RED HAT INC
Form 10-Q
October 05, 2017
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended August 31, 2017

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 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, 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	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

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

As of September 29, 2017, there were 176,947,183 shares of common stock outstanding.

Table of Contents

RED HAT, INC.

[Table of Contents](#)

CAUTIONARY NOTE ON FORWARD-LOOKING STATEMENTS

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

Table of Contents

PART I

ITEM 1. FINANCIAL STATEMENTS

RED HAT, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands except share and per share amounts)

	August 31, 2017 (Unaudited)	February 28, 2017 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,210,308	$ 1,090,808
Investments in debt securities, short-term	448,981	369,983
Accounts receivable, net of allowances for doubtful accounts of $3,026 and $2,791, respectively	418,449	634,821
Prepaid expenses	213,273	200,609
Other current assets	41,352	19,481
Total current assets	2,332,363	2,315,702
Property and equipment, net of accumulated depreciation and amortization of $261,704 and $231,533, respectively	206,195	189,629
Goodwill	1,121,602	1,040,709
Identifiable intangibles, net	156,659	137,767
Investments in debt securities, long-term	655,127	672,440
Deferred tax assets, net	101,778	104,833
Other assets, net	65,660	74,105
Total assets	$ 4,639,384	$ 4,535,185
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 323,245	$ 376,957
Deferred revenue, short-term	1,471,434	1,512,762
Other current obligations	1,147	1,354
Total current liabilities	1,795,826	1,891,073
Deferred revenue, long-term	581,077	557,194
Convertible notes	756,743	745,633
Other long-term obligations	105,391	93,965
Commitments and contingencies (NOTES 11 and 12)		
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, 237,977,604 and 236,804,594 shares issued, and 176,943,103 and 176,901,936 shares outstanding at August 31, 2017 and February 28, 2017, respectively		24		24
Additional paid-in capital		2,335,518		2,294,462
Retained earnings		1,523,040		1,352,991
Treasury stock at cost, 61,034,501 and 59,902,658 shares at August 31, 2017 and February 28, 2017, respectively		(2,425,059)		(2,311,805)
Accumulated other comprehensive loss		(33,176)		(88,352)
Total stockholders equity		1,400,347		1,247,320
Total liabilities and stockholders equity	$	4,639,384	$	4,535,185

(1) Derived from audited financial statements.

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

Table of Contents

RED HAT, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands except per share amounts)

(Unaudited)

	Three Months Ended August 31, 2017	Three Months Ended August 31, 2016	Six Months Ended August 31, 2017	Six Months Ended August 31, 2016
Revenue:				
Subscriptions	$ 637,562	$ 531,209	$ 1,234,070	$ 1,032,874
Training and services	85,793	68,596	166,081	134,829
Total subscription and training and services revenue	723,355	599,805	1,400,151	1,167,703
Cost of subscription and training and services revenue:				
Cost of subscriptions	46,324	39,678	89,957	76,222
Cost of training and services	60,393	47,993	117,456	95,496
Total cost of subscription and training and services revenue	106,717	87,671	207,413	171,718
Gross profit	616,638	512,134	1,192,738	995,985
Operating expense:				
Sales and marketing	278,548	253,255	575,007	496,503
Research and development	141,809	121,265	278,972	236,281
General and administrative	61,722	55,730	116,592	105,954
Total operating expense	482,079	430,250	970,571	838,738
Income from operations	134,559	81,884	222,167	157,247
Interest income	4,612	3,392	8,605	6,821
Interest expense	6,081	5,925	12,166	11,811
Other income (expense), net	(1,260)	84	(1,846)	(468)
Income before provision for income taxes	131,830	79,435	216,760	151,789
Provision for income taxes	34,971	20,663	46,711	31,832
Net income	$ 96,859	$ 58,772	$ 170,049	$ 119,957
Basic net income per common share	$ 0.55	$ 0.33	$ 0.96	$ 0.66
Diluted net income per common share	$ 0.53	$ 0.32	$ 0.93	$ 0.65
Weighted average shares outstanding:				
Basic	177,257	180,322	177,250	180,745

Diluted	183,021	183,346	182,460	183,750

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

5

Table of Contents

RED HAT, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

(Unaudited)

	Three Months Ended		Six Months Ended	
	August 31, 2017	**August 31, 2016**	**August 31, 2017**	**August 31, 2016**
Net income	$ 96,859	$ 58,772	$ 170,049	$ 119,957
Other comprehensive income (loss):				
Change in foreign currency translation adjustment	31,861	(2,472)	54,531	3,445
Available-for-sale securities:				
Unrealized gain on available-for-sale securities during the period	990	708	1,154	1,946
Reclassification for gain realized on available-for-sale securities, reported in Other income (expense), net				(9)
Tax benefit (expense)	(287)	(211)	(509)	(655)
Net change in available-for-sale securities (net of tax)	703	497	645	1,282
Total other comprehensive income (loss)	32,564	(1,975)	55,176	4,727
Comprehensive income	$ 129,423	$ 56,797	$ 225,225	$ 124,684

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

Table of Contents

RED HAT, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended August 31, 2017	Three Months Ended August 31, 2016	Six Months Ended August 31, 2017	Six Months Ended August 31, 2016
Cash flows from operating activities:				
Net income	$ 96,859	$ 58,772	$ 170,049	$ 119,957
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	24,136	21,160	45,953	41,862
Amortization of debt discount and transaction costs	5,570	5,393	11,110	10,758
Share-based compensation expense	46,947	45,357	90,665	86,632
Deferred income taxes	(359)	(5,467)	7,558	(7,619)
Net amortization of bond premium on debt securities available for sale	2,439	3,294	4,875	6,834
Other	571	328	1,532	(437)
Changes in operating assets and liabilities, net of effects of acquisitions:				
Accounts receivable	17,036	(30,684)	225,797	159,645
Prepaid expenses	(11,562)	8,883	(19,270)	(490)
Accounts payable and accrued expenses	2,008	19,763	(53,330)	(10,423)
Deferred revenue	(40,575)	(26,953)	(86,292)	(73,046)
Other	(174)	(3,044)	2,121	(4,574)
Net cash provided by operating activities	142,896	96,802	400,768	329,099
Cash flows from investing activities:				
Purchase of investment in debt securities available for sale	(109,669)	(163,043)	(259,193)	(297,644)
Proceeds from maturities of investment in debt securities available for sale	105,303	170,510	217,344	269,542
Proceeds from sales of investment in debt securities available for sale		7,018	14,324	25,168
Acquisition of businesses, net of cash acquired	(83,965)	(28,667)	(83,965)	(28,667)
Purchase of developed software and other intangible assets	(7,671)	(3,521)	(9,445)	(6,389)
Purchase of property and equipment	(25,781)	(15,539)	(51,681)	(33,192)
Other	(189)		(189)	(111)
Net cash used in investing activities	(121,972)	(33,242)	(172,805)	(71,293)

Cash flows from financing activities:				
Proceeds from exercise of common stock options	862	689	3,830	2,068
Proceeds from employee stock purchase program	10,952		22,713	
Payments related to net settlement of share-based compensation awards	(7,413)	(6,398)	(48,423)	(37,476)
Purchase of treasury stock	(75,015)	(127,386)	(137,002)	(193,864)
Payments on other borrowings	(418)	(463)	(861)	(906)
Other		415		913
Net cash used in financing activities	(71,032)	(133,143)	(159,743)	(229,265)
Effect of foreign currency exchange rates on cash and cash equivalents	29,959	8,587	51,280	14,250
Net (decrease) increase in cash and cash equivalents	(20,149)	(60,996)	119,500	42,791
Cash and cash equivalents at beginning of the period	1,230,457	1,031,565	1,090,808	927,778
Cash and cash equivalents at end of the period	$ 1,210,308	$ 970,569	$ 1,210,308	$ 970,569

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 is often freely shared, there are customarily no licensing fees for the use of open source software. Therefore, the Company does not recognize revenue from the licensing of the code itself. The Company provides value to its customers through the development, aggregation, integration, testing, certification, delivery, maintenance, enhancement and support of its Red Hat 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 to the Consolidated Financial Statements contained in the Company s Annual Report on Form 10-K for the fiscal year ended February 28, 2017.

NOTE 2 Summary of Significant Accounting Policies

Basis of presentation

The unaudited interim consolidated financial statements as of and for the three and six months ended August 31, 2017 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 United States (U.S. GAAP). Operating results for the three and six months ended August 31, 2017 are not necessarily indicative of the results that may be expected for the fiscal year ending February 28, 2018. 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, 2017. 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, 2017. These unaudited financial statements should be read in conjunction with the financial statements included in the Annual Report on Form 10-K.

Certain amounts for the three and six months ended August 31, 2016 have been reclassified to conform to the current year presentation.

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Consolidation policy

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

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.

Recent accounting pronouncements

Accounting pronouncements adopted

In May 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2017-09, *Compensation Stock Compensation (Topic 718): Scope of Modification Accounting* (ASU 2017-09). The FASB issued ASU 2017-09 to clarify and reduce both (i) diversity in practice and (ii) cost and complexity when applying the guidance in Topic 718, to a change to the terms and conditions of a share-based payment award. The Company has early adopted ASU 2017-09 as of the second quarter of its fiscal year ended February 28, 2018. The adoption of this update did not impact the Company s Consolidated Financial Statements.

In January 2017, the FASB issued Accounting Standards Update 2017-04, *Intangibles Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment* (ASU 2017-04). The FASB issued ASU 2017-04 to simplify the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under this updated standard, an entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit s fair value, but the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. An entity also should consider income tax effects from any tax-deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if any. The FASB also eliminated the requirement for reporting units with a zero or negative carrying amount to first perform a qualitative assessment. The Company has early adopted ASU 2017-04 as of the second quarter of its fiscal year ended February 28, 2018. The adoption of this update did not impact the Company s Consolidated Financial Statements.

Accounting pronouncements being evaluated

In August 2016, the FASB issued Accounting Standards Update 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* (ASU 2016-15). In November 2016, the FASB issued Accounting Standards Update 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash (* ASU 2016-18). The

FASB issued ASU 2016-15 and ASU 2016-18 to decrease the diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments in these updates provide guidance on nine specific cash flow issues. The guidance is effective for the Company as of the first quarter of its fiscal year ending February 28, 2019 and should be applied using the retrospective transition method to each period presented. Early adoption is permitted but all amendments must be adopted in the same period. The Company is currently evaluating the impact that these updated standards will have on its consolidated financial statements.

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 is currently evaluating the impact that this updated standard will have on its consolidated financial statements.

In January 2016, the 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. This guidance is effective for the Company as of the first quarter of the fiscal year ending February 28, 2020. The Company is currently evaluating the impact that this updated standard will have on its consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update 2014-09, *Revenue from Contracts with Customers*, now 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 and International Financial Reporting Standards. The standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes the current revenue recognition guidance. This guidance is effective for the Company beginning the first quarter of its fiscal year ending February 28, 2019. The standard must be adopted using either a full retrospective approach for all periods presented in the period of adoption or a modified retrospective approach.

The Company has substantially completed its preliminary assessment of the potential impact that the implementation of this updated standard will have on its consolidated financial statements. With respect to the Company s software subscription offerings, the Company provides value to its customers through continuous aggregation, integration, testing, certification, maintenance, enhancement and support of the open source technologies that it distributes. The Company currently recognizes subscription revenue ratably over the subscription period. Under the updated standard, these subscription attributes represent a series of performance obligations that are delivered over time, primarily on a stand-ready basis (for example, attributes such as updates, upgrades, and support are not forced upon subscribers but rather made available to subscribers). As a result, the Company believes that its subscription revenue meets the criteria for revenue recognition over time and will continue to be recognized ratably under the updated standard.

The Company also offers professional consulting and training services that are designed to help customers derive additional value from Red Hat technologies. Under the updated guidance, revenue from professional consulting and training services that were previously sold on a standalone basis will continue to be recognized over time as the Company satisfies its performance obligations by delivering and transferring such services to the customer.

With respect to customer contracts with multiple elements (such as software subscriptions and professional consulting and training services), under the current standard the Company allocates total contract revenue to each element s relative fair value when the Company can demonstrate sufficient vendor-specific objective evidence

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

(VSOE) of the fair value of at least those elements that are undelivered. For multiple-element contracts in which one or more of the undelivered elements lacks VSOE, the Company defers recognition of any revenue until the elements lacking VSOE have been delivered. However, under the updated standard, the Company will be required to allocate total contract revenue to each element (referred to as a distinct performance obligation under the updated standard) based on either an established or estimated standalone selling price. The Company would then recognize the allocated revenue as each element (performance obligation) is delivered. Because the Company has historically established VSOE for most of its offerings and as a result has not been required to defer a significant amount of revenue due to insufficient VSOE, the Company does not anticipate the updated standard s requirement to establish or estimate a standalone selling price, rather than defer revenues in the absence of VSOE, to have a significant impact on the Company s financial statements.

The Company continues to assess the impact of the updated guidance, 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 new guidance related to variable consideration, contract modifications, allocation of discounts and expanded disclosures. The Company has not yet finalized its decision with respect to transition method.

NOTE 3 Stockholders Equity

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

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders Equity
Balance at May 31, 2017	$ 24	$ 2,295,123	$ 1,426,181	$ (2,350,044)	$ (65,740)	$ 1,305,544
Net income			96,859			96,859
Other comprehensive income, net of tax					32,564	32,564
Exercise of common stock options		862				862
Common stock repurchase				(75,015)		(75,015)
Share-based compensation expense		46,947				46,947
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee		(7,413)				(7,413)

share-based awards						
Other adjustments		(1)				(1)
Balance at August 31, 2017	$ 24	$ 2,335,518	$ 1,523,040	$ (2,425,059)	$ (33,176)	$ 1,400,347

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the changes in the Company s stockholders equity during the three months ended August 31, 2016 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders Equity
Balance at May 31, 2016	$ 24	$ 2,176,208	$ 1,160,472	$ (1,919,622)	$ (67,747)	$ 1,349,335
Net income			58,772			58,772
Other comprehensive loss, net of tax					(1,975)	(1,975)
Exercise of common stock options		689				689
Common stock repurchase				(127,386)		(127,386)
Share-based compensation expense		45,357				45,357
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards		(6,398)				(6,398)
Other adjustments			2			2
Balance at August 31, 2016	$ 24	$ 2,215,856	$ 1,219,246	$ (2,047,008)	$ (69,722)	$ 1,318,396

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

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders Equity
Balance at February 28, 2017	$ 24	$ 2,294,462	$ 1,352,991	$ (2,311,805)	$ (88,352)	$ 1,247,320
Net income			170,049			170,049
Other comprehensive income, net of tax					55,176	55,176

Exercise of common stock options		3,830				3,830
Common stock repurchase				(137,002)		(137,002)
Share-based compensation expense		90,665				90,665
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards		(48,423)				(48,423)
Re-issuance of treasury stock under employee stock purchase plan				23,748		23,748
Other adjustments		(5,016)				(5,016)
Balance at August 31, 2017	$ 24	$ 2,335,518	$ 1,523,040	$ (2,425,059)	$ (33,176)	$ 1,400,347

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the changes in the Company s stockholders equity during the six months ended August 31, 2016 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders Equity
Balance at February 29, 2016	$ 23	$ 2,162,264	$ 1,099,738	$ (1,853,144)	$ (74,449)	$ 1,334,432
Net income			119,957			119,957
Other comprehensive income, net of tax					4,727	4,727
Exercise of common stock options	1	2,067				2,068
Common stock repurchase				(193,864)		(193,864)
Share-based compensation expense		86,632				86,632
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards		(37,476)				(37,476)
Other adjustments			1			1
Cumulative-effect adjustment from adoption of ASU 2016-09		2,369	(450)			1,919
Balance at August 31, 2016	$ 24	$ 2,215,856	$ 1,219,246	$ (2,047,008)	$ (69,722)	$ 1,318,396

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 will expire on the earlier of (i) June 30, 2018 or (ii) a determination by the Board, Chief Executive Officer or Chief Financial Officer to discontinue the program. The program replaced the previous $500.0 million repurchase program authorized on March 25, 2015, which was discontinued by the Board effective June 30, 2016.

During the six months ended August 31, 2017, the Company repurchased 1,480,203 shares of its common stock for $137.0 million under the repurchase program.

From its commencement on July 1, 2016 through August 31, 2017, the Company has repurchased 6,380,852 shares of its common stock under the program. As of August 31, 2017, the amount available under the program for the repurchase of the Company s common stock was $498.7 million.

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Accumulated other comprehensive loss

The following is a summary of accumulated other comprehensive loss as of August 31, 2017 and February 28, 2017 (in thousands):

	As of August 31, 2017	As of February 28, 2017
Accumulated loss from foreign currency translation adjustment	$ (33,253)	$ (87,784)
Accumulated unrealized gain (loss), net of tax, on available-for-sale securities	77	(568)
Accumulated other comprehensive loss	$ (33,176)	$ (88,352)

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 or the related asset s pattern of economic benefit. Useful lives range from two to 10 years. As of August 31, 2017 and February 28, 2017, trademarks with an indefinite estimated useful life totaled $11.7 million and $10.9 million, respectively.

See NOTE 13 Business Combinations for information regarding identifiable intangible assets acquired. The following is a summary of identifiable intangible assets (in thousands):

	As of August 31, 2017			As of February 28, 2017		
	Gross Amount	Accumulated Amortization	Net Amount	Gross Amount	Accumulated Amortization	Net Amount
Trademarks, copyrights and patents	$ 159,886	$ (64,945)	$ 94,941	$ 148,850	$ (59,440)	$ 89,410
Purchased technologies	129,272	(86,956)	42,316	107,078	(80,536)	26,542
Customer and reseller relationships	106,430	(92,004)	14,426	104,438	(88,046)	16,392
Covenants not to compete	15,817	(13,823)	1,994	14,081	(12,329)	1,752
Other intangible assets	8,833	(5,851)	2,982	8,833	(5,162)	3,671
Total identifiable intangible assets	$ 420,238	$ (263,579)	$ 156,659	$ 383,280	$ (245,513)	$ 137,767

Amortization expense associated with identifiable intangible assets recognized in the Company s Consolidated Financial Statements for the three and six months ended August 31, 2017 and August 31, 2016 is summarized as follows (in thousands):

	Three Months Ended		Six Months Ended	
	August 31, 2017	**August 31, 2016**	**August 31, 2017**	**August 31, 2016**
Cost of revenue	$ 4,670	$ 4,190	$ 8,850	$ 8,157
Sales and marketing	1,583	1,905	3,042	3,820
Research and development	35	34	69	69
General and administrative	2,227	1,848	4,053	3,601
Total amortization expense	$ 8,515	$ 7,977	$ 16,014	$ 15,647

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 Income Taxes

The effective tax rates for the three and six months ended August 31, 2017 of 26.5% and 21.5%, respectively, differed from the U.S. federal statutory rate of 35% primarily due to excess tax benefits from share-based compensation, foreign income taxed at lower rates, research tax credits and the domestic-production-activities deduction. Tax expense for the three and six months ended August 31, 2017 included net discrete tax benefits of $1.4 million and $13.1 million, respectively, primarily related to net excess tax benefits from share-based compensation.

For the three and six months ended August 31, 2016, the Company s then-effective tax rates of 26.0% and 21.0%, respectively, 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, research tax credits and the domestic-production-activities deduction. Tax expense for the three and six months ended August 31, 2016, included net discrete tax benefits of $0.8 million and $9.2 million, respectively, primarily related to net excess tax benefits from share-based compensation.

Excluding net discrete tax benefits, the Company s effective tax rate for the six months ended August 31, 2017 increased by 0.5% as compared to the six months ended August 31, 2016 primarily due to a higher percentage of income recognized in higher tax rate jurisdictions.

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 has concluded 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 August 31, 2017, it is reasonably possible that total gross unrecognized tax benefits may be reduced by up to $2.1 million within the next 12 months as a result of statutes of limitations expirations in various tax jurisdictions, all of which would affect the Company s effective tax rate.

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

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

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

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

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

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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.

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 income (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 income (expense), net. The Company does not recognize changes in the fair value of its investments in income unless a decline in value is considered other than temporary. The vast majority of the Company s investments are priced with the assistance of pricing vendors. These pricing vendors use the most recent observable market information in pricing these securities or, if specific prices are not available for these securities, use other observable inputs. In the event observable inputs are not available, the Company assesses other factors to determine the security s fair value, including broker quotes or model valuations. Independent price verifications of all holdings are performed by pricing vendors, which are then reviewed by the Company. In the event a price fails a pre-established tolerance check, it is researched so that the Company can assess the cause of the variance to determine what the Company believes is the appropriate fair 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 as of August 31, 2017 (in thousands):

	As of August 31, 2017	Level 1	Level 2	Level 3
Assets:				
Money markets (1)	$ 256,920	$ 256,920	$	$
Interest-bearing deposits (1)	59,382		59,382	
Available-for-sale securities (1):				
Commercial paper	200,744		200,744	

U.S. agency securities	318,619		318,619	
Corporate securities	690,134		690,134	
Foreign currency derivatives (2)	203		203	
Liabilities:				
Foreign currency derivatives (3)	(57)		(57)	
Total	$ 1,525,945	$ 256,920	$ 1,269,025	$

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

(1) Included in Cash and cash equivalents, Investments in debt securities, short-term or Investments in debt securities, long-term in the Company s Consolidated Balance Sheet as of August 31, 2017, in addition to $788.6 million of cash.
(2) Included in Other current assets in the Company s Consolidated Balance Sheet as of August 31, 2017.
(3) Included in Accounts payable and accrued expenses in the Company s Consolidated Balance Sheet as of August 31, 2017.

The following table summarizes the composition and fair value hierarchy of the Company s financial assets and liabilities as of February 28, 2017 (in thousands):

	As of February 28, 2017	Level 1	Level 2	Level 3
Assets:				
Money markets (1)	$ 258,188	$ 258,188	$	$
Available-for-sale securities (1):				
U.S. agency securities	327,430		327,430	
Corporate securities	714,993		714,993	
Foreign currency derivatives (2)	135		135	
Liabilities:				
Foreign currency derivatives (3)	(160)		(160)	
Total	$ 1,300,586	$ 258,188	$ 1,042,398	$

(1) Included in Cash and cash equivalents, Investments in debt securities, short-term or Investments in debt securities, long-term in the Company s Consolidated Balance Sheet as of February 28, 2017, in addition to $832.6 million of cash.
(2) Included in Other current assets in the Company s Consolidated Balance Sheet as of February 28, 2017.
(3) Included in Accounts payable and accrued expenses in the Company s Consolidated Balance Sheet as of February 28, 2017.

The following table represents the Company s investments measured at fair value as of August 31, 2017 (in thousands):

	Amortized	Gross Unrealized		Aggregate	Balance Sheet Classification		
					Cash Equivalent Marketable	Investments in debt securities,	Investments in debt securities,
	Cost	Gains	Losses (1)	Fair Value	Securities	short-term	long-term
Money markets	$ 256,920	$	$	$ 256,920	$ 256,920	$	$
Interest-bearing deposits	59,382			59,382		59,382	
Commercial paper	200,744			200,744	164,771	35,973	
U.S. agency securities	319,986	16	(1,383)	318,619		45,996	272,623
Corporate securities	689,033	1,432	(331)	690,134		307,630	382,504
Total	$ 1,526,065	$ 1,448	$ (1,714)	$ 1,525,799	$ 421,691	$ 448,981	$ 655,127

(1) As of August 31, 2017, there were $1.0 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 all investments with unrealized losses was $530.0 million.

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the stated maturities of the Company s investments in debt securities (in thousands):

	Total	Less than 1 Year	1-5 Years	More than 5 Years
Maturity of current and long-term investments in debt securities	$ 1,104,108	$ 448,981	$ 655,127	$

The following table represents the Company s investments measured at fair value as of February 28, 2017 (in thousands):

	Amortized	Gross Unrealized		Aggregate	Balance Sheet Classification		
	Cost	Gains	Losses (1)	Fair Value	Cash Equivalent Marketable Securities	Investments in debt securities, short-term	Investments in debt securities, long-term
Money markets	$ 258,188	$	$	$ 258,188	$ 258,188	$	$
U.S. agency securities	329,617	37	(2,224)	327,430		27,593	299,837
Corporate securities	714,226	1,416	(649)	714,993		342,390	372,603
Total	$ 1,302,031	$ 1,453	$ (2,873)	$ 1,300,611	$ 258,188	$ 369,983	$ 672,440

(1) As of February 28, 2017, there were $0.6 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 all investments with unrealized losses was $605.9 million.

NOTE 7 Derivative Instruments

The Company transacts business in various foreign countries and is, therefore, subject to risk of foreign currency exchange rate fluctuations. The Company from time to time enters into forward contracts to economically hedge transactional exposure associated with commitments arising from trade accounts receivable, trade accounts payable and fixed purchase obligations denominated in a currency other than the functional currency of the respective operating entity. All derivative instruments are recorded on the Consolidated Balance Sheets at their respective fair 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 6 Assets and Liabilities Measured at Fair Value on a Recurring Basis for information regarding the fair value hierarchy of derivative instruments.

18

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The effects of derivative instruments on the Company s Consolidated Financial Statements are as follows as of August 31, 2017 and for the three and six months then ended (in thousands):

	As of August 31, 2017			Classification of Unrealized Gain (Loss) Recognized in Income on Derivatives	Three Months Ended August 31, 2017	Six Months Ended August 31, 2017
	Balance Sheet Classification	**Fair Value**	**Notional Value**			
Assets foreign currency forward contracts not designated as hedges	Other current assets	$ 203	$ 24,166	Other income (expense), net	$ 675	$ 1,280
Liabilities foreign currency forward contracts not designated as hedges	Accounts payable and accrued expenses	(57)	12,748	Other income (expense), net	(263)	(583)
Total		$ 146	$ 36,914		$ 412	$ 697

The effects of derivative instruments on the Company s Consolidated Financial Statements are as follows as of August 31, 2016 and for the three and six months then ended (in thousands):

	As of August 31, 2016			Classification of Unrealized Gain (Loss) Recognized in Income on Derivatives	Three Months Ended August 31, 2016	Six Months Ended August 31, 2016
	Balance Sheet Classification	**Fair Value**	**Notional Value**			
Assets foreign currency forward contracts not designated as hedges	Other current assets	$ 51	$ 15,188	Other income (expense), net	$ 1,204	$ 2,403
Liabilities foreign currency forward contracts not designated as hedges	Accounts payable and accrued expenses	(89)	18,783	Other income (expense), net	(321)	(999)
Total		$ (38)	$ 33,971		$ 883	$ 1,404

NOTE 8 Share-based Awards

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

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following summarizes share-based compensation expense recognized in the Company s Consolidated Financial Statements for the three and six months ended August 31, 2017 and August 31, 2016 (in thousands):

	Three Months Ended		Six Months Ended	
	August 31, 2017 (1)	August 31, 2016	August 31, 2017 (1)	August 31, 2016
Cost of revenue	$ 4,261	$ 4,054	$ 8,209	$ 8,359
Sales and marketing	20,817	20,361	41,430	38,802
Research and development	14,220	12,969	27,666	24,971
General and administrative	7,649	7,973	13,360	14,500
Total share-based compensation expense	$ 46,947	$ 45,357	$ 90,665	$ 86,632

(1) Total share-based compensation expense of $46.9 million and $90.7 million includes $3.0 million and $5.9 million, respectively, of expense related to the Company s employee stock purchase plan (ESPP) for the three and six months ended August 31, 2017.

Share-based compensation expense qualifying for capitalization was insignificant for each of the three and six months ended August 31, 2017 and August 31, 2016. Accordingly, no share-based compensation expense was capitalized during the three and six months ended August 31, 2017 and August 31, 2016.

During the three and six months ended August 31, 2017 and August 31, 2016, the Company granted the following share-based awards:

	Three Months Ended			
	August 31, 2017		August 31, 2016	
	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	48,443	$ 98.53	133,550	$ 72.80
Performance share units target		$	1,826	$ 72.80
Total awards	48,443	$ 98.53	135,376	$ 72.80

	Six Months Ended			
	August 31, 2017		August 31, 2016	
	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	886,838	$ 86.85	1,068,440	$ 75.12
Performance share units target	261,760 (1)	$ 87.99	362,502	$ 76.68
Performance share awards	104,362 (2)	$ 87.99	140,182	$ 76.70
Total awards	1,252,960	$ 87.18	1,571,124	$ 75.62

(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

20

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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, 2017. 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, 2017.

(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, 2018 (the RSA Performance Goal). If the Company fails to achieve the RSA Performance Goal for the fiscal year ending February 28, 2018, then all such shares are forfeited. If the Company achieves the RSA Performance Goal for the fiscal year ending February 28, 2018, then 25% of the restricted stock vests on or about July 16, 2018, 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 9 Earnings Per Share

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

The following table reconciles the numerators and denominators of the earnings per share (EPS) calculation for the three and six months ended August 31, 2017 and August 31, 2016 (in thousands, except per share amounts):

	Three Months Ended		Six Months Ended	
	August 31, 2017	August 31, 2016	August 31, 2017	August 31, 2016
Net income, basic and diluted	$ 96,859	$ 58,772	$ 170,049	$ 119,957
Weighted average common shares outstanding	177,257	180,322	177,250	180,745
Incremental shares attributable to assumed vesting or exercise of outstanding equity award shares	3,058	2,829	3,021	2,923
Dilutive effect of convertible notes	2,706	195	2,189	82
Diluted shares	183,021	183,346	182,460	183,750
Diluted net income per share	$ 0.53	$ 0.32	$ 0.93	$ 0.65

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 14 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 and six months ended August 31, 2017 and August 31, 2016 but were not included

21

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

in the computation of diluted EPS because the warrants exercise price was greater than the average market price of the Company s common stock during the related period.

The following share awards were 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		Six Months Ended	
	August 31, 2017	August 31, 2016	August 31, 2017	August 31, 2016
Number of shares considered anti-dilutive for calculating diluted EPS		158	10	307

NOTE 10 Segment Reporting

The Company is organized primarily on the basis of three geographic business units: the Americas (U.S., Latin America and Canada), Europe, Middle East and Africa (EMEA) and Asia Pacific. The following summarizes revenue from unaffiliated customers and income (loss) from operations for the three and six months ended August 31, 2017 and August 31, 2016 and total cash, cash equivalents and available-for-sale investment securities and total assets as of August 31, 2017 and August 31, 2016, by geographic segment (in thousands):

	Americas	EMEA	Asia Pacific	Corporate (1)	Consolidated
	Three Months Ended August 31, 2017				
Revenue from unaffiliated customers	$ 463,359	$ 159,722	$ 100,274	$	$ 723,355
Income (loss) from operations	$ 110,353	$ 40,809	$ 30,344	$ (46,947)	$ 134,559
	Three Months Ended August 31, 2016				
Revenue from unaffiliated customers	$ 385,529	$ 127,467	$ 86,809	$	$ 599,805
Income (loss) from operations	$ 71,595	$ 28,210	$ 27,436	$ (45,357)	$ 81,884
	Six Months Ended August 31, 2017				
Revenue from unaffiliated customers	$ 901,739	$ 303,392	$ 195,020	$	$ 1,400,151
Income (loss) from operations	$ 184,291	$ 70,247	$ 58,294	$ (90,665)	$ 222,167
Total cash, cash equivalents and available-for-sale investment securities	$ 1,122,569	$ 820,130	$ 371,717	$	$ 2,314,416

Total assets	$ 2,861,387	$ 1,220,439	$ 557,558	$	$ 4,639,384
			Six Months Ended August 31, 2016		
Revenue from unaffiliated customers	$ 751,252	$ 251,766	$ 164,685	$	$ 1,167,703
Income (loss) from operations	$ 141,352	$ 53,898	$ 48,629	$ (86,632)	$ 157,247
Total cash, cash equivalents and available-for-sale investment securities	$ 1,113,971	$ 634,013	$ 294,661	$	$ 2,042,645
Total assets	$ 2,714,088	$ 944,290	$ 442,378	$	$ 4,100,756

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

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Supplemental information about geographic areas

The following table lists, for each of the three and six months ended August 31, 2017 and August 31, 2016, revenue from unaffiliated customers in the United States, the Company s country of domicile, and revenue from unaffiliated customers from foreign countries (in thousands):

	Three Months Ended		Six Months Ended	
	August 31, 2017	August 31, 2016	August 31, 2017	August 31, 2016
United States, the Company s country of domicile	$ 417,203	$ 343,766	$ 811,745	$ 672,295
Foreign	306,152	256,039	588,406	495,408
Total revenue from unaffiliated customers	$ 723,355	$ 599,805	$ 1,400,151	$ 1,167,703

Total tangible long-lived assets, net of accumulated depreciation, located in the United States, the Company s country of domicile, and similar tangible long-lived assets, net of accumulated depreciation, held outside the United States are summarized in the following table as of August 31, 2017 and February 28, 2017 (in thousands):

	August 31, 2017	February 28, 2017
United States, the Company s country of domicile	$ 138,484	$ 133,492
Foreign	67,711	56,137
Total tangible long-lived assets	$ 206,195	$ 189,629

Supplemental information about major customers

For each of the three and six months ended August 31, 2017 and August 31, 2016, the U.S. government and its agencies represented in the aggregate approximately 10% of the Company s total revenue.

At August 31, 2017 and February 28, 2017, the Company had no customers whose accounts receivable balance individually represented 10% or more of total accounts receivable.

Supplemental information about products and services

The following table, for each of the three and six months ended August 31, 2017 and August 31, 2016, provides further detail, by type, of the Company s subscription and services revenues. Infrastructure-related offerings subscription revenue includes subscription revenue generated from Red Hat Enterprise Linux and related technologies such as Red Hat Satellite and Red Hat Enterprise Virtualization. Subscription revenue generated from the Company s Application Development-related and other emerging technology offerings

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

includes Red Hat JBoss Middleware, Red Hat Storage, Red Hat Mobile Application Platform and Red Hat cloud offerings such as Red Hat OpenStack Platform, Red Hat OpenShift and Red Hat CloudForms (in thousands):

	Three Months Ended		Six Months Ended	
	August 31, 2017	August 31, 2016	August 31, 2017	August 31, 2016
Subscription revenue:				
Infrastructure-related offerings	$ 487,447	$ 427,035	$ 945,408	$ 830,216
Application Development-related and other emerging technology offerings	150,115	104,174	288,662	202,658
Total subscription revenue	637,562	531,209	1,234,070	1,032,874
Training and services revenue:				
Consulting services	65,174	51,277	126,662	101,586
Training	20,619	17,319	39,419	33,243
Total training and services revenue	85,793	68,596	166,081	134,829
Total subscription and training and services revenue	$ 723,355	$ 599,805	$ 1,400,151	$ 1,167,703

NOTE 11 Commitments and Contingencies

Operating leases

As of August 31, 2017, the Company had leases of office space and certain equipment under various non-cancelable operating leases. Rent expense under operating leases for the three months ended August 31, 2017 and August 31, 2016 was $12.8 million and $10.8 million, respectively. Rent expense under operating leases for the six months ended August 31, 2017 and August 31, 2016 was $25.3 million and $20.8 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. Historically, payments pursuant to these indemnifications have been immaterial.

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 12 Legal Proceedings

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

NOTE 13 Business Combinations

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. 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.

The consideration paid was $49.8 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 $49.8 million was allocated to the Company s assets and liabilities on a preliminary basis as follows: $39.6 million to goodwill, $10.2 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 recently announced hosted development environment for building hybrid cloud services on OpenShift.

The consideration paid was $34.3 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 $34.3 million was allocated to the Company s assets and liabilities on a preliminary basis as follows: $25.6 million to goodwill, $11.3 million to identifiable intangible assets and $2.6 million to working capital as a net current liability.

Transaction costs

The Company incurred approximately $1.4 million in transaction costs, including legal and accounting fees, relating to both the Permabit and Codenvy acquisitions. These transaction costs have been expensed as incurred and included in General and administrative expense on the Company s Consolidated Statement of Operations for the six months ended August 31, 2017.

Acquisition of 3scale, Inc.

On June 24, 2016, the Company completed its acquisition of all of the shares of 3scale, Inc. (3scale), a provider of application programming interface (API) management technology. By adding 3scale to its existing portfolio, including Red Hat JBoss Middleware, Red Hat OpenShift and Red Hat Mobile Application Platform, the Company strengthens its enablement of the API economy with simplified cloud integration and microservices-based architectures.

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The consideration paid was $29.1 million in cash. Management has completed its assessment of the acquisition-date fair value of the assets acquired and liabilities assumed. The total consideration transferred of $29.1 million was allocated to the Company s assets and liabilities as follows: $16.9 million to goodwill, $13.1 million to identifiable intangible assets and $0.9 million to working capital as a net current liability.

Pro forma consolidated financial information

Pro forma consolidated financial information for the three and six months ended August 31, 2017 and August 31, 2016 have not been provided because the acquisitions of Permabit, Codenvy and 3scale would not have had a significant impact on consolidated operating results if the acquisitions had closed on March 1, 2016.

Goodwill

The following is a summary of changes in goodwill for the six months ended August 31, 2017 (in thousands):

Balance at February 28, 2017	$ 1,040,709
Acquisitions	65,247
Impact of foreign currency fluctuations	15,646
Balance at August 31, 2017	$ 1,121,602

The excess of purchase price paid for Permabit, Codenvy, 3scale 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 14 Convertible Notes

Convertible note offering

On October 7, 2014, the Company completed its offering of $805.0 million aggregate principal amount of its 0.25% Convertible Senior Notes due 2019 (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 21 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, 2017.

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.

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 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 the fiscal quarter ended August 31, 2017. Therefore, as of August 31, 2017, the convertible notes became convertible at the holders option beginning on September 1, 2017 and ending November 30, 2017.

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. Based on the closing price of the Company s common stock of $107.50 on the last trading day of the second quarter of fiscal year 2018, the if-converted value of the convertible notes as of August 31, 2017 exceeded their principal amount by approximately $373.8 million.

The Company continues to classify the net carrying amount of the convertible notes as a long-term liability and the equity component of the convertible notes 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.

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

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

amortized to interest expense over the term of the convertible notes. As of August 31, 2017 and February 28, 2017, the convertible notes consisted of the following (in thousands):

	August 31, 2017	February 28, 2017
Liability component:		
Principal	$ 805,000	$ 805,000
Less: debt issuance costs	(6,089)	(7,442)
Less: debt discount	(42,168)	(51,925)
Net carrying amount	$ 756,743	$ 745,633
Equity component (1)	$ 96,890	$ 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 for the three and six months ended August 31, 2017 and August 31, 2016 (in thousands):

	Three Months Ended		Six Months Ended	
	August 31, 2017	August 31, 2016	August 31, 2017	August 31, 2016
Coupon rate 0.25% per year, payable semiannually	$ 503	$ 503	$ 1,006	$ 1,006
Amortization of convertible note issuance costs liability component	680	640	1,353	1,274
Accretion of debt discount	4,890	4,753	9,757	9,484
Total interest expense related to convertible notes	$ 6,073	$ 5,896	$ 12,116	$ 11,764

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 the convertible notes (the carrying value excludes the equity component of the convertible notes classified in equity) are as follows (in thousands):

	As of August 31, 2017	
	Fair Value	Carrying Value
Convertible notes	$ 771,727	$ 756,743

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.

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

28

Table of Contents

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

10,965,630, the same number of shares 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. However, subject to certain conditions, the Company may elect to settle all of the warrants in cash.

Table of Contents

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

OVERVIEW

We are a leading global provider of open source software solutions, using a community-powered approach to develop and offer reliable and high-performing operating system, virtualization, 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 is often freely shared, there are customarily no licensing fees for the use of open source software. Therefore, we do not recognize revenue from the licensing of the code itself. We provide value to our customers through the development, aggregation, integration, testing, certification, delivery, maintenance, enhancement and support of our Red Hat 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 Part II, Item 7 under Critical Accounting Estimates and in NOTE 2 Summary of Significant Accounting Policies to the Consolidated Financial Statements of our Annual Report on Form 10-K for the fiscal year ended February 28, 2017.

We believe our success is influenced by: (i) the extent to which we can expand the breadth and depth of our offerings, (ii) 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, (iii) the extent to which adoption of our emerging technology offerings by enterprises and similar institutions continues to increase, (iv) our involvement and leadership in key open source communities, which enable us to develop, enhance and maintain our offerings, (v) 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), original equipment manufacturers (OEMs), systems integrators, and value added resellers, (vi) our ability to generate new and recurring revenue for our offerings, (vii) the widespread and increasing deployment of open source technologies by enterprises and similar institutions, (viii) 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, (ix) our ability to provide customers with consulting and training services that generate additional subscription revenue, and (x) 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 our fiscal year ended February 28, 2017 we focused on, and in our fiscal year ending February 28, 2018 we expect to focus on, among other things: (i) driving the widespread adoption of our offerings, (ii) expanding our portfolio of technology offerings that enable hybrid cloud computing, (iii) investing in the development of open source technologies and promoting the use of our technologies by software developers globally, (iv) pursuing strategic acquisitions and alliances, (v) expanding relationships with our existing customers, (vi) increasing revenue by promoting a range of services to help our customers derive additional value, (vii) expanding routes to market, and (viii) growing our presence in international markets.

Non-GAAP disclosures

In accordance with accounting principles generally accepted in the U.S. (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 and six months ended August 31, 2017 in an effort to provide a comparable framework for assessing how our business performed in light of the effect of exchange rate differences when compared to the three and six months ended August 31, 2016. To compute the non-GAAP impact of foreign currency exchange rate fluctuations, we translate amounts from our non-U.S. operations for the three and six months ended August 31, 2017 using the average foreign currency exchange rate for the three and six months ended August 31, 2016.

Revenue

For the three months ended August 31, 2017, total revenue increased 20.6%, or $123.6 million, to $723.4 million from $599.8 million for the three months ended August 31, 2016. Excluding the impact of foreign currency exchange rate fluctuations, total revenue increased by 20.1% for the three months ended August 31, 2017, as detailed in the following table.

Table of Contents

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 and six months ended August 31, 2017 versus the three and six months ended August 31, 2016 are as follows (in thousands):

	Three Months Ended			Six Months Ended		
	August 31, 2017	August 31, 2016	Year-Over-Year Growth Rate	August 31, 2017	August 31, 2016	Year-Over-Year Growth Rate
Infrastructure-related subscription revenue, as reported	$ 487,447	$ 427,035	14.1%	$ 945,408	$ 830,216	13.9%
Adjustment for foreign currency exchange rates	(1,485)			1,846		
Infrastructure-related subscription revenue, excluding foreign currency impact	485,962	427,035	13.8%	947,254	830,216	14.1%
Application Development-related and other emerging technology subscription revenue, as reported	150,115	104,174	44.1%	288,662	202,658	42.4%
Adjustment for foreign currency exchange rates	(969)			112		
Application Development-related and other emerging technology subscription revenue, excluding foreign currency impact	149,146	104,174	43.2%	288,774	202,658	42.5%
Total subscription revenue, as reported	637,562	531,209	20.0%	1,234,070	1,032,874	19.5%
Adjustment for foreign currency exchange rates	(2,454)			1,958		
Total subscription revenue, excluding foreign currency impact	635,108	531,209	19.6%	1,236,028	1,032,874	19.7%
Total training and services revenue, as reported	85,793	68,596	25.1%	166,081	134,829	23.2%
Adjustment for foreign currency exchange rates	(328)			378		
Total training and services revenue, excluding foreign currency impact	85,465	68,596	24.6%	166,459	134,829	23.5%
	723,355	599,805	20.6%	1,400,151	1,167,703	19.9%

Total subscription and training and services revenue, as reported						
Adjustment for foreign currency exchange rates	(2,782)			2,336		
Total subscription and training and services revenue, excluding foreign currency impact	$ 720,573	$ 599,805	20.1%	$ 1,402,487	$ 1,167,703	20.1%

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

32

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 and second quarter of fiscal 2018 and for each quarter of fiscal 2017 and fiscal 2016 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 20.0%, or $106.4 million, for the three months ended August 31, 2017 as compared to the three months ended August 31, 2016. Excluding the impact of foreign currency exchange rate fluctuations, subscription revenue increased by 19.6% for the three months ended August 31, 2017. The increase in subscription revenue is driven primarily by additional subscriptions related to our principal Red Hat Enterprise Linux and Red Hat JBoss Middleware offerings, which continue to gain broader market acceptance in mission-critical areas of computing, and our expansion of sales channels and geographic footprint. The increase is, in part, a result of the continued migration of enterprises in industries such as financial services, government, technology and telecommunications to our open source solutions from proprietary technologies.

Training and services revenue

Training and services revenue increased 25.1%, or $17.2 million, for the three months ended August 31, 2017 as compared to the three months ended August 31, 2016. Excluding the impact of foreign currency exchange rates, training and services revenue increased by 24.6%. The increase is driven primarily by customer interest in new products and increased demand for our open source solutions.

Deferred revenue and billings proxy

Year-to-date deferred revenue

Our deferred revenue, current and long-term, balance at August 31, 2017 was $2.05 billion. Total deferred revenue at August 31, 2017 decreased 0.8%, or $17.4 million, as compared to the balance of $2.07 billion at February 28, 2017. Excluding the impact of foreign currency exchange rate fluctuations, total deferred revenue decreased by 4.2%, or $86.3 million, from February 28, 2017 to August 31, 2017. The decrease in deferred revenue is primarily attributable to our typically lower, seasonal first and second quarter billings. Because of our subscription model and revenue recognition policies, deferred revenue improves predictability of future revenue. For example, current deferred revenue provides a baseline for revenue to be recognized over the next twelve months. Similarly, long-term deferred revenue provides a baseline for revenue to be recognized beyond twelve months. Revenue derived from CCSPs for the delivery of our technologies as a service available on demand is recognized by us upon delivery and billed in arrears. As a result, revenue derived from CCSPs has no associated deferred revenue.

The decrease in deferred revenue reported on our Consolidated Balance Sheets of $17.4 million differs from the decrease of $86.3 million we reported on our Consolidated Statements of Cash Flows for the six months ended August 31, 2017 as the amount reported on our Consolidated Statements of Cash Flows excludes the impact of changes in foreign currency exchange rates used to translate deferred revenue balances from our foreign subsidiaries functional currency into U.S. dollars and an insignificant amount of deferred revenue acquired from business combinations.

Table of Contents

Below is a summary of our deferred revenue as of August 31, 2017 and February 28, 2017 (in thousands):

	August 31, 2017	February 28, 2017	Year-to-Date Growth Rate
Current deferred revenue, as reported	$ 1,471,434	$ 1,512,762	(2.7)%
Adjustment for foreign currency exchange rates	(46,146)		
Current deferred revenue, excluding foreign currency impact	$ 1,425,288	$ 1,512,762	(5.8)%
Long-term deferred revenue, as reported	$ 581,077	$ 557,194	4.3%
Adjustment for foreign currency exchange rates	(22,676)		
Long-term deferred revenue, excluding foreign currency impact	$ 558,401	$ 557,194	0.2%
Total deferred revenue, as reported	$ 2,052,511	$ 2,069,956	(0.8)%
Adjustment for foreign currency exchange rates	(68,822)		
Total deferred revenue, excluding foreign currency impact	$ 1,983,689	$ 2,069,956	(4.2)%

Year-over-year deferred revenue

Total deferred revenue increased by 22.1%, or $371.9 million, to $2.05 billion at August 31, 2017 from $1.68 billion at August 31, 2016. Excluding the impact of foreign currency exchange rate fluctuations, total deferred revenue increased by 20.0%, or $335.3 million, from August 31, 2016 to August 31, 2017. This increase in deferred revenue of $335.3 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 August 31, 2017, which includes an insignificant amount of deferred revenue acquired from business combinations.

Below is a summary of our deferred revenue as of August 31, 2017 and August 31, 2016 (in thousands):

	August 31, 2017	August 31, 2016	Year-Over-Year Growth Rate
Current deferred revenue, as reported	$ 1,471,434	$ 1,233,762	19.3%
Adjustment for foreign currency exchange rates	(24,611)		
Current deferred revenue, excluding foreign currency impact	$ 1,446,823	$ 1,233,762	17.3%
Long-term deferred revenue, as reported	$ 581,077	$ 446,890	30.0%
Adjustment for foreign currency exchange rates	(11,935)		