

VMWARE, INC.

Form 10-Q

May 05, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2016

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 001-33622

VMWARE, INC.

(Exact name of registrant as specified in its charter)

Delaware	94-3292913
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

3401 Hillview Avenue	94304
Palo Alto, CA	
(Address of principal executive offices) (Zip Code)	
(650) 427-5000	
(Registrant's telephone number, including area code)	

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

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

As of April 30, 2016, the number of shares of common stock, par value \$0.01 per share, of the registrant outstanding was 424,272,592 of which 124,272,592 shares were Class A common stock and 300,000,000 were Class B common stock.

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PART I
 FINANCIAL INFORMATION
 ITEM 1. FINANCIAL STATEMENTS

VMware, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(amounts in millions, except per share amounts, and shares in thousands)
 (unaudited)

	Three Months Ended March 31,	
	2016	2015
Revenues:		
License	\$572	\$ 576
Services	1,017	935
Total revenues	1,589	1,511
Operating expenses ⁽¹⁾ :		
Cost of license revenues	40	50
Cost of services revenues	211	193
Research and development	356	305
Sales and marketing	565	536
General and administrative	172	187
Realignment charges	53	22
Operating income	192	218
Investment income	16	12
Interest expense with EMC	(7)	(6)
Other income (expense), net	(1)	(2)
Income before income taxes	200	222
Income tax provision	39	26
Net income	\$161	\$ 196
Net income per weighted-average share, basic for Class A and Class B	\$0.38	\$ 0.46
Net income per weighted-average share, diluted for Class A and Class B	\$0.38	\$ 0.45
Weighted-average shares, basic for Class A and Class B	423,230	427,962
Weighted-average shares, diluted for Class A and Class B	424,180	430,496

⁽¹⁾ Includes stock-based compensation as follows:

Cost of license revenues	\$1	\$ 1
Cost of services revenues	12	11
Research and development	70	54
Sales and marketing	49	39
General and administrative	18	14

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

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VMware, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in millions)

(unaudited)

	Three Months Ended March 31,	
	2016	2015
Net income	\$161	\$196
Other comprehensive income (loss):		
Changes in market value of available-for-sale securities:		
Unrealized gains (losses), net of taxes of \$11 and \$4	18	6
Changes in market value of effective foreign currency forward contracts:		
Unrealized gains (losses), net of taxes of \$0 for all periods	2	(5)
Total other comprehensive income (loss)	20	1
Total comprehensive income (loss), net of taxes	\$181	\$197

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

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VMware, Inc.

CONDENSED CONSOLIDATED BALANCE SHEETS

(amounts in millions, except per share amounts, and shares in thousands)

(unaudited)

	March 31, 2016	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	\$2,785	\$2,493
Short-term investments	5,461	5,016
Accounts receivable, net of allowance for doubtful accounts of \$2 and \$2	1,089	1,633
Due from related parties, net	12	74
Other current assets	147	144
Total current assets	9,494	9,360
Property and equipment, net	1,108	1,128
Other assets	195	193
Deferred tax assets	464	456
Intangible assets, net	582	616
Goodwill	3,993	3,993
Total assets	\$15,836	\$15,746
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$106	\$138
Accrued expenses and other	622	746
Unearned revenues	3,181	3,245
Total current liabilities	3,909	4,129
Notes payable to EMC	1,500	1,500
Unearned revenues	1,795	1,831
Other liabilities	361	363
Total liabilities	7,565	7,823
Contingencies (refer to Note I)		
Stockholders' equity:		
Class A common stock, par value \$.01; authorized 2,500,000 shares; issued and outstanding 124,086 and 121,947 shares	1	1
Class B convertible common stock, par value \$.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3	3
Additional paid-in capital	2,897	2,728
Accumulated other comprehensive income (loss)	12	(8)
Retained earnings	5,356	5,195
Total VMware, Inc.'s stockholders' equity	8,269	7,919
Non-controlling interests	2	4
Total stockholders' equity	8,271	7,923
Total liabilities and stockholders' equity	\$15,836	\$15,746

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

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VMware, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(unaudited)

	Three Months Ended March 31,	
	2016	2015
Operating activities:		
Net income	\$161	\$196
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	88	76
Stock-based compensation	150	119
Excess tax benefits from stock-based compensation	—	(2)
Deferred income taxes, net	(18)	(15)
Impairment of strategic investments	5	—
Other	1	—
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	544	531
Other assets	(5)	—
Due to/from related parties, net	63	52
Accounts payable	(28)	(49)
Accrued expenses	(118)	(102)
Income taxes payable	(23)	(32)
Unearned revenues	(100)	(91)
Net cash provided by operating activities	720	683
Investing activities:		
Additions to property and equipment	(41)	(106)
Purchases of available-for-sale securities	(1,124)	(1,027)
Sales of available-for-sale securities	420	501
Maturities of available-for-sale securities	286	255
Proceeds from disposal of assets	3	—
Purchases of strategic investments	(2)	—
Business acquisitions, net of cash acquired	—	(21)
Decrease in restricted cash	2	1
Net cash used in investing activities	(456)	(397)
Financing activities:		
Proceeds from issuance of common stock	52	54
Repurchase of common stock	—	(438)
Excess tax benefits from stock-based compensation	—	2
Shares repurchased for tax withholdings on vesting of restricted stock	(24)	(34)
Net cash provided by (used in) financing activities	28	(416)
Net increase (decrease) in cash and cash equivalents	292	(130)
Cash and cash equivalents at beginning of the period	2,493	2,071
Cash and cash equivalents at end of the period	\$2,785	\$1,941
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$7	\$7
Cash paid for taxes, net	63	74
Non-cash items:		

Changes in capital additions, accrued but not paid \$(3) \$(42)

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

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

A. Overview and Basis of Presentation

Company and Background

VMware, Inc. ("VMware" or the "Company") is a leader in virtualization and cloud infrastructure solutions that enable businesses to transform the way they build, deliver and consume information technology ("IT") resources in a manner that is based on their specific needs. VMware's virtualization infrastructure solutions, which include a suite of products and services designed to deliver a software-defined data center, run on industry-standard desktop computers, servers and mobile devices and support a wide range of operating system and application environments, as well as networking and storage infrastructures.

Accounting Principles

The financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP").

Unaudited Interim Financial Information

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") for interim financial reporting. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware's condensed consolidated results of operations, financial position and cash flows for the periods presented. Results of operations are not necessarily indicative of the results that may be expected for the full year 2016. Certain information and footnote disclosures typically included in annual consolidated financial statements have been condensed or omitted. Accordingly, these unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in VMware's 2015 Annual Report on Form 10-K.

As of March 31, 2016, EMC held 80.9% of VMware's outstanding common stock and 97.4% of the combined voting power of VMware's outstanding common stock, including 43 million shares of VMware's Class A common stock and all of VMware's Class B common stock. VMware is a majority-owned and controlled subsidiary of EMC, and its results of operations and financial position are consolidated with EMC's financial statements. On October 12, 2015, Dell Inc. ("Dell"), Denali Holding Inc. ("Denali") and EMC entered into a definitive merger agreement under which Denali has agreed to acquire EMC (the "Dell Acquisition").

Management believes the assumptions underlying the condensed consolidated financial statements are reasonable. However, the amounts recorded for VMware's intercompany transactions with EMC may not be considered arm's length with an unrelated third party. Therefore, the financial statements included herein may not necessarily reflect the results of operations, financial position and cash flows had VMware engaged in such transactions with an unrelated third party during all periods presented. Accordingly, VMware's historical financial information is not necessarily indicative of what the Company's results of operations, financial position and cash flows will be in the future if and when VMware contracts at arm's length with unrelated third parties for the services the Company receives from and provides to EMC.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of VMware and subsidiaries in which VMware has a controlling financial interest. Non-controlling interests are presented as a separate component within total stockholders' equity and represent the equity and cumulative pro-rata share of the results of operations attributable to the non-controlling interests. The portion of results of operations attributable to the non-controlling interests is eliminated in other income (expense), net on the condensed consolidated statements of income and is not presented separately as the amount was not material for the periods presented. All intercompany transactions and account balances between VMware and its subsidiaries have been eliminated in consolidation. Transactions with EMC and its subsidiaries are generally settled in cash and are classified on the condensed consolidated statements of cash flows based upon the nature of the underlying transaction.

Use of Accounting Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses during the reporting periods, and the disclosure of contingent liabilities at the date of the financial statements. Estimates are used for, but not limited to, trade receivable valuation, marketing development funds and rebates, useful lives assigned to fixed assets and intangible assets, valuation of goodwill and definite-lived intangibles, income taxes, stock-based compensation, and contingencies. Actual results could differ from those estimates.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

New Accounting Pronouncements

During March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-09, Compensation—Stock Compensation (Topic 718), which impacts the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The updated standard is effective for interim and annual periods beginning after December 15, 2016 and permits early adoption in any interim or annual period. The Company is currently evaluating the effect that ASU 2016-09 will have on its consolidated financial statements and related disclosures.

During February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which requires a lessee to recognize a lease liability for the obligation to make lease payments and a right-to-use asset for the right to use the underlying asset for the lease term. This ASU also requires additional disclosure regarding leasing arrangements. The updated lease standard is effective for interim and annual periods beginning after December 15, 2018 and requires a modified retrospective adoption, with early adoption permitted. The Company is currently evaluating the effect that ASU 2016-02 will have on its consolidated financial statements and related disclosures, and expects that most of its lease commitments will be subject to the updated standard and recognized as lease liabilities and right-of-use assets upon adoption of ASU 2016-02.

During May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). The updated revenue standard establishes principles for recognizing revenue and develops a common revenue standard for all industries. In 2016, the FASB issued ASU 2016-08 and ASU 2016-10, which provide interpretive clarifications on the new guidance in Topic 606. The updates are effective for the Company in the first quarter of 2018 and permit the use of either the retrospective or cumulative effect transition method. Early adoption is permitted, but not earlier than the first quarter of 2017. The Company has not selected a transition method and is currently evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures.

B. Definite-Lived Intangible Assets, Net

Definite-Lived Intangible Assets, Net

As of March 31, 2016 and December 31, 2015, definite-lived intangible assets consisted of the following (amounts in tables in millions):

	March 31, 2016			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.6	\$ 646	\$ (320)	\$ 326
Leasehold interest	34.9	149	(21)	128
Customer relationships and customer lists	8.3	134	(52)	82
Trademarks and tradenames	8.6	61	(18)	43
Other	5.5	5	(2)	3
Total definite-lived intangible assets		\$ 995	\$ (413)	\$ 582
	December 31, 2015			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.6	\$ 648	\$ (298)	\$ 350
Leasehold interest	34.9	149	(20)	129
Customer relationships and customer lists	8.4	148	(62)	86
Trademarks and tradenames	8.6	61	(16)	45
Other	2.9	20	(14)	6

Total definite-lived intangible assets	\$ 1,026	\$ (410)	\$ 616
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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Amortization expense on definite-lived intangible assets was \$34 million and \$37 million during the three months ended March 31, 2016 and 2015, respectively.

Based on intangible assets recorded as of March 31, 2016 and assuming no subsequent additions or impairment of underlying assets, the remaining estimated annual amortization expense is expected to be as follows (table in millions):

Remainder of 2016	\$95
2017	122
2018	109
2019	88
2020	38
Thereafter	130
Total	\$582

C. Realignment Charges

On January 22, 2016, VMware approved a plan to streamline its operations, with plans to reinvest the associated savings in field, technical and support resources associated with growth products. As a result of these actions, approximately 800 positions were eliminated during the three months ended March 31, 2016. VMware recognized \$50 million of severance-related realignment charges during the three months ended March 31, 2016 on the condensed consolidated statements of income. Additionally, VMware is in the process of consolidating certain facilities as part of this plan, which resulted in the recognition of \$3 million of related charges during the three months ended March 31, 2016 on the condensed consolidated statements of income. As of March 31, 2016, \$30 million remained in accrued expenses and other on the condensed consolidated balance sheets, which is generally expected to be paid during 2016. Actions associated with the plan are expected to be completed by June 30, 2016. Additional charges to be incurred in future quarters associated with this plan are not expected to be material.

During the three months ended March 31, 2015, VMware eliminated approximately 350 positions across all major functional groups and geographies to streamline its operations. As a result of these actions, \$22 million of severance-related realignment charges were recognized during the three months ended March 31, 2015 on the condensed consolidated statements of income.

The following table summarizes the activity for the accrued realignment charges for the three months ended March 31, 2016 and 2015 (tables in millions):

	For the Three Months Ended March 31, 2016			
	Balance as of January 1, 2016	Realignment Charges	Utilization	Balance as of March 31, 2016
Severance-related costs	\$3 \$ 50		\$ (26)	\$ 27
Costs to exit facilities	— 3		—	3
Total	\$3 \$ 53		\$ (26)	\$ 30
	For the Three Months Ended March 31, 2015			
	Balance as of	Realignment Charges	Utilization	Balance as of March 31,

January	2015
1,	
2015	

Severance-related costs \$8 \$ 22 \$ (14) \$ 16

D. Net Income per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted-average number of common shares outstanding and potentially dilutive securities outstanding during the period, as calculated using the treasury stock method. Potentially dilutive securities primarily include unvested restricted stock units, including performance stock units, and stock options, including purchase options under VMware's employee stock purchase plan. Securities are excluded from the computations of diluted net income per share if their effect would be anti-dilutive. VMware uses the two-

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VMware, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

class method to calculate net income per share as both classes share the same rights in dividends, therefore basic and diluted earnings per share are the same for both classes.

The following table sets forth the computations of basic and diluted net income per share during the three months ended March 31, 2016 and 2015 (net income in millions, shares in thousands):

	Three Months Ended March 31, 2016 2015	
Net income	\$161	\$196
Weighted-average shares, basic for Class A and Class B	423,230	27,962
Effect of dilutive securities	950	2,534
Weighted-average shares, diluted for Class A and Class B	424,180	30,496
Net income per weighted-average share, basic for Class A and Class B	\$0.38	\$0.46
Net income per weighted-average share, diluted for Class A and Class B	\$0.38	\$0.45

The following table sets forth the weighted-average common share equivalents of Class A common stock that were excluded from the diluted net income per share calculations during the three months ended March 31, 2016 and 2015, because their effect would have been anti-dilutive (shares in thousands):

	Three Months Ended March 31, 2016 2015	
Anti-dilutive securities:		
Employee stock options	2,352	2,503
Restricted stock units	15,491	223
Total	17,843	2,726

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

E. Cash, Cash Equivalents and Investments

Cash, cash equivalents and investments as of March 31, 2016 and December 31, 2015 consisted of the following (tables in millions):

	March 31, 2016			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	\$716	\$ —	\$ —	\$ 716
Cash equivalents:				
Money-market funds	\$2,033	\$ —	\$ —	\$ 2,033
Time deposits	14	—	—	14
Municipal obligations	22	—	—	22
Total cash equivalents	\$2,069	\$ —	\$ —	\$ 2,069
Short-term investments:				
U.S. Government and agency obligations	\$813	\$ 2	\$ —	\$ 815
U.S. and foreign corporate debt securities	3,747	14	(3)	3,758
Foreign governments and multi-national agency obligations	35	—	—	35
Municipal obligations	618	1	—	619
Asset-backed securities	13	—	—	13
Mortgage-backed securities	221	—	—	221
Total short-term investments	\$5,447	\$ 17	\$ (3)	\$ 5,461
Other assets:				
Marketable available-for-sale equity securities	\$15	\$ 2	\$ —	\$ 17
	December 31, 2015			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	\$725	\$ —	—\$	—\$ 725
Cash equivalents:				
Money-market funds	\$1,763	\$ —	—\$	—