscriptions for certain emerging technology offerings: Ansible, OpenShift and OpenStack. We expect the growth rate of revenue derived from our Application Development-related and other emerging technology offerings to continue to exceed the growth rate of revenue derived from our Infrastructure-related offerings as our emerging technology offerings continue to gain broader market acceptance in the enterprise IT environment.

Training and services revenue

Training revenue includes fees paid by our customers for delivery of educational materials and instruction. Services revenue includes fees received from customers for consulting units regarding our offerings, deployment of Red Hat technologies and for delivery of added functionality to Red Hat technologies for our major customers and OEM partners. Total training and services revenue increased by 27.1%, or $21.7 million, to $102.0 million for the three months ended May 31, 2018 from $80.3 million for the three months ended May 31, 2017. Training revenue increased by 21.6%, or $4.1 million as a result of increased revenue generated from our Red Hat Learning Subscription (“RHLS”) offerings and increased consumption of training courses or units related to our emerging technology offerings. Services revenue increased by 28.7%, or $17.7 million, as a result of an increase in consulting engagements driven by increased demand for our open source cloud enabling solutions such as Ansible and OpenShift. We expect services revenue to continue growing as we continue to expand our reach by enabling our channel partners to provide consulting services on our behalf. Combined training and services revenue as a percentage of total revenue was 12.5% and 11.9%, respectively, for the three months ended May 31, 2018 and May 31, 2017.

Cost of revenue

Cost of subscription revenue

The cost of subscription revenue primarily consists of expenses we incur to support, distribute and package Red Hat offerings. These costs include labor-related costs to provide technical support, security updates and fixes, as well as costs for fulfillment. Cost of subscription revenue increased by 19.6%, or $8.5 million, to $52.2 million for the three months ended May 31, 2018 from $43.6 million for the three months ended May 31, 2017. The overall increase is primarily due to employee compensation expense, which increased $4.3 million due to the expansion of our technical staff in order to meet the demands of our growing subscriber base for support, security updates and fixes, especially with respect to the increase in demand for our emerging technology offerings. The remaining expense increase is primarily related to $5.4 million higher expense associated with facility and technology infrastructure enhancements. As the number of open source technology subscriptions continues to increase, we expect associated support costs will continue to increase, although we anticipate this will occur at an overall slower rate than that of subscription revenue growth due to economies of scale. Gross profit margin on subscriptions remained constant at 92.7% for the three months ended May 31, 2018 and May 31, 2017.

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Cost of training and services revenue

Cost of training and services revenue is mainly comprised of personnel and third-party consulting costs for the design, development and delivery of custom engineering, training courses and professional services provided to various types of customers. Cost of training and services revenue increased by 23.6%, or $13.5 million, to $70.5 million for the three months ended May 31, 2018 from $57.1 million for the three months ended May 31, 2017. The increase in cost to deliver training and services includes $6.9 million increased employee compensation expense and increased outside contractor fees of $5.1 million. The increase in employee compensation expense and outside contractor fees is due to the expansion of our professional consulting teams needed to meet the growing demand for services related to our emerging technology offerings. Total costs to deliver training and services as a percentage of training and services revenue decreased to 69.1% for the three months ended May 31, 2018 from 71.1% for the three months ended May 31, 2017.

Gross profit margin

Gross profit margin decreased to 84.9% for the three months ended May 31, 2018 from 85.1% for the three months ended May 31, 2017. This decrease was driven by a higher mix of training and services revenue relative to subscription revenue. Training and services revenue as a percentage of total revenue was 12.5% for the three months ended May 31, 2018 as compared to 11.9% for the three months ended May 31, 2017.

Operating expenses

Sales and marketing

Sales and marketing expense consists primarily of salaries and other related costs for sales and marketing personnel, sales commissions, travel, public relations and marketing materials and trade shows. Sales and marketing expense increased by 18.5%, or $54.5 million, to $348.8 million for the three months ended May 31, 2018 from $294.3 million for the three months ended May 31, 2017. This increase was primarily due to a $39.9 million increase in selling costs, which includes $29.1 million and $3.7 million of additional employee- and travel-related expenses, respectively, the majority of which is attributable to the expansion of our sales force from the prior year. The remaining increase relates to marketing costs, which grew 20.0%, or $14.6 million, for the three months ended May 31, 2018 as compared to the three months ended May 31, 2017 and includes incremental employee compensation expense and marketing program costs of $6.9 million and $4.1 million, respectively. Sales and marketing expense decreased as a percentage of revenue to 42.9% for the three months ended May 31, 2018 from 43.5% for the three months ended May 31, 2017, primarily as a result of additional sales productivity.

Research and development

Research and development expense consists primarily of personnel and related costs for development of software technologies and systems management offerings. Research and development expense increased by 21.4%, or $29.3 million, to $166.5 million for the three months ended May 31, 2018 from $137.2 million for the three months ended May 31, 2017. The increase in research and development costs primarily resulted from the expansion of our engineering group through both direct hires and business acquisitions as we continue investing in Application Development-related and other emerging technologies. Employee compensation expense increased by $22.8 million. The remaining increase in research and development costs relates primarily to process and technology infrastructure enhancements, which increased by $4.5 million. Research and development expense was 20.5% of total revenue for the three months ended May 31, 2018 compared to 20.3% for the three months ended May 31, 2017.

General and administrative

General and administrative expense consists primarily of personnel and related costs for general corporate functions, including information systems, finance, accounting, legal, human resources and facilities expense. General and administrative expense increased by 15.5%, or $8.5 million, to $63.4 million for the three months ended May 31, 2018 from $54.9 million for the three months ended May 31, 2017. The increase in general and administrative expense primarily resulted from increased employee compensation expenses of $3.6 million and $3.7 million higher expense associated with facility and technology infrastructure enhancements. General and administrative expense as a percentage of revenue was 7.8% and 8.1% for the three months ended May 31, 2018 and May 31, 2017, respectively. We expect general and administrative costs to continue to decrease relative to revenue as we leverage benefits from investments made during the current fiscal year to expand and enhance our corporate processes and technology

infrastructure.

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Interest income

Interest income increased by 96.2%, or $3.8 million, for the three months ended May 31, 2018 as compared to the three months ended May 31, 2017. The increase in interest income for the three months ended May 31, 2018 is attributable to higher yields earned on larger cash and investment balances.

Interest expense

Interest expense increased by $0.2 million for the three months ended May 31, 2018 as compared to the three months ended May 31, 2017. Interest expense is primarily attributable to the interest on our 0.25% Convertible Senior Notes due 2019 (the “convertible notes”).

Other expense, net

Other expense, net is primarily attributable to net losses recognized from the settlement of foreign currency transactions during the three months ended May 31, 2018 and May 31, 2017.

Income taxes

The effective tax rate for the three months ended May 31, 2018 differed from the U.S. federal statutory rate of 21.0% primarily due to excess tax benefits from share-based compensation, research tax credits and the impact from the Tax Act. The effective tax rate for the three months ended May 31, 2017 differed from the U.S. federal statutory rate of 35.0% primarily due to excess tax benefits from share-based compensation, foreign income taxed at lower rates and research tax credits. Tax benefit for the three months ended May 31, 2018 and tax expense for the three months ended May 31, 2017 included net discrete tax benefits of $26.8 million and $11.6 million, respectively, primarily related to net excess tax benefits from share-based compensation. For further discussion regarding our income taxes, see NOTE 7—Income Taxes to our Consolidated Financial Statements.

LIQUIDITY AND CAPITAL RESOURCES

We derive our liquidity and operating capital primarily from cash flows from operations. Historically, we also received cash from the sale of equity securities, including private sales of preferred stock and the sale of common stock in our initial and follow-on public offerings, and the issuance of convertible notes, including our issuance of convertible notes described in detail in NOTE 8—Convertible Notes to our Consolidated Financial Statements. At May 31, 2018, we had total cash and investments of $2.53 billion, which was comprised of $1.77 billion in cash and cash equivalents, $329.9 million of short-term investments and $428.8 million of long-term fixed-income investments. This compares to total cash and investments of $2.47 billion at February 28, 2018.

Convertible note conversions

For at least 20 trading days during the 30 consecutive trading days ending on the last trading day of the fiscal quarters ended August 31, 2017 through May 31, 2018, our common stock traded at a price exceeding 130% of the conversion price of the convertible notes. Accordingly, the convertible notes remain convertible at the holders’ option until August 31, 2018. To the extent we receive notices of conversion, we may choose to pay or deliver, as the case may be, either cash, shares of our common stock or a combination of cash and shares of our common stock. We currently intend to settle the principal amount of the convertible notes in cash. Total settled conversions through May 31, 2018 amounted to $26.0 million aggregate principal amount of the convertible notes. We expect to settle conversions of $202.3 million in principal amount of the convertible notes in the second quarter of fiscal 2019, by paying cash for the principal amount and issuing shares of common stock for the excess conversion value. We continue to receive conversion requests and as of July 6, 2018, such incremental requests totaled $45.3 million in principal amount of the convertible notes. The aggregate principal amount of the convertible notes remaining is expected to be $531.4 million after the expected conversion settlements as discussed above and the incremental conversion requests received as of July 6, 2018.

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Cash flows for the three months ended May 31, 2018

Cash flows—overview

At May 31, 2018, cash and cash equivalents totaled $1.77 billion, an increase of $44.3 million as compared to February 28, 2018. The increase in cash and cash equivalents for the three months ended May 31, 2018 is primarily the result of cash provided by operations, which generated $346.2 million. Partially offsetting cash provided by operating activities was cash used for the repurchase of 948,638 shares of our common stock for $150.0 million, payments made in return for common shares received from employees to satisfy employees' minimum tax withholding obligations related to share awards vesting of $77.1 million, repayments of convertible notes of $26.0 million, net purchases of available-for-sale debt securities of $20.8 million and investments in property and equipment of $13.0 million. Net cash generated by operating activities and net cash used for investing activities and financing activities is further described below.

Cash flows from operations

Cash provided by operations of $346.2 million during the three months ended May 31, 2018 includes net income of $113.2 million, adjustments to exclude the impact of non-cash income and expenses, which totaled a $77.3 million net source of cash, and changes in operating assets and liabilities, which totaled a $155.6 million net source of cash. Cash provided by changes in operating assets and liabilities for the three months ended May 31, 2018 was primarily the result of collections on our billings partially offset by a decrease in deferred revenue. The decrease in deferred revenue is primarily attributable to our typically lower seasonal first quarter billings.

Cash flows from investing

Cash used in investing activities of $36.3 million for the three months ended May 31, 2018 includes net purchases of available-for-sale debt securities of $20.8 million and investments in property and equipment of $13.0 million, which primarily relate to information technology infrastructure and leasehold improvements.

Cash flows from financing

Cash used in financing activities of $237.2 million for the three months ended May 31, 2018 includes $150.0 million to repurchase 948,638 shares of our common stock, $77.1 million of payments made in return for common shares received from employees to satisfy employees' minimum tax withholding obligations related to employee share awards vesting during the three months ended May 31, 2018 and repayments of convertible notes of $26.0 million. Partially offsetting these uses of cash were proceeds of $15.3 million from our employee stock purchase plan.

Investments in debt and equity securities

Our investments in debt securities are comprised primarily of available-for-sale fixed-income investments recorded at their fair values, of which $329.9 million are classified as short-term and $428.8 million are classified as long-term on the Consolidated Balance Sheet at May 31, 2018. The vast majority of our investments were 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, we assess other factors to determine the securities' fair values, including broker quotes or model valuations. Independent price verifications of all of our holdings are performed by the pricing vendors, which we review. In the event a price fails a pre-established tolerance check, it is researched so that we can assess the cause of the variance to determine what we believe is the appropriate fair value.

We presently do not intend to liquidate our short- and long-term investments in debt securities prior to their scheduled maturity dates. However, in the event that we liquidate these investments prior to their scheduled maturities and there are adverse changes in market interest rates or the overall economic environment, we could be required to recognize a realized loss on those investments when we liquidate these investments. At May 31, 2018 and February 28, 2018, net accumulated unrealized net losses on our available-for-sale debt securities totaled $4.8 million and $5.3 million, respectively.

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Capital requirements

Our capital requirements during the fiscal year ending February 28, 2019 will depend on numerous factors, including the amount of resources we devote to:

- funding the continued development of our technology offerings;
- improving and extending our services and the technologies used to market and deliver these services to our customers and support our business;
- pursuing strategic acquisitions and alliances;
- investing in or acquiring businesses, products and technologies; and
- investing in enhancements to the systems we use to run our business and the expansion of our office facilities.

We have utilized, and will continue from time to time to utilize, cash and investments to fund, among other potential uses, purchases of our common stock, purchases of fixed assets, purchases of intangible assets (primarily patents), and mergers and acquisitions. Given our historically strong operating cash flow and the $2.53 billion of cash and investments held at May 31, 2018, we believe our cash balances totaling $1.77 billion, together with our ability to generate additional cash from operations, should be sufficient to satisfy our cash requirements for the next twelve months and for the foreseeable future. However, we may take advantage of favorable capital market conditions that may arise from time to time to raise additional capital.

We believe that our ability to generate additional cash from operations will continue; however, there can be no assurances that we will be able to generate cash from operations at a level equal to the current rate or that such cash flows will be adequate to fund other investments or acquisitions that we may choose to make or that cash may be located in or generated in the appropriate geographic region where we can effectively use such cash. We may choose to accelerate the expansion of our business from our current plans, which may require us to raise additional funds through the sale of equity or debt securities or through other financing means. There can be no assurances that any such financing would occur in amounts or on terms favorable to us, if at all.

As of May 31, 2018, $1.14 billion of our total cash and investments were held outside the U.S. Our intent has been to reinvest the earnings of foreign subsidiaries indefinitely outside the U.S. to fund both organic growth and acquisitions. The Tax Act, which was enacted in December 2017, includes a provision to move the U.S. to a territorial tax system by imposing a transition tax on historic foreign earnings whether or not such earnings are repatriated to the U.S. An estimated transition tax of $96.4 million on such earnings was recognized as part of our fiscal 2018 financial results and is payable over a period of up to eight years. In light of the new territorial tax system, we are reviewing our prior position on the reinvestment of the earnings of our foreign subsidiaries outside of the U.S. As of February 28, 2018, cumulative undistributed foreign earnings totaled $226.0 million. For further discussion, see NOTE 10—Income Taxes to our Consolidated Financial Statements contained in our Annual Report on Form 10-K for the year ended February 28, 2018.

Off-balance sheet arrangements

As of May 31, 2018 and February 28, 2018, we have no off-balance sheet financing arrangements and do not utilize any “structured debt,” “special purpose” or similar unconsolidated entities for liquidity or financing purposes.

RECENT ACCOUNTING PRONOUNCEMENTS

For discussion of accounting pronouncements recently adopted and accounting pronouncements being evaluated, and the impact of such pronouncements on our consolidated financial statements, see NOTE 2—Summary of Significant Accounting Policies to our Consolidated Financial Statements.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to the impact of interest rate changes, foreign currency exchange rate fluctuations and changes in the market value of our investments.

Interest-rate risk

Our exposure to market-rate risk for changes in interest rates relates primarily to our investment portfolio. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we maintain our portfolio of short- and long-term investments in a variety of available-for-sale fixed- and floating-rate debt securities, including both government and corporate obligations and money market funds. Investments in both fixed-rate and floating-rate interest-earning instruments carry a degree of interest-rate risk. Fixed-rate securities may have their fair value adversely impacted due to a rise in prevailing interest rates, while floating-rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income related to these securities may fall short of expectations due to changes in interest rates, or we may suffer losses in principal if forced to sell securities that have declined in market value due to changes in interest rates or perceived credit risk related to the securities' issuers. A hypothetical one-half percentage point change in interest rates, assuming a parallel shift of all interest rates, would result in an approximate $0.4 million change in annual interest income derived from investments in our portfolio as of May 31, 2018. For further discussion related to our investments as of May 31, 2018 and February 28, 2018, see NOTE 15—Assets and Liabilities Measured at Fair Value on a Recurring Basis to our Consolidated Financial Statements.

Investment risk

The fair value of our available-for-sale investment portfolio is subject to interest-rate risk. Based on a sensitivity analysis performed on this investment portfolio, a hypothetical one percentage point increase in prevailing interest rates would result in an approximate $7.8 million decrease in the fair value of our available-for-sale investment securities as of May 31, 2018. For further discussion related to our investments as of May 31, 2018 and February 28, 2018, see NOTE 15—Assets and Liabilities Measured at Fair Value on a Recurring Basis to our Consolidated Financial Statements.

Credit risk

Investments in debt and equity securities

The fair values of our investment portfolio and cash balances are exposed to counterparty credit risk. Accordingly, while we periodically review our portfolio in an effort to mitigate counterparty risk, the principal values of our cash balances, money market accounts and investments in available-for-sale securities could suffer a loss of value.

Accounts receivable

As of May 31, 2018 and February 28, 2018, no individual customer accounted for 10% or more of our total accounts receivable.

Foreign currency risk

Approximately 45.6% of our revenue for the three months ended May 31, 2018 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 statements results in increased revenue and operating expenses for our non-U.S. operations. Similarly, our revenue and operating expenses for our non-U.S. operations decrease if the U.S. dollar strengthens against foreign currencies.

Using the average foreign currency exchange rates from the first quarter of our prior fiscal year ended February 28, 2018, our revenue and operating expenses from non-U.S. operations for the three months ended May 31, 2018 would have been lower than we reported by approximately $22.5 million and $15.8 million, respectively, which would have resulted in income from operations being lower by $6.7 million.

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Convertible notes

In October 2014, we issued $805.0 million of 0.25% convertible notes due 2019. The convertible notes have a fixed annual interest rate of 0.25%, and, therefore, we do not have economic interest-rate exposure on the convertible notes. However, the fair value of the convertible notes is exposed to interest-rate risk. Generally, the fair value of the convertible notes will increase as interest rates fall and decrease as interest rates rise. For further discussion regarding the fair value of the convertible notes, see NOTE 8—Convertible Notes to our Consolidated Financial Statements.

In connection with the sale of the convertible notes, we entered into convertible note hedge transactions and warrant transactions. The convertible note hedge transactions are expected to offset, to the extent that the market price per share of our common stock does not exceed $101.65, the potential dilution with respect to shares of our common stock upon any conversion of the convertible notes and/or offset any cash payments that we are required to make in excess of the principal amount of the converted notes, as the case may be. The warrant transactions will have a dilutive effect with respect to our common stock to the extent that the market price per share of our common stock, as measured under the terms of the warrant transactions, exceeds the applicable strike price of the warrants. However, subject to certain conditions, we may elect to settle all of the warrants in cash. The initial strike price of the warrants is $101.65 per share. The number of shares of our common stock underlying the warrants is 10,965,630 shares, subject to anti-dilution adjustments. The convertible note hedge and warrants are both considered indexed to our common stock and classified as equity; therefore, the convertible note hedge and warrants are not accounted for as derivative instruments.

Derivative instruments

We transact business in various foreign countries and are, therefore, subject to risk of foreign currency exchange rate fluctuations. From time to time we enter 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 values. We generally elect not to prepare and maintain the documentation required to qualify our forward contracts for hedge accounting treatment and, therefore, changes in fair value are recorded in our Consolidated Statements of Operations. For further discussion related to our management of foreign currency risk, see NOTE 6—Derivative Instruments to our Consolidated Financial Statements.

The aggregate notional amount of outstanding forward contracts at May 31, 2018 was $49.7 million. The fair value of these outstanding contracts at May 31, 2018 was a gross $0.1 million asset and a gross $0.8 million liability, and is recorded in Other current assets and Accounts payable and accrued expenses, respectively, on our Consolidated Balance Sheets. The forward contracts generally expire within three months of the period ended May 31, 2018. The forward contracts will settle in Australian dollars, Euros, Hong Kong dollars, Japanese yen, Norwegian krona, Singapore dollars, Swedish krona and Swiss francs.

The aggregate notional amount of outstanding forward contracts at February 28, 2018 was $62.3 million. The fair value of these outstanding contracts at February 28, 2018 was a gross $0.3 million asset and a gross $0.3 million liability, and is recorded in Other current assets and Accounts payable and accrued expenses, respectively, on our Consolidated Balance Sheets.

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ITEM 4. CONTROLS AND PROCEDURES

Role of Controls and Procedures

Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) or our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act) will prevent all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of the controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error and mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Also projections of any evaluation of effectiveness of controls and procedures to future periods are subject to the risk that the controls and procedures may become inadequate because of changes in conditions, or that the degree of compliance with the controls and procedures may have deteriorated.

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective at a reasonable assurance level.

Changes in Internal Control Over Financial Reporting

During the fiscal quarter ended May 31, 2018, we implemented a new revenue recognition software tool and related internal controls in connection with our adoption of ASC 606 effective March 1, 2018. There were no other changes in our internal control over financial reporting during the fiscal quarter ended May 31, 2018 with respect to our operations that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II

ITEM 1. 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.

ITEM 1A. RISK FACTORS

Set forth below are certain risks and cautionary statements, which supplement other disclosures in this report. Please carefully consider the following risks and cautionary statements. If any event related to the following risk factors occurs, our business, financial condition, operating results and cash flows could be materially adversely affected.

RISKS RELATED TO BUSINESS UNCERTAINTY

We face intense competition.

The enterprise software industry is rapidly evolving and intensely competitive, and is subject to changing technologies, shifting customer needs, and frequent introductions of new products and services by both new and established information technology ("IT") companies. We compete based on our ability to provide our customers with enterprise software and related service offerings that best meet their needs at a compelling price. We expect that competition will continue to be intense, and there is a risk that our competitors' products may provide better performance or include additional features when compared to our offerings. Competitive pressures could also affect the prices we may charge or the demand for our offerings, resulting in reduced profit margins and loss of market share.

Our current and potential competitors range from large and well-established companies to emerging start-ups. Some of our competitors have significantly greater financial resources and name recognition, larger development and sales staffs and more extensive marketing and distribution capabilities. Certain competitors also bundle hardware and software offerings, making it more difficult for us to penetrate their customer bases, while other competitors may be able to innovate and provide products and services faster than we can. As the enterprise software industry evolves, the competitive pressure for us to innovate encompasses a wider range of products and services, including new offerings that require different expertise than our current offerings. Moreover, if we are unable to effectively communicate the value of our subscription model, we may not compete effectively in attracting new, and maintaining existing, customers.

Given the rapid evolving nature of the enterprise software industry, the competitive landscape and the nature of the competition is constantly changing. Consolidation and divestitures in the technology industry are trends that we expect to continue as companies attempt to strengthen or maintain market positions as the technology industry evolves. Industry consolidation may affect competition by creating larger and potentially stronger competitors in the markets in which we compete or competitors that position themselves as key or single-source vendors providing end-to-end technology solutions for the data center. Moreover, other companies may currently be planning to, or are under pressure by stockholders to, divest businesses. These divestitures may result in additional competitors that may have an advantage by focusing on a single product or service. We also compete in certain areas with our partners and potential partners, some of which may from time to time form new strategic alliances designed to position one or more of them as a key or single-source vendor, and this may adversely impact our relationship with an individual partner or a number of partners.

Our efforts to compete effectively may not be sufficient, which may adversely affect our business, financial condition, operating results and cash flows.

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Our continued success depends on our ability to adapt to a rapidly changing industry. Investment in new offerings, business strategies and initiatives could disrupt our ongoing business and may present risks not originally contemplated.

We operate in highly competitive markets that are characterized by rapid technological change, such as the transition of many of our enterprise customers to cloud computing environments and frequent new product and service announcements. Our continued success will depend on our ability to adapt to rapidly changing technologies and user preferences, to adapt our offerings to evolving industry standards, to predict user preferences and industry changes in order to continue to provide value to our customers and to improve the performance and reliability of our offerings. Our failure to adapt to such changes could harm our business, and our efforts to adapt to such changes could require substantial expenditures on our part to modify our offerings or infrastructure. Delays in developing, completing or delivering new or enhanced offerings and technologies could result in delayed or reduced revenue for those offerings and could also adversely affect customer acceptance of those offerings and technologies. The success of new and enhanced offering introductions depends on several factors, including our ability to invest significant resources in research and development in order to enhance our existing offerings and introduce new offerings in a timely manner, successfully promote the offerings, manage the risks associated with the offerings, make sufficient resources available to support the offerings and address any quality or other defects in the early stages of introduction. Even if we are able to enhance our existing offerings or introduce new offerings that are well perceived by the market, if our marketing or sales efforts do not generate interest in or sales for these offerings, they may be unsuccessful.

Moreover, we believe that our continued success depends on our investing in new business strategies or initiatives that complement our strategic direction and technology road map. Such endeavors may involve significant risks and uncertainties, including distraction of management's attention away from other business operations, and insufficient revenue generation to offset liabilities and expenses undertaken with such strategies and initiatives. Because these endeavors may be inherently risky, no assurance can be given that such endeavors will not adversely affect our business, financial condition, operating results and cash flows.

If we fail to continue to establish and maintain strategic relationships with industry-leading companies, we may not be able to attract and retain a larger customer base.

Our success depends in part on our ability to continue to establish and maintain strategic relationships with industry-leading cloud service providers, hardware original equipment manufacturers ("OEMs"), independent software vendors ("ISVs") and system integrators ("SIs") to help us attract and retain a larger customer base. Many of these strategic partners have engineered and certified that their technologies run on or with our offerings and, in some cases, have built their products and solutions using our offerings. We may not be able to maintain these relationships or replace them on attractive terms in the future. Some of our strategic partners offer competing products and services. As a result of these factors, many of the companies with which we have strategic alliances may choose to pursue alternative technologies and develop alternative products and services in addition to or in lieu of our offerings, either on their own or in collaboration with others, including our competitors. Moreover, we cannot guarantee that the companies with which we have strategic relationships will market our offerings effectively or continue to devote the resources necessary to provide us with effective sales, marketing and technical support. As our agreements with strategic partners terminate or expire, we may be unable to renew or replace these agreements on comparable terms, or at all.

We rely, to a significant degree, on indirect sales channels for the distribution of our offerings, and disruption within these channels could adversely affect our business, financial condition, operating results and cash flows.

We use a variety of different indirect distribution methods for our offerings, including channel partners, such as certified cloud and service providers, distributors, embedded technology partners, OEMs, ISVs, SIs and value added resellers. A number of these partners in turn distribute via their own networks of channel partners with whom we have no direct relationship. These relationships allow us to offer our technologies to a much larger customer base than we would otherwise be able through our direct sales and marketing efforts.

We rely, to a significant degree, on each of our channel partners to select, screen and maintain relationships with its distribution network and to distribute our offerings in a manner that is consistent with applicable law and regulatory requirements and our quality standards. If our channel partners or a partner in its distribution network violate

applicable law or regulatory requirements or misrepresent the functionality of our offerings, our reputation could be damaged and we could be subject to potential liability. Furthermore, our channel partners may offer their own products and services or the products and services of other companies that compete with our offerings or may not distribute and market our offerings effectively. Moreover, our existing channel partner relationships do not, and any future channel partner relationships may not, provide for any exclusivity regarding marketing or distribution. In addition, if a channel partner is acquired by a competitor, its business units are reorganized or divested or its financial condition were to weaken, our revenue derived from that partner may be adversely impacted.

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Recruiting and retaining qualified channel partners and training them in the use of our enterprise technologies requires significant time and resources. If we fail to devote sufficient resources to support and expand our network of channel partners, our business may be adversely affected. In addition, because we rely on channel partners for the indirect distribution of our enterprise technologies, we may have little or no contact with the ultimate end-users of our technologies, thereby making it more difficult for us to establish brand awareness, ensure proper delivery and installation of our software, support ongoing customer requirements, estimate end-user demand, respond to evolving customer needs and obtain subscription renewals from end-users.

A portion of our sales to government entities have been made indirectly through our channel partners. Government entities may have statutory, contractual, or other legal rights to terminate contracts with our channel partners for convenience or due to a default, and any such termination may adversely impact our future operating results. Government entities routinely investigate and audit government contractors' administrative processes, and any unfavorable audit could result in a government entity refusing to continue buying our offerings, a reduction of revenue or fines or civil or criminal liability if the audit uncovers improper or illegal activities.

If our indirect distribution channel is disrupted, we may be required to devote more resources to distribute our offerings directly and support our customers, which may not be as effective and could lead to higher costs, reduced revenue and growth that is slower than expected.

If we fail to effectively manage our growth, our business, financial condition, operating results and cash flows could be adversely affected.

We have expanded our operations significantly in recent years. For example, our total revenue increased from $2.41 billion for the fiscal year ended February 28, 2017 to $2.92 billion for the fiscal year ended February 28, 2018 ("fiscal 2018"). Moreover, the total number of our employees increased from approximately 10,500 as of February 28, 2017 to approximately 11,870 as of February 28, 2018. In addition, we continue to explore ways to extend our offerings and geographic reach. Our growth has placed and will likely continue to place a strain on our management systems, information systems, resources and internal controls. Our ability to successfully provide our offerings and implement our business plan requires adequate information systems and resources, internal controls and oversight from our senior management. As we expand in international markets, these challenges increase as a result of the need to support a growing business in an environment of multiple languages, cultures, customs, legal systems, dispute resolution systems, regulatory systems and commercial practices. As we grow, (i) we may not be able to adequately screen and hire or adequately train, supervise, manage or develop sufficient personnel, and (ii) we may not be able to develop or effectively manage our controls, oversight functions or information systems. If we are unable to effectively manage our growth, our business, financial condition, operating results and cash flows could be adversely affected.

We have entered into and may continue to enter into or seek to enter into business combinations and acquisitions, which may be difficult to complete and integrate, disrupt our business, divert management's attention, adversely affect our business, financial condition, operating results and cash flows or dilute stockholder value.

As part of our business strategy, we have in the past entered into business combinations and acquisitions, and we may continue to do so in the future. These types of transactions can increase the expense of running our business and present significant challenges and risks, including:

- integrating the acquired business' accounting, financial reporting, management, information and information security, human resource and other administrative systems to permit effective management and reporting, and the lack of control if such integration is delayed or not implemented;
- incorporating and further developing acquired products or technology into our offerings and maintaining quality standards consistent with our brands;
- effectively evaluating talent at an acquired business or identifying cultural challenges associated with integrating employees from the acquired business into our organization;
- losing key employees of the acquired business;
- achieving the expected benefits of the transaction, which may include generating greater market acceptance of our offerings and technologies, increasing our revenue or integrating the assets acquired into one or more of our current offerings;
- increasing or adding operating expenses related to the acquired business or technology;

- identifying acquisition targets that complement our strategic direction and technology road map;

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- gathering full information regarding a business or technology prior to a transaction, including the identification and assessment of liabilities, claims or other circumstances that could result in litigation or regulatory exposure, unfavorable accounting treatment, unexpected tax implications and other adverse effects on our business;
- maintaining or establishing acceptable standards, controls, procedures and policies;
- disrupting our ongoing business and distracting management;
- impairing relationships with our employees, partners or customers as a result of any integration of new management and other personnel, products or technology or as a result of the changes in the competitive landscape affected by the transaction;
- maintaining good relationships with customers or business partners of the acquired business;
- incurring expenses related to the transaction;
- assuming claims and liabilities from the acquired business or technology, or that are otherwise related to the transaction;
- entering into new markets in which we have little or no experience or in which competitors may have stronger market positions;
- impairing of intangible assets and goodwill acquired in transactions; and
- for foreign transactions, managing additional risks related to the integration of operations across different cultures and languages, and the economic, political, compliance and regulatory risks associated with specific countries.

There can be no assurance that we will manage these challenges and risks successfully. Moreover, if we are not successful in completing transactions that we have pursued or may pursue, our business may be adversely affected, and we may incur substantial expenses and divert significant management time and resources. In addition, in pursuing and completing such transactions, we could use substantial portions of our available cash as all or a portion of the purchase price for these transactions or as retention incentives to employees of the acquired business, or we may incur substantial debt. We could also issue additional securities as all or a portion of the purchase price for these transactions or as retention incentives to employees of the acquired business, which could cause our stockholders to suffer significant dilution. Any transaction may not generate additional revenue or profit for us, or may take longer to do so than expected, which may adversely affect our business, financial condition, operating results and cash flows.

Our offerings and third-party products upon which our offerings depend may contain errors or defects that may be costly to correct or work around, delay market acceptance of our enterprise technologies and expose us to claims and litigation.

Despite our testing procedures, errors have been and may continue to be found in our offerings after deployment. This risk is increased by the fact that much of the code in our offerings is developed by independent parties over whom we exercise no supervision or control. If errors are discovered, we may have to make significant expenditures of capital and devote significant technical resources to analyze, correct, eliminate or work around them, and we may not be able to successfully do so in a timely manner or at all.

In addition, errors or defects (including deviations from published specifications) in our technologies or the design architecture or implementation of third-party products upon which our offerings depend could have a material adverse effect on our business, financial condition, operating results and cash flows. For example, in January 2018, computer security researchers publicly disclosed the discovery of hardware-based security vulnerabilities known as Meltdown and Spectre. The Meltdown and Spectre vulnerabilities affect many modern microprocessors and could allow an unauthorized individual to gain access to privileged memory that would otherwise be inaccessible. While we have issued updates for our offerings designed to address the Meltdown and Spectre vulnerabilities, such updates could slow the performance of affected machines. Meltdown and Spectre and similar vulnerabilities, errors or defects in our technologies or the third-party products on which our offerings depend could cause system failures, security breaches, loss of data, performance issues or other adverse effects for our customers who may assert warranty and other claims for substantial damages against us.

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Although our agreements with our customers often contain provisions that seek to limit our exposure to potential product liability claims, it is possible that these provisions may not be effective or enforceable under the laws of some jurisdictions. While we seek to insure against these types of claims, our insurance policies may not adequately limit our exposure to such claims. These claims, even if unsuccessful, could be costly and time-consuming to defend and could adversely affect our business, financial condition, operating results and cash flows. Any errors or defects in our offerings or third-party products upon which our offerings depend could result in a loss of, or delay in, market acceptance of our offerings, loss of existing or potential customers and delayed or lost revenue, damage to our reputation, declining market acceptance of emerging technologies, such as cloud computing, negatively affect demand for our technologies or delay their release, or otherwise adversely affect our business, financial condition, operating results and cash flows.

Security breaches and data loss may expose us to liability, harm our reputation and adversely affect our business.

Our business involves the production and distribution of enterprise software technologies, as well as hosting applications. As part of our business, we receive, store and process our data, as well as our employees', customers' and partners' data. We also work with third-party service providers and vendors that offer technologies, systems and services that we use in our business operations and in connection with the receipt, storage and processing of such data. While we take security measures relating to our offerings and business operations seriously and devote significant resources to implement and maintain security measures, those measures (or those of our third-party service providers and vendors) may not prevent security breaches or data loss or unauthorized disclosure that could harm our business, our employees or the businesses of our customers and partners. Inadequate technology or security measures, the failure to follow proper security protocols or other factors may result in data loss or unauthorized disclosure or a compromise or breach of our systems and the data we receive, store and process (or systems and the data received, stored and processed by our third-party service providers and vendors). Security measures may be breached or data may be lost or disclosed by third parties (such as through social engineering techniques to induce disclosure of passwords or other sensitive information, other actions to gain access to our data or our customers' or partners' data, or the use of ineffective security measures or failure to follow proper security protocols), human error (such as the use of weak passwords or unencrypted devices), malfeasance or vulnerabilities (including vulnerabilities of our third-party service providers and vendors) or bugs found in software code. A party who is able to circumvent security measures or exploit inadequacies in security measures, could, among other things, misappropriate proprietary information (including information about our employees, customers and partners, our customers' information, financial data and data that others could use to compete against us), cause the loss, misuse or disclosure of some or all of this information, cause interruptions or denial of service in our or our customers' operations, cause delays in development efforts or expose customers (and their customers) to computer viruses or other disruptions or vulnerabilities. A compromise to these systems could remain undetected for an extended period of time, exacerbating the impact of that compromise. While we have not yet experienced a cyber security incident that has had a material adverse effect on our business, reputation, financial condition, operating results or cash flows, we have experienced the unauthorized exposure of limited data by a third-party service provider.

Risks arising from or related to security breaches or data loss are likely to increase as we continue to grow our cloud, mobile and services offerings and as we receive, store and process more data. Actual or perceived vulnerabilities may lead to regulatory investigations and sanctions, claims against us by current or former employees, customers, partners or other third parties, or costs, such as those related to providing breach notifications and fraud monitoring. While our customer agreements typically contain provisions that seek to limit our liability, there is no assurance these provisions will be enforceable and effective under applicable law. In addition, the cost and operational consequences of remediating any incidents, implementing further data protection measures or upgrading our cybersecurity systems could be significant. Moreover, because the techniques used to obtain unauthorized access, disable or degrade service or sabotage systems change frequently, often grow more complex over time and often are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures, which could exacerbate the effects of a breach. We can make no assurance that we will be able to detect, prevent, timely and adequately address, or mitigate the negative effects of cyberattacks or other security breaches. Any loss of data or compromise of our systems or the data we receive, store or process (or systems and the data

received, stored and processed by our third-party service providers and vendors) could result in a loss of confidence in the security of our offerings, damage our reputation, cause the loss of current or potential customers or partners, lead to legal liability and adversely affect our business, financial condition, operating results and cash flows.

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The duration and extent of economic downturns, regional financial instability, and economic and market conditions in general could adversely affect our business, financial condition, operating results and cash flows.

Economic weakness and uncertainty, tightened credit markets and constrained IT spending from time to time contribute to slowdowns in the technology industry, as well as in the industries of our customers and the geographic regions in which we operate, which may result in reduced demand and increased price competition for our offerings. Our operating results in one or more geographic regions or customer industries may also be affected by uncertain or changing economic conditions within that region or industry. Uncertainty about future economic conditions may, among other things, negatively impact our current and prospective customers and result in delays or reductions in technology purchases or lengthen our sales cycle. Adverse economic conditions also may negatively impact our ability to obtain payment for outstanding debts owed to us by our customers or other parties with whom we do business. In addition, such conditions may impact our investment portfolio, and we could determine that some of our investments have experienced an other-than-temporary decline in fair value, requiring an impairment charge that could adversely impact our financial condition and operating results. Also, such conditions may make it more difficult to forecast operating results. If global economic conditions, or economic conditions in the U.S., Europe, Asia or in other key geographic regions or customer industries, were to deteriorate, current and prospective customers may delay or reduce their IT spending, which could adversely affect our business, financial condition, operating results and cash flows.

We depend on our key employees, and our inability to attract and retain such employees could adversely affect our business or diminish our brands.

Competition in our industry for qualified employees, especially technical employees, is intense and our competitors may directly target our employees. Our inability to attract and retain key employees could hinder our influence in open source projects and seriously impede our success. We have from time to time in the past experienced, and we may experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. Potential changes to U.S. immigration policies may inhibit our ability to hire and retain qualified employees to the extent these policies restrain the mobility of technical and professional talent. Also, to the extent we hire personnel from competitors, we may be subject to allegations that they have been improperly solicited, that they have divulged proprietary or other confidential information, or that their former employers own their inventions or other work product. Moreover, the loss of these key employees, particularly to a competitor, some of which may be in a position to offer greater compensation, and any resulting loss of customers could reduce our market share and diminish our brands.

A number of our key employees have become, or will become, vested in a significant amount of their equity compensation awards. Employees may be more likely to leave us after a significant portion of their equity compensation awards fully vest, especially if the shares underlying the equity awards have significantly appreciated in value. Additionally, as we grow, there may be less equity compensation to award per employee. If we do not succeed in attracting and retaining key personnel, our business, financial performance, operating results and cash flows may be adversely affected.

We may not be able to continue to attract and retain capable management.

Our future success depends on the continued services and effectiveness of a number of key management personnel. The loss of these individuals, particularly to a competitor, some of which may be in a position to offer greater compensation, could adversely affect our business or stock price.

Our ability to retain key management personnel or hire capable new management personnel as we grow may be challenged to the extent that other companies are able to offer more attractive opportunities to the individuals we seek to hire or retain. In addition, historically we have used share-based compensation as a key component of our compensation packages. If the price of our common stock falls, the value of our share-based awards to recipients is reduced. Such events, or if we are unable to secure stockholder approval for increases in the number of shares eligible for share-based compensation grants, could adversely affect our ability to successfully attract and retain key management personnel. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key management personnel could hinder our strategic planning and execution.

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Because of the characteristics of open source software, there are few technology barriers to entry into the open source market by new competitors and it may be relatively easy for competitors, some of which may have greater resources than we have, to enter our markets and compete with us.

One of the characteristics of open source software is that anyone may modify and redistribute the existing open source software and use it to compete with us. Such competition can develop without the degree of overhead and lead time required by traditional proprietary software companies. It is possible for competitors with greater resources than ours to develop their own open source solutions or acquire a smaller business that has developed open source offerings that compete with our offerings, potentially reducing the demand for, and putting price pressure on, our offerings. In addition, some competitors make their open source software available for free download and use on an ad hoc basis or may position their open source software as a loss leader. We cannot guarantee that we will be able to compete successfully against current and future competitors or that competitive pressure and/or the availability of open source software will not result in price reductions, reduced operating margins and loss of market share. Additionally, any failure by us to provide high-quality technical support, or the perception that we do not provide high-quality technical support, could harm our reputation and negatively impact our ability to sell subscriptions for our open source offerings to existing and prospective customers. If we are unable to differentiate our open source offerings from those of our competitors or compete effectively with other open source offerings, our business, financial condition, operation results and cash flows could be adversely affected.

Our corporate culture has contributed to our success, and if we cannot maintain this culture as we grow, we could lose the innovation, creativity and collaboration fostered by our culture, and our business may be adversely affected.

We believe that a critical contributor to our success has been our corporate culture, which we believe fosters innovation, creativity and collaboration. As our organization grows, our employees (including remote workers) and our resources become more globally dispersed and our organizational management structures become more complex, we may find it increasingly difficult to maintain these beneficial aspects of our corporate culture. If we are unable to maintain our corporate culture, we may find it difficult to attract and retain motivated employees, continue to perform at current levels or execute on our business strategy. As a result, our business, financial condition, operating results and cash flows could be adversely affected.

Our emerging technology offerings are based on developing technologies and business models, and the potential market for these offerings remains uncertain.

Our emerging technology offerings, which include our cloud, mobile and storage offerings, are based on developing technologies and business models, the success of which will depend on the technological and operational benefits and cost savings associated with the adoption of these technologies. These technologies are rapidly evolving, and their development is a complex and uncertain process requiring high levels of innovation and investment as well as the accurate anticipation of technology trends, market demand and customer needs. We expect competition to remain intense and, as with many emerging IT sectors, these technologies may be subject to a “first mover” effect pursuant to which certain product offerings rapidly capture a significant portion of market share and developer attention. Moreover, we may make errors in reacting to relevant business trends and predicting which technologies will be successful or otherwise develop into industry standards.

Adoption of emerging technologies may occur more slowly or less pervasively than we expect and the revenue growth associated with these offerings may be slower than currently expected. Moreover, even if emerging technologies are adopted widely by enterprises, our offerings in these areas may not attract a sufficient number of users or generate attractive financial results. We incur expenses associated with these offerings in advance of our ability to generate associated revenue. Demand for our emerging technology offerings may unfavorably impact demand for our other offerings, including software subscriptions and related professional services. For example, revenue growth in our Middleware portfolio has moderated as customers shift their workloads from traditional Java deployments to containerized environments with middleware-as-a-service on OpenShift. If the market for our emerging technologies offerings fails to develop adequately, it could have an adverse effect on our business, financial condition, operating results and cash flows.

We may experience a decline in the demand for our offerings.

Demand for our offerings depends substantially on the general demand for enterprise software, which fluctuates based on numerous factors, including the spending levels and growth of our current and prospective customers, and general economic conditions. In addition, our customers generally undertake a significant evaluation process that may result in a lengthy sales cycle. We spend substantial time, effort, and money on our sales efforts, including developing and implementing appropriate go-to-market strategies and training our sales force and channel partners in order to effectively market new offerings, without any assurance that our efforts will produce any sales. The purchase of our offerings may be discretionary and can involve significant expenditures. If our current and prospective customers cut costs, then they may significantly reduce their enterprise software expenditures.

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An increased focus on developing and providing emerging technology offerings may place a greater emphasis on marketing more holistic solutions, rather than individual offerings. Consequently, we may need to adapt our marketing and pricing strategies for our offerings, our customers' purchasing decisions may become more complex and require a more significant evaluation process and additional levels of approval and the duration of sales cycles for our offerings may increase.

If demand for our offerings declines, our business, financial condition, operating results and cash flows could be adversely affected.

If our customers do not renew their subscription agreements with us, if they renew on less favorable terms, or they renew their subscription agreements prior to the expiration of such agreements, our business, financial results, operating results and cash flows may be adversely affected.

Our customers may not renew their subscriptions after the expiration of their subscription agreements and in fact some customers elect not to do so. In addition, our customers may choose a lower-priced edition of our offerings, fewer subscriptions or to renew their subscription agreements prior to the expiration of such agreements. We have limited historical data with respect to rates of customer subscription renewals, so we cannot accurately predict customer renewal rates. Our customers' renewal rates may decline or fluctuate as a result of a number of factors, including their level of satisfaction with our offerings and their ability to continue their operations and spending levels. If we experience a decline in the renewal rates or a change in renewal timing for our customers or they opt for lower-priced editions of our offerings or fewer subscriptions, our business, financial condition, operating results and cash flows may be adversely affected.

Our business model may encounter customer resistance.

We provide Red Hat enterprise technologies primarily under annual or multi-year subscriptions. A subscription generally entitles a customer to, among other things, a specified level of support, as well as security updates, fixes, functionality enhancements, upgrades to the technologies, each, if and when available, and compatibility with an ecosystem of certified hardware and software. While we believe this practice complies with the requirements of the GNU General Public License, and while we have reviewed this practice with the Free Software Foundation, the organization that maintains and provides interpretations of the GNU General Public License, customers may fail to honor the terms of our subscription agreements.

As technologies and the markets for our enterprise offerings change, our annual or multi-year subscription-based business model may no longer meet the needs of our customers. For example, a business model based on annual or multi-year subscriptions may no longer be competitive in an environment where disruptive technologies (such as cloud computing) enable customers to consume competitive offerings available from companies such as Amazon Web Services, Inc., Google Inc. and Microsoft Corporation on an hourly basis or for free. We also develop and offer these disruptive technologies with consumption-based pricing, which may have an effect on the demand for our subscription-based offerings.

If we are unable to adapt our business model to changes in the marketplace, our business, financial condition, operating results and cash flows could be adversely affected.

If third-party enterprise hardware and software providers do not continue to make their products and services compatible with our offerings, our software may cease to be competitive and our business, financial condition, operating results and cash flows may be adversely affected.

The competitive position of our offerings is dependent on their compatibility with products and services of third-party enterprise hardware and software companies. To the extent that a hardware or software vendor might have or develop products and services that compete with ours, the vendor may have an incentive to seek to limit the performance, functionality or compatibility of our offerings when used with one or more of the vendor's offerings. In addition, these vendors may fail to support or issue statements of compatibility or certification of our offerings when used with their offerings. We intend to encourage the development of additional applications that operate on both current and new versions of our offerings by, among other means, attracting third-party developers to our offerings, providing open source tools to create these applications and maintaining our existing developer relationships through marketing and technical support. We intend to encourage the compatibility of our software with various third-party hardware and software offerings by maintaining and expanding our relationships, both business and technical, with relevant

independent hardware and software vendors. If we are not successful in achieving these goals, however, our offerings may not be competitive and our business, financial condition, operating results and cash flows may be adversely affected.

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If open source software programmers, most of whom we do not employ, do not continue to develop and enhance open source technologies, we may be unable to develop new technologies, adequately enhance our existing technologies or meet customer requirements for innovation, quality and price.

We rely to a significant degree on a number of largely informal communities of independent open source software programmers to develop and enhance our enterprise technologies. For example, Linus Torvalds, a prominent open source software developer, and a relatively small group of software engineers, many of whom are not employed by us, are primarily responsible for the development and evolution of the Linux kernel, which is the heart of the Red Hat Enterprise Linux operating system. If these groups of programmers fail to adequately further develop and enhance open source technologies, we would have to rely on other parties to develop and enhance our offerings or we would need to develop and enhance our offerings with our own resources. We cannot predict whether further developments and enhancements to these technologies would be available from reliable alternative sources. In either event, our development expenses could be increased and our technology release and upgrade schedules could be delayed. Moreover, if third-party software programmers fail to adequately further develop and enhance open source technologies, the development and adoption of these technologies could be stifled and our offerings could become less competitive. Delays in developing, completing or delivering new or enhanced offerings could result in delayed or reduced revenue for those offerings and could also adversely affect customer acceptance of those offerings.

Our continued success depends on our ability to maintain and enhance strong brands.

We believe that the brand identities that we have developed have contributed significantly to the success of our business. We also believe that maintaining and enhancing our brands is important to expanding our customer and partner base and attracting talented employees. In order to maintain and enhance our brands, we may be required to make further investments that may not be successful. Maintaining our brands will depend in part on our ability to remain a leader in open source technology and our ability to continue to provide high-quality offerings. If we fail to promote and maintain our brands, or if we incur excessive costs in doing so, our business, financial condition, operating results and cash flows may be adversely affected.

We are vulnerable to technology infrastructure failures, which could harm our reputation and adversely affect our business.

We rely on our technology infrastructure, and the technology infrastructure of third parties, for many functions, including selling our offerings, supporting our partners, fulfilling orders and billing, and collecting and making payments. This technology infrastructure may be vulnerable to damage or interruption from natural disasters, power loss, telecommunication failures, terrorist attacks, computer intrusions, vulnerabilities and viruses, software errors, computer denial-of-service attacks and other events. A significant number of the systems making up this infrastructure are not redundant, and our disaster recovery planning may not be sufficient for every eventuality. This technology infrastructure may fail or be vulnerable to damage or interruption because of actions by third parties or employee error or malfeasance. We may not carry business interruption insurance sufficient to protect us from all losses that may result from interruptions in our services as a result of technology infrastructure failures or to cover all contingencies. Any interruption in the availability of our websites and on-line interactions with customers or partners may cause a reduction in customer or partner satisfaction levels, which in turn could cause additional claims, reduced revenue or loss of customers or partners. Despite any precautions we may take, such problems could result in, among other consequences, a loss of data, loss of confidence in the stability and reliability of our offerings, damage to our reputation, and legal liability, all of which may adversely affect our business, financial condition, operating results and cash flows.

A decline in or reprioritization of funding in the U.S. or foreign government budgets or delays in the budget process could adversely affect our business, financial condition, operating results and cash flows.

We derive, and expect to continue to derive, a portion of our revenue from U.S. and foreign governments. Government deficit reduction and austerity measures can place pressure on U.S. and foreign government spending. Government contracts could be subject to future funding that may affect the extension or termination of programs and generally are subject to the right of the government to terminate for convenience or non-appropriation. The termination of, or delayed or reduced funding for, government-sponsored programs and contracts from which we derive revenue could adversely affect our business, financial condition, operating results and cash flows.

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We may be unable to predict the future course of open source technology development, which could reduce the market appeal of our offerings, damage our reputation and adversely affect our business, financial condition, operating results and cash flows.

We do not exercise control over many aspects of the development of open source technology. Different groups of open source software programmers compete with one another to develop new technology. Typically, the technology developed by one group will become more widely used than that developed by others. As a result, a new technology we acquire or adopt and incorporate into our offerings could become less widely used or accepted than a competing technology, which could reduce the market appeal of our offerings and harm our reputation, diminish our brands and adversely affect our business, financial condition, operating results and cash flows.

We include software licensed from other parties in our offerings, the loss of which could increase our costs and delay availability of our offerings.

We utilize various types of software licensed from unaffiliated third parties in our offerings. Aspects of our business could be disrupted if any of the software we license from others or functional equivalents of this software were no longer available to us, no longer offered to us on commercially reasonable terms or changed in ways or included defects that make the third-party software unsuitable for our use. In these cases, we would be required to either redesign our technologies to function with software available from other parties, develop these components ourselves or eliminate the functionality, which could result in increased costs, the need to mitigate customer issues, delays in delivery of our offerings and the release of new offerings and limit the features available in our current or future offerings.

RISKS RELATED TO LEGAL UNCERTAINTY

If our technologies are found or alleged to infringe third-party intellectual property rights, we may be required to take costly and time-consuming actions to meet our commitments to customers.

We regularly commit to our subscription customers that if portions of our offerings are found to infringe third-party intellectual property rights we will, at our expense and option: (i) obtain the right for the customer to continue to use the technology consistent with their subscription agreement with us; (ii) modify the technology so that its use is non-infringing; or (iii) replace the infringing component with a non-infringing component, and defend them against specified infringement claims. Although we cannot predict whether we will need to satisfy these commitments and we often have limitations on these commitments, satisfying these commitments could be costly, be time-consuming, divert the attention of technical and management personnel, and adversely affect our business, financial condition, operating results and cash flows. In addition, our insurance policies would likely not adequately cover our exposure to this type of claim. Finally, because we have agreed to defend our subscription customers against specified infringement claims arising from the use of our offerings, we could become involved in litigation brought against such customers if our services and technology are allegedly implicated.

We are vulnerable to claims that our technologies infringe third-party intellectual property rights, and an unfavorable legal decision affecting our intellectual property could adversely affect our business.

We are vulnerable to claims that our technologies infringe third-party intellectual property rights, including patents, copyrights, trademarks and trade secrets, because our technologies are comprised of software components, many of which are developed by numerous independent parties. We are also unlikely to be able to assess adequately the relevance of patents to our technologies, and may be unable to take appropriate responsive action in a timely or economic manner because, among other reasons, the scope of software patent protection is often not well defined or readily determinable, patent applications in the U.S. are not publicly disclosed at the time of filing, and the number of software patents that are issued each year is significant and growing. Our exposure to risks associated with the use of intellectual property may increase as a result of acquisitions. In addition, third parties may make infringement and similar or related claims after we have acquired technology that had not been asserted prior to our acquisition of such technology.

In the past, our technologies have been subject to intellectual property infringement claims. Some of these claims have been brought by entities that do not design, manufacture, or distribute products or services or that acquire intellectual property such as patents for the sole purpose of monetizing their acquired intellectual property through asserting claims of infringement. As these entities do not have operating businesses of their own and therefore have limited risk

of counterclaims for damages or injunctive relief, it may be difficult to deter them from bringing intellectual property infringement claims. We expect to face the possibility of more intellectual property infringement claims as our prominence increases, business activities expand, market share and revenue grow, the number of products and competitors in our industry grows and the functionality of products in different portions of the industry overlap. We may not be able to accurately assess the risk related to these suits, and we may be unable to accurately assess our level of exposure.

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Defending patent and other intellectual property claims, even claims without significant merit, can be time-consuming and costly and can divert the attention of technical and management personnel. We may receive unfavorable preliminary or interim rulings in the course of litigation, and there can be no assurances that favorable final outcomes will be obtained in all cases. We may decide to settle certain lawsuits and disputes on terms that are disadvantageous to us. Similarly, if any litigation to which we are a party is resolved adversely, we may be subject to an unfavorable judgment that may not be reversed upon appeal. The terms of such a settlement or judgment may require us to cease offering certain of our technologies or pay substantial amounts to the other party. In addition, we may have to seek a license to continue offering technologies found to be in violation of a third party's rights, which may not be available on reasonable terms, or at all, and may significantly increase our operating costs and expenses and which could have a material adverse effect on our business, financial condition and operating results. As a result, we may also be required to develop alternative non-infringing technology or practices or discontinue the practices. The development of alternative non-infringing technology or practices could require significant effort and expense or may not be feasible. An unfavorable legal decision regarding the intellectual property in and to our technology and other offerings could adversely affect our business, financial condition, operating results and cash flows. See Part II, Item 1, "Legal Proceedings" for additional information.

Our activities, or the activities of our partners, may violate anti-corruption laws and regulations that apply to us.

In many foreign countries, particularly in certain developing economies, there may be business practices that are prohibited by regulations that may apply to us, such as the U.S. Foreign Corrupt Practices Act and similar laws. Although we have policies and procedures designed to help promote compliance with these laws, our employees, contractors, partners and agents, as well as those companies to which we outsource certain of our business operations or which we acquire, may take actions in violation of our policies and procedures. Any violation of these laws and regulations could result in fines, criminal sanctions against us, our officers, or our employees, prohibitions on the conduct of our business, and damage to our reputation.

Governmental regulations affecting the import or export of software could adversely impact our business.

Due to the global nature of our business, we are subject to import and export restrictions and regulations, including the Export Administration Regulations administered by the U.S. Commerce Department's Bureau of Industry and Security ("BIS") and the trade and economic sanctions regulations administered by the U.S. Treasury Department's Office of Foreign Assets Control ("OFAC"). The U.S., through the BIS and OFAC, places restrictions on the sale or export of certain products and services to certain countries and persons ("denied parties"). Violators of these export control and sanctions laws may be subject to significant penalties, which may include significant monetary fines, criminal proceedings against them and their officers and employees, a denial of export privileges, and suspension or debarment from selling products or services to the federal government. Any such penalties could have an adverse effect on our business, financial condition, operating results and cash flows. In addition, the political and media scrutiny surrounding any governmental investigation of us could cause us significant expense and reputational harm and distract senior executives from managing our normal day-to-day operations.

Our products could also be shipped to denied parties by third parties, including our channel partners. Even though we take precautions to ensure that our channel partners comply with all relevant import and export regulations, any failure by our channel partners to comply with such regulations could have negative consequences for us, including reputational harm, government investigations and penalties.

We could be prevented from selling or developing our software if the GNU General Public License and similar licenses under which our technologies are developed and licensed are not enforceable or are modified so as to become incompatible with other open source licenses.

A number of our offerings, including Red Hat Enterprise Linux, have been developed and licensed under the GNU General Public License and similar open source licenses. These licenses state that any program licensed under them may be liberally copied, modified and distributed. It is possible that a court would hold these licenses to be unenforceable or that someone could assert a claim for proprietary rights in a program developed and distributed under them. Additionally, if any of the open source components of our offerings may not be liberally copied, modified or distributed, then our ability to distribute or develop all or a portion of our offerings could be adversely impacted. In addition, licensors of open source software employed in our offerings may, from time to time, modify the terms of

their license agreements in such a manner that those license terms may become incompatible with other open source licenses in our offerings or our end user license agreement, and thus could, among other consequences, prevent us from distributing the software code subject to the modified license.

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Our efforts to protect our trademarks may not be adequate to prevent third parties from misappropriating our intellectual property rights in our trademarks.

Our collection of trademarks is valuable and important to our business. The protective steps we have taken in the past may have been, and may in the future continue to be, inadequate to protect and deter misappropriation of our trademark rights. Policing unauthorized use of our trademark rights is difficult, expensive and time-consuming and our efforts may be inadequate. We may be unable to detect the unauthorized use of, or take appropriate steps to enforce, our trademark rights in a timely manner. We have registered some of our trademarks in countries in North America, South America, Europe, Asia, Africa and Australia and have other trademark applications pending in various countries around the world. Effective trademark protection may not be available in every country in which we offer or intend to distribute our offerings. We may be unable to prevent third parties from acquiring domain names that are similar to, infringe upon, or diminish the value of our trademarks and other proprietary rights. Failure to adequately protect our trademark rights could damage or even destroy one or more of our brands and impair our ability to compete effectively. Furthermore, defending or enforcing our trademark rights could result in the expenditure of significant financial and managerial resources. The loss of any material trademark could have a material adverse effect on our business, financial condition or operating results.

Efforts to assert intellectual property ownership rights in our technologies could impact our standing in the open source community, which could limit our technology innovation capabilities and adversely affect our business.

When we undertake actions to protect and maintain ownership and control over our intellectual property, including patents, copyrights and trademark rights, our standing in the open source community could be adversely affected as the community supports the ability to write and share code freely. This in turn could limit our ability to continue to rely on this community, upon which we are dependent, as a resource to help develop and improve our technologies and further our research and development efforts, which could adversely affect our business.

Our “Patent Promise” on software patents limits our ability to enforce our patent rights in certain circumstances.

As part of our commitment to the open source community, we provide our Patent Promise on software patents. Under our Patent Promise, we agree, subject to certain limitations, to not enforce our patent rights against users of open source software covered by any open source license listed by the Open Source Initiative as meeting its definition of “Open Source” or listed by the Free Software Foundation as meeting its definition of “Free Software.” While we may be able to claim protection of our intellectual property under other rights, such as trade secrets or contractual rights, our Patent Promise effectively limits our ability to assert our patent rights against these third parties (even if we were to conclude that their use infringes our patents with competing offerings), unless any such third party asserts its patent rights against us. This limitation on our ability to assert our patent rights against others could harm our business and ability to compete.

We are, and may become, involved in disputes and lawsuits that could adversely affect our business.

Lawsuits or legal proceedings may be commenced against us. These disputes and proceedings may involve significant expense and divert the attention of management and other employees. If we do not prevail in these matters, we could be required to pay substantial damages or settlement costs, which could adversely affect our business, financial condition, operating results and cash flows. See Part II, Item 1, “Legal Proceedings” for additional information.

If we fail to comply with laws and regulations regarding data privacy and protection, our business could be adversely affected.

Our business is subject to a variety of federal, state and international laws and regulations that apply to the collection, use, retention, protection, disclosure, transfer and processing of personal data. These data privacy- and protection-related laws and regulations are evolving, with new or modified laws and regulations proposed and implemented frequently and existing laws and regulations subject to new or different interpretations. For example, the European Union has adopted the General Data Protection Regulation, a new regulation effective May 2018 governing data practices and privacy that establishes new requirements applicable to the handling of personal data and provides for greater penalties for noncompliance.

Any failure by us to comply with data privacy- and protection-related laws and regulations could result in enforcement actions, significant penalties or other legal actions against us or our customers or suppliers. An actual or alleged failure to comply, which could result in negative publicity, reduce demand for our offerings, increase the cost of

compliance, require changes in business practices that result in reduced revenue, restrict our ability to provide our offerings in certain locations, result in our customers' inability to use our offerings and prohibit data transfers or result in other claims, liabilities or sanctions, including fines, could have an adverse effect on our business, financial condition, operating results and cash flows.

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If we fail to comply with our customer contracts or government contracting regulations, our business could be adversely affected.

Our contracts with our customers may include specialized performance requirements. In particular, our contracts with federal, state, provincial and local governmental customers are subject to various government certification requirements, procurement regulations, contract provisions and other requirements relating to their formation, administration and performance. Any failure by us or our channel partners to comply with the specific provisions in our customer contracts or any violation of government contracting regulations by us or our channel partners could result in the imposition of various civil and criminal penalties, which may include termination of contracts, forfeiture of profits, suspension of payments and, in the case of our government contracts, fines and suspension from future government contracting. In addition, we may be subject to qui tam litigation, the process by which a private individual sues or prosecutes on behalf of the government relating to government contracts and shares in the proceeds of any successful litigation or settlement, which could include claims for up to treble damages. Further, any negative publicity related to our customer contracts or any proceedings surrounding them, regardless of its accuracy, may damage our business and affect our ability to compete for new contracts. If our customer contracts are terminated, if we are suspended from government work, if we are unable to meet government certification requirements, or if our ability to compete for new contracts is adversely affected, we could suffer an adverse effect on our business, financial condition, operating results and cash flows.

We may be subject to legal liability associated with providing online services or content.

We provide offerings, such as Red Hat OpenShift, that enable users to exchange information, advertise products and services, conduct business, and engage in various online activities. The law relating to the liability of providers of these online offerings for activities of their users is relatively unsettled and still developing both in the U.S. and internationally and may be significantly different from jurisdiction to jurisdiction. Claims could be brought against us based on the nature and content of information that we publish or to which we provide links or that may be posted online or generated by us or by third parties, including our customers. In addition, we could be subject to domestic or international actions alleging that certain content we have generated or third-party content that we have made available within our services violates applicable law.

Open source development and licensing practices may limit the value of our software copyright assets.

Our offerings, including Red Hat Enterprise Linux and Red Hat JBoss Middleware, are built primarily from software components licensed under various open source licenses. While some components are developed by our employees, we obtain many components from software developed and released by contributors to independent open source software development projects. Open source licenses grant licensees broad permissions to use, copy, modify and redistribute the software. Certain open source licenses, such as the GNU General Public License, impose significant limits on a distributor’s ability to license derivative works under more restrictive terms and generally require the distributor to disclose the source code of such works. The inclusion of software components governed by such licenses in our offerings limits our ability to use traditional proprietary software licensing models for those offerings. As a result, while we have substantial copyright interests in our software technologies, open source development and licensing practices may have the effect of limiting the value of our software copyright assets.

RISKS RELATED TO FINANCIAL UNCERTAINTY

Our quarterly and annual operating results may not be a reliable indicator of our future financial performance.

Due to the unpredictability of the IT spending environment, among other reasons, our revenue and operating results have fluctuated and may continue to fluctuate. We base our current and projected future expense levels, in part, on our estimates of future revenue. Our expenses are, to a large extent, fixed in the short term. Accordingly, we may not be able to adjust our spending quickly enough to protect our projected operating results for a quarter if our revenue in that quarter falls short of our expectations.

Our fourth fiscal quarter has historically been our strongest quarter for sales. This pattern has become more pronounced as the number of customers with renewal dates occurring in the last half of our fiscal year has continued to increase. Additionally, a significant portion of our quarterly sales typically occur during the last weeks of the quarter and our operating results may be adversely impacted if we do not have sufficient time to bill and collect from our customers in the same quarter or fiscal year. Some of our customers may wait until the end of the quarter to

negotiate their contracts in the hope of obtaining more favorable terms, which can also impede our ability to execute these contracts within the same quarter. Moreover, as an increasing number of customers enter into larger, multi-year transactions with us, such transactions tend to have longer sales cycles and can involve customers choosing to pay annually, which may impact our quarterly financial results. If, among other considerations, our future financial performance falls below the expectations of securities analysts or investors or we are unable to increase or maintain profitability, the market price of our common stock may decline.

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We may not be able to meet the financial and operational challenges that we will encounter as our international operations, which represented approximately 43.6% of our total revenue for fiscal 2018, continue to expand.

Our international operations accounted for approximately 43.6% of total revenue for fiscal 2018. As we expand our international operations, we may have difficulty managing and administering a globally dispersed business and we may need to expend additional funds to, among other activities, reorganize our sales force and technical support services team, outsource or supplement general and administrative functions, staff key management positions, obtain additional information technology infrastructure and successfully localize offerings for a significant number of international markets, which may adversely affect our operating results. Additional challenges associated with the conduct of our business globally that may adversely affect our operating results include:

- fluctuations in exchange rates;
- pricing environments;
- longer payment cycles and less financial stability of customers;
- economic, political, compliance and regulatory risks associated with specific countries;
- laws and policies of the U.S. and other jurisdictions affecting trade, foreign investment, loans, immigration and taxes, including any adverse effects that may result from the United Kingdom's vote to exit the European Union;
- difficulty selecting and monitoring channel partners;
- differing technology standards and customer requirements;
- lower levels of availability or use of the Internet, through which our software is often delivered;
- difficulty protecting our intellectual property rights globally due to, among other reasons, the uncertainty of laws and enforcement in certain countries relating to the protection of intellectual property rights;
- difficulty in staffing, developing and managing foreign operations as a result of distance and language, legal, cultural and other differences;
- different employee/employer relationships and the existence of works councils and labor unions;
- difficulty maintaining quality standards consistent with our brands;
- export and import laws and regulations that could prevent us from delivering our offerings into and from certain countries;
- public health risks and natural disasters, particularly in areas in which we have significant operations;
- limitations on the repatriation and investment of funds and foreign currency exchange restrictions;
- changes in import/export duties, quotas or other trade barriers that could affect the competitive pricing of our offerings and reduce our market share in some countries; and
- economic or political instability or terrorist acts in some international markets that could adversely affect our business in those markets or result in the loss or forfeiture of some foreign assets and the loss of sums spent developing and marketing those assets and the revenue associated with them.

Any failure by us to effectively manage the challenges associated with the international expansion of our operations could adversely affect our business, financial condition, operating results and cash flows.

A substantial portion of our revenue is derived from our Red Hat Enterprise Linux platform.

During fiscal 2018, a substantial portion of our subscription revenue was derived from our Red Hat Enterprise Linux offerings. Although we are continuing to develop other offerings, we expect that revenue from Red Hat Enterprise Linux will constitute a majority of our revenue for the foreseeable future. Declines and variability in demand for Red Hat Enterprise Linux could occur as a result of:

- competitive products and pricing;
- failure to release new or enhanced versions of Red Hat Enterprise Linux on a timely basis, or at all;
- maturity of the market for Red Hat Enterprise Linux;
- technological change that we are unable to address with Red Hat Enterprise Linux; or

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- future economic conditions.

Additionally, as more customers and potential customers virtualize their data centers and move computing projects to cloud environments, demand for operating systems such as Red Hat Enterprise Linux may decline. Moreover, as data centers become more virtualized and move to cloud environments, we may experience a decline in growth if we are unsuccessful in adapting our business model and offerings accordingly. Due to the concentration of our revenue from Red Hat Enterprise Linux, our business, financial condition, operating results and cash flows could be adversely affected by a decline in demand for Red Hat Enterprise Linux.

We are subject to risks of currency fluctuations and related hedging operations.

A portion of our business is conducted in currencies other than the U.S. dollar. Changes in exchange rates among other currencies and the U.S. dollar may affect our revenue, operating expenses and operating margins, which are reported in U.S. dollars. We cannot predict the impact of future exchange rate fluctuations. For example, 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 statements results in increased revenue and operating expenses for our non-U.S. operations. Similarly, our revenue and operating expenses for our non-U.S. operations decreases if the U.S. dollar strengthens against foreign currencies.

As we expand international operations, our exposure to exchange rate fluctuations may increase. We may use financial instruments, primarily forward purchase contracts, to economically hedge currency commitments arising from trade accounts receivable, trade accounts payable and fixed purchase obligations. If these hedging activities are not successful or we change or reduce these hedging activities in the future, we may experience significant unexpected expenses from fluctuations in exchange rates. For information regarding our hedging activity, see Part I, Item 3, “Quantitative and Qualitative Disclosures About Market Risk.”

If our growth rate slows, our stock price could be adversely affected.

As the markets for our offerings mature and the scale of our business increases, our rate of revenue, deferred revenue and operating cash flow growth may be lower than the growth rates we experienced in earlier periods. In addition, to the extent that the adoption of our offerings occurs more slowly or is less pervasive than we expect or have experienced in the past, our growth rates may slow or decline, which could adversely affect our stock price. Historical period-to-period comparisons of our revenue, deferred revenue and operating cash flow may not be meaningful and are not guarantees of our future performance.

We may be subject to greater tax liabilities.

We are subject to income tax and other taxes in the U.S. and in numerous foreign jurisdictions. Our domestic and foreign tax liabilities are dependent on the jurisdictions in which profits are determined to be earned and taxed. Additionally, the amount of taxes paid is subject to our interpretation of applicable tax laws in the jurisdictions in which we operate. Changes in tax laws, or in judicial or administrative interpretations of tax laws, could have an adverse effect on our business, financial condition, operating results and cash flows. Significant judgment, knowledge and experience are required in determining our worldwide provision for income taxes. Our future effective tax rate is impacted by a number of factors including our interpretation of the Tax Cuts and Jobs Act (the “Tax Act”) enacted into law on December 22, 2017 and any pending regulations and interpretive guidance to be released on the Tax Act, changes in the valuation of our deferred tax assets and liabilities, increases in expenses not deductible for tax, including impairment of goodwill in connection with acquisitions, and changes in available tax credits. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We are regularly and increasingly subject to audits by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. Economic and political pressures to increase tax revenue in various jurisdictions may make resolving tax disputes more difficult. The results of an audit or litigation could adversely affect our financial statements in the period or periods for which that determination is made.

We anticipate that the U.S. Department of the Treasury, the Internal Revenue Service and other standard-setting bodies may issue regulations and interpretive guidance on how the provisions of the Tax Act will be applied or otherwise administered, and additional regulations or interpretive guidance may be issued in the future that is different

from our current interpretation. We have made significant judgments and assumptions in the interpretation of the Tax Act and in our calculations of the provisional amounts reflected in our financial statements. As we continue to analyze the Tax Act and collect relevant information to complete our computations of the related impact, we may make adjustments to the provisional amounts that could materially affect our provision for income taxes in the period in which the adjustments are made, which could have a significant impact on our future operating results and cash flows.

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We earn a significant amount of our operating income from outside the U.S., and any repatriation of funds currently held in foreign jurisdictions that are not permanently reinvested may result in higher effective tax rates for the Company. For example, as a consequence of the Tax Act, foreign earnings are now deemed to be repatriated, resulting in a higher effective tax rate for the Company's fiscal year ended February 28, 2018. In addition, the Tax Act will significantly impact how U.S. multinational corporations are taxed on foreign earnings. Numerous countries are evaluating their existing tax laws due in part, to recommendations made by the Organization for Economic Co-operation and Development's ("OECD's") Base Erosion and Profit Shifting ("BEPS") project and in response to the changes in U.S. tax laws. Although we cannot predict whether or in what form any legislation based on such proposals may be adopted by the countries in which we do business, future tax reform based on such proposals may increase the amount of taxes we pay and adversely affect our operating results and cash flows.

Because we recognize revenue from subscriptions over the term of the subscription, downturns or upturns in sales may not be immediately reflected in our operating results.

We generally recognize subscription revenue from customers ratably over the term of their subscription agreements, which are generally 12 to 36 months. As a result, much of the revenue we report in each quarter is deferred revenue from subscription agreements entered into during previous quarters. Consequently, a decline in subscriptions in any one quarter will not necessarily be fully reflected in the revenue in that quarter and will negatively affect our revenue in future quarters. In addition, we may be unable to adjust our cost structure to reflect this reduced revenue. Accordingly, the effect of significant downturns in sales and market acceptance of our service, and potential changes in our rate of renewals, may not be fully reflected in our operating results until future periods. Our subscription model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, as revenue from new customers must be recognized over the applicable subscription term.

If our goodwill or amortizable intangible assets become impaired, we may be required to record a significant charge to earnings.

Under generally accepted accounting principles, we review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment at least annually. Factors that may be considered a change in circumstances indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable include a decline in stock price and market capitalization, reduced future cash flow estimates and slower growth rates in our industry. We may be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, which could adversely affect our operating results.

We may be exposed to potential risks if we do not have an effective system of disclosure controls or internal controls.

We must comply, on an on-going basis, with the requirements of the Sarbanes-Oxley Act of 2002, including those provisions that establish the requirements for both management and auditors of public companies with respect to reporting on internal control over financial reporting. We cannot be certain that measures we have taken, and will take, will be sufficient or timely completed to meet these requirements on an on-going basis, or that we will be able to implement and maintain adequate disclosure controls and controls over our financial processes and reporting in the future, particularly in light of our rapid growth, international expansion and changes in our offerings, which are expected to result in on-going changes to our control systems and areas of potential risk.

If we fail to maintain an effective system of disclosure controls or internal control over financial reporting, including satisfaction of the requirements of the Sarbanes-Oxley Act, we may not be able to accurately or timely report on our financial results or adequately identify and reduce fraud. As a result, the financial condition of our business could be adversely affected, current and potential future stockholders could lose confidence in us and/or our reported financial results, which may cause a negative effect on our trading price, and we could be exposed to litigation or regulatory proceedings, which may be costly or divert management attention.

Changes in accounting principles and guidance, or their interpretation, could result in unfavorable accounting charges or effects, including changes to previously filed financial statements, which could cause our stock to decline.

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the U.S. These principles are subject to interpretation by the U.S. Securities and Exchange Commission and various

bodies formed to create and interpret appropriate accounting principles and guidance. A change in these principles or guidance, or in their interpretations, may have a significant effect on our reported results, as well as our processes and related controls, and may retroactively affect previously reported results.

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For example, in May 2014, the Financial Accounting Standards Board issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers, now commonly referred to as Accounting Standards Codification Topic 606 ("ASC 606"). This guidance was effective for us beginning the first quarter of our fiscal year ending February 28, 2019 and we have adopted ASC 606 using the full retrospective transition method. While the adoption of the new standard does not change the cash flows received from our contracts with customers, its adoption could adversely affect our financial position or operating results.We have implemented a new revenue recognition software tool in connection with our adoption of ASC 606. If the new software tool does not work as expected and we incur additional costs or any new or revised internal controls implemented as a result of the adoption of ASC 606 are insufficient, this could have an adverse effect on our financial position, operating results or cash flows.

For a discussion of the impact that the implementation of ASC 606 has had and is expected to have on our consolidated financial statements and related disclosures, see NOTE 2—Summary of Significant Accounting Policies to our Consolidated Financial Statements in Part I, Item 1, "Financial Statements."

Our investment portfolio is subject to credit and liquidity risks and fluctuations in the market value of our investments and interest rates. These risks may result in an impairment of, or the loss of all or a portion of, the value of our investments, an inability to sell our investments or a decline in interest income.

We maintain an investment portfolio of various holdings, types and maturities. Our portfolio generally consists of certificates of deposit, commercial paper, corporate securities, European sovereign and agency securities with a rating of AA or higher, money market funds, and U.S. government and agency securities. Although we follow an established investment policy and seek to minimize the risks associated with our investments by investing primarily in investment grade, highly liquid securities and by limiting the amounts invested with any one institution, type of security or issuer, we cannot give assurances that the assets in our investment portfolio will not lose value or become impaired, or that our interest income will not decline.

A significant part of our investment portfolio consists of U.S. government and agency securities. If global credit and equity markets experience prolonged periods of decline, or if there is a default or downgrade of U.S. government or agency debt, our investment portfolio may be adversely impacted and we could determine that some of our investments have experienced an other-than-temporary decline in fair value, requiring impairment charges that could adversely affect our financial condition and operating results.

Future fluctuations and uncertainty in economic and market conditions could adversely affect the market value of our investments, and we could record additional impairment charges and lose some or all of the principal value of investments in our portfolio. A total loss of an investment or a significant decline in the value of our investment portfolio could adversely affect our financial condition and operating results. For information regarding the sensitivity of and risks associated with the market value of portfolio investments and interest rates, see Part I, Item 3, "Quantitative and Qualitative Disclosures About Market Risk."

Our investments in public and private companies are subject to risk of loss of investment capital. Some of these investments may have been made to further our strategic objectives and support our key business initiatives. Our investments in public and private companies are inherently risky because the markets for the technologies they have under development are typically in the early stages and may never materialize. We could lose the value of our entire investment in these companies.

Epidemics, geo-political events, Internet and power outages or natural disasters could adversely affect our business, financial condition, operating results and cash flows.

The occurrence of one or more epidemics, geo-political events (such as civil unrest or terrorist attacks), Internet and power outages, telecommunications failures, fire or natural disasters (including those due to the effects of climate change such as increased storm severity, drought, wildfires, and potential flooding due to rising sea levels and storm surges) in a country in which we operate or in which technology industry suppliers or our customers are located, could adversely affect our business, financial condition, operating results and cash flows. Such events could result in physical damage to, or the complete loss of, one or more of our facilities, the lack of an adequate work force in a market, the inability of our customers to access our offerings, the inability of our associates to reach or have transportation to our facilities or our customers' facilities directly affected by such events, the evacuation of the populace from areas in which our facilities are located, changes in the purchasing patterns of our customers, the

temporary or long-term disruption in the supply of computer hardware and related components, the disruption or delay in the manufacture and transport of goods globally, the disruption of utility services to our facilities or to suppliers, partners or customers, or disruption in our communications with our customers.

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RISKS RELATED TO THE CONVERTIBLE NOTES

The convertible notes are effectively subordinated to any secured debt we incur in the future and to any liabilities of our subsidiaries.

In October 2014, we issued $805.0 million of 0.25% Convertible Senior Notes due 2019 (the "convertible notes"). The convertible notes will rank senior in right of payment to any of our indebtedness that is expressly subordinated in right of payment to the convertible notes; equal in right of payment to any of our existing and future indebtedness and other liabilities that are not so subordinated; effectively junior in right of payment to any of our secured indebtedness to the extent of the value of the assets securing such indebtedness; and structurally junior to all existing and future indebtedness and other liabilities of our subsidiaries (including trade payables). In the event of our bankruptcy, liquidation, reorganization or other winding up, our assets that secure debt ranking senior in right of payment to the convertible notes will be available to pay obligations on the convertible notes only after the secured debt has been repaid in full from these assets, and the assets of our subsidiaries will be available to pay obligations on the convertible notes only after all claims senior to the convertible notes have been repaid in full. There may not be sufficient assets remaining to pay amounts due on any or all of the convertible notes then outstanding.

We may still incur substantially more debt or take other actions that could diminish our ability to make payments on the convertible notes.

We and our subsidiaries may be able to incur substantial additional debt in the future, subject to the restrictions contained in our future debt instruments, some of which may be secured debt. We are not restricted under the terms of the indenture governing the convertible notes from incurring additional debt, securing existing or future debt, recapitalizing our debt or taking a number of other actions that are not limited by the terms of the indenture governing the convertible notes that could have the effect of diminishing our ability to make payments on the convertible notes when due.

We may not have the ability to raise the funds necessary to settle conversions of the convertible notes in cash, repay the convertible notes at maturity or repurchase the convertible notes upon a fundamental change, and our future debt may contain limitations on our ability to pay cash upon conversion or repurchase of the convertible notes.

Holders of the convertible notes will have the right to require us to repurchase all or a portion of their convertible notes upon the occurrence of a fundamental change at a repurchase price equal to 100% of the principal amount of the convertible notes to be repurchased, plus accrued and unpaid interest, if any. In addition, upon conversion of the convertible notes, unless we elect to deliver solely shares of our common stock to settle such conversion (other than paying cash in lieu of delivering any fractional share), we will be required to make cash payments in respect of the convertible notes being converted. However, we may not have enough available cash or be able to obtain financing at the time we are required to make repurchases of the convertible notes surrendered therefor or pay cash with respect to the convertible notes being converted or at their maturity.

In addition, our ability to repurchase or to pay cash upon conversions of the convertible notes may be limited by law, regulatory authority or agreements governing our future indebtedness and is dependent on our future performance, which is subject to economic, financial, competitive and other factors beyond our control. Our failure to repurchase the convertible notes at a time when the repurchase is required by the indenture or to pay any cash payable on future conversions of the convertible notes as required by the indenture would constitute a default under the indenture. A fundamental change under the indenture or a default under the indenture could also lead to a default under agreements governing our future indebtedness. If the repayment of the related indebtedness were to be accelerated after any applicable notice or grace periods, we may not have sufficient funds to repay the indebtedness and repurchase the convertible notes or make cash payments upon conversions thereof.

The conditional conversion feature of the convertible notes, if triggered, may adversely affect our financial condition and operating results.

Prior to April 1, 2019, holders of the convertible notes may elect to convert their notes during any fiscal quarter (and only during such fiscal quarter) if the last reported sale price of our common stock for at least 20 trading days during the period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to the conversion price of the convertible notes (the "Conversion Condition"). The Conversion Condition was met for the convertible notes during the fiscal quarters ended August 31, 2017 through May 31, 2018,

which means that the holders of the convertible notes may elect to convert such notes at their option at any time during the fiscal quarter ending August 31, 2018. If one or more holders elect to convert their convertible notes, unless we elect to satisfy our conversion obligation by delivering solely shares of our common stock (other than paying cash in lieu of delivering any fractional share) or electing to have a financial institution accept convertible notes in exchange for cash and/or shares of common stock, we would be required to settle a portion or all of our conversion obligation through the payment of cash, which could adversely affect our liquidity.

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The accounting method for convertible debt securities that may be settled in cash, such as the convertible notes, could have a material effect on our reported financial results.

Accounting Standards Codification Subtopic 470-20, Debt with Conversion and Other Options ("ASC 470-20"), requires an entity to separately account for the liability and equity components of convertible debt instruments (such as the convertible notes) that may be settled entirely or partially in cash upon conversion in a manner that reflects the issuer's non-convertible debt interest rate. Accordingly, the equity component of the convertible notes is required to be included in the additional paid-in capital section of stockholders' equity on our consolidated balance sheet, and the value of the equity component is treated as original issue discount for purposes of accounting for the debt component of the convertible notes. As a result, we are required to recognize a greater amount of non-cash interest expense in our consolidated income statements in the current and future periods presented as a result of the amortization of the discounted carrying value of the convertible notes to their principal amount over the term of the convertible notes. We will report lower net income (or greater net losses) in our consolidated financial results because ASC 470-20 will require interest to include both the current period's amortization of the original issue discount and the instrument's non-convertible interest rate. This could adversely affect our reported or future consolidated financial results, the trading price of our common stock and the trading price of the convertible notes.

In addition, under certain circumstances, in calculating earnings per share, convertible debt instruments (such as the convertible notes) that may be settled entirely or partly in cash are currently accounted for utilizing the treasury stock method, the effect of which is that the shares of common stock issuable upon conversion of the convertible notes, if any, are not included in the calculation of diluted earnings per share except to the extent that the conversion value of the convertible notes exceeds their principal amount. Under the treasury stock method, diluted earnings per share is calculated as if the number of shares of common stock that would be necessary to settle such excess, if we elected to settle such excess in shares, were issued. We cannot be sure that the accounting standards in the future will continue to permit the use of the treasury stock method. If we are unable to use the treasury stock method in accounting for the shares issuable upon conversion of the convertible notes, if any, then our diluted consolidated earnings per share would be adversely affected.

The convertible note hedge and warrant transactions may affect the value of our common stock.

In connection with the sale of the convertible notes, we entered into convertible note hedge transactions with institutions that we refer to as the option counterparties. We also entered into warrant transactions with the option counterparties pursuant to which we sold warrants for the purchase of our common stock. The convertible note hedge transactions are expected to offset the potential dilution to our common stock upon any conversion of the convertible notes and/or offset any cash payments we are required to make in excess of the principal amount upon conversion of any convertible notes. The warrant transactions could separately have a dilutive effect to the extent that the market price per share of our common stock exceeds the strike price of the relevant warrants, unless, subject to certain conditions, we elect to settle the warrants in cash.

The option counterparties or their respective affiliates may modify their hedge positions by entering into or unwinding various derivatives with respect to our common stock and/or purchasing or selling our common stock or other securities of ours in secondary market transactions prior to the maturity of the convertible notes (and are likely to do so during any observation period related to a conversion of the convertible notes or following any repurchase of convertible notes by us in connection with any fundamental change repurchase date or otherwise). This activity could suppress or inflate the market price of our common stock.

We do not make any representation or prediction as to the direction or magnitude of any potential effect that the transactions described above may have on the price of the convertible notes or our common stock. In addition, we do not make any representation that the option counterparties or their respective affiliates will engage in these transactions or that these transactions, once commenced, will not be discontinued without notice.

We are subject to counterparty risk with respect to the convertible note hedge transactions.

The option counterparties are financial institutions or affiliates of financial institutions, and we will be subject to the risk that these option counterparties may default under the convertible note hedge transactions. Our exposure to the credit risk of the option counterparties will not be secured by any collateral. If one or more of the option counterparties to one or more of our convertible note hedge transactions becomes subject to insolvency proceedings,

we will become an unsecured creditor in those proceedings with a claim equal to our exposure at the time under those transactions. Our exposure will depend on many factors but, generally, the increase in our exposure will be correlated to the increase in the market price of our common stock and in the volatility of the market price of our common stock. In addition, upon a default by one of the option counterparties, we may suffer dilution with respect to our common stock as well as adverse financial consequences. We can provide no assurances as to the financial stability or viability of any of the option counterparties.

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RISKS RELATED TO OWNERSHIP OF OUR COMMON STOCK

Our stock price has been volatile historically and may continue to be volatile.

The trading price of our common stock has been and may continue to be subject to wide fluctuations. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in operating results, announcements of technological innovations or new offerings by us or our competitors, announcements relating to strategic decisions, announcements related to key personnel, customer purchase delays, service disruptions, changes in financial estimates and recommendations by securities analysts, the operating and stock price performance of other companies that investors may deem comparable to us, news reports relating to trends in our markets, the commencement or termination of any share repurchase program, general economic conditions and other risks listed herein.

The sale of our common stock by significant stockholders may cause the price of our common stock to decrease.

Several of our stockholders own significant portions of our common stock. If these stockholders were to sell all or a portion of their holdings of our common stock, then the market price of our common stock could be negatively impacted. The effect of such sales, or of significant portions of our stock being offered or made available for sale, could result in strong downward pressure on our stock price. Investors should be aware that they could experience significant short-term volatility in our stock if such stockholders decide to sell all or a portion of their holdings of our common stock at once or within a short period of time.

We may issue or sell additional shares of our common stock or instruments convertible into shares of our common stock and thereby materially and adversely affect the market price of our common stock.

We are not restricted from issuing additional shares of our common stock or other instruments convertible into, or exchangeable or exercisable for, shares of our common stock. If we issue or sell additional shares of our common stock or instruments convertible into shares of our common stock, it may materially and adversely affect the market price of our common stock.

In addition, a substantial number of shares of our common stock are reserved for issuance under our equity compensation plans, including for issuance upon the exercise of stock options and the vesting of performance share units, restricted stock, restricted stock units and deferred stock units. A substantial number of shares of our common stock are also reserved in relation to the convertible notes and the warrant transactions and for our employee stock purchase plan. We may not be able to predict the size of future issuances or the effect, if any, that they may have on the market price for our common stock. The issuance or sale of substantial amounts of common stock, or the perception that such issuances or sales may occur, could adversely affect the market price of our common stock and impair our ability to raise capital through the sale of equity or equity-linked securities.

We do not currently expect to pay dividends on our common stock, so any returns may be limited to changes in the value of our common stock.

We have never declared or paid any cash dividends on our common stock. We currently anticipate that we will retain future earnings for the development, operation and expansion of our business and do not anticipate declaring or paying any cash dividends for the foreseeable future. In addition, our ability to pay cash dividends on our common stock may be prohibited or limited by the terms of any future debt financing arrangement. Any return to stockholders will therefore be limited to the increase, if any, of our stock price.

Conversion of the convertible notes may dilute the ownership interest of existing stockholders, including holders who had previously converted their convertible notes, or may otherwise depress the price of our common stock.

The conversion of the convertible notes into shares of our common stock, to the extent that we choose not to deliver all cash for the conversion value, will dilute the ownership interests of existing stockholders. Any sales in the public market of the common stock issuable upon conversion of the convertible notes could adversely affect prevailing market prices of our common stock. In addition, the existence of the convertible notes may encourage short selling by market participants due to this dilution or may facilitate trading strategies involving the convertible notes and our common stock.

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Provisions of our certificate of incorporation, by-laws, Delaware law and the convertible notes may have anti-takeover effects that could prevent a change in control even if the change in control would be beneficial to our stockholders.

Provisions of our certificate of incorporation, by-laws and Delaware law could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders. These provisions include:

- our Board of Directors has the right to elect directors to fill a vacancy created by the expansion of the Board of Directors or the resignation, death or removal of a director, which prevents stockholders from being able to fill vacancies on our Board of Directors;
- stockholders must provide advance notice to nominate individuals for election to the Board of Directors or to propose matters that can be acted upon at a stockholders' meeting; such provisions may discourage or deter a potential acquirer from conducting a solicitation of proxies to elect the acquirer's own slate of directors or otherwise attempting to obtain control of our company; and
- our Board of Directors may issue, without stockholder approval, shares of undesignated preferred stock; the ability to issue undesignated preferred stock makes it possible for our Board of Directors to issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to acquire us.

Further, as a Delaware corporation, we are also subject to certain Delaware law anti-takeover provisions. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the Board of Directors has approved the transaction. Our Board of Directors could rely on Delaware law to prevent or delay an acquisition of us.

Additionally, certain provisions of the convertible notes could make it more difficult or more expensive for a third party to acquire us or could also have the effect of delaying or reducing the likelihood of a change in control of us even if such acquisition or change of control may be favorable to our stockholders.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Unregistered Sales of Equity Securities

During the three months ended May 31, 2018, the Company issued 185,252 shares of its unregistered common stock upon settlement of conversions of an aggregate of $26.0 million in principal amount of the convertible notes. These shares of the Company's common stock were issued in reliance on the exemption from registration provided by Section 3(a)(9) of the Securities Act of 1933, as amended.

Issuer Purchases of Equity Securities

The table below sets forth information regarding the Company's purchases of its common stock during its first fiscal quarter ended May 31, 2018:

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased [1][2]	Weighted Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs [3]	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs [3]
March 1, 2018—March 31, 2018	8,816	$ 148.58	8,806	$ 397.4 million
April 1, 2018—April 30, 2018	1,240,348	$ 158.72	763,792	$ 277.7 million
May 1, 2018—May 31, 2018	361,220	$ 117.74	176,040	$ 248.7 million
Total	1,610,384		948,638	

(1) During the three months ended May 31, 2018, the Company withheld an aggregate of 476,507 shares of its common stock (with a weighted average share price of $161.78) from employees to satisfy minimum tax withholding obligations relating to the vesting of restricted share awards. These shares were not withheld pursuant to the programs described in Note (3) below.

(2) In connection with the convertible note conversions settled during the three months ended May 31, 2018, the Company exercised a portion of the options that are part of the convertible note hedge transactions and acquired 185,239 shares of its common stock. The counterparties to the convertible note hedge transactions may be deemed to be an "affiliate purchaser" and may have purchased the shares of the Company's common stock deliverable to the Company upon the exercise of the options.

(3) On June 21, 2018, the Company announced that its Board authorized a new $1.0 billion repurchase program effective July 1, 2018 and the prior $1.0 billion repurchase program in effect since July 1, 2016 expired on June 30, 2018. See NOTE 18—Subsequent Events for additional information regarding the Company's new share repurchase program.

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ITEM 6. EXHIBITS

Exhibit No.	Exhibit Description	Provided Herewith	Incorporated by Reference			
			Form	File No.	Exhibit	Filing Date
10.1*	Executive Base Salaries and Target Award Amounts under Red Hat, Inc.'s Executive Variable Compensation Plan for the Fiscal Year Ending February 28, 2019		8-K	001-33162	99.1	May 10, 2018
10.2*	Peer Group for PSUs Granted in FY19		8-K	001-33162	99.2	May 10, 2018
10.3*	Form of Operating Performance Share Unit Agreement adopted May 6, 2018	X				
10.4*	Form of Total Shareholder Return Performance Share Unit Agreement adopted May 6, 2018	X				
10.5*	Form of Restricted Stock Agreement adopted May 6, 2018	X				
31.1	Certification of the registrant's Chief Executive Officer pursuant to Rule 13a-14(a)/Rule 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	X				
31.2	Certification of the registrant's Chief Financial Officer pursuant to Rule 13a-14(a)/Rule 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	X				
32.1	Certification of the registrant's principal executive officer and principal financial officer pursuant to 18 U.S.C. Section 1350	X				
101.INS	XBRL Instance Document	X				
101.SCH	XBRL Taxonomy Extension Schema	X				
101.CAL	XBRL Taxonomy Extension Calculation Linkbase	X				
101.DEF	XBRL Taxonomy Extension Definition Linkbase	X				
101.LAB	XBRL Taxonomy Extension Label Linkbase	X				
101.PRE	XBRL Taxonomy Extension Presentation Linkbase	X				

*Indicates a management contract or compensatory plan, contract or arrangement.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

RED HAT, INC.

Date: July 9, 2018 By: /S/ JAMES M. WHITEHURST
James M. Whitehurst
President, Chief Executive Officer
(Duly Authorized Officer on Behalf of the Registrant)

RED HAT, INC.

Date: July 9, 2018 By: /S/ ERIC R. SHANDER
Eric R. Shander
Executive Vice President and
Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)